Fair Political Practices Commission

Memorandum

To: Chair Ravel, Commissioners Casher, Eskovitz, Wasserman, and Wynne

From: Zackery P. Morazzini, General Counsel
William J. Lenkeit, Senior Commission Counsel

Subject: Adoption of Proposed Amendments to the Conflict of Interest Regulations – Regulation 18700: Basic Rule

Date: April 25, 2013

Executive Summary

This proposed regulation would restructure the existing conflict of interest analysis by consolidating and reorganizing multiple steps in the analysis. First, it is recommended that current steps one ("am I a public official?"), two ("am I participating in a governmental decision?"), and three ("what are my financial interests?") from the existing eight-step analysis, be eliminated and moved into the definitional section of the regulation. Those seeking advice typically know the answers to these questions and their inquiry focuses on the foreseeability of the decision having an effect on their interests, and whether that effect will be material.

Second, it is recommended that the "reasonably foreseeable" step be moved up from the end of the analysis to the beginning. Generally, the first thing a public official should consider in determining if there is a potential conflict is whether the decision will have a financial effect on the official's financial interests. This question is also generally the main focus in investigations conducted by our Enforcement Division.

Finally, it is recommended that the Commission bring uniformity and consistency to the use of the terms "financial interest" and "economic interest" in the conflicts regulations. To do so, it is proposed that the term "financial interest" be used to refer to any and all of an official's relevant interests under the conflicts regulations, as that term is used in the statute.

Proposed Commission Action and Staff Recommendation:

Adopt the amendment to Regulation 18700 interpreting Section 87100 of the Political Reform Act's (the "Act")[1] conflict of interest regulations.

---

[1] The Political Reform Act is contained in Government Code Sections 81000 through 91014. All statutory references are to the Government Code, unless otherwise indicated. The regulations of the Fair Political Practices Commission are contained in Sections 18110 through 18997 of Title 2 of the California Code of Regulations. All regulatory references are to Title 2, Division 6 of the California Code of Regulations, unless otherwise indicated.

Introduction:

Over the next several months, Commission staff will be continuing its project to revise the Act's conflict of interest (hereafter "conflicts") regulations, which interpret Section 87100 and Section 87103 of the Act. The goal is to make Commission regulations easier to understand and apply, and more helpful for public officials to determine if a conflict of interest exists under the Act.

This project began last year with the most misunderstood and misapplied step[2] in the conflicts analysis – determining if a material financial effect on a public official's economic interest is "reasonably foreseeable." (See Staff Memorandum, dated August 6, 2012 (http://www.fppc.ca.gov/agendas/08-12/26_18706%20Memo.pdf).) Last September, the Commission adopted staff's proposed amendments defining what is reasonably foreseeable. Those amendments, however, like the remaining amendments that will be brought before the Commission this year, will not go into effect until the entire package of amendments to the conflict rules has been approved and adopted by the Commission, hopefully by the end of this year. The purpose of this memorandum is two-fold: to explain the current item and to provide an overview of some of the remaining issues relating to the conflicts process.

Staff proposes to continue this process with this initial regulation that sets forth the outline for the analysis of the Act's conflicts procedure. This amendment would shorten the number of steps in order to obtain greater clarity. This is being accomplished by consolidating the basic rule and applicable definitional terms into the initial regulation.

This effort to simplify and clarify the regulations has presented some obstacles. For example, public discussions regarding the definitions of the terms "consultant" and "otherwise related business entities" have generated significant input and will require further consideration and public input as we continue this project in the months ahead.

Nevertheless, the regulation staff is proposing that the Commission adopt serves as the basic roadmap to proposed amendments to the Act's conflicts regulations that will be brought before the Commission later this year.

General Overview of Conflict of Interest Law[3]

The Act's Conflicts Statutes: The Act's conflicts prohibitions are contained in Sections 87100 through 87105. Section 87100 provides the basic rule:

---

[2] The Commission has developed an eight-step process (as explained below) for use in determining if a conflict of interest exists.

[3] In 1905, George Washington Plunkitt of New York's Tammany Hall published a book about his long political career in which he attempted to distinguish between "honest" graft and dishonest graft. "I seen my opportunities, and I took 'em," he stated, in describing his practice of honest graft. Conflict of interest laws are directed at taking these private "opportunities" out of the public decision making process.

