

**A REPORT TO THE BOARD OF REGENTS OF
THE SMITHSONIAN INSTITUTION**

June 18, 2007

The Honorable Charles A. Bowsher

The Honorable Stephen D. Potts

A.W. "Pete" Smith, Jr.

"This new era also demands from public (as well as private) organizations increased fiscal accountability. We must use our resources efficiently and intelligently both to husband them and to underscore our credibility to those who provide them -- the government and our donors."

Michael Heyman, former Secretary, Smithsonian Institution

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TABLE OF CONTENTS

	<u>Page</u>
EXECUTIVE SUMMARY	1
A. Overview	1
B. Summary of Committee Findings	3
1. Mr. Small’s Compensation Far Exceeded the Compensation of Prior Secretaries	3
2. The Terms of Mr. Small’s Compensation Were Not Fully Disclosed to the Board	4
3. Private Grants and Contributions and Business Revenues Have Declined During	
Mr. Small’s Tenure, Making the Smithsonian More Reliant on Federal	
Appropriations and Grants	5
4. Mr. Small’s Expenses Were Not Reviewed for Reasonableness	7
5. Mr. Small and the Deputy Secretary Have Been Absent from the Smithsonian for	
Substantial Periods Due to Vacation and Compensated Service on Corporate	
Boards	7
6. Mr. Small’s Disposition Was Ill-Suited for the Position of Secretary	8
7. The Board Exercised Inadequate Oversight Over Mr. Small	9
8. The “Gatekeepers” of the Smithsonian Were Marginalized	10
9. The Smithsonian’s Internal Financial Controls and Audit Function Are	
Inadequate	11
10. Smithsonian Business Ventures Has Operated with Insufficient Oversight from	
the Board or Senior Smithsonian Management	11
11. The Smithsonian Appears to Remain a Strongly Ethical Institution Despite the	
Problems with the Office of the Secretary and SBV	12
C. Summary Of Recommendations	12
1. The Regents Must Act Quickly to Address the Governance Crisis	13
2. The Expenses of Mr. and Mrs. Small Should be Subject to an Audit for	
Reasonableness and the Expenses of Senior Management Should Be Subject to	
Annual Audits	13
3. The Compensation of the Secretary Should be Reasonably Competitive and	
Transparent and Take Into Account the Smithsonian’s Unique Nature	14
4. The Smithsonian’s Policies Should Be Consistent With Federal Regulations and	
its Salary Schedule Should be Consistent With Government Salary Schedules..	14
5. The Smithsonian Should Have an Active Governing Board with a Chairman Who	
Can Provide the Time and Proper Oversight	16
6. The Role of the Chief Justice and Vice President Should Be Clarified	18
7. Congressional Regents Should Accept Fiduciary Responsibilities	19
8. The Board Should be Expanded or Reorganized to Allow for the Addition of	
Regents with Needed Expertise	19
9. Internal Financial Controls, Audit Functions and the Role of the General Counsel	
and Inspector General Must be Strengthened	20
10. Smithsonian Executives Should Be Permitted to Participate in Only Nonprofit	
Board Activities Subject to Prior Approval	21

11. The Selection of the Next Secretary Must Reflect the Governance Challenges Facing the Smithsonian.....	22
12. Achieving Effective Oversight and Governance at Nonprofit Organizations May Ultimately Require Legislative Action	22
BACKGROUND ON INDEPENDENT REVIEW COMMITTEE	24
A. Formation of IRC	24
B. Scope of Review	26
C. Review Process	26
STANDARDS FOR REVIEW	28
A. The Smithsonian’s Legal Status.....	28
B. Governance and Applicable Fiduciary Duties	28
C. Applicable Tax Laws and Principles	31
D. Smithsonian Policies	33
E. Best Practices in Nonprofit Corporate Governance.....	33
COMPENSATION AND PERFORMANCE OF MR. SMALL	34
A. How Secretary Small’s Initial Compensation Package was Established.....	35
B. The Housing Allowance	43
C. The Use of Compensation Consultants.....	46
D. Performance of Mr. Small.....	52
EXPENSES OF THE SECRETARY	57
A. Mr. Small’s Expenses	57
B. Mr. Small’s Entertainment Expenses.....	63
C. Mrs. Small’s Travel Expenses	64
BOARD OVERSIGHT OF MR. SMALL	67
A. Mr. Small’s Compensation Was Not Approved by the Board for the 2000-2003 Period	67
B. The Board Failed to Respond to “Red Flags” and Exert Necessary Oversight	68
PARTICIPATION ON OUTSIDE BOARDS AND ABSENCES FROM THE SMITHSONIAN OFFICES	73
A. Mr. Small’s Board Service.....	73
B. Mr. Small’s Leave from the Office.....	77
C. Ms. Burke’s Outside Activities.....	78
INTERNAL FINANCIAL CONTROLS.....	81
A. No Review of Secretary’s Expenses	81
B. No Approval for Exceptions to Smithsonian Policies	82
C. Inadequate Record Keeping.....	82
D. Insufficient Accounting Resources	83
E. Ineffectiveness of Accounting Staff.....	83
ROLE OF THE “GATEKEEPERS”	84

A.	Role of the Smithsonian Inspector General	84
B.	Role of the General Counsel	85
	ROLE OF OUTSIDE AUDITOR.....	88
	SMITHSONIAN BUSINESS VENTURES	90
	OVERALL ETHICAL TONE AT THE SMITHSONIAN	91
	RECOMMENDATIONS.....	92
1.	The Regents Must Act Quickly to Address the Governance Crisis.....	92
2.	The Expenses of Mr. and Mrs. Small Should be Subject to an Audit for Reasonableness and the Expenses of Senior Management Should Be Subject to Annual Audits	92
3.	The Compensation of the Secretary Should be Reasonably Competitive and Transparent and Take Into Account the Smithsonian’s Unique Nature	93
4.	The Smithsonian’s Policies Should Be Consistent With Federal Regulations and its Salary Schedule Should Be Consistent With Government Salary Schedules. 96	
5.	The Smithsonian Should Have an Active Governing Board with a Chairman Who Can Provide the Time and Proper Oversight	99
6.	The Role of the Chief Justice and Vice President Should Be Clarified.....	102
7.	Congressional Regents Should Accept Fiduciary Responsibilities	104
8.	The Board Should be Expanded or Reorganized to Allow for the Addition of Regents with Needed Expertise	104
9.	Internal Financial Controls, Audit Functions and the Role of the General Counsel and Inspector General Must Be Strengthened	105
10.	Smithsonian Executives Should be Permitted to Participate in Only Nonprofit Board Activities Subject to Prior Approval	106
11.	The Selection of the Next Secretary Must Reflect the Governance Challenges Facing the Smithsonian.....	107
12.	Achieving Effective Oversight and Governance at Nonprofit Organizations May Ultimately Require Legislative Action	107

EXECUTIVE SUMMARY

A. Overview

The Independent Review Committee came to its task with a deep affection for the Smithsonian Institution.¹ It is the Committee's hope that its work will help restore the people's trust in the Smithsonian and bring to an end the adverse media and public attention of the past several months. Although the Smithsonian is in the midst of a governance crisis, the IRC believes the Institution itself appears sound and that its problems can be solved expeditiously if the Regents recognize the urgency of the situation and commit sufficient time and resources to correcting the matters. The Committee recognizes that the Board of Regents, through its Committee on Governance, has begun this process by developing an initial set of reform initiatives.

In reviewing the operations of the Smithsonian during the tenure of Lawrence M. Small as Secretary, with a particular focus on his compensation, benefits and expenses, the IRC has determined that the problem was not one merely of misunderstood guidelines, nor was it one only of poor decisions in spending Smithsonian funds on expensive or lavish travel, entertainment and personal needs. The problems go much deeper than this. Mr. Small's management style – limiting his interaction to a small number of Smithsonian senior executives and discouraging those who disagreed with him – was a significant factor in creating the problems faced by the Smithsonian today. In addition, Mr. Small limited the flow of information so as to prevent the Board from hearing criticism of his stewardship.

¹ The Committee is referred to in this Report as the "IRC" or "Committee" and the Smithsonian as the "Smithsonian" or "Institution." References to the "Board" are to the Board of Regents of the Smithsonian.

The Committee, however, believes that the resignation of Mr. Small has not, by itself, remedied the problems at the Smithsonian. The Smithsonian must correct the underlying deficiencies in its organizational structure, decision-making and financial controls that allowed inappropriate management conduct to go undetected. As noted by the Office of the Vice President in its letter to the Committee, the current situation presents the Smithsonian with an opportunity to bring its management in line with best practices and to revamp the composition, selection and duties of the Board of Regents.

The root cause of the Smithsonian's current problems can be found in failures of governance and management. The governance structure of the Institution is antiquated and in need of reform. The relationship between the Board of Regents and Mr. Small, as Secretary, was contrary to effective oversight. At a time when organizations are expected to operate with increasing transparency, the operation of the Smithsonian, and especially the actions of Mr. Small and those who reported directly to him, had become increasingly secretive. Mr. Small created an imperialistic and insular culture in the Office of the Secretary in which the Secretary, rather than the Board, dominated the setting of policy and strategic direction for the Smithsonian. The Board of Regents allowed this culture to prevail by failing to provide badly needed oversight of Mr. Small and the operations of the Smithsonian. The Board did not look behind the tightly controlled data provided by Mr. Small. Nor did it engage in the active inquiry of Mr. Small and Smithsonian management that would have alerted the Board to problems.

As a result of the corporate scandals of the early part of this decade and the adoption of the Sarbanes-Oxley Act of 2002, boards of directors have become increasingly active in the oversight of management and in the development of strategy and long-term plans for organizations they control. Many nonprofit institutions have also updated their governance

practices following the adoption of Sarbanes-Oxley. Historically, the Smithsonian Board of Regents appears not to have taken a strong oversight role. Mr. Small's predecessor tried to increase the involvement of the Regents in the affairs of the Smithsonian, but found a limited interest on the part of the Regents in taking a more active role. During Mr. Small's tenure, some changes were made to the Smithsonian's governance that brought it more in line with best practices. Over the last several years, for example, the Board, to its credit, has held planning and strategy sessions and has established committees on audit, compensation and governance. These efforts, however, did not go far enough. The governance structure of the Institution needs more comprehensive reform. The Committee hopes that the findings and recommendations of this Report will aid the Smithsonian in its efforts at such reform.

B. Summary of Committee Findings

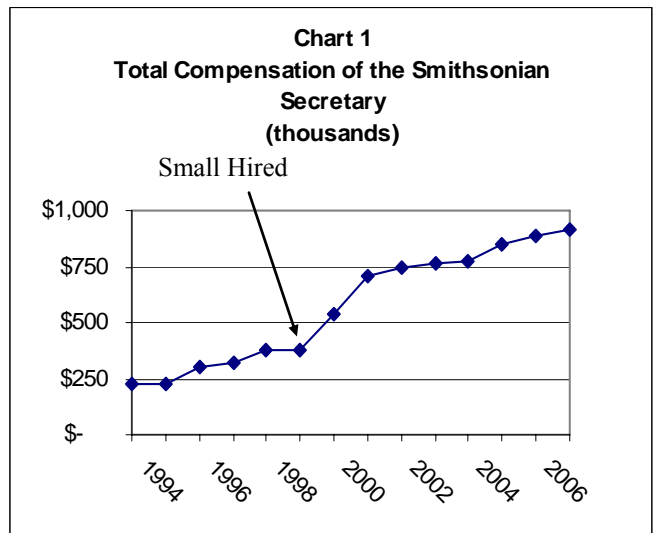
1. Mr. Small's Compensation Far Exceeded the Compensation of Prior Secretaries

Historically, the Secretary of the Smithsonian received total compensation near the mid-point of comparable positions, with modest annual increases. In contrast, Mr. Small's total starting compensation – \$536,100 – was forty-two percent higher than the compensation of his predecessor, and by the time he left office this year, Mr. Small's total compensation – \$915,658 – was almost 2½ times the compensation of his predecessor. What made Mr. Small's initial package so much larger than that of his predecessor was a \$150,000 annual payment styled as a housing allowance.

Mr. Small's initial compensation package would have been reasonable had the \$150,000 housing allowance been a true housing allowance and not simply additional salary. The language of Mr. Small's contract read as if this housing allowance was to reimburse Mr.

Small for his out-of-pocket housing costs in making his home available for Smithsonian business and social functions. An individual who played a key role in the initial financial negotiations with Mr. Small conceded that the language of the contract was misleading and that the housing allowance was, in fact, a “packaging device” for delivering Mr. Small additional compensation in a manner that would conceal the true size of his pay.

Another troubling aspect of Mr. Small’s compensation was the forty-five percent increase in base salary – from \$330,000 to \$480,000 – he received in 2001. The then-Executive Committee increased Mr. Small’s base salary, at his request, to put him in the 75th percentile of what Smithsonian management had chosen



as comparable institutions. The selection of the 75th percentile applied only to Mr. Small’s compensation. Compensation for the rest of the Smithsonian senior staff remained close to the 50th percentile.

2. The Terms of Mr. Small’s Compensation Were Not Fully Disclosed to the Board

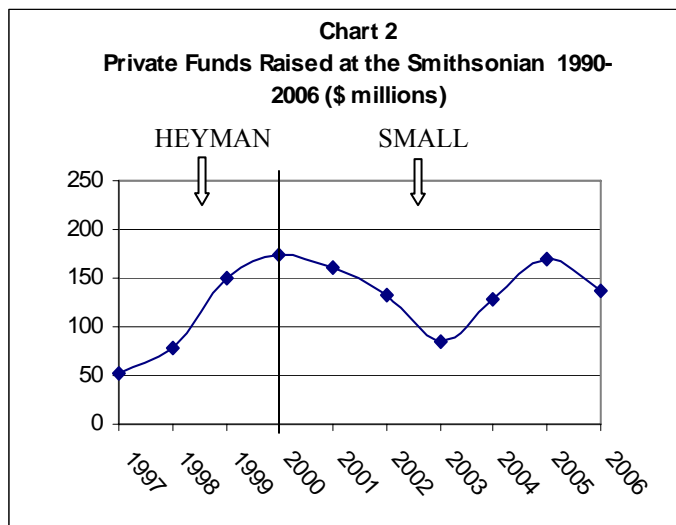
Mr. Small’s initial compensation package was negotiated between Mr. Small and a small number of Regents, none of whom is currently on the Board. The Committee found no evidence that the Board of Regents as a whole ever learned the terms of Mr. Small’s initial compensation package. In fact, contrary to the requirements of the Smithsonian’s governing documents, the full Board did not formally approve the terms of Mr. Small’s annual total compensation until

2004, and some Regents did not learn all the details of Mr. Small's compensation until they read about it in the recent press accounts.

3. Private Grants and Contributions and Business Revenues Have Declined During Mr. Small's Tenure, Making the Smithsonian More Reliant on Federal Appropriations and Grants

One of the reasons for hiring Mr. Small was the belief that his business background and connections would allow him to increase the Smithsonian's private fundraising and business income and thereby reduce the Smithsonian's reliance on federal monies. There is a perception among many of the individuals interviewed by the IRC and the public that Mr. Small succeeded in those efforts. Certain Regents have defended Mr. Small's actions by pointing to this success, going so far as to suggest that his excesses might be excused in light of the fact that he raised over a billion dollars for the Smithsonian. This justification is

wrong for two reasons. First, the IRC rejects the idea that success is in any way a license for inappropriate behavior. Second, as shown by Chart 2, private funds raised annually from donors have actually declined over the course of Mr. Small's tenure. Funds contributed by private sources peaked in 2000, and

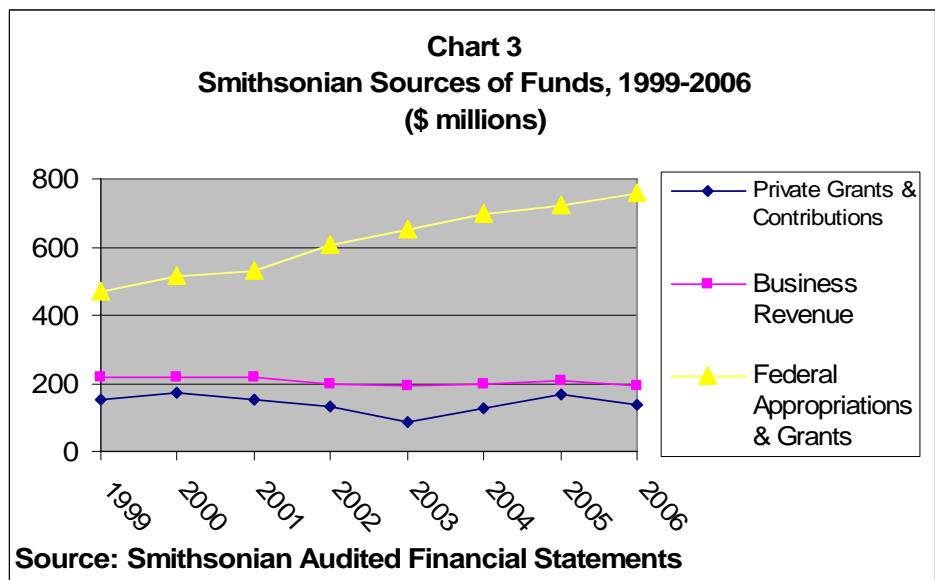


thereafter the amount of private funds committed to the Smithsonian began to decline, reaching a low of \$88 million in 2003. Although Mr. Small was involved in finalizing a gift of \$80 million from The Behring Foundation in 2000 and gifts of \$30 million and \$45 million from the Donald Reynolds Foundations in 2001 and 2005, respectively, those donations originated from the work

of others. Private funds raised in 2006 improved to \$132 million, but that figure is about ten percent lower than the amount raised in 1999, the year before Mr. Small took over. The evidence collected by the Committee regarding comparable nonprofits does not show a similar decline in fundraising over the same period.

As Chart 3 shows, business revenue has dropped by a similar percentage during Mr. Small’s tenure. This drop in business revenue has been further exacerbated by increased operating expenses (most notably senior executive salaries) at Smithsonian Business Ventures. In contrast, funds from federal appropriations and governmental grants have increased more than sixty percent over the same period. The Smithsonian informed the IRC that the increase in federal appropriations reflects, in significant part, the opening of two new museums and increased spending

for anti-terrorism measures following 9/11, and noted that the Smithsonian’s federal staff has decreased by about five percent since 2000. Nevertheless,



the net effect is that the Smithsonian became more dependent on taxpayer funds during Mr. Small’s tenure.

4. Mr. Small's Expenses Were Not Reviewed for Reasonableness

Nonprofit organizations like the Smithsonian must properly document expenses incurred in the conduct of the organization's activities to evidence reasonableness and relation to the organization's mission. With respect to Mr. Small's expenses, the Smithsonian failed to do so. Until the recent review completed by Cotton & Co., there had been no review of Mr. Small's expenses by either the Chief Financial Officer or internal or external auditors of the Smithsonian. Instead, Mr. Small and his staff exercised sole discretion in determining which expenses would be charged to the Smithsonian. At the beginning of 2000 and 2001, Mr. Small was given by his chief of staff signed blank expense authorizations. Thereafter, while the Smithsonian had detailed guidelines and policies for business expenses, Mr. Small exempted himself from these policies.

5. Mr. Small and the Deputy Secretary Have Been Absent from the Smithsonian for Substantial Periods Due to Vacation and Compensated Service on Corporate Boards

The records provided by the Smithsonian show that from 2000 through 2006 Mr. Small and Sheila P. Burke, the current Deputy Secretary, were absent from the Smithsonian for about 400 and 550 work days, respectively, as a result of vacation time and time spent serving on corporate and other boards and performing other non-Smithsonian-related duties. This level of absenteeism was not prohibited by the Smithsonian leave policy because Mr. Small and Ms. Burke were allowed unlimited leave. Mr. Small appears to have taken nearly 70 weeks of vacation over his seven years (or nearly 10 weeks per year). In addition, he spent 64 business days serving on for-profit corporate boards for which he earned approximately \$642,925 in cash compensation, \$3.3 million in stock compensation and \$1.8 million in stock option compensation.

Ms. Burke appears to have been out of the office for about 400 business days (or about one-quarter of the work days) during her tenure because of her service on boards and her other non-Smithsonian activities. For her corporate board service, Ms. Burke earned approximately \$1.2 million in cash compensation, \$3.5 million in stock compensation and \$5.6 million in stock option compensation. Her total compensation for outside board service was more than three times the compensation she received from the Smithsonian over the same period. The Committee is cognizant of her reputation for hard work, long hours, willingness to return phone calls promptly, and ready response to email, even when she is away from the office. Still, the IRC believes that any person who holds the job of Deputy Secretary and Chief Operating Officer should expect to spend full time at the Smithsonian without the distraction of extensive outside activities.

