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Opportunities and Threats to Charitable Organization Funding: Market Volatility, the Economic Crisis and Madoff

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In the midst of the financial strain already being faced by charitable organizations resulting from the US economic recession and declines in the stock market comes the latest bombshell . . . Madoff.

While Madoff's alleged Ponzi scheme had an immediate and very negative impact on many charities, we believe that it can serve as a wake-up call for charitable organization funding and management of donor assets.

Will this scandal lead to a cessation or permanent reduction of charitable giving by corporations and individuals? We don't think so, but it could. American's are known for our private and corporate charity – studies have shown that we give at levels far higher than those in other developed countries – however, we do not like to see our charity lost or wasted by those who are given the fiduciary responsibility to manage these assets.

We believe that the Madoff tragedy will have an impact on charitable organizations similar to the recent United Way excess compensation scandal(s). As a result of the United Way scandal(s), charities are now expected to benchmark their expenses and document how donor assets are used. This level of transparency gives efficient organizations a competitive advantage over "wasteful" ones in the competition for donations.

An organization with sound internal fiduciary controls and a documented level of fiduciary excellence would not have lost money to Madoff's alleged scheme. This is because Madoff's "hedge fund" would have not passed even the most basic fiduciary due diligence process and therefore would have been ineligible for consideration as an investment option.

Relying on professional reputation and personal referrals (items Madoff leveraged to his advantage) are not, by themselves, a sound due diligence process. A sound fiduciary due diligence process consists of four steps: 1) Organize, 2) Formalize, 3) Implement, 4) Monitor. Each of these steps in turn involves fiduciary practices and criteria that quantify the legal requirements placed upon trustees and other fiduciaries by the various bodies of law under which charitable trusts and foundations operate. Some of the fiduciary practices documented by the Foundation for Fiduciary Studies are listed below. Had these practices been followed, the trustees would not have approved the Madoff investment.

Practice 1.5 - Assets are within the jurisdiction of the US Courts and are protected from theft and embezzlement.
Comment: Hedge funds are unregulated investments and typically operate without transparency regarding the underlying holdings thus making it difficult to determine how and where assets are held.

Practice 2.5 - Selected asset classes are consistent with implementation and monitoring constraints.

Comment: The secretive nature of hedge funds preclude a trustee from properly monitoring investment expenses, investment manager strategies and decisions to determine initial and on-going prudence.

Practice 3.1- The investment strategy is implemented in compliance with the required level of prudence.

Comment: A due diligence process contains at least nine quantitative criteria and benchmarks. The inability to apply this process to hedge funds and other similar unregulated and "less than transparent" investments only serves to highlight their inappropriateness in a fiduciary environment.

Practice 3.4 - A due diligence process is followed in selecting service providers, including the custodian.

Comment: Investment custodians play an important role in holding assets for safekeeping, reporting on activity and assisting with trading. The fact that Madoff acted as his own custodian and operated without transparency or third party documentation of investment activity would have prevented a trustee from being able to perform adequate due diligence and would have precluded investment in his fund.

Looking forward, charitable organizations that respond to the Madoff tragedy by building a documented level of fiduciary excellence will enjoy a significant competitive advantage in the competition for charitable donations.

To learn more about the Fiduciary Firewall™ process for developing, implementing and maintaining internal fiduciary controls, contact Brian S. Lakkides, AIF®.



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