> "No public official[4] at any level of state or local government shall make, participate in making or in any way attempt to use his [or her] official position to influence a governmental decision in which he [or she] knows or has reason to know he [or she] has a financial interest."

Section 87101 creates an exception that allows an official to participate in a governmental decision in which he or she has an otherwise disqualifying financial interest when that participation is "legally required" for the action or decision to be made.

Section 87103 provides that an official has a financial interest in a decision within the meaning of Section 87100 "if it is reasonably foreseeable that the decision will have a material financial effect, distinguishable from its effect on the public generally, on the official, a member of his or her immediate family, or on any" of the following:

(1) A business entity if the official has a direct or indirect investment[5] of $2,000 or more;

(2) Real property in which the public official has a direct or indirect interest worth $2,000 or more;

(3) Any source of income, other than gifts or loans from a commercial lending institution made in the regular course of business on terms available to the public without regard to official status, aggregating $500 or more, received by the official within 12 months before the decision was made;

(4) Any business entity in which the public official is a director, officer, partner, trustee, employee, or holds any position of management;

(5) Any donor of, or any intermediary or agent for a donor of, a gift or gifts aggregating to more than $ 440 provided to, received by, or promised to the official within 12 months before the decision is made.

The Act's Conflicts Regulations: Regulations 18700 through 18709 comprise the Act's conflicts regulations. Regulation 18700 is the introductory regulation, providing the basic rules as set forth in the statute and setting forth the current eight-step process for analyzing how the statutory rules are applied. The current eight steps are:

(1) Are you a *public official*?

---

[4] Public official is defined as "every member, officer, employee or consultant of a state or local government agency." (Section 82034(a).) There are certain exceptions, mostly related to judicial positions, provided under subdivision (b) thereof.

[5] "For purposes of this section, indirect investment or interest means any investment or interest owned by the spouse or dependant child of a public official, by an agent on behalf of a public official, or by a business entity or trust in which the official's agents, spouse, or dependant children own directly, indirectly, or beneficially a 10-percent interest or greater." (Section 87103(e).)

(2) Are you *participating in a governmental decision*?

(3) Do you have any *economic interests*?

(4) Are your economic interests directly involved or indirectly involved in the decision?

(5) Are the financial effects of the decision *material*?

(6) Are the material financial effects of the decision *reasonably foreseeable*?

(7) May you nevertheless participate in a decision in which you have a disqualifying interest under the "*public generally*" exception?

(8) May you nevertheless participate in a decision in which you have a disqualifying interest under the "*legally required participation*" exception? (Section 87101.)

While the current eight-step process provides a logical approach in the conflicts analysis by tracking each of the significant terms used in Sections 87100 and 87103,[6] (adding one at step four), the resulting process as applied to real world facts has proven cumbersome and, in many cases, less than helpful to the advisee. Additionally, some of the mechanisms that we have developed over the years to implement the basic prohibition may be too mechanical under certain factual scenarios, as discussed further below, and have led to some unreasonable conclusions.

Background – Common Law Development and Statutory Laws: The concept of conflicts of interest originated in the English common law, believed to be the rules of trust, applicable to the behavior of government officials. These "rules of trust" established that a governmental officer has an obligation to the public and must not have a direct or indirect interest in a governmental transaction, because it is the public official's job to act solely in the public interest.[7]

California has a long history of statutory prohibitions on public officials participating in governmental decisions in which they have a conflict of interest.[8] These statutes are primarily drawn from English common law rules.[9] Many of the early prohibitions restricted public employees from being privately financially involved in contracts with their public employer, and they were incorporated in state statutes, city charters, and local ordinances. One early statute[10] included Political Code Section 920-922, which provided that state public officers "shall not be

---

[6] The statute uses the term "financial interest" while the regulations refer to the interests listed under §87103 as "economic interests" (discussed below).

[7] *Learning Module, Unit 5 Misconduct: What Does Misconduct in the Legislature Look Like?* The World Bank Institute Professional Development Program for Parliamentarians and Parliamentary Staff <http://parliamentarystrengthening.org/ethicsmodule/pdf/ethicsunit5.pdf> (Citing Zimmerman, Joseph F., Curbing Unethical Behavior in Government, Praeger, August 16, 1994.)