6. Mr. Small's Disposition Was Ill-Suited for the Position of Secretary

In selecting Mr. Small as Secretary, the Regents hoped that his experience in the business world would bring talents that complemented the Smithsonian's existing expertise in science and the arts. As one now looks back over his tenure, it is clear, however, that his attitude and disposition were ill-suited to public service and to an institution that relies so heavily, as the Smithsonian does, on federal government support. The mismatch between Mr. Small and the Institution appeared as early as the initial negotiations with Mr. Small when he made it clear that if he and his wife were not allowed to travel in first class, it would be a "deal breaker." Over the years, Mr. Small placed too much emphasis on his compensation and expenses. Rather than seeing this as an indication of the need for careful oversight, the Regents involved in Mr. Small's compensation, to the contrary, became complicit in Mr. Small's desire to maximize his personal income and have the Smithsonian pay his expenses.

7. The Board Exercised Inadequate Oversight Over Mr. Small

The Board frequently deferred to the Secretary, allowing him to run and dominate the meetings, set the agendas, and determine who would contact the Regents and what information would be provided them. With limited and controlled information provided by the Secretary, the Regents were unable to engage in real and effective debate. During Mr. Small's tenure, it appears that the Board reported to him rather than the Secretary reporting to the Board. The Committee was told by a Regent that Mr. Small "did not listen to the opinions of the Regents" and "did not seek input from the Regents in decision making." Another Regent commented that Mr. Small did not seek advice, only approval.

In the place of full Board oversight, the Executive Committee, on numerous occasions, agreed to compensation requests from Mr. Small without engaging in its own analysis of the reasonableness of those requests. In 2001, for example, as discussed above, the then-Executive Committee acquiesced to a request by Mr. Small for a forty-five percent increase to his salary without questioning the need for the increase and without consulting with the full Board. More recently, when asked, the Board retroactively approved actions of the Secretary that were contrary to Smithsonian guidelines and to contractual arrangements, in almost all situations without adequate investigation or analysis. The Board often minimized Mr. Small's mistakes, glossed over or ignored criticism of him, and offered post-hoc justifications for his improper acts even in the face of new revelations and Congressional scrutiny.

As early as 2001, there was public criticism of actions taken by Mr. Small that should have raised questions about his ability to manage the Smithsonian effectively. For example, several newspaper articles questioned Mr. Small's use of a privately chartered plane for Smithsonian business. Yet the minutes and transcripts of the Board meetings give no indication

that the Regents at the time ever discussed, let alone investigated, this or any other adverse comments. Had the Board done so, it would have learned that Mr. Small did not pay for the plane as he claimed, but rather the Smithsonian paid for it and management directed accounting staff to alter its accounting records after the fact.

The Board also had no involvement, either before or after the fact, in setting the terms of the employment for Ms. Burke, the Deputy Secretary and the Institution's number two official. (Ms. Burke became the Deputy Secretary in 2004. Prior to that, her title was Under Secretary for American Museums and National Programs.) The basic terms and policies of her service were set solely by Mr. Small and, in most instances, were known only to her and Mr. Small. Despite the fact that Ms. Burke disclosed her outside board service on her conflict of interest forms submitted to the Office of the Secretary, Mr. Small failed to provide these forms or the information regarding Ms. Burke's outside board service to the Board.

8. The "Gatekeepers" of the Smithsonian Were Marginalized

The General Counsel and the Inspector General of the Smithsonian should serve "gatekeeper" roles by monitoring compliance of senior management with laws and policies. The General Counsel and the Inspector General did not play these monitoring roles because Mr. Small isolated them from not only the Board of Regents but also from having any meaningful oversight of the Secretary's office. Additionally, over time Mr. Small significantly reduced the budget and staff of, among others, both the Office of General Counsel and the Office of Inspector General. Neither the General Counsel nor the Inspector General made adequate efforts to overcome the isolation from the Board or the diminution of their respective roles. The Chief Financial Officer was also ineffective in monitoring financial matters of the Office of the Secretary.

9. The Smithsonian's Internal Financial Controls and Audit Function Are Inadequate

Internal financial controls are systems of policies and procedures that create reliable financial reporting, promote compliance with laws and regulations and achieve effective and efficient operations. The Smithsonian's internal financial controls have been inadequate to achieve these goals for a number of reasons. First, the Smithsonian has not committed sufficient resources to the accounting and audit functions. Second, the Smithsonian lacks comprehensive and formal accounting procedures and policies. Third, the Smithsonian has not complied with its own policies and procedures with respect to accounting for expenses. Finally, the Smithsonian's outside auditor had not been vigorous in monitoring the Smithsonian's implementation of recommendations contained in its management letters until early 2007, when it finally noted that insufficient accounting resources and staff capacity at the Institution constituted a "reportable condition."

10. Smithsonian Business Ventures Has Operated with Insufficient Oversight from the Board or Senior Smithsonian Management

In the course of its review, the Committee has become aware of significant failures of internal controls and inappropriate conduct at Smithsonian Business Ventures ("**SBV**"), the Smithsonian division responsible for managing the commercial activities of the Smithsonian. Senator Grassley has indicated his desire for the Committee to conduct a review of the senior management of SBV and the appropriateness of compensation and benefits paid to senior management of SBV. While the Committee agrees that such a review is necessary and warranted, it is beyond the scope of the Committee's review. There appear to have been severe failures in oversight of SBV by Smithsonian senior management and the Board. It also appears that neither the Board nor the Smithsonian executives who sat on the SBV board, including the

Chief Financial Officer and the Deputy Secretary, provided oversight of SBV, even though all acknowledged the widespread allegations of inappropriate activity and failures of internal controls at SBV.

11. The Smithsonian Appears to Remain a Strongly Ethical Institution Despite the Problems with the Office of the Secretary and SBV

The ethics of an organization usually reflect the attitude and behavior of those in senior management. There was a clear indication that Mr. Small deemed himself outside the Smithsonian's otherwise recognized ethics standards. Accordingly, given the "tone at the top" set by the Office of the Secretary, one might expect to find the absence of internal controls and ethical lapses to be pervasive at the Smithsonian. While it did not undertake a comprehensive review, the Committee did not find evidence that indicated that there are major internal control issues at the Smithsonian as a whole, other than in the Office of the Secretary and at Smithsonian Business Ventures. Nor did the Committee find evidence to indicate that the strong ethical principles that have characterized the Smithsonian over the years have been compromised.

C. Summary Of Recommendations

The Committee recommends that, wherever possible, the Board of Regents should implement the following recommendations by reorganizing its internal governance structures and procedures. The Committee, however, offers no legal opinion as to whether these recommendations can be implemented solely by the Board of Regents. If the implementation of any recommendation requires legislative action, the Committee urges the Board of Regents to seek Congressional assistance promptly and for Congress to act with all deliberate speed to enact necessary legislation.

1. The Regents Must Act Quickly to Address the Governance Crisis

The current crisis of governance at the Smithsonian and the resulting loss of public confidence necessitate urgent action by the Regents. To restore public and Congressional confidence, the Regents must devote substantial time and resources over the next several months to considering and then implementing a comprehensive program to improve governance. With diligence, the IRC believes the necessary governance changes can be implemented by the end of the year.

2. The Expenses of Mr. and Mrs. Small Should be Subject to an Audit for Reasonableness and the Expenses of Senior Management Should Be Subject to Annual Audits

The Committee did not conduct a complete audit of Mr. Small's expenses. Rather, the Committee reviewed the work of Cotton & Co. and the supporting materials. The Cotton & Co. review was a limited review based on information and policy interpretations provided by the Smithsonian. Thus, there has been no independent audit of the expenses of Mr. Small. If for no other reason than potential tax liabilities, the Committee recommends that the Smithsonian have an independent auditor perform an audit of Mr. Small's expenses and those of his wife. The Committee believes this audit could be done expeditiously because a significant amount of information has already been collected by Cotton & Co. The Committee also recommends that the Audit and Review Committee of the Smithsonian undertake to have the expenses of senior management audited on an annual basis for compliance with Smithsonian policies and reasonableness.

3. The Compensation of the Secretary Should be Reasonably Competitive and Transparent and Take Into Account the Smithsonian's Unique Nature

The Committee recommends that compensation for the Secretary be competitive with similar CEO roles at comparable nonprofits focusing on a comparison group that includes a significant number of institutions (such as major state universities) that principally rely, as the Smithsonian does, on public funds. Historically, the Smithsonian appears to have had little difficulty in attracting qualified Secretaries at such compensation levels. It is the Regents' responsibility to determine this amount, and the Committee considers it beyond its mandate to provide specific guidance as to the appropriate compensation level. In determining this level, the Committee urges the Regents to consider developing a compensation philosophy that is transparent, reasonably competitive and reflective of the special nature of the Smithsonian. Working at the Smithsonian is a privilege. Serving as its Secretary is an honor. Compensation levels should reflect this. The Committee sees no reason why the Secretary should be given special travel privileges, perquisites or other benefits that are not available to other executives of the Smithsonian, except where the Board makes a determination in advance that such perquisites and benefits are reasonable and appropriate.

4. The Smithsonian's Policies Should Be Consistent With Federal Regulations and its Salary Schedule Should be Consistent With Government Salary Schedules

The Committee is concerned about the tendency of the Institution to embrace those federal regulations it finds convenient while ignoring others. For example, at times, the Smithsonian denies requests filed under the Freedom of Information Act ("**FOIA**") on the ground that it is not a federal entity, while, at other times, it grants FOIA requests. The IRC recommends that the Smithsonian affirmatively adopt policies to promote openness,

transparency and effective governance consistent with federal regulations, such as FOIA, the Privacy Act of 1974, Chief Financial Officer Act of 1990, the Sunshine Act, personal financial disclosure requirements, the Ethics in Government Act and conflict of interest rules. If the Smithsonian does not so act, Congress should consider appropriate legislation.

The IRC finds that there has been a marked disparity in the salary structure of the Smithsonian due, in part, to the fact that most employees are bound by government pay scales while others are employed by the Smithsonian trust and are paid on a separate scale. Additionally, the Committee learned that, for the purpose of raising the salaries of certain individuals who worked closely with the Secretary, positions were transferred from government pay scales to the trust.

To bring better balance to the Smithsonian's salary structure, the Committee recommends that the Smithsonian develop one comprehensive salary structure for all Smithsonian employees, rather than having a separate structure for trust employees. To the degree possible, this structure should align with the salary structure that incorporates standards of the federal senior executive service ("SES") or its equivalent. To be competitive in attracting talented museum curators or scientists, the Smithsonian should also be allowed, on a very limited basis, to exceed federal salary limitations in order to ensure that they can hire highly qualified individuals for key positions. Those paid above federal SES levels should be limited in number, perhaps 40 or 50. The needs of the Smithsonian when it comes to compensation should be well thought out, open to Congressional and public scrutiny and not arbitrary.

In determining the salaries of the Secretary and those who are paid above government salary limitations, careful attention should be paid to developing appropriate peer group analysis and maintaining reasonable ratios between these salaries and those governed by

federal pay structures. The IRC recognizes that there is significant competition for museum curators, directors and scientists, but it recommends that the Smithsonian strive to pay at the 50th percentile, recognizing that a job with the Smithsonian carries great prestige to the outside world and offers the opportunity to make substantial contributions to the arts and sciences. It is also recognized that there may be instances that call for travel and expense guidelines to be exceeded. These should be carefully controlled and should be subject to prior approval. The Board should maintain oversight of these instances and make sure that they are in fact the exception and not the rule. So that the Secretary and Deputy Secretary set an appropriate example, the expenses of the Office of the Secretary should be audited annually and reviewed by the Audit and Review Committee of the Board.

5. The Smithsonian Should Have an Active Governing Board with a Chairman Who Can Provide the Time and Proper Oversight

The Committee proposes the governing structure of the Smithsonian be reorganized by establishing a Governing Board as a major component of the Board of Regents that would take on primary fiduciary responsibility for overseeing the Smithsonian. Being a fiduciary carries with it a major commitment of time and effort, a reputational risk and, potentially, financial liability.

The IRC recognizes the historical value of having the three branches of government represented on the Board. Fiduciary constraints, however, require that the Smithsonian be run by a governing board whose members act as true fiduciaries and who have both the time and the experience to assume the responsibilities of setting strategy and providing oversight. Time is a major factor. For an organization as complex as the Smithsonian and with a budget surpassing \$1 billion a year, the Regents should expect to meet at least six times each

year. As discussed further below, the Committee recognizes and agrees that the governmental Regents play an important substantive, as well as symbolic, role at the Smithsonian.

The establishment of a Governing Board would in many ways formalize the Smithsonian's informal governance structure in which a "Committee of the Whole" meets in advance of the Board of Regents meeting to have a vigorous and probing discussion of issues requiring Board consideration. Under this present system, the Board of Regents meetings that follow have been formal proceedings to approve what had been discussed by the Committee of the Whole. The proposal of the IRC would formalize this process by establishing within the Smithsonian's governance documents a recognition that the Governing Board members would be the Regents responsible for the oversight of the Smithsonian and its management.

The Governing Board should have its own Chairman who would handle issues requiring the attention of the Board where items would be discussed and debated and where reports would be received from officers such as the Inspector General, Chief Financial Officer, General Counsel, Ethics Officer and museum and scientific project leaders. The IRC believes strongly that an organization with a budget as large and with operations as complex as the Smithsonian requires the services of a chairman who can devote far more time to the operations of the Board than can the Chief Justice.

While meetings of the Governing Board should be open to those whose knowledge or reports are important to deliberations of the Governing Board, the Board should reserve, at every meeting, time for an executive session where issues involving management, including the Secretary's performance, can be freely and openly discussed without the presence of employees. The Committee also recommends that the Executive Committee be enlarged to five members and its activity limited in practice to handling routine affairs of the Board between

meetings and when special meetings, either in person or telephonically, cannot be arranged. All actions of the Executive Committee should be presented to the full Governing Board for review.

6. The Role of the Chief Justice and Vice President Should Be Clarified

Historically, the Chief Justice has been elected to serve as the Chancellor. In that role, the Chief Justice would preside over the second part of the Board meeting where discussion and formal votes would be taken on those issues requiring action of the Board of Regents. Under the IRC proposal, however, the Chief Justice would not be considered a fiduciary Regent. Only fiduciary Regents would vote. The IRC recommends such a unique structure because it believes the historic role played by the Chief Justice in governance of the Smithsonian should not lightly be discarded and because the Chief Justice has made it clear he wishes to remain associated with the Institution. The Committee believes, however, that if governance of the Smithsonian is to be updated, it will require a commitment of time on the part of every Regent that far surpasses that which has been expected in the past. The Committee also questions if it is appropriate for the Chief Justice to have fiduciary obligations to a separate entity, even if that entity is closely linked to the government, and to assume the legal and reputational risks associated with being a fiduciary. The Committee believes that it is not feasible to expect the Chief Justice to devote the hours necessary to serve as a fiduciary Regent.

The same situation applies to the Vice President. Under the IRC's proposal, the Vice President would continue to serve as a Regent in a non-fiduciary capacity, and would chair meetings of the Board in the absence of the Chief Justice. If neither the Chief Justice nor the Vice President were present at a meeting of the Board, the Chairman would preside.

7. Congressional Regents Should Accept Fiduciary Responsibilities

A clear understanding needs to be reached regarding the role of the Congressional Regents. Service as a Regent must require that all members of the Board, including members of Congress, be willing and able to assume a role with clear fiduciary responsibilities and to devote the time necessary to carry out those duties personally. So that there will be neither an actual nor an appearance of conflict of interest, the IRC believes that any Congressional Regent who serves on one of the Congressional authorizing or appropriations committees with authority over the Smithsonian should recuse himself or herself from Congressional votes involving Smithsonian financial matters.

8. The Board Should be Expanded or Reorganized to Allow for the Addition of Regents with Needed Expertise

The Board must expand the level of expertise among the Regents on key issues, especially financial management and facilities and museum management, and ensure that the Regents who are appointed have sufficient time and attention to dedicate to the Smithsonian. To achieve this expansion of current expertise and ensure that Regents are active and engaged, the Committee recommends the Regents consider the following: (1) if current Regents have sufficient time and interest in continuing to serve; (2) adding to Board Committees – such as Audit and Review, Governance and Compensation and Human Resources – non-Regent members with special expertise; (3) employing outside experts to advise the Board and its Committees in specific subject areas; and (4) increasing the total number of citizen Regents from 9 to 11 by either adding two additional citizen Regents or reducing the number of Congressional Regents from six to four - two from the House and two from the Senate.

To make sure that the Smithsonian Board is made up of individuals capable of providing the necessary expertise, the Regents should adopt a nominating process that allows for a broader field of candidates. In looking at candidates, those charged with picking future Regents should note the necessity for expertise in financial management, investment strategies, audit functions, governance, compensation, and facilities management, as well as an interest in and a devotion to the arts and sciences. Contributions to the Smithsonian should not be the determining factor for service on the Board, but only one of many factors considered in the selection of Regents. Care should be taken to avoid appointing Regents who have clear personal and professional ties to the Secretary that may compromise the Board's independence.

In addition, if the Smithsonian desires to have positions for individuals that honor them for their contributions to the arts and sciences, including their financial generosity, it should establish non-fiduciary advisory boards for the Institution in general as well as for its various museums and divisions. The National Board, now primarily a development group, could have its scope expanded. The formerly active but now moribund Smithsonian Council could be revived to bring together distinguished scientists, academics, and museum directors to advise the Smithsonian and its constituent parts on programs, policy, and long range planning. Having both a vibrant Board and Council should help curb the extensive criticism the Smithsonian received during recent years regarding the conditions on certain donations and the scope and content of certain shows and displays.

9. Internal Financial Controls, Audit Functions and the Role of the General Counsel and Inspector General Must be Strengthened

The Smithsonian's system of internal controls and audit needs to be strengthened through additional resources, adoption of best practices and retention of personnel with

substantial experience in the financial and audit area. In February 2007, KPMG identified the inadequacy of the Smithsonian's accounting staffing and resources as a "reportable condition." The Committee understands that the Smithsonian is in the process of selecting an outside auditor, and the Committee recommends that the Smithsonian expeditiously implement the recommendations of this auditor, as well as those recommendations contained in prior management letters. In addition, the Committee recommends that (1) the Smithsonian provide the General Counsel's office and Office of the Inspector General with the necessary tools and resources to perform their gatekeeper and guardian functions, (2) the General Counsel serve as the Smithsonian's corporate secretary and (3) the Smithsonian ensure vigorous compliance with the Inspector General Act.

10. Smithsonian Executives Should Be Permitted to Participate in Only Nonprofit Board Activities Subject to Prior Approval

As a general rule, the Smithsonian has been careful in monitoring the outside work of its employees. The exceptions have been Mr. Small and the Deputy Secretary, both of whom have been allowed to collect significant compensation for service on the boards of for-profit corporations. As discussed above, these outside commitments have taken these individuals away from the Smithsonian during working hours for significant periods of time. The Board must develop a uniform policy on outside work. The IRC recognizes that arguments can be made in favor of allowing an organization's senior executives to serve on the boards of for-profit corporations. The benefits of doing so, however, accrue primarily to the individuals and only secondarily to the Institution. Accordingly, the IRC recommends that the Board prohibit its executives from serving on the boards of for-profit corporations.

With respect to nonprofit boards, the Regents should control and require prior approval of any outside activities, including service on any other professional service boards and teaching and lecturing obligations, weighing carefully the time commitments needed and the benefits to the Smithsonian. Any compensation received by any Smithsonian employee for service on any outside board or organization should not be kept by the individual, but should be turned over to the Smithsonian for the benefit of the Institution.

11. The Selection of the Next Secretary Must Reflect the Governance Challenges Facing the Smithsonian

Being Secretary is a difficult and time consuming job. The Secretary oversees a complex amalgam of museums, research centers, a zoo, retail shops, restaurants and buildings. The Secretary is the caretaker for one of the great names in the science and arts. It is also a job with great challenges, prestige, and opportunities to have a lasting mark on our national heritage. Business skills are valuable to the Smithsonian and efforts to introduce business planning and measurement tools should be encouraged. But what must be avoided in picking the next Secretary is the manner in which Mr. Small operated. The Secretary must work for the Board. The Secretary must set the ethical tone, not sidestep it. The operations of the Smithsonian, especially the Secretary's office, should be open and transparent.

12. Achieving Effective Oversight and Governance at Nonprofit Organizations May Ultimately Require Legislative Action

Unfortunately, the problems at the Smithsonian are not unique. As the media and Congressional oversight committees have made clear, there have been similar problems at several large tax-exempt organizations, including major museums and universities, not to mention the income and expense excesses and governance issues at for-profit companies. This raises the issue of effective management of nonprofits and how governance at these entities

should be structured, the responsibilities of their boards of directors and trustees, and how oversight of these organizations should be provided. The IRC believes that boards of nonprofits – especially large nonprofits – should move to reform their governance structures to bring them into line with best practices that have been well documented. These include the financial management and audit requirements in the Sarbanes-Oxley legislation, as well the recent Securities and Exchange Commission requirements for disclosure of the total compensation of senior executives. Some nonprofits have made progress in these areas, while others have not. Failure to take voluntary action will likely lead, ultimately, to action by Congress, state legislatures, and the courts to impose reforms from without, just as was done in the case of the corporate world.

BACKGROUND ON INDEPENDENT REVIEW COMMITTEE

A. Formation of IRC

In February 2007, *The Washington Post* began a series of articles reporting the history of compensation and benefits for Lawrence M. Small, Secretary of the Smithsonian Institution. Beyond these news stories, Senator Charles Grassley, R-Iowa, the Ranking Minority Member of the Senate Finance Committee, posed a number of specific questions to the Smithsonian about the compensation and benefits granted to Mr. Small, and asked for a number of documents related to these matters.