[8] See *City of Carmel-By-The-Sea v. Young* (1970) 2 Cal.3d 259, 262), where the court found more than 85 separate provisions concerning conflicts in the California Constitution and state statutes at the time of the decision.

[9] Kaufmann, Dan and Widiss, Alan I., *California Conflict of Interest Laws* (1963) 36 So.Cal.L.Rev. 186, citing *Berka v. Woodward* (1899) 125 Cal. 119.)

[10] See *Stockton Plumbing and Supply Company v. Wheeler* (1924) 68 Cal.App 592, 597.

interested in any contract made in their official capacity, or by any body or board of which they are members."

In *Berka v. Woodward* (1899) 125 Cal. 119, 122, the court stated the principle upon which conflicts concerns are to be considered:

> "any officer … cannot be permitted to place himself in any situation where his personal interest will conflict with the faithful performance of his duty as trustee, and it matters not how fair upon the face of it the contract may be, the law will not suffer him to occupy a position so equivocal and so fraught with temptation."

This principle has been liberally construed to place the public interest above any other concerns that may otherwise prevail. (See *Stockton Plumbing and Supply Company v. Wheeler* (1924) 68 Cal. App 592.) The development of public policy concerns through California court decisions has formed the basis of California's general common law rules against conflicts, by broadly interpreting statutory provisions to protect the public interest. However, the common law may be abrogated by express statutory provisions.[11] "Where the common law has been abrogated by a statutory enactment, the common law prohibition may not then be applied in a manner inconsistent with the statute." (Conflicts of Interest 2010, California Attorney General's Office, Ted Prim and Erin Peth, Editors, p.102 (hereinafter referred to as the "AG Manual").

Section 1090 and Other Conflicts Provisions Outside the Act: "The common law prohibition against 'self-dealing' has long been established in California law." (*AG Manual*, p. 55 [citation omitted].) Section 1090 codifies the common law prohibitions as to contracts and "can be traced back to an act passed in 1851." (*Ibid*.) Section 1090 "is the principal California statute governing conflicts of interest in the making of government contracts. In turn, the Act is the principal California law governing conflicts of interest in the making of all government decisions." (*Lexin v. Superior Court* (2010) 47 Cal.4th 1050, 1090.) Section 1090 "essentially prohibits a public official from being financially interested in a contract in both the official's public and private capacities." (*AG Manual, supra*.)

In analyzing whether a conflict of interest exists, in many situations one must consider both Section 1090 and the provisions of the Act. Even if a contract is permissible under Section 1090, it may be prohibited by the Act, and vice versa.[12]

In addition to Section 1090, there are other statutory and constitutional prohibitions related to conflicts. Public Contracts Code Sections 10410 and 10411 prohibit current and former state officers and employees from participating in state contracts. California Constitution Article 12, Section 7 prohibits "public officers" from accepting passes or discounts from transportation companies. There are laws relating to incompatible activities for both local and state employees and prohibitions against holding incompatible offices as well as a "multitude of

---

[11] (Conflicts of Interest 2010, California Attorney General's Office, Ted Prim and Erin Peth, Editors, p.102 (hereinafter referred to as the "AG Manual").

[12] *Ibid*. For a discussion of the interrelationship between Section 1090 and the provisions of the Act see *Lexin, supra,* pp. 1090-1092.

conflict of interest statutes that are applicable only to particular officers and agencies." (*AG Manual, supra,* p. 105.)

It was the passage of the Political Reform Act of 1974, however, that provided the first comprehensive statutory scheme covering all public officials in all governmental decisions.

Conflicts Provisions Under the Act (1975-2013):"The people find and declare as follows:

> […]
> "Public officials, whether elected or appointed, should perform their duties in an impartial manner, free from bias caused by their own financial interests or the financial interests of persons who have supported them;" (Section 81001 (b); Findings and Declarations of the Political Reform Act, approved by the voters as Proposition 9, June 6, 1974.)

With the passage of Proposition 9, California voters enacted, for the first time, a body of law that enumerated certain financial interests and specifically prohibited public officials from engaging in the public decisionmaking process when these private interests were affected by the governmental decision.