Following the initial news stories and the letter from Senator Grassley, Roger Sant, the Chair of the Executive Committee of the Board of Regents asked Charles A. Bowsher, former Comptroller General of the United States, to chair a committee to review issues raised by the news reports and by Senator Grassley. Mr. Bowsher was appointed by President Reagan and served as Comptroller General of the United States and as head of what was then known as the General Accounting Office for fifteen years between 1981 and 1996. Before that he was associated with Arthur Andersen & Co. for 25 years except for four years when he served under the administrations of former Presidents Lyndon Johnson and Richard M. Nixon as Assistant Secretary of the Navy for Financial Management.

Mr. Bowsher agreed to chair such a committee on condition that he would be allowed to choose other members of what became known as the Independent Review Committee and that the Committee be allowed to select counsel of its own choice to assist in the review. When these requests were accepted, Mr. Bowsher asked these two individuals to join him on the IRC:

- Stephen D. Potts is chairman of the Ethics Resource Center. He served as director of the U.S. Office of Government Ethics under Presidents

George H.W. Bush and William J. Clinton between 1990 and 2000. He previously served as a partner at the Washington law firm of Shaw, Pittman, Potts & Trowbridge.

- A.W. “Pete” Smith, Jr. is a retired executive with extensive experience in both the private and public sectors. He served as chief executive officer of the Private Sector Council, a nonprofit organization dedicated to improving the management of the federal government and previously served as president and chief executive officer of Watson Wyatt Worldwide, human resource consultants, where he worked for 30 years.

To assist the IRC with its inquiry, Mr. Bowsher engaged the services of Paul Martin Wolff and Stephen P. Sorensen of Williams & Connolly and James P. Joseph of Arnold & Porter, LLP. Cleve E. Corlett, retired director of external affairs of GAO, was retained as a consultant. The Smithsonian Board of Regents formally announced the creation of the IRC on March 19, 2007.

From the beginning, the Committee insisted that it be granted unfettered access to documents and that it be allowed to interview current employees of the Smithsonian Institution. The Smithsonian and its counsel have worked diligently to provide all information requested by the Committee. In addition, the Committee made it clear that, while this report would be submitted for comment to the Regents, the Committee would retain authority for the final content of this report.

B. Scope of Review

The Board of Regents asked the Committee to conduct an independent examination of the Secretary's compensation and expenses and related Smithsonian governance. The following areas were beyond the IRC's purview and so were not examined by the IRC:

- Management of the Smithsonian physical operations;
- Management of the Smithsonian museums or research programs;
- Smithsonian Business Ventures or any retail operations of the Smithsonian;
- General policies and systems for Smithsonian personnel; and
- General financial controls and systems.

The IRC did not conduct an audit of the Secretary's expenses. The Committee reviewed the report prepared by Cotton & Co., as well as drafts of that report and the materials relied upon by Cotton & Co. in preparing its report. Cotton & Co. did not look behind those materials or do any testing, nor did the Committee. Therefore, the Smithsonian has yet to determine whether these expenses of the office of the Secretary were incurred for Smithsonian business purposes and were reasonable. It would be prudent for the Smithsonian to have an independent auditor make such a determination to avoid any potential adverse tax consequences.

C. Review Process

The IRC received the full cooperation of the Smithsonian, its employees and Regents. The IRC examination included a review of over 15,000 pages of documents and 46 in-person or telephonic interviews. The IRC met with all of the current Regents except for the Vice President, whose office, however, sent the Committee a thoughtful letter raising a wide range of

governance issues.² In addition, the Smithsonian facilitated access to former Board members, current and former employees and other stakeholders. All of the people interviewed by the IRC were cooperative and forthcoming with information. Interviewees also were advised that specific comments would not be ascribed in this report to any named individuals. Two individuals – Lawrence Small and Mr. Small’s personal assistant – did not accept the invitation to meet with the IRC.³

Documents were obtained from a variety of sources. The Smithsonian provided, among other items, Board minutes, correspondence, financial materials and internal governance documents. The IRC also reviewed legislative materials relating to the Smithsonian and applicable statutory provisions. In addition, the IRC consulted legal, academic and other professional sources, materials obtained from leading governance-related organizations, governance-related materials from other nonprofit organizations and studies of federally chartered nonprofits and other federally chartered entities.

² Exhibit 1.

³ The Committee invited Gary Beer, the Chief Executive Officer of SBV, to meet with the Committee in early May. The Committee did not receive a response from Mr. Beer until June 12, 2007, by which time the Committee was finalizing its review. Mr. Beer’s counsel provided the documents attached as Exhibit 2.

STANDARDS FOR REVIEW

A. The Smithsonian's Legal Status

The Smithsonian is a trust instrumentality that was established by Congress in 1846 to hold in trust property donated by James Smithson and to carry out the provisions of his will for the “increase and diffusion of knowledge.”⁴ Like other quasi-governmental entities, the Smithsonian, though a creation of federal law, has an independent organizational existence and is not an agency of the United States government.

The legal status of the Smithsonian has been raised periodically in lawsuits against the Smithsonian. Federal courts have considered the Smithsonian to be an establishment, agency or authority of the federal government in some circumstances, but not others.⁵

The Smithsonian is unique among quasi-governmental organizations in that, while most of its employees are treated as federal employees with all the protections, benefits and restrictions applicable thereto, a limited number of employees are considered to be employed by the Smithsonian trust.

The Smithsonian's main source of funds is the federal government, which currently provides more than seventy percent of the Smithsonian's budget. This reliance on federal funding has been increasing in recent years.

B. Governance and Applicable Fiduciary Duties

The structure, organization, management and oversight of the Smithsonian were established by federal statute in 1846, providing that the Board of Regents shall be the governing

⁴ The Smithsonian Act of August 10, 1846, as amended and codified, 20 U.S.C. §§ 41-67.

⁵ For example, the Smithsonian has been deemed to fall within the definition of “federal agency” for purposes of the Federal Tort Claims Act, and so entitled to immunity against a defamation action under that statute. See Expeditions Unlimited Aquatic Enterprises, Inc. v. Smithsonian Inst., 566 F. 2d. 289 (D.C. Cir. 1977) (*en banc*).

body.⁶ The Board has the responsibility for appointing the Secretary, who is charged with managing the operations of the Smithsonian.

Unlike the vast majority of nonprofit organizations whose governance is informed by applicable state statutes and common law of fiduciary duties, there is no developed body of federal common law setting forth the duties and obligations of the Board. Nonetheless, it is clear that the Regents are fiduciaries of the Smithsonian. First, the Regents are trustees charged with managing the original Smithsonian trust for the benefit of the American people.⁷ Second, the Regents are analogous to directors of a nonprofit organization and therefore must fulfill the fiduciary duties of directors. While trustees and directors are both subject to duties of loyalty and care, the trustee is expected to satisfy a higher standard with respect to both duties.⁸ The fiduciary duties of the Regents are spelled out clearly in Smithsonian Directive 150:

The Board of Regents bears the responsibility of the United States as trustee for carrying out the Smithsonian bequest and the public trust for which it provided. The primary obligation of the Board of Regents is to manage the resources of the Institution for the benefit of all mankind.⁹

The standards applied to the Regents derive from trust law:

A trust is a fiduciary relationship whereby a trustee holds and administers property for stated purposes on behalf of named beneficiaries. A trustee who holds legal title to trust property can use that property only in accordance with trust purposes to serve trust beneficiaries. In addition, a trustee must exercise prudent oversight of trust assets, keep strict accounts, make

⁶ 20 U.S.C. §§ 41-67.

⁷ A trustee has a “fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another.”
RESTATEMENT (SECOND) OF TRUSTS 2 (1957).

⁸ See George B. Bogert & George T. Bogert, *THE LAW OF TRUSTS AND TRUSTEES* §394 (Rev. 2d 1994) (higher standard of care and stricter duty of loyalty generally imposed upon trustees under trust law than on trustees or directors under nonprofit corporation statutes).

⁹ SMITHSONIAN DIRECTIVE 150, Smithsonian Institution Origins, Governance, and Relationship to the Federal Government (April 16, 1996), attached as Exhibit 3.

every effort to further trust purposes, and account for stewardship of the trust to all proper authorities.¹⁰

The duties required of one in such a fiduciary capacity are well established in the law. The duty of care generally describes the level of attention required of a director in all matters related to the organization.¹¹ This duty of care is perhaps more accurately described as a “duty to be informed.” A director has the responsibility to become informed about an issue before making a business decision relating to the issue.¹² A director will fulfill the duty of care if, prior to making a decision, he or she seeks out and considers all material information reasonably available to him or her. To fulfill the duty of care, the directors should follow deliberate procedures and consult with appropriate committees, officers or employees of the organization or other outside experts in making corporate decisions. This often means going beyond what is provided to the board by in-house staff, including consulting with outside experts, talking directly to, and questioning, employees with knowledge of the facts and, above all, asking thoughtful and probing questions. Board members may not simply rely on the word of senior management without further inquiry.

The duty of loyalty requires a director to act in the interest of the entity rather than in the personal interest of the director or some other person or organization.¹³ More importantly, the duty of loyalty encompasses an obligation of directors and key employees with financial or other decision-making authority to avoid conflicts of interest. For a director, a violation of this duty may result in personal liability for a breach of fiduciary duty. For the organization, such a

¹⁰ *Id.*

¹¹ *See* 3A William Meade Fletcher, FLETCHER CYCLOPEDIA OF THE LAW OF CORP. § 1029 (duty of care requires that directors perform their obligations with a minimum standard of care).

¹² *See id.* § 1034.80 (director’s failure to make a reasonable inquiry may constitute breach of duty of care).

¹³ *See id.* § 837.60 (duty of loyalty mandates that best interest of the corporation take precedence).

breach may allow a court to void the corporate transaction in which a conflict was present.¹⁴ There have been no allegations, nor is the IRC aware of any evidence whatsoever, that any Regent violated this duty of loyalty.

These duties of care and loyalty are heightened for the Regents due to their status as trustees of the Smithsonian trust. In short, Regents owe the highest possible fiduciary duty to the Smithsonian and the American people.

C. **Applicable Tax Laws and Principles**

The Smithsonian is treated as an organization exempt from taxation under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (“**Code**”). Accordingly, certain provisions of the Code dealing with compensation and expenses apply to the Smithsonian.

Code section 4958 imposes a tax on excess benefit transactions for those organizations which are exempt from taxation under Code sections 501(c)(3) or 501(c)(4).¹⁵ In general, an excess benefit transaction is any transaction in which an economic benefit (including compensation) is provided to or for the use of any “disqualified person,” if the value of the economic benefit provided to the disqualified person exceeds the value of the consideration (including the performance of services) received by the organization in return for such benefit. The intermediate sanction excise tax, therefore, may be imposed on a senior executive who is paid excess compensation by a nonprofit organization, with compensation including not just base salary, but all other forms of compensation, including bonuses, benefits, and deferred compensation.

¹⁴ *See id.* § 916 (transaction voidable where unfair to the corporation or entered into in bad faith).

¹⁵ *See also* Treas. Reg. § 53.4958-1T *et seq.*

The specific excise taxes imposed by section 4958 are the following:

- On the disqualified person who engages in an excess benefit transaction, twenty-five percent of the excess benefit amount;
- On the disqualified person, two-hundred percent of the excess benefit amount, if the excess benefit transaction is not corrected after notice from the IRS; and
- On any organization manager who knowingly participates in an excess benefit transaction (including individual board or compensation committee members who approve the payment of excessive compensation to a disqualified person), ten percent of the excess benefit amount. (The aggregate tax imposed on all organization managers for any one excess benefit transaction may not exceed \$20,000.)

The Code requires that travel expenses not be “lavish or extravagant under the circumstances,” though “lavish” and “extravagant” remain undefined in the tax code or in regulations.¹⁶ Travel expenses that are paid or reimbursed but not properly documented or “lavish or extravagant” are treated as taxable compensation to the individual so benefiting. In addition, the payment of travel for an employee’s spouse may also be treated as taxable compensation. If a public charity provides a compensation benefit to a disqualified employee or his or her spouse, the charity is required to provide contemporaneous written substantiation (e.g., a Form W-2, Form 1099 or written employment agreement) of its intent to treat such payment as compensation. If the organization fails to indicate in such a contemporaneous writing that it is providing an economic benefit in return for services, the compensation paid will be treated

¹⁶ Code § 162(a)(2); Treas. Reg. §§ 1.162-2, 1.162-17.

automatically as an “excess benefit.”¹⁷ Board members and executives of charitable organizations who approve or receive excessive travel benefits are subject to penalties under the Code.¹⁸ The audit committee should have responsibility for ensuring compliance. The IRS has provided detailed guidance for managers of charitable organizations in avoiding lavish, extravagant, or excessive expenditures.¹⁹

D. Smithsonian Policies

The Smithsonian has its own compensation and expenses guidelines. In particular, the Smithsonian has a travel policy that requires all Smithsonian employees to comply with the Federal Travel Regulation, as well as policies and procedures for the use of the various Smithsonian funds. The Smithsonian also has a conflicts of interest policy.

E. Best Practices in Nonprofit Corporate Governance

Governance of nonprofits has come into focus in recent years following the passage of the Sarbanes-Oxley Act of 2002 and in light of recent conflicts of interest and improprieties at prominent nonprofit organizations. The last few years have witnessed substantial work in corporate governance of nonprofits, and the IRC’s review and recommendations benefited from this work.²⁰

¹⁷ Code § 4958(c)(1)(A); Treas. Reg. § 53.4958-4(c)(1).

¹⁸ Code §§ 4941, 4958.

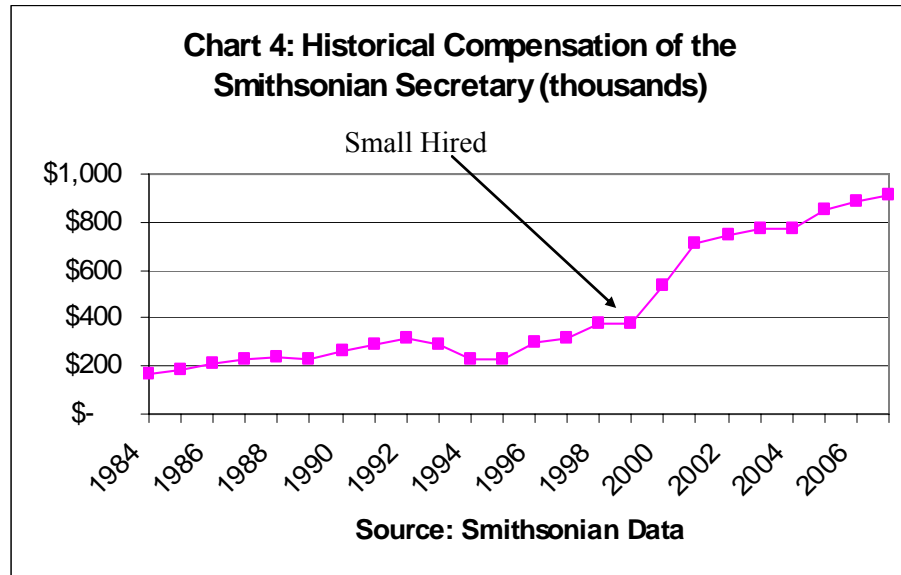
¹⁹ IRS Publication 463, “Travel, Entertainment, Gift and Car Expenses” (2006).

²⁰ See, e.g., Panel on the Nonprofit Final Report to Congress Nonprofit Sector, *Strengthening Transparency, Governance and Accountability of Charitable Organizations*, 2005.

COMPENSATION AND PERFORMANCE OF MR. SMALL

Allegations of excessive compensation paid to Mr. Small were part of the impetus for the formation of the IRC. In reviewing the compensation of Mr. Small, the IRC found it instructive to consider the compensation of the Smithsonian Secretary over recent history.

Historically, compensation for the Smithsonian Secretary was generally conservative. As Chart 4 shows, from the mid 1980's through the hiring of Secretary Small in 2000, the base



salary of the Secretary increased at a relatively modest pace. Secretary Robert M. Adams was also provided a pension of ten percent of pay and lived in a house owned at the time by the Smithsonian. Secretary Michael Heyman declined a housing allowance. He did receive a modest pension benefit equal to 2.5 percent of his salary for each year of service.

By the end of the 1990's, as Secretary Heyman was preparing for retirement, the former Executive Committee determined that a salary of approximately \$300,000 would probably be required to attract a well-qualified successor.²¹ Mr. Heyman's salary was raised to \$300,000 in

²¹ See April 6, 1999 memorandum from Jim Hobbins to the Executive Committee of the Board of Regents, attached as Exhibit 4.

1999, and Mr. Small's salary was purportedly set at \$330,000, a ten percent increase over Mr. Heyman's 1999 salary, when he assumed office in early 2000.

A. How Secretary Small's Initial Compensation Package was Established

A very small group of Regents, supported by the Executive Assistant to the Secretary, James Hobbins²², were involved in recruiting and hiring Mr. Small as Secretary. It is not clear, however, how certain elements of compensation ended up being included in Mr. Small's total compensation. What is clear is that these Regents, none of whom is currently on the Board, used the different compensation benefits provided to prior Secretaries as a guide, with base pay, pension and housing being the starting points in formulating the total package. Each part of Mr. Small's compensation, however, was increased above what each prior Secretary had received, and Mr. Small was allowed to "double-up" on certain benefits provided to prior Secretaries. Although Secretary Adams received all three elements (base pay, pension and housing), his base salary, when adjusted in constant dollars, was significantly lower (\$180,000) than his successors. Secretary Heyman did not need or want Smithsonian-provided housing, so he received only base pay and a pension, with his base pay being adjusted very slightly upward.

When hired, Mr. Small's total compensation, included, in addition to a competitive base salary which was set at ten percent above the final salary of Secretary Heyman, a payment "in lieu of pension" equal to seventeen percent of his annual base pay.²³ Mr. Small was also granted a "housing allowance" of up to \$150,000 per year.²⁴ Mr. Small's insistence on a large payment in lieu of pension is noteworthy because he was, at the time, already receiving pensions from

²² Mr. Hobbins has been at the Smithsonian for more than forty years and in that position since 1980.

²³ Exhibit 5.

²⁴ *Id.*

both Fannie Mae and Citicorp.²⁵ Counting the “in lieu of pension” payment and the housing allowance, Mr. Small’s total cash compensation for his first year – 2000 – came to \$536,100, over sixty percent higher than both the \$330,000 figure that was publicly disclosed and Mr. Heyman’s compensation in the previous year. Mr. Small’s employment agreement also stipulated that he “fly” first class, and that his spouse’s travel expenses be paid when “her presence is appropriate.”²⁶ Neither of these benefits had been accorded to the prior Secretaries.

If Mr. Small had not received a housing allowance and had received only a modest pension benefit, his initial compensation package would have been reasonable. But there was a clear intent of the small group involved with hiring Mr. Small to increase his compensation substantially and “package” it in a way that would mask the substantial increase in compensation as compared with Mr. Small’s predecessor.

The Committee was told by individuals directly involved in negotiating Mr. Small’s initial compensation that there was concern, among the limited number of former Regents involved in setting Mr. Small’s compensation, that there would be adverse publicity if the Smithsonian announced that Mr. Small was being hired at a salary in excess of \$500,000 a year. Rather than characterizing Mr. Small’s annual salary as \$536,100, which was his true cash compensation, the then-Executive Committee announced Small’s salary at \$330,000 (a ten percent increase over Heyman’s total cash compensation) and then paid him additional cash compensation of \$206,100 in payments for housing and in lieu of pension. When discussed with

²⁵ According to Fannie Mae’s May 18, 2000 proxy statement, Mr. Small’s estimated annual retirement benefits for his nine years of service was \$581,836 per year, assuming full vesting at normal retirement age. It appears from the proxy that Mr. Small was 90 percent vested in his pension, which would result in an annual benefit of more than \$500,000 for life. Based on Citicorp’s federal securities filings, Mr. Small’s Citicorp pension is approximately \$400,000 per year.

²⁶ Employment Agreement ¶ 8, attached as Exhibit 5.

the press, the \$330,000 base salary was generally presented as Mr. Small's compensation, and the press generally reflected this figure.²⁷

In his second year (2001), Mr. Small's base salary jumped about forty-six percent, from \$330,000 to \$480,000, an increase for which there is little documentation other than a memo from Mr. Hobbins approving the increase and a short summary of the Executive Committee's actions, also prepared by Mr. Hobbins.²⁸ The large increase in base salary had the ripple effect of increasing Mr. Small's payment in lieu of pension from \$56,100 to \$81,600. Beginning in 2002, Mr. Small's housing allowance was also linked to his base salary and increased each year. Together with his pension payment and housing allowance, Mr. Small's compensation for his second year – 2001 – was now \$711,600, nearly two times greater than the total compensation Mr. Heyman received in the same position only two years prior.²⁹ This \$150,000 increase in base salary was approved by the then-Executive Committee without informing the full Board and without decreasing the \$150,000 housing allowance, which was, in effect, simply additional cash compensation.

The Committee learned that Mr. Small requested that the Executive Committee increase his base salary by \$150,000 in 2001. One Regent involved in the discussions explained that Mr. Small indicated such an increase was necessary because his salary was “compressing” the

²⁷ “Small will be taking quite a salary cut. He made \$4.2 million plus housing in 1998 [from Fannie Mae]. The Smithsonian salary is \$333,000 [sic]. ‘I have been extremely fortunate,’ he says. ‘I am perfectly fine with reducing my salary.’” Jacqueline Trescott, Player: Lawrence Small Knows Finances, But That's Not The Richest Part of the Experience He Brings to the Smithsonian, WASH. POST, Jan. 25, 2000, at C1.

²⁸ Exhibit 6.

²⁹ The large increase in Mr. Small's compensation had an additional cost for the Smithsonian. Former Secretary Ripley had been promised an annuity equal to 80 percent of the current Secretary's base pay, plus another 20 percent of the current Secretary's base pay as an annual payment for “research support.” Thus, Mr. Ripley was being paid at a \$480,000 annual annuity rate in 2001 when his highest salary as Smithsonian Secretary was \$100,000. The Smithsonian's Chief Financial Officer and the Regents appear to have been unaware of this.

salaries of museum heads and senior executives of the Smithsonian below market. The IRC was told that Mr. Small claimed that his request for a salary increase of almost fifty percent was “not about the money” for himself, but rather was a way to revamp the salary structure for the entire institution, thus enabling the Smithsonian to recruit and retain the best and the brightest.

This increase, as discussed in contemporaneous documents, was also to recognize the performance of Mr. Small and to bring the Secretary’s compensation in line with what the Executive Committee deemed to be the prevailing market rate of the 75th percentile for comparable positions.³⁰ The increase in Mr. Small’s compensation was also justified as a reward for his ostensibly raising \$200 million in his first year as Secretary.³¹ It was originally considered that Mr. Small’s salary would be increased by only \$50,000, with the remaining \$100,000 to be paid as a one-time bonus.³² Mr. Small indicated that he would give the \$100,000 back to the Smithsonian in the form of a leadership donation. This approach was ultimately scrapped, and Mr. Small’s base salary was instead increased by \$150,000.³³

In reaching this decision, the Executive Committee, none of whom is currently on the Board, relied on a compensation study presented by Towers Perrin (discussed further below) that concluded that the market rate comparison at the 75th percentile for presidents of research universities and executives at select nonprofit organizations was \$670,835 (excluding housing).

³⁰ Exhibit 7.

³¹ *Id.*

³² Exhibit 8.

³³ Mr. Small made cash donations to the Smithsonian totaling \$2,938 and donations of stock totaling \$426,356 over the course of his tenure as Secretary.

Table 1
Mr. Small's Compensation, 2000-2007

Year	Base Salary	Housing Allowance	Payment in Lieu of Pension	Total Compensation
2000	\$ 330,000	\$ 150,000	\$ 56,100	\$ 536,100
2001	\$ 480,000	\$ 150,000	\$ 81,600	\$ 711,600
2002	\$ 502,896	\$ 157,155	\$ 85,492	\$ 745,543
2003	\$ 518,486	\$ 162,027	\$ 88,142	\$ 768,655
2004	\$ 541,351	\$ 140,977	\$ 92,030	\$ 774,358
2005	\$ 573,832	\$ 179,322	\$ 97,551	\$ 850,705
2006	\$ 596,785	\$ 186,495	\$ 101,454	\$ 884,734
2007	\$ 617,672	\$ 193,022	\$ 105,004	\$ 915,698

Neither Mr. Small nor the then-Executive Committee considered recharacterizing as base salary Mr. Small's \$150,000 housing allowance, which would have allowed the salary scale of other Smithsonian employees to move upward, without raising Mr. Small's salary. As for the rationale that the 2001 increase in base compensation would allow the Smithsonian to raise the compensation of other Smithsonian employees, the IRC notes that the Executive Committee, at the time it increased Mr. Small's salary, accepted Mr. Small's recommendations to make the following adjustments in compensation for the top 31 Smithsonian employees: 16 received no salary increase, 1 received an increase of 21 percent and the remaining 14 received an average increase of 9.8 percent.³⁴ These salary adjustments could have been made under the salary structure in existence before 2001 and certainly without any adjustment to Mr. Small's salary. As these numbers show, though Mr. Small's base salary was increased by more than 40 percent, he did not decompress senior executive salaries.

³⁴ Exhibit 7.

Driving this high level of compensation was Mr. Small's own expectations. First, Mr. Small requested the \$150,000 raise in 2001 using an argument that should have been questioned by the Executive Committee. Second, the Committee was told in its interviews that Mr. Small had very high expectations for his compensation and benefits even before he was hired. Among other things, when he was negotiating his employment contract, he made clear that his contract must provide him with the right to "fly" first class. In fact, the IRC was told that Mr. Small stated that first-class travel was a "deal breaker."

Mr. Small appears to have aggressively guarded each and every element of what he viewed as his rightful compensation package. For example, after the Regents learned earlier this year the true nature of Mr. Small's housing allowance and the details of his total compensation package, there was an attempt to clarify certain terms of his employment agreement. Mr. Hobbins, assisted by Mr. John Huerta, the Smithsonian's General Counsel, drafted clarifying amendments to Mr. Small's employment agreement. These provided: (1) increases to Mr. Small's housing allowance at the discretion of the Regents (rather than being linked to the Secretary's salary as had become the custom, though not required by his 1999 employment agreement), (2) clarification that first-class travel includes the use of car services and premium hotel accommodations (rather than simply allowing Mr. Small to "fly first class"), and (3) limitations on the Smithsonian's payment of Mrs. Small's travel to "bona fide and official business of the Institution" (rather than paying for Mrs. Small's travel "where her presence is appropriate"). Mr. Small's response to these proposed changes was as follows:

I'm not willing to discuss giving up one iota of what the Institution agreed to provide me before I came to work It would represent

the highest form of naiveté to think . . . I would entertain some form of “give-up.”³⁵

Mr. Small further demanded that the Smithsonian pay for legal counsel should he find counsel necessary. Mr. Small suggested that, if his first-class travel were limited in any way, the Smithsonian could increase his housing allowance by the value of the estimated first-class travel expenses that he and his wife might incur for Smithsonian business each year. Most disturbing from a governance perspective, Mr. Small instructed Messrs. Hobbins and Huerta to keep these issues from Mr. Sant, the Chair of the Executive Committee.

I do not want any of my comments passed along to Roger [Sant]. This is strictly a discussion that you [Mr. Huerta], Jim [Hobbins] and I are having. We shouldn't go to Roger [Sant] until we are completely comfortable that any proposed amendment is good for the Institution, good for me, is economically equivalent to the existing arrangement and operative practices and protect everyone from adverse consequences.³⁶

His closing remark to Mr. Huerta is perhaps the most telling about Mr. Small's attitude regarding his own compensation and the oversight authority of the Board: “These problems should be settled before we go back to the Board. It's not right to toss any perceived problems in their lap.”³⁷

These remarks are typical of an attitude that was confirmed in the IRC interviews and other information. Evidence collected by the Committee indicated Mr. Small considered himself to be in charge of his own compensation. The Board was not to consider the terms of his employment, and Mr. Small expected the Smithsonian staff to help him manage the approval process with the Board to achieve this.

³⁵ Exhibit 9.

³⁶ Exhibit 10.

³⁷ *See id.*

Another factor that led Mr. Small's compensation to grow so significantly was that only a few people were involved in negotiating his initial contract and, until quite recently, in fully discussing and understanding the full scope of his total compensation package. The full Board of Regents was apparently not aware of the details of Mr. Small's employment arrangements until 2007 because, prior to 2004, his compensation increases were approved by the Executive Committee only, not the full Board. In the early years of Secretary Small's tenure, the members of the Executive Committee appeared willing to acquiesce to Mr. Small's demands without questioning the justification or appropriateness for providing such benefits.

Mr. Small's employment agreement was largely negotiated without the assistance of either internal Smithsonian legal counsel or external counsel. Rather than engage outside counsel to represent the Smithsonian in its negotiations with Mr. Small, the record shows the agreement was drafted by Mr. Hobbins (who is not a lawyer), and provided to the General Counsel and other lawyers in the General Counsel's office before it was finalized, but after the terms had been worked out with Mr. Small. This put the Smithsonian legal department in the position of negotiating against its eventual boss. The General Counsel and one of his staff members offered very minor suggestions, all of which were incorporated into the final agreement. Even considering the agreement in light of comparable agreements in 1999, the agreement is inadequate at best, with key terms and provisions both vague and internally contradictory.

Despite the awkward position in which the General Counsel found himself, the IRC believes he should have more vigorously represented the interest of the Smithsonian in this situation. Had the Board engaged outside legal counsel, the IRC believes the issues relating to housing and travel would more likely have been addressed appropriately.

B. The Housing Allowance

Unlike his predecessor, Secretary Small was provided with an allowance for housing. In particular, Secretary Small's Employment Agreement provide as follows:

The Secretary shall make his personal residence available for official Smithsonian hospitality and will receive a housing allowance not to exceed \$150,000 per year in compensation for up to fifty percent (50%) of the actual costs of his housing. Payment of these funds will be made by the Smithsonian to the Secretary monthly upon his presentation monthly of records of housing, operating and maintenance expenditures including but not to be limited to: homeowner's insurance, utilities, ordinary maintenance and cleaning, grounds service, real estate taxes, mortgage interest or equivalent costs of home ownership, etc., but not capital expenditures.

Despite this language, which contemplates a reimbursement of Mr. Small's actual costs incurred as compensation for use of his house for Smithsonian entertainment, the Committee was told that it was understood by all those involved in the negotiation of Secretary Small's agreement that because Mr. Small owned his home outright, the housing allowance was a means to increase compensation to the Secretary.

The payment to Mr. Small of this housing allowance of \$150,000 – which was increased beginning in 2002, and which reached \$193,000 in 2007 – highlights not only the flaws in the Smithsonian's compensation system, but also Mr. Small's control over the Smithsonian and the Board on this issue and the failure of the Regents to understand and limit Mr. Small's compensation.

The employment agreement provides that, in return for making "his personal residence available for official Smithsonian hospitality," Mr. Small was to receive a housing allowance of up to 50 percent "of the actual costs of his housing." (Emphasis added.) Before Mr. Small could receive such payment, he was required, according to the terms of this agreement, to present each

month “records of housing operating and maintenance expenditures including but not limited to: homeowner’s insurance, utilities, ordinary maintenance and cleaning, grounds service, real estate taxes, mortgage interest or equivalent costs of home ownership, etc., but not capital expenditures.” In an email dated January 11, 2000, Mr. Hobbins confirmed to Yong Lee, Mr. Small’s personal assistant, that Mr. Small would “be reimbursed” for his housing “upon the Secretary’s presentation in writing of accounts and receipts.”³⁸ Based on Mr. Small’s employment agreement, therefore, in return for use of his house for Smithsonian entertaining, the Smithsonian initially understood that Mr. Small was to be reimbursed for actual housing expenses, upon presentation of receipts.

Within a month of assuming the position of Secretary, however, Mr. Small “establish[ed] the procedure” for the “monthly payment of the housing allowances.”³⁹ This procedure, which appears to have been created by Mr. Small, did not require Mr. Small to present any receipts, nor provide any evidence of use of his house for Smithsonian entertaining. Rather, Mr. Small, who owned outright not only his house, but also a personal gallery of artifacts located in an apartment near his home, calculated a “virtual mortgage” payment on both the house and gallery. He used a hypothetical mortgage rate of 8.5 percent⁴⁰ on an assumed principal amount of \$4 million. The cost of this virtual mortgage would be \$340,000 per year, 50 percent of which is \$170,000, \$20,000 more than the cap on his housing allowance. In a February 10, 2000 letter to Messrs. Hobbins and former Congressman Barber Conable, then a citizen Regent, Mr. Small concludes

³⁸ Exhibit 11.

³⁹ Exhibit 12.

⁴⁰ While an 8.5 percent mortgage rate was consistent with the market in February 2000, this hypothetical rate remained constant despite the large drop in mortgage interest rates after 2000.

that “[s]ince the 50% share of my calculated cost of ownership exceeds the Smithsonian’s housing allowance, I would ask for the maximum \$150,000 per year, or \$12,500 per month.”

It went without saying that Mr. Small expected these payments without “presentation monthly of records of housing operating and maintenance expenditures” as required by his employment agreement. The payment procedure established by Mr. Small failed to take into account the requirement in his employment agreement that he be reimbursed only for “actual costs of his housing.” (emphasis added.) Yet, these payment procedures, apparently, were accepted by the Smithsonian without question, despite the fact that Mr. Small’s interpretation that he was to be paid for a “virtual mortgage” is not supported by his written employment agreement and contradicts the interpretation set forth by Mr. Hobbins in his January 2000 email to Mr. Small’s assistant. Thus, Mr. Small very quickly turned the reimbursement payments for use of his house described in his employment agreement into additional salary. This additional salary went up each year.

There was no need for a housing allowance in the first place. Unlike previous Secretaries who received a housing allowance, Mr. Small already resided in Washington when he assumed the Secretary position. He had no extraordinary expenses associated with moving to a location where housing costs are far higher than the national average in order to accept the position of Secretary. His annual retirement benefits from Citicorp and Fannie Mae totaled nearly a million dollars.

The fact that the housing allowance was actually additional salary is also made manifest by the fact that Mr. Small rarely used his house for entertaining Smithsonian donors or potential donors. As Mr. Small himself explained in an email to *The Washington Post*, “[g]iven the exciting new museums and modernized exhibits which opened over the last several years, it

became overwhelmingly clear it was far more compelling and cost-effective to entertain donors and potential supporters in the Smithsonian's unique settings than in a private home."⁴¹ In his seven years as Secretary, Mr. Small held 23 Smithsonian events at his house or gallery, five of which were "staff development" events for a very small number of Small's senior staff. In total, Mr. Small entertained 47 donors and potential donors at the 18 fund-raising events held at his house from 2000-2007, most of which occurred in the early years of his tenure. Over this same period, Mr. Small received, based on documents provided to the Committee by the Smithsonian, \$1,198,715 in housing allowance from the Smithsonian. Calculated as a per person venue fee for fund-raising, this works out to be over \$25,000 per potential donor or almost \$70,000 per fund-raising event. The characterization of the \$150,000 cash payment (growing to over \$190,000 at the time of Mr. Small's resignation) as a housing allowance, rather than additional base salary, appears to the Committee to be part of an overall compensation package that was fundamentally deceptive from the beginning and which has created many of the compensation-related problems that, in recent months, have confronted the current members of the Board — most of whom never knew the details of Mr. Small's compensation or saw his contract.

C. The Use of Compensation Consultants

In 2000, Secretary Small directed the management of the Smithsonian to hire independent compensation consultants to evaluate management compensation at the Institution. After he was hired, but before he started work at the Smithsonian, Mr. Small made clear that the Smithsonian needed to develop a systematic approach to benchmarking executive compensation with a defined group of comparable nonprofit organizations. Mr. Small brought a "for-profit"

⁴¹ James V. Grimaldi and Jacqueline Trescott, Small's House Rarely Used For Business, WASH. POST, Apr. 19, 2007, at C1.

mind set to the Smithsonian's compensation practices, suggesting that the executive compensation specialists at Fannie Mae, Small's then-employer, could be of assistance.⁴² His stated purpose was to provide the Regents with comparable information on management pay in what he considered to be peer institutions, a review process that continued throughout his tenure.

While formalizing this process and providing the Regents with comprehensive information on management compensation was a good idea, it appears that the process actually put in place was not objective and became used primarily as a method of justifying substantial compensation increases for Secretary Small and his management team. The process was not used by the Regents for a thorough discussion of compensation strategy or what would constitute reasonable compensation for these individuals.

The first study done by the outside consulting firm of Towers Perrin, presented in September 2000, appears to have been primarily intended to justify the substantial 2001 increase in Secretary Small's compensation. Both this first Towers Perrin study and the subsequent study carried out in 2002 raise a number of issues:

- Towers Perrin was hired by Smithsonian management, and not the Regents or the Compensation Committee. This gave management undue control over the outcome of the study.
- As stated clearly in the compensation reports, management provided the comparable organizations, a decision that significantly influenced the results of the study. The group of comparables was comprised of major research universities and large nonprofit organizations. Different groups of universities and nonprofits

⁴² Exhibit 13.

would have produced different results, with lower market rates for the positions surveyed, including the Secretary.

For example, the Towers Perrin 2002 report on the Secretary's compensation showed median cash compensation for comparable positions to be \$515,000 in large nonprofits, \$530,000 in select universities, and \$350,000 in public universities, which, like the Smithsonian, receive substantial public funding and therefore are more appropriate comparisons. At the time, the Secretary's base pay was \$480,000 just below the median of the first two groups, but forty-four percent above the median for public university presidents. Mr. Small's actual cash compensation, including his housing allowance and payments in lieu of pension, was well above the median of all comparable groups.

- Documents received from the Smithsonian show that, in the early years of Secretary Small's tenure, the Smithsonian management (and the consultants they employed) were targeting compensation for the Secretary at the 75th percentile, rather than the median or average compensation for comparable positions.
- The findings in the Towers Perrin report used the following as "comparable" nonprofit institutions: the Ford Foundation, the J. Paul Getty Trust, the National Geographic Society, the Metropolitan Museum of Art, the American Museum of Natural History, The Carnegie Corporation of New York and the Kennedy Center for the Performing Arts. The Committee was told that the comparison group was hand-picked by Smithsonian management. The average compensation for this group (salary, bonuses, fees, and severance payments) was reported as \$487,200 in 2000 and the 75th percentile was \$544,900. None of these

organizations, however, receives the substantial majority of its budget from government sources, and so needs to be as sensitive to government budgetary concerns and salary needs as does the Smithsonian.

- Both Towers Perrin reports (and the later Watson Wyatt reports) compared base compensation for Secretary Small to the cash compensation received by Presidents or Executive Directors in the survey sample, without including the substantial value of his housing allowance and payments in lieu of pension. It is true that college and university presidents often receive free housing, but this housing usually requires the president to live on campus, to be available around the clock and to use the house for frequent entertaining. This was not the case with the housing allowance accorded Mr. Small, who used his home infrequently for entertaining.
- By not treating the housing allowance as additional cash compensation, Mr. Small's total compensation was significantly understated.

The Towers Perrin firm was replaced by Watson Wyatt (hired through a competitive bidding process) in 2004 and 2006.⁴³ The Watson Wyatt relationship was similar to the Towers Perrin relationship. Watson Wyatt was hired by Smithsonian management (the Human Resources Department), not the Regents or their Compensation Committee. The peer group was defined by management, with no input from the Regents or from the Watson Wyatt consultants.

In line with typical governance practices, the Watson Wyatt consultants encouraged Smithsonian management to provide them direct access to the Regents, but were denied this

⁴³ IRC member Pete Smith was employed by Watson Wyatt from 1968 to 1999. During his tenure at Watson Wyatt, the Smithsonian was not a client of the firm. Mr. Smith has had no formal relationship with Watson Wyatt since July of 1999.

access and during their involvement had only one brief meeting with the Smithsonian's Compensation Committee. This meeting typified the strong influence that management exercised over Regents' discussions:

- Smithsonian management including Mr. Small and Chief Operating Officer Sheila Burke were present throughout the meeting.
- The questions asked by the Committee members were good ones: Was the data aged appropriately? What was the source of the data, and was the comparison group reasonable? Did their approach and methodology correspond to accepted industry standards?
- The consultant's response to each of these questions, appropriately, was yes. But there were deeper questions that needed to be asked: Was the Secretary's compensation reasonable? Why was the housing allowance excluded from the comparisons? Why was this peer group used, and would the result have been materially different if a different peer group was used?

The consultants should have urged the Committee to meet in executive session to discuss these questions, but undoubtedly it was difficult to do so given their limited assignment (basically to "crunch the numbers," as they put it) and given the fact that both Mr. Small and Ms. Burke were in attendance.

In the IRC's view, this situation is a clear demonstration of how governance at the Smithsonian appeared to be improving, while the decision making process remained overly controlled by the Secretary and his staff. The Regents believed they were doing the right thing,

but they were not being served as effectively as they could have been by the consultants and they were being misled by management.

When Watson Wyatt was retained, the target for the Secretary's compensation was dropped from the 75th percentile to the 50th percentile of the comparison group. This drop, however, did not result in a reduction in Mr. Small's salary because the median compensation ranges shifted significantly upward. The Smithsonian achieved this by changing its group of comparable nonprofits. While public universities represented twenty percent of the original group of comparables, this percentage was dropped to eight percent in the later study. As presidents of public universities were generally the lowest compensated executives in the Smithsonian's comparison groups, this reduction had the effect of increasing the study's median compensation significantly.

The Smithsonian's compensation strategy under Mr. Small is also troubling. In the early years of his tenure, the documentation the IRC received states that the strategy for the Secretary was to pay him at about the 75th percentile of the survey comparisons, while the strategy for other key executives was to pay them at the 50th percentile, raising questions of equity.