Prior to the passage of the Act, in 1969, a bill was signed into law by Governor Reagan, which began the process of requiring candidates and certain public officials to file financial disclosure statements for the public to see.

Declaring that the "representative form of government is founded upon a belief that those entrusted with the offices of government have nothing to fear from full public disclosure of their financial and business holdings," the law required, for the first time, that certain public officers[13] and candidates for public office "file, as a public record, a statement describing the nature and extent of his investments, including the ownership of shares in any corporation or the ownership of a financial interest in any business entity, which is subject to regulation by any state or local public agency, if such investment is in excess of ten thousand dollars ($10,000) at the time of the statement."

The law was immediately challenged in *City of Carmel By The Sea v. Young*[14] (*supr*a, n. 10) in which numerous officers and officials of a city and county threatened to resign their positions "rather than being subjected to what they contend is an unconstitutional invasion of their privacy by requiring them to file such a statement of assets disclosing their personal financial affairs and those of their spouses and children." (*supra,* p. 262.)

---

[13] Defined as "a Member of the Legislature, a Secretary of the Governor, the Chief Clerk and the Sergeant at Arms of the Senate, an administrative aide or committee consultant of the Legislature, a constitutional officer, and any other officer of a public agency; and includes civil servants in a public agency who are classified as career executives, and the appointive or civil servant employee of the highest class or grade in each department, bureau, division, or other administrative subdivision of a public agency, as defined in regulations adopted by the public agency, but does not include other civil servants in a public agency." (Section 3605.)

[14] The full content of the 1969 statute is attached as the appendix in this case.

Weighing "the public's right to know of matters which might bring about a conflict of interest between the public employment and the private financial interests of those holding public office" (*supra*) against the constitutional rights to privacy of the individual official, the court found that the statute was an overbroad intrusion into the right of privacy and thereby impermissibly restricted the right to seek or hold public office or employment. This holding was based on the fact that (1) the disclosure requirements applied regardless of the nature and scope of activity of the agency, and (2) there was not a sufficient nexus between the information required to be disclosed and the duties of the office held.

Following the court's invalidation of the 1969 financial disclosure law, the state legislature in 1973 enacted the Moscone Governmental Conflict of Interest and Disclosure Act, a new conflicts of interest law replacing the statute struck down by the court in *Carmel By The Sea*. Again, this law was immediately challenged. However, in *County of Nevada v. MacMillen* (1974), 11 Cal. 3d 662,[15] the same court held that the new law had been "specially tailored to meet and satisfy the primary concerns of our *Carmel* ruling." The court explained that its "major objection" to the provisions considered in the *Carmel* case was that:

> "No effort is made to relate the disclosure to financial dealings or assets which might be expected to give rise to a conflict of interest; that is, to those having some rational connection with or bearing upon, or which might be affected by, the functions or jurisdiction of any particular agency, whether statewide or local, or on the functions or jurisdiction of any particular public officer or employee." (*County of Nevada*, *supra*, p. 671.)

The Moscone Governmental Conflict of Interest and Disclosure Act was repealed with the enactment of the Political Reform Act.[16]

The original language in Section 87103 of the Act was much the same as it is today, although there have been seven amendments since it was adopted, most of which were minor or nonsubstantive. The first occurred in 1979, and changed the last clause defining indirect investment/interest from a "substantial interest" standard (with "substantial interest" defined as more than $1,000), to a ten percent interest or greater standard, still used today. A 1984 amendment added subsection (e), which read: "any donor of, or any intermediary or agent for a donor of, a gift or gifts aggregating two hundred fifty dollars ($250) or more in value provided to, received by, or promised to the public official within 12 months prior to the time when the decision is made." This change took the term "gift" out of the definition of income[17] under subdivision (c) for purposes of this statute, so as to include "or any intermediary or agent for a donor of." A 2000 amendment raised the $1,000 limits to $2,000 and the $250 limits to $500.

The only major change occurred in 1985, 10 years after the Act had been in operation. Up until that time, the Act only prohibited officials from participating in a decision if the decision had a financial effect on a business entity in which the official had an ownership interest

---

[15] This case was published 13 days after the voters had approved Proposition 9.
[16] See *California Voters Pamphlet, June 4, 1974 Primary Election*, (attachment 1).
[17] The definition of "income" under Section 82030 includes "gift."

or position, real property owned by the official either directly or indirectly, or a source of income to the official. It did *not* prohibit an official from engaging in a decision if the decision had a direct financial effect on the official or a member of his or her family. As discussed below, that same year the legislature passed, and the Governor signed, a bill that closed this loophole in the conflicts law by extending the prohibitions to cover the officials and their immediate family members.

Early Commission Advice and Regulations: In interpreting the Act, early advice letters did not apply a standardized approach regarding conflicts issues. One of the more difficult issues in the beginning was developing guidelines for what was considered a "material" financial effect. An early memorandum states that the "general consensus was that a material financial effect was something difficult of precise dollar or percentage definition."[18] One comment received in a memo from the Attorney General's office suggested that any dollar threshold "contains the negative inference" that it is permissible to dip into the public's pocket book "until such a threshold is reached."[19]

In 1976, Regulation 18702, the initial conflict of interest regulation addressing materiality (see attachment 2), was adopted by the Commission. The regulation provided that the financial effect of a decision was material if, "in light of all the circumstances and facts known at the time of the decision, the official knows or has reason to know that the existence of the financial interest might interfere with the official's performance of his or her duties in an impartial manner free from bias." This rule essentially mirrored language found in many of the common law cases addressing conflicts of interest. However, the regulation also provided guidelines:

> "(b) In determining the existence of a material [financial] effect upon a financial interest, consideration should be given, but not be limited to, an analysis of the following factors:"

It then listed certain monetary considerations based on both a fixed dollar amount and a percentage effect for (1) investments in and positions with business entities, (2) interest in real property, and (3) sources of income. For example, the financial effect on the value of a real property interest was stated at an increase (but not a decrease) of $1,000 or more in fair market value or by .5 percent, whichever is greater. Finally, the regulation provided:

> "The specific dollar or percentage amounts set forth above do not constitute either absolute maximum or minimum levels, but are merely intended to provide guidance and should be considered along with other relevant factors in determining whether a financial interest may interfere with the official's exercise of his or her duties in rendering a decision."

[18] Staff Memorandum by Delbert Spurlock, Jr., Chief Conflicts of Interest Division, December 17, 1975.
[19] Memorandum dated November 5, 1975, Floyd D. Shimomura, Deputy Attorney General.

Two events changed the interpretation of the conflicts provisions of the Act dramatically in early 1985, both as a result of requests for advice. In March of that year, the Commission received a request asking if a city councilmember could vote to approve the payment of city warrants for invoices totaling $1,386.76 submitted to the city by the councilmember's business for work performed by the business for the city.[20] Because the advice turned on the then existing materiality standard, staff advised that the councilmember *could* vote on the matter:

> "… the amount in question does not meet the current guidelines for materiality ... Given our understanding that Morrow & Holman Plumbing has annual gross revenues of $1,000,000 [footnote omitted] the threshold under either regulation's guidelines would be a $10,000 effect on annualized gross revenues. The decision at hand is only $1,386.76." (*Einboden* Advice Letter, A-85-072, p.3.)

The letter stated that the Commission would be considering the adoption of a new Regulation 18702.1, "which, if adopted as noticed, could require disqualification where Mr. Margrave's business is the *direct subject* of the decision (if the decision is not ministerial in nature), without regard to the relative magnitude of the effect." (*Einboden, supra*, p.4. emphasis added; footnote omitted.) This regulation was the beginning of the direct/indirect approach to determine materiality, which is currently step 4 of the analytical process.[21] It appears to have been implemented to cover what had always been the common law conclusion that a conflict of interest exists whenever there is a direct tie-in with the decision, even if there is no allegation of financial gain. New Regulation 18702.1 was adopted by the Commission in July of 1985.

Subsequently, staff received an advice request asking if a member of the board of directors for a hospital district could participate in a decision to hire his spouse. This request brought to light the oversight in the original language contained in Section 87103. Because there was nothing in the Act preventing officials from voting on such matters, staff advised that he could. (*Heywood Advice Letter*, dated May 31, 1985.)