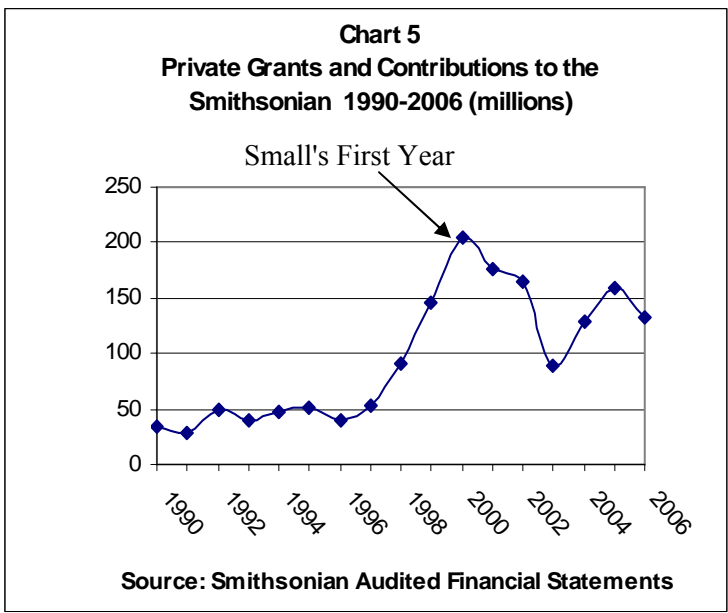
There are other issues of internal fairness. Comparisons for scientists and museum directors and others directly carrying out the mission of the Smithsonian show that their salaries, on average, are generally below the survey targets, while senior executives in the "Castle" – Mr. Small and the other senior executives – were generally above the survey averages. Put simply, this is bad compensation policy – it demoralizes regular employees when their leader is paid at the 75th percentile of market while everyone else is paid at the mid-market range.

To be fair to the Regents currently serving the Smithsonian, recent increases in Secretary Small's base compensation since 2002 have been reasonable, generally at the level of

comparable percentage increases in base salaries in any sector, and often at or below the percentage increase being given to federal employees. A Regent who joined the Board in 2002 and who approved a modest increase in the Secretary's base salary may have believed that there was no reason to worry about unreasonable compensation. By 2002, the Secretary's total compensation was already well above the 75th percentile, and this should have been brought to the Regents' attention or uncovered by them long before Senator Grassley and the media raised this issue.

D. Performance of Mr. Small

The Committee heard from many individuals involved with the Smithsonian that Mr. Small, whatever his short-comings, was a prodigious fund-raiser for the Smithsonian. For example, the Committee heard on numerous occasions the statistic that Mr. Small had raised more than a \$1 billion, which was an amount that exceeded all the funds raised previously in the history of the Smithsonian. The Committee does not believe that success in fundraising has any bearing on its analysis of the governance issues discussed in this report, as fund-raising success should not excuse failures to satisfy fiduciary duties.



That said, to the extent that fund-raising is a metric to be used by the Board in assessing and rewarding the performance of the Secretary, the Committee deemed it appropriate to consider

Mr. Small's fund-raising record at the Smithsonian. This section provides a historical perspective on private fundraising at the Smithsonian, and shows that annual private fundraising actually declined during Mr. Small's tenure.

Prior to the late 1990s, the Smithsonian had raised very little in the way of private donations, and had no real institutional capacity for fundraising. In fact, prior to 1994, the year in which Mr. Heyman became Secretary, the Smithsonian appears to have raised less than \$350 million in its entire history. As Chart 5 shows, the average amount raised annually for the years 1990 through 1997 was less than \$50 million.

After taking over as Secretary in 1994, Mr. Heyman increased the effectiveness of the central fund-raising capacity that had been sorely lacking at the Smithsonian. Prior to Mr. Heyman's tenure, fundraising was mostly decentralized, with individual museums bearing the burden of raising funds for themselves.

The steep increase shown in Chart 5 that begins in the 1997-98 period demonstrates fundraising success from Mr. Heyman's efforts. From 1997 to 1999, he tripled the amounts raised from private sources. During his six-year tenure, he raised more than \$400 million in private grants and contributions. Mr. Heyman could thus claim, as Mr. Small did, that he had raised more money for the Smithsonian during his tenure than had been raised in the history of the Smithsonian theretofore.

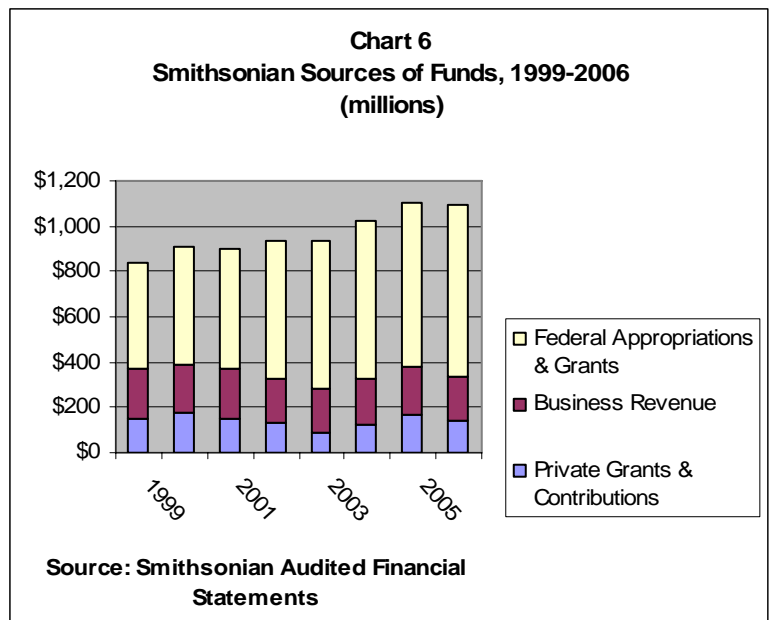
Mr. Heyman's most notable success was the Steven Udvar-Hazy gift for the Air & Space Museum at Dulles Airport. Although the Udvar-Hazy pledge was fulfilled during Mr. Small's tenure, the gift from Mr. Udvar-Hazy was raised during Mr. Heyman's tenure.

Mr. Heyman also laid the groundwork for several other large gifts that would come into the Smithsonian during Mr. Small's tenure. For example, Mr. Heyman developed a relationship

with Kenneth Behring, a California philanthropist, which ultimately resulted in gifts of \$20 million in 1998 and \$80 million in 2000. During Mr. Heyman’s tenure, the Smithsonian developed a relationship with the Lemelson Foundation that resulted in gifts of \$54 million in 1994, \$5 million in 1998, \$5 million in 2000 and \$14.6 million in 2001.

When Mr. Small became Secretary in 2000, he inherited from Mr. Heyman a functioning centralized fund-raising capacity and pipeline that had already been developed. As Chart 5 shows, 2000 was the high point of fund-raising success for the Smithsonian. This spike in private donations largely reflects the \$80 million gift from Mr. Behring for the National Museum of Natural History. In 2001, the Smithsonian received a gift of \$30 million from the Donald W. Reynolds Foundation to purchase the Lansdowne Portrait of George Washington as a result of the public plea on the “Today” show from Marc Pachter, Director of the National Portrait Gallery for financial help. The Donald W. Reynolds Foundation contributed an additional \$45 million in 2005 for the renovation of the National Portrait Gallery.

Even including these large gifts, the amount of private funds contributed to the Smithsonian began to decline after 2000,



reaching a low of \$88 million in 2003, even though smaller contributions remained constant or increased slightly.⁴⁴ Private funds raised in 2006 improved to \$132 million, though that figure is still about ten percent lower than the amount raised in 1999 during Mr. Heyman's last year as Secretary. Notwithstanding this decline, Smithsonian data show that gifts under \$5 million have been rising over the same time period.⁴⁵ This overall decline in annual fundraising at the Smithsonian over this period stands in contrast to the fundraising record of comparable institutions that saw their fundraising improve over the same period.⁴⁶

As private contributions have receded in recent years, the Smithsonian has come to rely more heavily on the Federal government for its funds. In 1999 federal appropriations and grants constituted approximately fifty-four percent of the Smithsonian's revenue. By 2006, this proportion of federal funds had increased to about two-thirds. As Chart 6 shows, federal funding increased from \$470 million in 1999 to about \$760 million in 2006, an increase of about sixty-one percent. The Smithsonian informed the IRC that the increase in federal appropriations reflects, in significant part, the opening of two new museums and increased spending for anti-terrorism measures following 9/11, and noted that the Smithsonian's federal staff has decreased by about five percent since 2000.⁴⁷

In contrast, over the same period the Smithsonian's business revenue dropped by ten percent from \$217 million to \$194 million and private grants and contributions dropped by nine percent from \$151 million to \$137 million. If these two sources of funds for the Smithsonian

⁴⁴ Exhibit 14.

⁴⁵ *Id.*

⁴⁶ Exhibit 15.

⁴⁷ A summary of the Smithsonian's sources of funds provided to the IRC by the Smithsonian is attached as Exhibit 16.

continue to decline, the Smithsonian will necessarily come to rely even more on federal funds for more of its operations.

EXPENSES OF THE SECRETARY

A. Mr. Small's Expenses

Mr. Small made perfectly clear in 1999 to the Regents working out the terms of his employment agreement that it was absolutely necessary that he travel first class. There appears to have been no consideration by Mr. Small that the Smithsonian was a nonprofit organization, funded primarily with taxpayer dollars, and no apparent sensitivity to the public perception of what many Smithsonian employees and visitors might consider lavish travel expenses.

Mr. Small also seemed unwilling to consider using his own funds or frequent flyer miles to upgrade to first class when available, as his predecessor often did and as many in the nonprofit world did in 1999 and do today. The Regents involved in contract discussions with Mr. Small appear to have acquiesced to Mr. Small's demands without questioning the appropriateness or potential adverse publicity of such an arrangement.

These issues were compounded by the failure of the Smithsonian to enforce the contract terms as drafted. Mr. Small's employment agreement states that he is "authorized to fly first class."⁴⁸ (emphasis added). This was interpreted by Mr. Small to mean first class accommodations, as well as other travel amenities, despite Smithsonian policies to the contrary. While there is no support within the written agreement for Mr. Small's interpretation, no one – not the Regents, the Compensation Committee, the Audit and Review Committee, the Chief Financial Officer, the General Counsel, nor the outside auditors – questioned Mr. Small's expansion of his contract rights.

One clear example of Mr. Small's excessive travel expenses and his disregard for Smithsonian policy was his chartering a private jet, at a cost of \$14,000, to fly to San Antonio,

⁴⁸ Employment Agreement ¶ 8, attached as Exhibit 5.

Texas to receive a “Golden Plate Award” from the American Academy of Achievement⁴⁹ on Saturday, May 5, 2001 and return to Washington the next day to attend a Board of Regents’ committee meeting on Sunday and a Board meeting on Monday. Mr. Small's stated rationale for using a charter jet, rather than flying commercial, available at a fraction of the cost, was his need to attend the Board committee meeting scheduled for Sunday afternoon. Even though a commercial flight was available that would have allowed Mr. Small to return to Washington late Sunday morning, with two hours to spare before the committee meeting and 20 hours before the Board meeting, he rejected this option, the IRC learned, because he feared any delay, either in San Antonio or in making a connecting flight, would make him miss or be late for the committee meeting.⁵⁰

When *The Washington Post* reported on the extravagance of this chartered flight, it noted, on the basis of statements from Smithsonian personnel, that Mr. Small had paid for the jet himself out of a separate fund he had personally funded at the Smithsonian. There was, however, no such fund, and the flight was paid for from several Smithsonian funds. Moreover, Smithsonian management had directed accounting staff to alter its accounting records.⁵¹

The IRC analyzed the recent investigation of such expenses by the Smithsonian’s Inspector General.⁵² In the summer of 2006, the Smithsonian chose Cotton & Co. for a review of

⁴⁹ The American Academy of Achievement is an organization headed by Northern Virginia businesswoman Catherine Reynolds and her husband Wayne which, according to press accounts, was established to honor "superachievers." A few days after Mr. Small received the award, Mrs. Reynolds announced a \$38 million gift from the charitable foundation that bears her name to the Smithsonian to create a hall of achievement for prominent Americans. The gift was later withdrawn after strong objections from Smithsonian curators and others.

⁵⁰ Exhibit 17.

⁵¹ Exhibit 18.

⁵² The current Inspector General was provided a draft of the Report and an opportunity to comment. She provided written comments to the Committee, which are attached as Exhibit 19. The Committee gave due

the following: (1) whether the expenses of Small and Gary Beer, the Chief Executive Officer of Smithsonian Business Ventures had been properly accounted for and (2) whether the expenses of the Secretary and the Chief Executive Officer of SBV have been reasonable in the context of the purpose of the expense and the mission of the Smithsonian and SBV, respectively.

The statement of work called for Cotton & Co. to opine as to the reasonableness of expenses.⁵³ Cotton & Co. and the Inspector General,⁵⁴ however, later agreed that Cotton & Co.'s work instead would be limited to a review of whether expenses and compensation of the Secretary and Chief Executive Officer of SBV conformed to Smithsonian's agreed-upon procedures ("**AUP**"). In contrast to an audit, an AUP engagement does not determine whether expenses are properly incurred and recorded in an absolute sense, but rather whether the expenses were incurred and recorded in accordance with an organization's policies.

This limiting of Cotton & Co.'s engagement had two undesirable effects. First, it meant that the Smithsonian would not obtain a professional opinion as to whether the expenses and compensation of the Secretary were reasonable. Second, by using an AUP, it afforded the Smithsonian an opportunity to influence the results in a manner that would have been precluded had the original request been honored.

If the clear meaning of "fly first class" were applied to Mr. Small's travel expenditures, his expenses for accommodations, food, car services and other items would have been limited to the Federal Travel Regulation limits.

consideration to these comments, but disagreed with them, and determined that no changes to the Report were warranted.

⁵³ Exhibit 20.

⁵⁴ Initially, the Smithsonian CFO intended to oversee the work of Cotton & Co. It was later agreed that such oversight role was best handled by the Inspector General.

A November 30, 2006 draft of the Cotton & Co. report shows that expenditures of \$43,310 in Mr. Small's mixed travel and other expenses (travel costs, furniture for the Secretary's office, catering, florists and other costs) were unsupported or had inadequate support.⁵⁵ In addition, Cotton & Co. identified \$54,911.97 in travel costs (primarily car services, the charter flight from San Antonio and some hotel costs) that it deemed unallowable under its understanding of Smithsonian policies, plus another \$68,665.40 in "other" unallowable expenses (more catering, a portion of expenses incurred by Mrs. Small on a trip to Cambodia with Smithsonian donors, florist charges, and Citibank credit card charges for which the Cotton & Co. report provides no description).⁵⁶ The total charges in the November 30, 2006 draft of the Cotton & Co. report that were either unallowable, were not supported or were inadequately supported came to \$210,197.89.

Cotton & Co. and the Acting Inspector General provided the November 30, 2006 draft report to the Secretary for comment and response. Under normal procedures, the Secretary would have been limited to calling any factual inaccuracies to the Acting Inspector General's attention and commenting on the report. The Acting Inspector General and Cotton & Co. would have determined if changes should have been made to the report and then they would have issued it.

Instead there were significant back-and-forth discussions among the Acting Inspector General, Cotton & Co. and the Secretary's office regarding his expenses, with the Secretary's staff suggesting several rounds of changes to the draft report and arguing that "fly first class" in

⁵⁵ Exhibit 21.

⁵⁶ *Id.*

the Secretary's employment agreement permitted Mr. Small to first class accommodations and meals, as well as car services whenever he traveled.⁵⁷

Eventually, Roger Sant, as Chair of the Executive Committee, signed a letter to Cotton & Co. dated December 7, 2006, drafted by Mr. Small's office, confirming that the "fly first class" provision permitted "the Secretary to be reimbursed for travel expenditures in excess of the Federal Travel Regulation limits, such as hotel daily ceilings and ground transportation choices, without requiring prior or specific justification or approval for those expenditures."⁵⁸ In this letter, Mr. Sant also acknowledges that the Smithsonian selected the transactions for review by Cotton & Co. and the Acting IG and that the Smithsonian confirmed that such transactions were business related.⁵⁹

Similar to Mr. Sant's representations, Mr. Small, Ms. Alice Maroni, the Chief Financial Officer, and Mr. Andrew Zino, the Comptroller, also acknowledged in a letter to Cotton & Co., dated January 4, 2007, that "[w]e are responsible for selecting the transactions for review" and ensuring that those transactions are business related.⁶⁰ From the Committee's interviews, it appears that the Smithsonian staff selected the transactions for review and determined the business nature of such transactions, without discussion or input with the Executive Committee or the other Regents.

Following the back-and-forth discussions among Cotton, the IG and the office of the Secretary, the scope of the Cotton review and its findings were substantially narrowed. In the Cotton & Co. report dated December 22, 2006, which was provided to the Audit and Review

⁵⁷ A sample of email correspondence is attached as Exhibit 22.

⁵⁸ Exhibit 23.

⁵⁹ *Id.*

⁶⁰ Exhibit 24.

Committee with a transmittal letter from the Acting Inspector General⁶¹, Cotton reported unsupported expenses or those with inadequate support for mixed travel and other costs had been reduced from \$43,310.49 to \$28,565.58.⁶² Unallowable travel expenses were reduced from \$54,911.97 to \$21,689.21 (primarily by removing costs for car services), and “other” unallowable expenses were reduced from \$68,665.40 to \$67,845.61.⁶³ In all, because of the objections of the Secretary and the representations from Mr. Sant, Ms. Maroni and Mr. Zino, the total of expenses that were either unsupported or which lacked adequate support, or which were unallowable, was reduced by nearly half, from \$210,197.89 to \$118,120.19.

The Committee would have expected the Acting Inspector General, as an independent internal investigator, to have determined the scope, transactions and standard of review, rather than having the key elements of the investigation determined by members of Mr. Small’s executive team. The Cotton & Co. report should have stated specifically that a large number of transactions were treated as “authorized” solely because the Secretary and the Smithsonian’s Executive Committee agreed that they interpreted “fly first class” to have a much broader meaning than the normal meaning of the words. The final Cotton report does not clearly state that the conclusions in the report were derived from these post-hoc interpretations by the Smithsonian.

Because at the time the report was being prepared neither the Acting IG nor the auditors from Cotton & Co. had a reporting relationship to the Board or the Audit and Review Committee, the Acting IG may have felt that she lacked the authority to reject the Secretary’s suggestions. The Committee, however, would have expected the Acting IG to have followed a

⁶¹ Exhibit 25.

⁶² Exhibit 26.

⁶³ *Id.*

more traditional and appropriate approach in preparing the report. Similarly, the Audit and Review Committee should not have permitted the scope and results of the review to be so influenced by Smithsonian management.

B. Mr. Small's Entertainment Expenses

The initial rationale that Mr. Small was to have a housing allowance because he would use his home and gallery for entertainment had long been ignored by the time of the Cotton report. Mr. Sant, in his December 7, 2006 letter, stated that “the employment agreement was intended to compensate the Secretary for imputed mortgage interest.” Because Mr. Sant was not on the Board at the time the 1999 agreement was signed, he apparently relied on others at the Smithsonian to provide him with this interpretation. It appears that, when he signed this letter, Mr. Sant did not have all the background information and relevant facts regarding the housing allowance and Mr. Small's very limited use of his residence for entertaining.

Apparently as a consequence of these assertions that the housing allowance was “intended to compensate the Secretary for imputed mortgage interest” with no reference to the original justification that Mr. Small would use his home for entertainment, the review by the Acting Inspector General and Cotton investigators of entertainment expenses was as limited as the review of Mr. Small's travel expenditures.

As discussed above, Mr. Small did a negligible amount of Smithsonian entertaining at his house, and the Committee believes that the housing allowance is properly classified as cash compensation, rather than as an entertainment expense. It is difficult for the Committee, in the limited time available and without a forensic audit, to determine the reasonableness of Mr. Small's entertainment expenses.

The Cotton report and the information culled by Cotton & Co. do provide limited access to information regarding Mr. Small's entertainment expenses. First, as with all of Mr. Small's expenses, the recordkeeping is incomplete, and there is insufficient detail to analyze the business purpose of many of the Secretary's expenditures. Second, a number of the entertaining expenses incurred by Mr. Small appear to be for internal staff-related events. It is unclear if Cotton & Co. reviewed all the records relating to entertainment of donors and potential donors in its limited "agreed-upon procedures" review. Finally, what is clear is that there was no collection or analysis of entertainment expenses of the Office of the Secretary by the accounting staff, the Audit and Review Committee, or the Board of Regents on any regular basis, if at all.

C. Mrs. Small's Travel Expenses

The Committee has a number of serious concerns about Mrs. Small's travel on behalf of the Smithsonian.⁶⁴ Mr. Small's employment agreement permits him to receive reimbursement for the costs of Mrs. Small's trip for the Smithsonian where "appropriate." The Committee understands that the Smithsonian did not analyze Mrs. Small's travel to ensure that the payment of her expenses were not taxable to Mr. Small under the Internal Revenue Code. Even if properly paid for by the Smithsonian under Mr. Small's contract, the reimbursements from the Smithsonian may still be taxable income to Mr. Small. Because the Smithsonian staff was not permitted to review any aspects of Mr. or Mrs. Small's travel and the Regents did not make any inquiries into such matters, there was a complete lack of oversight to ensure compliance with the income tax rules relating to Mrs. Small's travel.