At the time, a bill sponsored by the Commission (AB 670, 1985) was making its way through the legislative process and had just been approved in the Assembly. The bill sought to add "city attorneys" and "county counsel" to the list of positions included as Section 87200 filers (commonly referred to as statutory filers.) The Senate then added language to the bill creating a new disqualifying conflict for an official's personal financial effects by adding the words "on the official or a member of his or her immediate family or on:" after the words "public generally" in the section's first paragraph. This amendment was described as a minor technical amendment to "clarify existing law,"[22] but it in fact greatly expanded the scope of conflicts laws by extending

---

[20] The councilmember's business had been performing work for the city for years before the he had become a member of the city council and he took no part in any of the previous arrangements.

[21] Additional information on this event was provided in a telephone conversation on March 21, 2013, with Robert E. Leidigh, former FPPC Commissioner and the Legal Division staff attorney who prepared the advice letter.

[22] Legislative bill file including letter from Assemblyman Johan Klehs to Governor George Deukmejian dated September 4, 1985. Additional background on this action was provided in a telephone conversation on March

the Act's conflicts prohibitions directly to official's personal financial interests and those of their immediate family.

The *Heywood* advice letter included a footnote stating that the Commission was considering adopting a regulation that would prohibit a public official from participating in a decision if the decision would increase or decrease the personal income of the official or his or her immediate family by $250. This regulation, along with the addition of the language added to Section 87103, became the new "personal finances" disqualification rule with the still current $250 threshold. (Currently Regulations 18703.5, 18704.5, and 18705.5.)

Other Relevant Amendments:[23] The "materiality" regulations have been amended a number of times. In the early 1980s, staff was having problems applying the percentages used in the then-applicable regulations.[24] Beginning with the above discussed regulatory changes in 1985 and continuing through 1988, staff proposed and the Commission adopted significant changes to the materiality regulations. These included different materiality standards for business entities based upon the size of the entity and which of the various stock exchanges it is listed on. The so called "donut rule," implementing the distance test for materiality with respect to real property, also came about with the 1988 changes.[25] This rule extended the "directly involved" standard with respect to real property from the actual property at issue in the decision itself to all properties within 300 feet of it (the donut hole).

Toward the end of the last century, Commission staff undertook a complete and thorough reorganization of the conflicts provisions. This project created the present eight-step process. This review and examination of conflict issues faced under the Act highlighted many issues that were never addressed, but that will be considered again as we continue this current project.

Proposed Regulation 18700

Consolidation and Reorganization of Steps: Ultimately, creation of the eight-step process was a significant organizational accomplishment that established a solid analytical framework for determining when a public official is prohibited from making, participating in, or using his or her official position to influence a governmental decision. It provided an excellent vehicle to be used by public officials to understand the process, aided Commission legal advisors in providing the clear legal advice that they are required to provide under the Act, and assisted with the enforcement of the prohibitions. However, as its creator stated in one of his memos, "improvement is always possible."[26]

21, 2013, with Kathy Donovan, former FPPC General Counsel and the Legal Division staff attorney who prepared the advice letter.

[23] This brief overview is presented for the purpose of providing a basic background for the issues to be discussed in the currently proposed regulation. Staff will provide an in-depth history of the regulatory development of each individual proposed regulatory amendment as those projects are presented to the Commission in the upcoming months.

[24] Leidigh telephone conversation, *ibid*.

[25] See staff memorandum prepared by Robert E. Leidigh, dated July 14, 1988, (attachment 3).

[26] Vergelli memo, dated April 24, 1998.

Staff now believes there are a few unnecessary steps in the conflicts analysis, and it is our recommendation that the Commission should consider shortening and better organizing the implementing regulations. Staff also recommends that the Commission analyze the core issues of conflicts as we move forward with this project: foreseeability, materiality, when the financial effect is not the same as the effect on the public generally, and what constitutes participation in a decision.