⁶⁴ The Committee has attempted to piece together Mrs. Small's total travel expenses. Without doing an audit of the travel expenses of the Office of the Secretary, it is difficult to know the exact amount of her travel expenses paid for by the Smithsonian.

When an employer pays the travel expenses of an employee's spouse who travels with the employee on official business, this benefit is excludable from tax only if the spouse performs a bona fide business function on the trip. To the extent that there is no business purpose for the spouse's travel, the spousal travel expenses paid by the employer are includable in the employee's taxable income, and reportable on that employee's Form W-2 and on the tax-exempt organization's Form 990.

The courts have used a two-part analysis in determining whether a spouse has satisfied the business purpose test: (1) the dominant purpose of the spouse's travel must serve the employer's business, and (2) the spouse must actually spend a substantial amount of time assisting the accomplishment of the employer's purpose. The performance of simply "social function[s]" does not satisfy the business purpose test. Therefore, to be considered a bona fide business purpose, the spouse must do more than socializing or performing services of incidental benefit to the organization.

Where the spousal travel is taxable income to the employee and there is no contemporaneous written substantiation showing the tax-exempt organization's intent to treat the payment as consideration for services (for example, on the employee's Form W-2 or in his or her employment agreement), such payment is treated as an automatic excess benefit transaction (with penalties being imposed on board members or senior executives who approved the reimbursement) unless the organization can establish that the payment was received in exchange for other consideration.

Therefore, to ensure that no excess benefit transactions have taken place, Mrs. Small's prior travel should be reviewed to determine whether it satisfies the business purpose test

described above.⁶⁵ If Mrs. Small's travel is found not to have had a bona fide business purpose and it was not previously documented as compensation (i.e., on Mr. Small's Form W-2 or on the organization's Form 990), then Mr. Small's Form W-2 and the organization's Form 990 should be amended to reflect this increased income. If these amendments are made prior to the beginning of any IRS examination of Mr. Small or the Smithsonian for the years in which these benefits were provided, then they would not be considered an "automatic excess benefit" subject to penalties and reportable as an excess benefit on the organization's Form 990.

⁶⁵ The Committee understands that the Smithsonian has begun this process.

BOARD OVERSIGHT OF MR. SMALL

Through late 2006, the impression the IRC has from its interviews and research is that the Board failed to exercise sufficient oversight. The Committee was told that Secretary Small worked to cut off direct communications between the Regents and senior Smithsonian management. He exercised strong control over the information being presented to the Regents. He attended all Committee meetings and, according to some, even ran some of them. The Committee was told that Mr. Small actively forbade employees from sharing concerns with the Regents and, to some extent, from even communicating with them. He would not permit the General Counsel, the Inspector General or the CFO to contact the Board directly. He even refused the Inspector General's request to send her audit reports to the Board.

A. Mr. Small's Compensation Was Not Approved by the Board for the 2000-2003 Period

For the years 2000 through 2003, the Board did not formally approve the Secretary's compensation. The Office of the Secretary appears to have taken the position that the Executive Committee had the authority to approve the Secretary's compensation as a result of its power to act on behalf of the Board when the Board is not in session. This position is contrary to the Smithsonian's Charter and Bylaws, as well as sound corporate governance principles. The Committee finds it troubling that the Executive Committee followed this procedure and that the full Board never questioned the practice.

The Smithsonian Bylaws, like the bylaws of many organizations, permit the Executive Committee to act between board meetings on matters that do not require full Board approval:

The Executive Committee shall have and may exercise all powers of the Board of Regents when the Board of Regents is not in session, except those expressly reserved to itself by the Board of

Regents, provided that all such proceedings shall be reported to the Board of Regents when next the Board meets.⁶⁶

This grant of interim authority, however, does not apply to approval of the compensation of the Secretary because the Smithsonian Charter reserves that power to the Board: “The Secretary and his assistants shall, respectively, receive for their services such sum as may be allowed by the Board of Regents.”⁶⁷

The Smithsonian’s auditors requested evidence that the Secretary’s compensation was approved by the Board in 2003.⁶⁸ The IRC has found no such evidence. The full Board of Regents first approved Mr. Small’s compensation in 2004. Based on interviews and evidence collected, the Regents were not provided with full details of Mr. Small’s compensation and the Regents understood that Mr. Small had received only modest increases in compensation, keeping his total compensation below the 50th percentile. As discussed above, this was not correct. Mr. Small’s total cash compensation, \$774,358 in 2004, was well in excess of the 50th percentile of the comparison group hand-picked by Smithsonian management.

B. The Board Failed to Respond to “Red Flags” and Exert Necessary Oversight

Based on the limited information presented to the Board by Smithsonian management, it might have been reasonable for the Regents to assume that things at the Smithsonian were generally going well. But throughout Secretary Small’s tenure, a number of serious issues were raised that should have prompted detailed questions from the Board, if not an external review by the Inspector General or an outside auditor.

As early as 2001, *The Washington Post* and others in the media questioned Mr. Small’s excessive spending, noting, as discussed above, the use of a privately chartered plane for

⁶⁶ Smithsonian Bylaws § 3.01, attached as Exhibit 27.

⁶⁷ Smithsonian Charter § 48, attached as Exhibit 28.

⁶⁸ Exhibit 29.

Smithsonian business. Yet the minutes and transcripts of the Board meetings give no indication that the Regents ever discussed, let alone investigated, the chartered plane incident. Had the Board done so, it would have learned, as the Committee did, that there was a viable commercial flight available (contrary to Mr. Small's claim), Mr. Small did not pay for the plane as he claimed, but rather the Smithsonian paid for it, and Smithsonian management instructed the accounting staff to alter travel reimbursement records to obscure this fact.

In May 2001, Mr. Small negotiated a gift of \$38 million from the Catherine B. Reynolds Foundation to finance a permanent exhibition at the National Museum of American History to commemorate the achievements of prominent Americans.⁶⁹ The gift was highly criticized by a group of Smithsonian's curators and scholars who questioned the degree of control Ms. Reynolds would have over the project (including the power to recommend 10 of the 15 members of the panel that would determine which individuals would be featured in the exhibition, as well as other supervisory powers in the development of the exhibition).⁷⁰ Although Mr. Small and other top-ranking Smithsonian officials claimed that the Smithsonian would have ultimate control over the nature of the exhibit, the Smithsonian community was up-in-arms regarding the loss of curator control of a major exhibit. Due to the controversy, Ms. Reynolds withdrew the gift in February 2002.⁷¹ Small's handling of the gift was considered a "debacle"⁷² and led outsiders to question Mr. Small's abilities to lead the Smithsonian.⁷³ In response, the Regents revised grant

⁶⁹ Jacqueline Trescott, Smithsonian Toasts \$38 Million Donor, WASH. POST, May 10, 2001 at C3.

⁷⁰ Jacqueline Trescott, Smithsonian Gifts With Strings Alarm Some Scholars; Secretary's Dealings With Big Donors Questioned by Staff, WASH. POST, May 26, 2001 at C1.

⁷¹ Jacqueline Trescott, Smithsonian Benefactor Cancels \$38 Million Gift, Wash. Post, Feb. 5, 2002 at A1; *see also* 60 Minutes – CBS News, Who is Catherine Reynolds? (Dec. 2002), *available at* <http://www.cbrf.org/video/60min.html>.

⁷² Larry Van Dyne, Money Man, WASHINGTONIAN, Mar. 2002.

⁷³ Editorial, Smithsonian Pluses and Minuses, N.Y. TIMES, Feb. 7, 2002 at A28 ("there is reason to question [Small's] leadership").

approval processes to include Board approval in certain instances, but there was no additional inquiry into the apparent lapses in judgment that lead to the controversy.

In October 2001, Milo Beach, the long-standing director of the Freer and Sackler galleries of Oriental art resigned, citing Small's preference for "good administrators" over scholars, giving the impression, Beach said, that the secretary viewed "the life of the mind with astonishing indifference."⁷⁴ There was also criticism from within the Smithsonian regarding Mr. Small's oversight, or lack thereof, of the SBV, with a number of museums paying SBV not to run their museum's shops and other business ventures. And finally, in 2004, Secretary Small pled guilty to the illegal importation of bird feathers into the United States.⁷⁵

After these public reports of misconduct, possible unapproved use of funds and mismanagement, the Board should have commissioned and overseen an independent, objective review of the issues that had been raised, without any involvement of the Secretary. Rather than doing this, the Board allowed Mr. Small to maintain control over the Board and its processes. Mr. Small continued to dominate committee meetings, set meeting agendas, and determine, without informing the Board, who would contact the Regents and what information would be provided them. During Mr. Small's tenure, it often appeared that the Board reported to him rather than the other way around. The Committee was told by one Regent that the Secretary "did not listen to the opinions of the Regents" and "did not seek input from the Regents in decision making." Another commented that the Secretary did not seek advice, only approval.

⁷⁴ Larry Van Dyne, Money Man, WASHINGTONIAN, Mar. 2002.

⁷⁵ In January 2004, Mr. Small pled guilty to a misdemeanor violation of the Migratory Bird Treaty Act arising from his 1998 purchase of a "\$400,000 collection of tribal articles that contained 219 items with endangered feathers." Jacqueline Trescott, Smithsonian's Small Still Awaits Word on Community Service, WASH. POST, Feb. 23, 2005, at C1. Small was sentenced to two years' probation and 100 hours of community service, and was required to submit letters of apology to national publications. Jacqueline Trescott, Small Gets 2 Years' Probation; Smithsonian Secretary Bought Protected Artifacts, WASH. POST, Jan. 24, 2004, at A1.

Mr. Small's management and control of the Board had an adverse impact on effective oversight by the Regents. In addition, the former Chancellor of the Smithsonian ran the Board meetings on a very tight schedule, limiting the number of comments and questions any Regent was permitted to ask and moving quickly through the afternoon agenda. The former Chancellor's desire to avoid lengthy meetings allowed only for limited debate by and discussion among the Regents. Therefore, their ability to analyze issues and get behind the well-orchestrated materials provided to them by the Office of the Secretary was compromised.

It was only after several years that the Smithsonian's Acting Inspector General and Chief Financial Officer finally retained an independent auditor to evaluate the Secretary's expenses. The resulting report, however, as with the compensation consultants' studies, was controlled by Smithsonian management's formulation of the scope of the assignment. Moreover, after receiving the Cotton & Co. report, the Regents passed two resolutions, both of which approved retroactively expenses that the Cotton & Co. consultant had challenged. Evidence collected by the Committee shows that these resolutions were written in the Office of the Secretary, which, in effect, controlled the outcome of this review.

In defense of the Regents, it must be noted that neither the Secretary's office nor the Acting IG provided the Audit and Review Committee with the full details of the Cotton & Co. work. The Regents received only the much-sanitized final report and a transmittal letter from the Acting Inspector General, along with an even-more innocuous summary of just over one page prepared by the Secretary's office.⁷⁶ With this limited information in front of them, the Audit and Review Committee approved the resolutions prepared by Mr. Small and recommended them to the full Board of Regents. The Committee believes that the members of the Audit and Review

⁷⁶ Exhibit 30.

Committee and the Regents, in fully exercising their fiduciary duties, should have been more diligent in understanding how the Cotton & Co. report was prepared, questioning the Acting IG and Cotton & Co. investigators and understanding the scope of their investigation, along with the limitations placed on, and the assumptions used in formulating, the report.

**PARTICIPATION ON OUTSIDE BOARDS AND
ABSENCES FROM THE SMITHSONIAN OFFICES**

One of the most disturbing failures of governance and oversight uncovered by the Committee in its investigation relates to the service on outside boards by Secretary Small and Deputy Secretary Burke, the amount of time spent by them, especially Ms. Burke, on these outside duties, and the leave policies and practices that permitted the two top executives of the Institution to be frequently absent from the office without the knowledge or approval of the Board of Regents. Serving on outside boards – profit and nonprofit – may provide benefits to senior executives: exposure to leading governance practices, sharpening of strategic planning skills, connecting with potential donors and mentors. But the potential for conflicts of interest, or perceptions of such conflicts, raises serious issues for those who serve in executive capacities at entities largely funded by taxpayer dollars.

A. Mr. Small's Board Service

Mr. Small's contract provided that he could serve on up to two outside boards, and retain the income from such service, subject to approval by the Executive Committee and review by the General Counsel, as the Chief Ethics Officer.⁷⁷ Throughout his tenure as Secretary of the Smithsonian, Mr. Small served on the Boards of the Chubb Corporation ("**Chubb**") and Marriott International Inc. ("**Marriott**"), earning \$642,925 in cash compensation, \$3.5 million in stock compensation and \$1.8 million in stock option compensation during this period.⁷⁸ The Committee has not found, and was not provided with, any formal approval by the Executive Committee of Mr. Small's service on the Chubb and Marriott boards or review by the General Counsel. Some current and former members of the Executive Committee, and most Board

⁷⁷ See Employment Agreement, ¶ 9, attached as Exhibit 5.

⁷⁸ A chart detailing Mr. Small's compensation from outside service is listed in Exhibit 31.

members, admitted knowing, through personal knowledge, press reports or anecdotally that Mr. Small served on one or both of these boards, but there was no systematic briefing of, and review and approval by, the Executive Committee or the Regents of Mr. Small's outside board service. Based on calendars and other records made available to and collected by the Committee, it appears that Mr. Small was absent from the Smithsonian for 64 days for-profit board service during his tenure.⁷⁹

As an employee of the Trust, Mr. Small was not covered by federal regulations that prohibit outside for-profit board service by high-level government officials. In addition, the lack of a leave policy for Mr. Small allowed him to take unlimited time off work to fulfill his service on corporate boards. The same is true for Ms. Burke.

In analyzing Mr. Small's outside board service, it is particularly important to understand the issues raised by his service on the Chubb board, and how this was handled by the Smithsonian. When he became head of the Smithsonian, Mr. Small was already serving on the Chubb board. Ms. Burke was also serving on the Chubb board when she was appointed Deputy Secretary and Chief Operating Officer. The Smithsonian purchases insurance from the Chubb. It is an obvious conflict of interest for an organization to purchase insurance from a company on whose board the organization's chief executive and chief operating officers sit. To be handled properly, such a conflict must be fully disclosed, and the conflicted employees must be removed from any involvement in decisions regarding the organization's dealings with the company on whose board these employees sit. When the conflicted employees are the organization's senior executives, the decision for doing business with the company should be removed from lower-level employees, who might believe themselves obligated to steer business to a company on

⁷⁹ *See id.*

whose board their superiors serve. The final decision to do business with such a company should rest with the organization's board. This is a "best practice" of governance that the Smithsonian did not follow.

When Mr. Small was chosen as the Secretary in 1999, Wesley S. Williams Jr., the Chair of the Search Committee, knew, and at least some other members of the Search and Executive Committees appear to have known, that Mr. Small served on the Chubb and Marriott boards. There is, however, no indication that all members of the Executive Committee knew of Mr. Small's outside board service or ever formally approved his service on these boards, as required by his employment agreement. Nor did the Board inform any members of the Smithsonian staff of Mr. Small's board service or establish any process for monitoring and handling conflicts of interest that might arise.

Senior Smithsonian officials and employees with contracting authority are required to complete conflict of interest forms each year. Mr. Huerta, as the Chief Ethics Officer, collects these forms (over 1,000 of them each year) and he and his staff review them and follow-up on all potential conflicts uncovered through this process. From the time Mr. Huerta joined the Smithsonian in 1995 until 2004, he, as the Chief Ethics Officer, did not receive copies of conflict forms for the Secretary and his senior staff. These employees would send their forms directly to Mr. Hobbins. Mr. Huerta was not allowed to see the disclosure forms or to know their contents. In its interviews of current and former Regents, the IRC was told in every instance that the conflict forms were not provided to the Board, and none of the Regents recalls being informed that such forms were available for their review. It appears, therefore, that the conflict of interest forms of senior executives were not being reviewed and potential and actual conflicts were not

being discussed by the Smithsonian until 2004, when the Board decided that Mr. Huerta should receive and review all conflict disclosure forms.

While Mr. Huerta did not receive conflict of interest forms until 2004, he learned earlier from office conversations of Mr. Small's and Ms. Burke's service on the Chubb board. Around the same time, he also learned of Ms. Burke's service when she returned from a Chubb board meeting to deal with a Smithsonian crisis. After these events, Mr. Huerta asked Mr. Small to formally recuse himself and Ms. Burke from the purchase of the Institution's insurance by sending such a letter to Mr. Huerta, as Chief Ethics Officer. Although Mr. Small agreed, Mr. Huerta never received such a letter. The Committee understands from its interviews that Mr. Small never discussed the request with Ms. Burke.

Mr. Huerta did contact the Treasurer, who is responsible for purchasing the Smithsonian's insurance. Mr. Huerta told the Treasurer about the conflicts. The Treasurer assured Mr. Huerta that neither Mr. Small nor Ms. Burke had ever been involved in the purchase of insurance. Mr. Huerta and the Treasurer agreed to wall-off Mr. Small and Ms. Burke from any such decisions in the future. Mr. Huerta never contacted Ms. Burke about this issue and never asked Mr. Small about it again.

Mr. Huerta also did not report these conflict issues to the Audit and Review Committee. It was his understanding that the Audit and Review Committee saw the disclosure forms each year and that the Committee knew that Chubb provided insurance to the Smithsonian. Mr. Huerta, therefore, assumed that the Audit and Review Committee, with full knowledge of the facts, had chosen not to take any action on the conflicts issue. It is unclear to what extent Mr. Huerta's assumptions were correct.

B. Mr. Small's Leave from the Office

The Smithsonian had no uniform leave policy for its senior executives. While leave for some senior executives was specified in their appointment letters, neither Mr. Small, nor Ms. Burke, had any limits on their leave. From its interviews, the Committee understands that all or most of the Regents were never informed and did not know of the absence of a policy or the unlimited leave for Mr. Small and Ms. Burke. The absence of a uniform leave policy appears to pre-date Mr. Small's appointment as Secretary.

The Committee finds a policy of unlimited leave for senior executives unacceptable, especially without very close oversight by the Board. According to Mr. Small's calendar, in each full year of his employment except 2006, he took more than 10 weeks of vacation. (In 2006, he took eight weeks.)⁸⁰ In addition, he took 64 days of leave during his time with the Smithsonian to fulfill his service on the Chubb and Marriott boards. Moreover, it appears that Mr. Small did not make himself regularly available during these extended absences from the office. The Committee learned from its interviews that Mr. Small was frequently out of the office and unreachable when needed for Smithsonian business.

It is obviously not appropriate for the Smithsonian to have an unlimited leave policy for senior staff. The concern is intensified by the fact that the Board was unaware of both the policy and the excessive use of personal leave by Mr. Small. Moreover, the difficulties for the Smithsonian of an absent chief executive were exacerbated by Ms. Burke's even more frequent absences from the office.

⁸⁰ A chart detailing Mr. Small's total time out of office is attached as Exhibit 32.

C. Ms. Burke's Outside Activities

More disturbing to the Committee are Deputy Secretary Burke's extensive outside activities and their effect on her ability to focus on the significant duties she has at the Smithsonian. While a full-time employee of the Smithsonian, in its second most senior executive position, Ms. Burke serves on two outside for-profit boards (Chubb and Wellpoint), serves on more than a dozen nonprofit boards and commissions, and continues to serve as an active member of the faculty of Harvard's Kennedy School of Government.

From 2000 through 2006, these outside activities provided her with \$1.2 million in cash compensation, \$3.5 million in stock compensation and \$5.6 million in stock option compensation⁸¹ – far exceeding her salaried compensation from the Smithsonian, currently \$400,000 annually. Further, an analysis of her calendar and other data obtained by the Committee show that she spent more than 400 work days away from her office performing non-Smithsonian activities.⁸² This represents almost two full work years or about one-quarter of her normal working time during her tenure with the Smithsonian.⁸³

As promised, the Committee delivered to Ms. Burke's counsel its preliminary findings regarding her outside activities, including both outside board service and leave. In letters to the Committee's counsel, Ms. Burke's counsel contended that some of the preliminary findings were not accurate.⁸⁴ The Committee reviewed again the available documents, and concluded that certain adjustments needed to be made. Those adjustments are reflected in this report.

⁸¹ A chart detailing Ms. Burke's outside compensation is attached as Exhibit 33.

⁸² *See id.* Ms. Burke's annual vacation, which averaged about four weeks during this time period, is not included in this estimate.

⁸³ Attached as Exhibit 34 is a chart compiled by the IRC detailing Ms. Burke's total time out of office.

⁸⁴ Exhibit 35.

Ms. Burke told the IRC that she works 24 hours a day, seven days a week and that she is and has always been available by email or cell phone whenever Smithsonian staff need to contact her. She also states that she always takes work with her on vacation. Those interviewed by the IRC indicated that Ms. Burke has a strong work ethic. In interviews with the Committee, many employees noted that, unlike Mr. Small, Ms. Burke was available by phone and email when she was out of the office. There is, however, no substitute for the in-person presence of an organization's Chief Operating Officer on a daily basis. This position, more than many others, requires one's presence in the office, especially given the size and complexity of the Smithsonian. Clearly, Ms. Burke has not been satisfying this very basic job requirement in a normal manner. Moreover, the compensation issue here goes well beyond perception. If one's income from outside sources far exceeds the income from his or her main employment, it is difficult to believe that the primary employer is getting the full attention it deserves.

It is the IRC's understanding that Ms. Burke's outside board activities were approved by Mr. Small, not the Board of Regents, and there is no indication that the Regents knew the extent of Ms. Burke's outside activities. The IRC questions Mr. Small's judgment in approving such extensive outside commitments and his failure to inform the Board. Moreover, Ms. Burke disclosed her outside activities on her annual conflict of interest forms and provided the forms, through 2003, to Mr. Hobbins in the Secretary's office and, from 2004, to Mr. Huerta. There is no evidence, however, that these forms were provided to the Board or that the Board was informed of the contents of such forms. The Board's failure to uncover such a significant issue

highlights the extent to which the Board was kept in the dark and failed to ask very basic questions about the Smithsonian's operations.⁸⁵

As a general rule, the Smithsonian has been most careful in monitoring the outside work of its employees. The exceptions have been Mr. Small and the Deputy Secretary. As discussed above, these outside commitments have taken these individuals away from the Smithsonian during working hours for significant periods of time. The Board must develop a uniform policy on outside work and the Board itself must carefully monitor this when it comes to the leadership of the Institution. The IRC sees little benefit to the Smithsonian in allowing its senior executives to serve on the boards of for-profit corporations. Accordingly, as discussed below, the IRC recommends that the Board prohibit its executives from serving on the boards of for-profit corporations.

⁸⁵ Ms. Burke's counsel, in his June 7, 2007 letter to the Committee (attached as Exhibit 35), noted the following:

"I thought it very important that the Committee's report make plain that Ms. Burke accepted employment with the Smithsonian on the express understanding that she could engage in various outside activities, including teaching at Harvard University and serving on boards of profit and non-profit organizations.... [I]t is essential that the report make clear that Ms. Burke disclosed her outside activities and the compensation she received in her annual Smithsonian financial disclosure statement, and that she was never asked to curtail those activities."

INTERNAL FINANCIAL CONTROLS

Internal financial controls are systems of policies and procedures that create reliable financial reporting, promote compliance with laws and regulations and achieve effective and efficient operations. These systems should include:

- handling funds received and expended by the organization
- preparing appropriate and timely financial reporting to the board and management
- conducting the annual audit
- evaluating staff and programs
- implementing personnel and conflict of interest policies.

In the nonprofit context, an essential element of good financial controls is a system for assuring that expenses are properly documented, support the organization's mission and are not lavish or extravagant. The IRC found that the Smithsonian's systems for handling the expenses of the Secretary and other members of senior management were not adequate for providing this assurance. Basic failures of internal controls put the Smithsonian and its Regents at risk of liability and adverse publicity.

A. No Review of Secretary's Expenses

Basic internal controls require that the expenses of everyone in an organization be subject to review by someone in the organization. With respect to the chief executive of an organization, such review needs to be done by someone with access to the organization's audit committee. It appears that, until the most recent review by Cotton & Co., neither the Chief Financial Officer nor the Inspector General has reviewed the Secretary's expenses for reasonableness over the last seven years. As discussed above, the Cotton & Co. review was not an audit of such expenses and the issue of reasonableness had been negotiated out of the review.

B. No Approval for Exceptions to Smithsonian Policies

The Smithsonian had detailed travel and other expense policies and procedures that applied to everyone, including the Secretary. Mr. Small had negotiated a contractual right to first class air travel, which would not have been permitted under the Smithsonian's policies except in extraordinary circumstances, though he remained subject to the remainder of the Smithsonian policies. The IRC learned that at the beginning of 2000 and 2001 the Executive Assistant signed blanket authorizations for Mr. Small.⁸⁶ The Office of the Secretary has also asserted that Mr. Small had the authority to waive the application of the Smithsonian policies as they applied to him, though it cited no authority for this position. Such blanket authority eliminated accountability and critically undermined the internal controls of the Smithsonian.

The IRC found that several transactions involving Mr. Small, such as the charter jet to and from San Antonio and certain of Mrs. Small's travel, should have been subject to prior review and approval outside the Office of the Secretary. The blanket authority exercised by the Office of the Secretary in spending Smithsonian funds without any objective determination as to whether these funds were being spent in support of the Smithsonian mission and in accordance with Smithsonian policies represented a significant failure of internal controls.

C. Inadequate Record Keeping

Nonprofit organizations must properly document expenses incurred in the conduct of the organization's activities to evidence reasonableness and relatedness to the mission. With respect to Mr. Small's expenses, the Smithsonian failed to do so. The backup documentation to support Mr. Small's expenses was maintained in the Secretary's office, rather than with the Chief Financial Officer, so the Chief Financial Officer essentially had no way to audit the Secretary's

⁸⁶ Exhibit 36.

expenses. There was never a review or even spot-checking of the expense records maintained by the Office of the Secretary,

D. Insufficient Accounting Resources

The accounting staff of the Smithsonian has been reduced by about fifty percent during Mr. Small's tenure. As KPMG noted in its recent audit letter, accounting personnel in the Office of the Comptroller were "stretched thin."⁸⁷ The IRC is thus sensitive to the fact that the accounting staff was trying to fulfill its increasingly more difficult internal financial control responsibilities with less and less resources. It was particularly troubling to learn that the Smithsonian had reduced its accounting personnel at the same time that it was implementing a new accounting system, as the implementation of new systems generally requires a ramp-up of personnel.

E. Ineffectiveness of Accounting Staff

The IRC found no evidence that anyone on the accounting staff of the Smithsonian, including the Chief Financial Officer, ever raised any concerns that the Office of the Secretary was compromising the Smithsonian's internal controls. Raising such concerns about an organization's chief executive, while undoubtedly difficult and fraught with personal risk, is nonetheless the correct action for a chief financial officer.

In 2002, the Audit and Review Committee considered whether any parts of the Sarbanes-Oxley legislation should be adopted by the Smithsonian. It appears that the Board took no action to implement any aspects of this legislation.

⁸⁷ Letter from KPMG to The Audit and Review Committee of the Board of Regents and the Inspector General, dated February 20, 2007, attached as Exhibit 37.

ROLE OF THE “GATEKEEPERS”

A. Role of the Smithsonian Inspector General

The Office of the Inspector General (“**OIG**”) in the Smithsonian Institution is an independent, objective office within the Smithsonian. The OIG is charged with conducting and supervising audits and investigations relating to Smithsonian programs and operations and preventing and detecting fraud, waste, and abuse in Smithsonian programs and operations. The Inspector General at the Smithsonian is subject to provisions of the Inspector General Act of 1978, as amended, which provides what is expected of an Inspector General.⁸⁸

- Independence to determine what reviews to perform.
- Access to all information necessary for the reviews.
- Authority to publish findings and recommendations based on our reviews.

For the period 2000 to the present, there have been three Inspectors General at the Smithsonian. Thomas Blair served as the Inspector General through the end of 2004. Debra Ritt, the former Deputy Inspector General at the Department of Transportation, served as Inspector General from January 2005 through June 2006. A. Sprightley Ryan, the current Inspector General, previously served as counsel to the former Inspector General on a part-time basis, and became Acting Inspector General in July 2006. She was appointed Inspector General in March 2007. Ms. Ritt told the IRC that it became evident that she could not carry out the full duties and responsibilities of an IG, and she left the Smithsonian after 18 months.

From 2000 until 2006, the OIG performed no audits or investigations of any matters relating to executive compensation or expenses at the Smithsonian. This absence of activity by

⁸⁸ 5 U.S.C.A. Appx. §1 (2001).

the OIG is surprising. First, the Inspector General is expected to perform periodic audits of expenses to satisfy his or her obligation to detect fraud. Second, public allegations regarding the inappropriate use of Smithsonian funds for travel by the Secretary's office should have prompted an investigation by the OIG. In particular, in August of 2001, *The Washington Post* reported that a Smithsonian spokesperson had stated that Small had created a discretionary fund with his own money "to pay for extraordinary expenses," and had used \$14,600 from this fund to pay to charter a Learjet.⁸⁹ This is inaccurate because the jet was paid for with Smithsonian funds. The Committee finds it very troubling that these public allegations of wrongdoing did not prompt an OIG investigation.

Until June 2006, the Inspector General reported to the Secretary rather than the Board of Regents. In 2006, Mr. Small moved the OIG's office out of the District to Crystal City in Virginia. Removing the Inspector General from the Smithsonian's central offices has the inevitable effect of eliminating the day-to-day interactions with Smithsonian staff that are conducive to the effective performance of the OIG's duties. Moreover, not having the OIG present in the Smithsonian's central office would also appear to violate at least the spirit of the Inspector General Act of 1978, as amended, which requires the Secretary to "provide the [OIG] with appropriate and adequate office space at central and field office locations."⁹⁰

B. Role of the General Counsel

The General Counsel should serve a "gatekeeper" role by monitoring compliance of senior management with laws and policies. This is particularly true at the Smithsonian where the General Counsel also serves as the Chief Ethics Officer. The General Counsel, however, did not

⁸⁹ WASH. POST, Aug. 7, 2001, at C3.

⁹⁰ 5 U.S.C.A. Appx. § 6(c) (2001).

play this monitoring role because Mr. Small not only isolated him from the Board of Regents, but also blocked him from having any meaningful oversight of the Secretary's office. The Smithsonian's own Charter further inhibited the General Counsel from playing the gatekeeper role because it designates the Secretary, rather than the General Counsel, to be the corporate secretary of the Institution.

A telling example of Mr. Small's isolation of the General Counsel and his office occurred within weeks of the new Secretary's arrival at the Smithsonian. Soon after Mr. Small took office as the Secretary, he came, at Mr. Huerta's invitation, to talk at a staff meeting of the General Counsel's office. One of the staff attorneys asked Mr. Small how he saw the role of the Office of General Counsel under his leadership. It was reported to the Committee that Mr. Small responded that he did not think that lawyers served a constructive purpose and that the lawyers at the Smithsonian should, in effect, keep out of his way. The Committee was told that members of the General Counsel's office felt this set the tone for Mr. Small's interaction with the legal department throughout his tenure.

Another example of how Mr. Small ignored and worked around concerns raised by the General Counsel's office occurred as soon as he was hired. As one Smithsonian employee put it, right from the beginning, Mr. Small demonstrated an attitude that the rules did not apply to him. One of the first exhibits to be mounted under Mr. Small's leadership was an exhibit on the American Presidency. There was an amount budgeted for this exhibit that was approved by the Board of Regents. Prior to Mr. Small, if there were any significant deviations from a budget item approved by the Board, the staff was required, by the terms of the Board resolution, to go back to the Board for approval for a revised budget.

In planning the exhibit, Mr. Small announced his plan to reallocate funds to the exhibit from other budget items. According to information provided to the Committee, the General Counsel informed Mr. Small that he had to obtain Congressional permission and approval from the Board or the Executive Committee for such reallocations. Mr. Small was described as “mad” that a staff member had raised a roadblock to Mr. Small’s plans, and he refused to go back to the Board. He did seek Congressional authorization, but his request was denied.⁹¹

As with the accounting and finance and other staff, the staff of the General Counsel’s office was cut during Secretary Small’s tenure, as the size and complexity of the workload increased. This had the adverse effect of limiting the General Counsel’s office involvement in governance and ethics issues. The much-reduced staff of the General Counsel’s office was fully occupied with the day-to-day crises of providing legal support to a \$1 billion-a-year Institution. One tangible result of these cuts was the elimination of ethics training for employees by the General Counsel’s office. These cuts also made it difficult for the General Counsel to maintain a rigorous ethics program and prohibited him from having a dedicated lawyer responsible for ethics, conflicts of interest and governance issues, which, in the Committee’s view, can only strengthen oversight within the Institution.

⁹¹ Exhibit 38.

ROLE OF OUTSIDE AUDITOR

KPMG has served as the outside auditor for the Smithsonian for the last thirteen years. The IRC has reviewed the audited financial statements and KPMG management letters for the reporting years 2000-2006.

During that period, KPMG did not audit the expenses of the Secretary, either on its own initiative or at the request of the Board or the Audit and Review Committee. To its credit, as early as 2000, KPMG recommended that the Smithsonian “assign a high priority to obtaining funding for a new core financial system and to developing a timetable for implementation of that system.”⁹² In 2002, the Smithsonian began to implement the KPMG recommendation by installing the PeopleSoft system. The Smithsonian accounting staff was reduced by almost half in the same year. This reduction in staff, coming at a time when staff needed to be increased to implement the new system, should have been a warning that there were inadequate resources for the implementation of the new system.

The chronic understaffing of the accounting department over the 2000-2006 period was not consistently noted by KPMG until its most recent management letter, when such understaffing had finally risen to the level of a reportable condition: “The reportable conditions noted during our audit ... relate to the accounting resources and staff capacity.”⁹³

The Smithsonian also failed to implement another recommendation made by KPMG in 2002:

The Smithsonian’s practices for communicating and documenting accounting policies and procedures have generally been informal. . . . We believe the Smithsonian would benefit from a

⁹² KPMG letter to The Audit and Review Committee of the Board of Regents dated April 4, 2001, attached as Exhibit 39.

⁹³ KPMG letter to The Audit and Review Committee of the Board of Regents dated February 20, 2007, attached as Exhibit 37.

more formal approach to the documentation of its accounting policies and procedures. Accordingly, we recommend that the Smithsonian consider assigning a team to assume responsibility for developing a comprehensive accounting policies and procedures manual in 2002. This manual would provide information about the application of significant accounting policies and guidance on related procedures, including requirements for documentation of the review/approval procedures performed. It could be made available on the network and would provide a valuable reference source for accounting and management personnel and a useful training tool for new employees or employees who change responsibility.⁹⁴

While the Smithsonian agreed with this recommendation, it apparently took limited action to develop the policies and procedures manual. Although the KPMG engagement partner had an annual meeting with Mr. Small, very limited progress resulted over a six year period. Five years after its first recommendation, KPMG was still calling for the development of the manual.⁹⁵ The Smithsonian, though supporting the concept of such a manual, did nothing, stating that “[f]unding and staffing limitations will limit our ability to develop and finalize this manual in the near term.”⁹⁶

In sum, while KPMG noted the weakness in internal controls at the Smithsonian as early as 2000, it was not an effective advocate for reform and action with its client. Suggestions were ignored. Yet KPMG waited over five years, until February 2007, to label the inadequacy of accounting resources and staff a “reportable condition.”⁹⁷ The IRC is concerned that KPMG may have had a complacent relationship with the Smithsonian.

⁹⁴ KPMG letter to The Audit and Review Committee of the Board of Regents dated April 9, 2002, attached as Exhibit 40.

⁹⁵ KPMG letter to The Audit and Review Committee of the Board of Regents dated February 20, 2007 (“we recommend the Smithsonian develop a plan and timetable for compiling and maintaining an accounting policies and procedures manual in 2007.”), attached as Exhibit 37.

⁹⁶ *Id.*

⁹⁷ “Reportable conditions” under standards established by the American Institute of Certified Public Accounts are matters that, in the judgment of the auditor, relate to significant deficiencies in the design

SMITHSONIAN BUSINESS VENTURES

In the course of its review, the Committee understands that there have been significant failures of internal controls and inappropriate conduct at SBV. For example, the Inspector General, in her review of executive compensation, found that SBV's accounting system had weaknesses.⁹⁸

Senator Grassley has indicated his desire for the Committee to conduct a review of the senior management of SBV and the appropriateness of compensation and benefits paid to senior management of SBV. While the Committee agrees that such a review is necessary and warranted, it is beyond the scope of the Committee's review. Based on the information collected by the Committee, however, there was inadequate oversight of SBV by Smithsonian senior management and the Board. Neither the Board nor the Smithsonian executives who sat on the SBV board, including the Chief Financial Officer and the Chief Operating Officer, has taken appropriate actions to remedy the deficiencies in governance and accounting controls at SBV, even though all acknowledged the widespread allegations of inappropriate activity and failures of internal controls at SBV.

or operation of internal control and could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with assertions of management in the financial statements. *Id.*

⁹⁸ Smithsonian Institution, Office of the Inspector General, Executive Compensation at Smithsonian Business Ventures I, Report No.A-06-02, January 19, 2007. As of the date of this report, the Inspector General had not released the second part of her report on SBV.

OVERALL ETHICAL TONE AT THE SMITHSONIAN

The ethics of an organization usually reflect the attitude and behavior of those in senior management. There was a clear indication that the Secretary and those whom he selected deemed themselves outside the Smithsonian's otherwise recognized ethics standards. Accordingly, given the "tone at the top" set by the Office of the Secretary, one might expect to find the absence of internal controls and ethical lapses to be pervasive at the Smithsonian. While it did not undertake a comprehensive review, the evidence the Committee did collect indicates that there does not appear to be major internal control issues at the Smithsonian as a whole, other than in the Office of the Secretary and at Smithsonian Business Ventures. Similarly, the Committee found no evidence to indicate that the strong ethical principles that have characterized the Smithsonian over the years have been compromised.

RECOMMENDATIONS

The Committee recommends that, wherever possible, the Board of Regents should implement the following recommendations by reorganizing its internal governance structures and procedures. The Committee, however, offers no legal opinion as to whether these recommendations can be implemented solely by the Board of Regents. If the implementation of any recommendation requires legislative action, the Committee urges the Board of Regents to promptly seek Congressional assistance.

1. The Regents Must Act Quickly to Address the Governance Crisis

The current crisis of governance at the Smithsonian and the resulting loss of public confidence necessitate urgent action by the Regents. To restore public and Congressional confidence, the Regents must devote substantial time and resources over the next several months to considering and then implementing the chosen governance recommendations from the IRC and the Smithsonian's Committee on Governance. To the extent that any of the recommendations discussed in this Report require Congressional action, the Regents should ask Congress to act quickly to address these recommendations with appropriate legislation. If the Regents meet regularly over the next few months, the IRC believes the necessary governance changes can be implemented by the end of the year.

2. The Expenses of Mr. and Mrs. Small Should be Subject to an Audit for Reasonableness and the Expenses of Senior Management Should Be Subject to Annual Audits

The Committee did not conduct a complete audit of Mr. Small's expenses. Rather, the Committee reviewed the work of Cotton & Co. and the backup materials for its review. Thus, there has been no independent audit of Mr. Small's expenses. If for no other reason than potential tax liabilities and automatic excess benefit excise taxes, the Committee recommends

that the Smithsonian have an independent auditor perform an audit of Mr. Small's expenses, as well as those attributable to Mrs. Small. The Committee believes this audit could be done expeditiously because the bulk of the work has been completed by Cotton & Co.

The Committee also recommends that the Audit and Review Committee of the Smithsonian undertake to have the expenses of senior management audited on an annual basis for compliance with Smithsonian policies and reasonableness.

3. **The Compensation of the Secretary Should be Reasonably Competitive and Transparent and Take Into Account the Smithsonian's Unique Nature**

Arguments have been made for a wide range of "appropriate" compensation levels for the Smithsonian Secretary. At the low end, some people have questioned why the Secretary should earn more than the Vice President of the United States (currently \$215,700), or alternatively the President (\$400,000). The rationale is that no federal employee earns more than these positions, and since more than seventy percent of the Smithsonian's budget comes from the federal government, these limits should apply as well. At the other extreme, others have argued that the Secretary should receive the salary of comparable for-profit CEO's.

The IRC finds neither of these extremes persuasive. The salaries for the President and Vice President of the United States in no way reflect the enormous responsibility and influence of these positions. Further, it is not uncommon in government-sponsored organizations to have individuals with specific abilities paid more than the leader of the related government. In many states, for example, the heads of the state universities are paid salaries well in excess of the Governor, and the coach of the football or basketball team is compensated well in excess of the university president.

Nor is comparison with the private sector appropriate. In the private sector, an individual capable of leading an organization as vast and complex as the Smithsonian would probably earn total compensation (salary, incentive compensation, stock compensation, and benefits) well in excess of \$1 million per annum.

The Smithsonian is not a private enterprise. Most of its funding is provided by the federal government with substantial help from private donors. Many of the individuals working there – scientists, curators, employees at the National Zoo, former Secretaries and others – have done so because of a love of their profession and the institution. Earnings are not their first priority. They recognize that as part of a nonprofit organization they cannot expect to earn what they could in the private sector. The Regents and the next Secretary should think this way as well. The Committee believes that such high compensation is inappropriate for a nonprofit executive, especially for an executive working at a nonprofit that receives significant government funding.

Given the special nature of the Smithsonian and the honor associated with being its Secretary, we acknowledge that a well-qualified individual, ready for a new phase in his or her career, might offer to serve as Secretary for a nominal salary. If this occurs it should be understood that the search for a new Secretary is not in any way limited by this possibility and that the Secretary's salary does not limit paying appropriately competitive salaries for other important positions at the Smithsonian – the undersecretaries, museum directors, key scientists, and other key staff members.