Staff advice letters demonstrate the issues we are presented with. Quite often, staff is unable to provide the core advice to officials on conflicts questions, and many letters spend significant space discussing steps that are not at issue. Virtually no one asks if they are a public official (step1) or if voting is participating in a decision (step 2). Likewise, few ask "what is an interest" that would prohibit them from participating in the decision? (step 3); they already know these things, and that is why they are writing – to see if it will cause a problem.[27] Yet we typically lay out all the interests whether the official indicates they have them or not. The proposed amendment would move the questions of "who is a public official" and "what interests" need to be considered under the definitional terms, thereby eliminating two steps, but still providing the information necessary to perform the analysis. Of course, under the proposed regulation, staff will still be able to inform individuals whether they are public officials, what their financial interests are, and whether their proposed action is covered by the Act, when necessary.

In staff's August 2012 memorandum (see page 2, above) addressing the recent amendments to the "reasonably foreseeable" analysis, we described the current application of the eight-step process as a game of chutes and ladders. Step four is where the game begins. As we have seen from the discussion above, what developed into the step four "directly involved/indirectly involved" test evolved from a situation where an official was being asked to vote on a matter in which his business was the subject of the decision. Under what one could reasonably argue were quite high materiality standards, there was nothing to prohibit the official from voting on a contract with his own company.

To fix this situation, instead of lowering the materiality standards, we developed a new rule that prohibited officials from participating in decisions where their interests were involved as the subject of the decision. This seemed to make a good deal of sense, as the rule was based on common law principles, which were even stricter, but were not necessarily based on financial considerations. Under the Act, however, conflicts are based only on financial considerations, and only those that are material. Because of this, although the theory was good, the application has had some strange consequences, especially with respect to real property decisions.

Part of the problem is that the directly involved/indirectly involved test leads to a materiality determination when it more aptly should be considered a factor in determining foreseeability. The fact that one is being directly considered in the decision does not change the

[27] For the years 2011 and 2012 staff sent out 107 and 86 conflicts letters, respectively. For 2011, only three requestors asked if they were a public official (one other asked if it was a public agency). In 2012, there were none. The overwhelming majority, around 95 percent, were from members of city councils, or members of other public boards, commissions, or committees (information compiled by Whitney Prout, Legal Division Intern).

value of what is being awarded, but it does change the likelihood that it will be awarded. This, coupled with the fact that under step six of the analysis staff was advising that a financial effect was not reasonably foreseeable unless it was "substantially likely"[28] to occur led to absurd results.

The net result was a public official would often be taken through the first five steps of a conflicts analysis, with a determination of a "material" financial effect of anywhere from one penny (possibly less) to thousands of dollars, and then be told on the last step that there was no conflict of interest because there was only a fifty percent or less chance of it happening.[29] As explained in the prior memorandum concerning the "reasonably foreseeable" step (above), through regulatory amendment the Commission has now solved a portion of this problem by clarifying the standard to be applied in making this determination.

In light of these problems, staff believes that the reasonably foreseeable step should now be moved from the end of the analysis to the beginning. The first thing a public official should consider in determining if he or she has a conflict of interest is whether the decision will have a financial effect on any of the official's interests. To try to determine if a financial effect will be material seems to presume that there will already be a financial effect.

"Financial Interest" vs. "Economic Interest": Staff also proposes to bring uniformity and consistency to use of the terms "financial interest" and "economic interest" throughout the conflicts regulations. The Act does not use the term "economic interests" relative to its conflicts provisions. The Act's only use of this term, save three uses in a different context,[30] is in Section 84211(t)(4) (addressing the contents of a campaign statement), Section 86104(d)(4)(D) (regarding lobbying firm registration requirements), and Section 86501(d)(4) (regarding lobbyist employer registration requirements), is in reference to the financial disclosure statements certain public officials are required to file (commonly known as the Form 700 or SEIs).

Originally, the term "financial interest" was used to mean those interests listed in Section 87103(a)–(e) (and later the added personal interests). This is evident in early Commission opinions, memoranda, staff advice letters, legislative bills, attorney general opinions, and court cases.[31] At some point, staff began using the terms "financial interest" and "economic interest" interchangeably.

As the regulations became more developed, and those who interpreted their provisions became more acquainted with the requirements, questions arose as to the difference between a "financial interest" and an "economic interest." While the Act does not suggest any distinctions,

---

[28] We never actually defined substantially likely on a percentage basis, but it was considered to be, at the very least, a better than even chance.