We consider it beyond our authority to provide specific guidance as to the specific compensation level for the next Secretary. However, in determining this level, we recommend that the Regents develop a compensation philosophy that is:

- **Transparent.** Whatever compensation is provided the Secretary, the amount of compensation and its elements should be reported clearly in filings with the federal government and in the Smithsonian’s annual report. The Regents should go beyond the minimum IRS requirements for reporting compensation on the Form 990, perhaps using a format similar to the “Compensation Disclosure and Analysis” now required by the SEC, clearly describing the organization’s compensation philosophy, the process used to determine executive pay, and each element of compensation for top officers.
- **Reasonable.** The Secretary’s compensation, and that of other senior positions at the Smithsonian, should be at levels that people with an understanding of general compensation practices for nonprofit managers in the Washington metropolitan area will agree are reasonable. Given the variety of views on what positions are worth, we do not expect that everyone will believe that whatever the Secretary is paid will be reasonable. But the Secretary’s compensation should appear reasonable to the Congressional Committees responsible for Smithsonian oversight and to the public at large. In setting the salary, the Regents and all other stakeholders, including Congress, must acknowledge that the Smithsonian is a remarkably varied and complex institution and that the leadership of the Smithsonian requires a range of knowledge, experience and skills – an understanding of science and art, the ability to manage complex organizations, the ability to raise substantial funds, diplomacy in dealing with Congress and other stakeholders, and the ability to integrate different organizational units while respecting their individuality.
- **Competitive.** One of the most important decisions the Regents will make is determining an appropriate comparison group on which to base the Secretary’s compensation package. One could selectively pick nonprofits – the Kennedy Center and the Getty Museum come to mind – to justify a very high level of compensation for the Secretary. The Committee feels that rather than a selective comparison, the appropriate group should include museums, universities, and other major nonprofits in the Northeastern United States with budgets of the size of the Smithsonian and activities of similar scope. Universities in the comparison group should emphasize public institutions, which like the Smithsonian receive substantial funding from governments.
- **Pegged at the 50th percentile (or median).** Smithsonian documents show that in the beginning of Secretary Small’s tenure, the Executive Committee targeted all management compensation at the 50th percentile. At Mr. Small’s urging, this was changed early on to the 75th percentile and a skewed comparison group was selected by Smithsonian management. This is not an acceptable approach. The Smithsonian’s management

compensation should be targeted at the median. Targeting the median compensation will also have the effect of lessening the impact of “outliers” in the peer group – both on the high and low side – from having a significant effect on determining the appropriate compensation level.

- **Reflective of the special nature of the Smithsonian.** Working at the Smithsonian is a privilege. Serving as its Secretary is an honor. If a candidate for the Secretary position cannot be hired without offering compensation that pushes the limits of reasonableness, he or she is not the right person for this position, regardless of qualifications.
- **Direct.** As with other Smithsonian employees, the Secretary should be compensated through salary, pension, and health benefits alone. As is the practice in some nonprofits, the Board may want to provide some additional pension benefit beyond the level capped by IRS regulations. But unless a housing supplement is required to compensate the new Secretary for moving from a location with a much lower cost of living than that of Washington, D.C., there is no need for a housing allowance. And if a housing supplement is provided, its purpose should be transparent – it should not be justified as reimbursement for entertaining potential donors.
- **Limited Perquisites.** The Secretary should be given no special travel privileges, or any other perquisites or benefits that are not available to other executives of the Smithsonian, except where the Board makes a determination in advance that such perquisites and benefits are reasonable and appropriate.

4. **The Smithsonian’s Policies Should Be Consistent With Federal Regulations and its Salary Schedule Should Be Consistent With Government Salary Schedules**

The Committee is concerned about the tendency of the Institution to embrace those federal regulations it finds convenient while ignoring others. For example, the Smithsonian sometimes denies requests filed under FOIA on the ground that it is not a federal entity, while, at other times, it grants FOIA requests. The IRC recommends that the Smithsonian affirmatively adopt policies to promote openness, transparency and effective governance consistent with federal regulations, such as FOIA, the Privacy Act of 1974, Chief Financial Officer Act of 1990, the Sunshine Act, personal financial disclosure requirements, the Ethics in Government Act and

conflict of interest rules. If the Smithsonian does not so act, Congress should consider appropriate legislation.

At the Smithsonian, some employees are paid using government salary schedules while others are paid from the Smithsonian trust. A further complication is that federal Smithsonian employees are prohibited from earning compensation greater than that provided by the federal General Schedule, which currently caps the salary of Senior Level/Senior Technical employees at \$154,600 per year (exclusive of bonuses), lower than federal SES employees in federal agencies who can earn up to \$168,000 (exclusive of bonuses). Apparently, this regulation is the result of a determination by the Office of Personnel Management that, since the Smithsonian is not a federal agency and since the SES compensation schedule applies by law only to federal agencies, the higher SES pay levels are not available to Smithsonian employees. The IRC recommends that the Smithsonian adjust its salary structure to pay employees up to the maximum of the SES schedule where appropriate, with Congressional approval if necessary.

In recent years, some employees have been moved out of the federal general schedule pay system and rehired by the trust at much higher salaries. Smithsonian management has argued that since trust employees serve at the pleasure of the Secretary (and thus do not have the employment protections that employees paid by the federal schedule enjoy), their compensation should be higher. This has often resulted in paying salaries for some positions (in areas such as finance and government relations) that are unnecessarily higher than those paid in much larger federal agencies. This can only cause morale issues. Allowing use of the SES pay scales would help alleviate this problem.

The Committee recommends that the Smithsonian provide employee compensation and benefits as follows:

- The salary structure would align with that provided to federal employees, with pay and bonus opportunity similar to the federal structure from the entry level through the Senior Executive Service.
- All Smithsonian employees would be covered by similar health benefits, retirement benefits, and time off policies as federal employees, with these benefits adjusted accordingly whenever changes were made in the corresponding federal programs.
- The Smithsonian would be permitted to pay salaries above the maximum limits in the federal program for those filling certain positions. In addition to the Secretary, this could include such positions as the undersecretaries, museum directors, top scientists, and others where independent compensation analyses indicate that median pay in comparable nonprofit organizations is materially higher than existing maximum federal salaries.
- A limit should be placed on the number of Smithsonian employees that can exceed the federal maximums – perhaps 40 to 50 – with the understanding that this limit could be increased as the Institution grows, or to reflect unusual increases in competition for key personnel. Approval by the Regents should be required for a position to be paid above the federal ceiling.
- Those employees in positions paid above the federal ceilings serve at the pleasure of the Secretary (or the Regents, in the case of the Secretary).

Whether the Regents accept the recommendations above, the Institution must harmonize compensation and benefit programs throughout the Institution. The Board of Regents should address compensation in the following ways:

- The Compensation Committee should be independent, both in fact and perception, from the Secretary. The Secretary should not be a member of this Committee, and there should be no current or past interlocking relationships between the Secretary and any Committee member.
- The Compensation Committee should formally review all elements of compensation for Smithsonian senior management positions at least annually.
- Any changes in the Secretary's compensation and benefits should be reviewed and approved by the full Board of Regents, not just the Compensation Committee or the Executive Committee.

- Any compensation consultant hired to evaluate management compensation at the Smithsonian should be retained by and report directly to the Compensation Committee (or the full Board of Regents). To be effective, the consultant will also have to work with management, but the contract should be with the Regents, and important decisions on compensation philosophy and peer group selection should be made in conjunction with the Regents.
- At least every other year, an independent qualified compensation expert should be asked by the Regents to provide an opinion on the reasonableness⁹⁹ of the Secretary's total compensation package. This opinion should be made public.
- Transparency should be a guiding principle. Decisions on compensation for Smithsonian executives should be made with the expectation that they will generally appear reasonable to reasonable observers, including donors and federal oversight committees.

5. The Smithsonian Should Have an Active Governing Board with a Chairman Who Can Provide the Time and Proper Oversight

The Board of a nonprofit organization must “oversee the operations of the organization in such manner as will assure effective and ethical management.”¹⁰⁰ The Board is charged with overseeing the management of the Smithsonian, while the Secretary's responsibility is to run its operations.¹⁰¹ As part of its governance role, the Board must provide oversight of operations, set strategy and monitor the implementation of the strategic plans. This relationship between the

⁹⁹ In accordance with the IRS “Intermediate Sanctions” regulations.

¹⁰⁰ American Bar Association, ABA Coordinating Committee on Nonprofit Governance, *Guide to Corporate Governance in the Wake of Sarbanes-Oxley* 17, 19 (2005).

¹⁰¹ See, e.g., BoardSource, *The Source: Twelve Principles of Governance That Power Exceptional Boards* Principle 1 (2005) (“Nonprofit boards have primary legal responsibility for governance - the exercise and assignment of power and authority - of their organizations. Boards reserve to themselves organizational oversight and policy setting, and delegate to the chief executive responsibility for managing operations and resources.”).

Board and the Secretary is a “constructive partnership” in which the Board sets strategic plans and then delegates operations to the Secretary.¹⁰²

Experts in the area of nonprofit governance have identified a series of functions that form the core of a nonprofit Board’s responsibilities and that the IRC believes apply well to the Smithsonian:

- determining the organization’s mission;
- reviewing and monitoring implementation of strategic plans;
- selecting, compensating and evaluating the organization’s chief executive;
- evaluating the performance and establishing the compensation of the senior leadership team;
- planning for management development and succession;
- overseeing the integrity and reliability of the organization’s finances;
- overseeing management in its operation of the organization and its programs;
- overseeing legal and ethical compliance; and
- identifying, cultivating and soliciting donor support for the organization.¹⁰³

In light of the demands these responsibilities place on directors in the post-Sarbanes-Oxley governance environment, the IRC believes the Smithsonian should consider, as the Office of the Vice President suggested to the IRC, “what if any changes . . . the Institution [should] seek with respect to the existence, composition, selection or functions of the Board of Regents.”¹⁰⁴ The time commitment necessary to fulfill the fiduciary responsibility placed on

¹⁰² BoardSource, *The Source: Twelve Principles of Governance That Power Exceptional Boards* Principle 1 (2005).

¹⁰³ See, e.g., BoardSource, *The Source: Twelve Principles of Governance That Power Exceptional Boards* (2005).

¹⁰⁴ Letter from David Addington, Chief of Staff to the Vice President, to Charles A. Bowsher dated May 18, 2007, attached as Exhibit 1.

the directors of an organization as large and complex as the Smithsonian is significant. In light of the demanding nature of the jobs of the modern Vice President and Chief Justice, the IRC has serious doubts that individuals in these positions will have the time, attention and qualified staff necessary to fulfill their fiduciary duties.

The IRC believes the Smithsonian could preserve its unique historical structure, yet at the same time, address the pressing need for active oversight, through the establishment of a Governing Board that would take on the fiduciary responsibility for overseeing the operations and management of Smithsonian. The IRC recommends that the Governing Board meet no less frequently than every other month. The Governing Board should, as the current Board does, also govern through active committees, particularly through the Audit and Review, Human Resources and Compensation and Nominating and Governance Committees. The Governing Board would consist of all Regents except the Chief Justice and Vice President. Service as a Regent must require that all members of the Governing Board, including members of Congress, be willing and able to assume a role with clear fiduciary responsibilities and to devote the time necessary to carry out those duties personally.

The establishment of a Governing Board would formalize the Smithsonian's informal governance structure under which the "Committee of the Whole" meets in advance of the Board of Regents meeting, while the Board of Regents meetings that follow, in contrast, have been formal proceedings to approve what had been decided by the Committee of the Whole.

The Governing Board would have a Chairman who should handle day-to-day issues requiring the attention of the Board and preside over initial meetings of the Board, where all actionable items would be discussed and debated and reports from, for example, the Inspector

General, Chief Financial Officer, General Counsel, Ethics Officer and museum and scientific project leaders, and others would be received. The Chairman's duties would include:

- Communicating to the Secretary the policies and programs adopted or approved by the Board.
- Reporting to the Board the conduct and management of the affairs of the Smithsonian.
- Chairing and presiding over the Governing Board.
- Communicating with the Chancellor regarding Smithsonian matters.

The Governing Board should reserve, at every meeting, time for an executive session where issues involving management, including the Secretary's performance, can be freely and openly discussed without the presence of employees.

The IRC also recommends that the Executive Committee be enlarged to five members, and its activity limited in practice to handling routine affairs of the Board between meetings and when special meetings, either in person or telephonically, can not be arranged. All actions of the Executive Committee should be presented to the Governing Board for review.

6. The Role of the Chief Justice and Vice President Should Be Clarified

Historically, the Chief Justice has been elected to serve as the Chancellor. Under the IRC's proposal, the Chief Justice, while not on the Governing Board, would continue to serve as Chancellor. In that role, the Chancellor would preside over the second portion of the Governing Board meeting where discussion and formal votes would be taken on those issues requiring action of the Board of Regents. Only those Regents who serve on the Governing Board, however, would vote. The IRC recommends such a unique structure because it believes the historic role played by the Chief Justice in governance of the Smithsonian should not lightly be

discarded and because the Chief Justice has made it clear he wishes to remain associated with the Institution.

The Committee also believes, however, that if governance of the Smithsonian is to be updated, it will require a commitment of time on the part of every Regent that far surpasses that which has been expected in the past. The Committee believes that it is not feasible to expect the Chief Justice to devote the hours necessary to service as a fiduciary Regent. The Committee also questions if it is appropriate and necessary for the Chief Justice to have fiduciary obligations to a separate entity, even if that entity is closely linked the government, and to assume the legal and reputational risks associated with being a fiduciary.

The same situation applies to the Vice President. Under the IRC's proposal, the Vice President would continue to serve as a Regent in a non-fiduciary capacity, and would chair meetings of the Board in the absence of the Chief Justice. If neither the Chief Justice nor the Vice President were present at a meeting of the Board, the Chairman would preside.

If the Smithsonian desires to have positions for individuals that honor them for their contributions to the arts and sciences, including their financial generosity, it should establish nonfiduciary advisory boards for the Institution in general as well as for its various museums and divisions. The National Board, now primarily a development group, could have its scope expanded. The formerly active, but now moribund Smithsonian Council could be revived to bring together distinguished scientists, academics, and museum directors to advise the Smithsonian and its constituent parts on programs, policy, and long range planning. Having both a vibrant Board and Council should help curb the extensive criticism the Smithsonian received during recent years regarding the conditions on certain donations and the scope and content of certain shows and displays.

7. Congressional Regents Should Accept Fiduciary Responsibilities

A clear understanding needs to be reached regarding the role of the Congressional Regents. Service as a Regent must require that all members of the Governing Board be willing and able to assume a role with clear fiduciary responsibilities and to devote the time necessary to carry out those duties personally. So that there will be neither an actual nor an appearance of conflict of interest, the IRC believes that any Congressional Regent who serves on one of the Congressional authorizing or appropriations committees with authority over the Smithsonian should recuse himself or herself from votes in Congress involving Smithsonian financial matters.

8. The Board Should be Expanded or Reorganized to Allow for the Addition of Regents with Needed Expertise

The Board must expand the level of expertise among the Regents on key issues, especially financial controls and facilities and museum management, and ensure that the Regents who are appointed have sufficient time and attention to dedicate to the Smithsonian.

While a larger board may be necessary to ensure the range of perspectives and expertise required for some organizations or to share fundraising responsibilities, some experts believe that effective governance is best achieved by a smaller board with more active participation from each member.¹⁰⁵ To achieve this expansion of current expertise and ensure that Regents are active and engaged, the Committee recommends the Regents consider the following: (1) if current Regents have sufficient time and interest in continuing to serve; (2) adding to Board Committees – such as Audit and Review, Governance and Compensation and Human Resources – non-Regent members with special expertise; (3) employing outside experts to advise the Board

¹⁰⁵ See American Bar Association, ABA Coordinating Committee on Nonprofit Governance, *Guide to Corporate Governance in the Wake of Sarbanes-Oxley* 21 (2005); Discussion Draft, U.S. Senate Finance Committee, at 13 (2004) (suggesting that the size of nonprofit boards be set at “no less than three members and no more than fifteen”).

and its Committees in specific subject areas; and (4) increasing the total number of citizen Regents from 9 to 11 by either adding two additional citizen Regents or reducing the number of Congressional Regents from six to four – two from the House and two from the Senate.

To make sure that the Smithsonian Board is made up of individuals capable of providing the necessary expertise, the Regents should move to a nominating process that allows for a broader field of candidates. In looking at candidates, those charged with picking future Regents should note the necessity for expertise in financial controls, investment strategies, audit functions, governance, compensation, and facilities management, as well as an interest in and a devotion to the arts and sciences. Contributions to the Smithsonian should not be the determining factor for service on the Board, but only one of many factors considered in the selection of Regents. Care should be taken to avoid appointing Regents who have clear personal and professional ties to the Secretary that may compromise the Board's independence.

9. Internal Financial Controls, Audit Functions and the Role of the General Counsel and Inspector General Must Be Strengthened

The Smithsonian's system of internal controls and audit needs to be strengthened through additional resources, adoption of best practices and retention of personnel with substantial experience in the financial and audit area. In February 2007, KPMG identified the inadequacy of the Smithsonian's accounting staffing and resources as a "reportable condition." The Committee understands that the Smithsonian is in the process of selecting an outside auditor, and the Committee recommends that the Smithsonian expeditiously implement the recommendations of this auditor, as well as those recommendations contained in prior management letters.

Corporate governance principles require that the general counsel of an organization be the gatekeeper of information for the Board and a guardian of the Board's independence. The

General Counsel of the Smithsonian has been hindered from playing this role due to lack of regular, direct access to the Board. The Committee recommends that (1) the Smithsonian provide the General Counsel's office and Office of the Inspector General with the necessary tools and resources to perform their gatekeeper and guardian functions, (2) the General Counsel serve as the Smithsonian's corporate secretary and (3) the Smithsonian ensure vigorous compliance with the Inspector General Act.

10. Smithsonian Executives Should be Permitted to Participate in Only Nonprofit Board Activities Subject to Prior Approval

Generally, the Smithsonian has been careful in monitoring the outside work of its employees. The exceptions have been Mr. Small and the Deputy Secretary, both of whom have been allowed to collect significant compensation for service on the boards of for-profit corporations. As discussed above, these outside commitments have taken these individuals away from the Smithsonian during working hours for significant periods of time. The Board must develop a uniform policy on outside work. The IRC acknowledges that there are arguments for allowing an organization's senior executives to serve on the boards of for-profit corporations. The benefits of doing so, however, accrue primarily to the individual and only secondarily to the organization. Accordingly, the IRC recommends that the Board prohibit its executives from serving on the boards of for-profit corporations.

With respect to nonprofit boards, the Regents should control and require prior approval of any outside activities, including service on any other nonprofit or professional service boards and teaching and lecturing obligations, weighing carefully the time commitments needed and the benefits to the Smithsonian. Any compensation received by any Smithsonian employee for

service on any outside board or organization should not be kept by the individual, but should be turned over to the Smithsonian for the benefit of the Institution.

11. The Selection of the Next Secretary Must Reflect the Governance Challenges Facing the Smithsonian

Being Secretary is a difficult and time consuming job. The Secretary oversees a complex amalgam of museums, research centers, a zoo, retail shops, restaurants and buildings. The Secretary is the caretaker for one of the great names in the science and arts. It is also a job with great challenges, prestige, and opportunities to have a lasting mark on our national heritage.

Business skills are valuable to the Smithsonian and efforts to introduce business planning and measurement tools should be applauded. But what must be avoided in picking the next Secretary is the manner in which Mr. Small operated. The Secretary must work for the Board. The Secretary must set the ethical tone, not sidestep it. The operations of the Smithsonian, especially the Secretary's office, should be open and transparent.

The Board will be well served, when picking the next Secretary, if it follows the words of former Secretary Michael Heyman: "This new era also demands from public (as well as private) organizations increased fiscal accountability. We must use our resources efficiently and intelligently both to husband them and to underscore our credibility to those who provide them – the government and our donors."¹⁰⁶

12. Achieving Effective Oversight and Governance at Nonprofit Organizations May Ultimately Require Legislative Action

Unfortunately, the problems at the Smithsonian are not unique. As the media and Congressional oversight committees have made clear, there have been similar problems at

¹⁰⁶ I. Michael Heyman, Installation Address, September 19, 1994. (available at <http://www.150.si.edu/chap13/install.htm>), attached as Exhibit 41.

several large tax-exempt organizations, including major museums and universities, not to mention the income and expense excesses and governance issues at for-profit companies. This raises the issue of effective management of nonprofits and how governance at these entities should be structured, the responsibilities of their boards of directors and trustees, and how oversight of these organizations should be provided. The IRC believes that boards of nonprofits – especially large nonprofits – should move to reform their governance structures to bring them into line with best practices that have been well documented. These include the financial management and audit requirements in the Sarbanes-Oxley legislation, as well the recent Securities and Exchange Commission requirements for more transparent disclosure of the total compensation of senior executives. Some nonprofits have made progress in these areas, while others have not. Failure to take voluntary action will likely lead, ultimately, to action by Congress, state legislatures, and the courts, to impose reforms from without, just as it did in the case of the corporate world.