[29] In many cases we would take it to this step and then punt, telling the requestor that it was up to the public official to make a determination of whether the result was reasonably foreseeable "based on all the facts."

[30] The context used in these sections requires the filer to identify "any industry, trade, profession, or other group with a common *economic interest*." (emphasis added.)

[31] See *Consumers Union of United States, Inc. v. California Milk Producers Advisory Board* (1978) 82 Cal.App. 3d 433, pp.443-444 "the official must have a financial interest of the type described in *section 87103, subdivision (a)-(d).*"

some have suggested that the term financial interest be used to indicate a "legal conclusion."[32] In other words, a "financial interest" under Section 87103 would not exist unless the official has an investment, etc., and a decision is presented that will reasonably foreseeably and materially financially affect the identified interest in a manner distinguishable from the public generally. But this conclusion-based definition was never the intended meaning of "financial interest" under the Act.

Section 87302 (the disclosure requirements for designated employees, commonly referred to as "code filers") requires disclosure of *financial interests* not "economic interests." It makes it mandatory for an agency to enumerate "the positions … [that] involve the making or participation in the making of decisions which may foreseeably have a material effect on any *financial interest*." (Section 87302(a), emphasis added.)

At best, application of the "legal conclusion" interpretation makes the language redundant, because a financial interest would already be interpreted to be foreseeably and materially affected by a decision. Application of the above interpretation also makes that determination incomprehensible. In order to alleviate this problem, we now give the explanation that "economic interests are for disclosure, while financial interests are for disqualification; you have to disclose your economic interests so that you know what your financial interests are." In other words, "economic interest" is the larval stage before metamorphosis turns it into a financial interest.

This interpretation has become one of the main factors leading to overdisclosure, the "make them disclose everything; that way you do not miss anything" syndrome. To interpret the term "financial interest" as an interest that only develops after the interest becomes reasonably foreseeable, material, and distinguishable from the public generally under Section 87302 plays havoc with its usage elsewhere in the Act.[33]

Staff purposes to consolidate, clarify, and harmonize the statutory use and regulatory use of the term "financial interest" and return to the meaning that it plainly had in the beginning. With respect to the use of the term "economic interest" we suggest that it be confined, as the statute confines it, to its usage on the financial disclosure form.

Conclusion and Future Issues

One of the main goals in this project is to provide clarity in the conflicts process. The regulations should be easily understandable by anyone who wishes to participate in public service. The regulations should not read like a technical manual or contain convoluted and unusable formulas. At the same time, they should not be made so simplistic as to ignore real life situations.

---

[32] Donovan telephone conversation, *ibid.*

[33] See also Section 82034, which defines "investment" as a financial interest in a business entity. If a financial interest only comes into being after a decision converts it into one, no one would have an investment in a business entity until it is affected by a decision.

At the May Commission meeting, staff will present a "discussion only" memorandum providing the history and background for our examination of real property decisions, with the hope that the discussion will elicit some useful suggestions that staff may incorporate into new proposed materiality regulations for real property decisions. Because many of the processes that Legal Division staff developed in this area have been based upon inexperience with the evaluation of financial effects on real property in the appraisal process, staff will attempt to make available to the Commission a real estate appraiser who has served as an expert witness and supervising appraiser with the Office of Real Estate Appraisers (OREA) in prosecuting licensing action for violations of the Uniform Standards of Professional Appraisal Practice (USPAP) under California state law.

Later meetings over the course of the remainder of the year will focus on: (1) developing new materiality standards for business interests, sources of income, and personal financial effect; (2) reexamining the rules for what is "distinguishable from the public generally," while attempting to make this calculation more determinable, especially with respect to real property; (3) trying to come up with an appropriate interpretation of when someone is "participating in" a governmental decision; (4) providing usable and workable definitions, including the definition of "consultant" and "otherwise related business entities; and (5) providing a regulation that will serve as a guide to determine when an organization is acting as a government agency.

Attachments:
Attachment 1 -- *California Voters Pamphlet, June 4, 1974 Primary Election*
Attachment 2 -- Regulation 18702, 1976
Attachment 3 -- Staff Memorandum prepared by Robert E. Leidigh, Counsel, dated July 14, 1988