

Memorandum

To : Chairman Larson, Commissioners Fenimore,
Lee, Montgomery and Roden

Date : July 14, 1988

From : Fair Political Practices Commission

Robert E. Leidigh, Counsel *REL*
Legal Division

Subject :

Adoption of Proposed Materiality Regulations

Background

The Political Reform Act (the "Act")^{1/} provides that no public official shall make, participate in, or use his or her official position to influence, a governmental decision in which the official has a financial interest. (Section 87100.) An official has a financial interest in a decision if it is reasonably foreseeable that the decision will have a material financial effect on the official, on a member of the official's immediate family, or on one of the official's economic interests (e.g., an investment, real property, or a source of income).^{2/}

A key component of any analysis of whether an official has a financial interest in a decision is whether or not the decision will have a material financial effect on the official's economic interest. Economic interests include a business entity in which the official is an officer, employee, partner, or holds a position of management, or in which the official holds an investment of \$1,000 or more. Economic interests also include any real property in which the official has a direct or indirect interest worth \$1,000 or more. They also include sources of income or gifts totalling \$250 or more within the preceding 12-month period.

^{1/} Government Code Sections 81000-91015. All statutory references are to the Government Code unless otherwise indicated. Commission regulations appear at 2 California Code of Regulations Section 18000, et seq. All references to regulations are to Title 2, Division 6 of the California Code of Regulations.

^{2/} The decision's effect on the official, his or her family, or the economic interest also must be distinguishable from the effect on the public generally.

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In 1985, the Commission began the process of revising, restructuring and updating the Commission's regulation defining a "material financial effect." Two parts of the existing regulation were revised and became current Regulations 18702.1 and 18702.2. Two other proposed regulations were developed in 1985 to deal with real property and redevelopment decisions. Commissioners Montgomery and Roden worked with staff in developing these.

In the fall of 1985, the League of California Cities (the "League") appeared before the Commission and expressed concern over the piecemeal approach to the revisions. At the League's request, the Commission agreed to postpone further consideration of the revisions until the staff and representatives of the League could meet to discuss the entire package of revisions and hopefully achieve some agreement on what the entire package should look like.

It has been a lengthy and arduous task. However, staff and representatives of the League, who have been joined more recently by a representative of the County Counsel Association, have met repeatedly and have now reached consensus on a package of regulations. We jointly believe these proposed regulations will greatly improve the process of analyzing the materiality issue for conflicts of interest questions. The attached package will be presented to you at this meeting for adoption. It is expected that representatives from the League will be present to express the League's concurrence. (The League's letter of support is attached.)

Synopsis

The proposed regulations adopt the structure of the gift regulations. They begin with a "road map" regulation setting forth the general rule and containing a list of cross-references to specific rules (found in the companion regulations) which apply in certain situations.

Decisions Directly Involving an Official's Interest

The specific rules are divided into two groups. The first applies whenever the official's economic interest is directly involved in the decision. Those circumstances dictate

disqualification unless it can be shown that there is no financial effect on the official's economic interest which reasonably could result from the decision. For example, a decision to rezone property in which the official has an interest, or to grant a business license to the official's employer, are decisions in which the official's economic interest is directly involved and disqualification is required.

Decisions Indirectly Involving an Official's Interest

The second group of specific regulations applies whenever the official's economic interest is not directly involved in the decision, but it is reasonably foreseeable that the economic interest will be affected by the decision. For example, a decision to rezone property across the street from property owned by a source of income to the official is a situation where the official's economic interest (i.e., the source of income) is not directly involved in the decision. However, it may be reasonably foreseeable that the rezone decision will have a material financial effect on the source of income. Under the second group of regulations, a standard is provided for measuring the materiality of a financial effect in such situations.

Overall the package of regulations seeks to provide clearer and more detailed guidance in determining the question of material financial effect. To that end, it delineates some situations where disqualification is almost always required and some situations where it almost never is required. The regulations seek to eliminate confusion and debate over those situations which seem clear and to focus the process of analysis on those situations in between, which necessitate a case-by-case approach.

The Proposed Regulations

1. Proposed Regulation 18702 - The existing Regulation 18702 would be repealed. Currently, it contains both general guidelines and specific guidelines for situations where decisions indirectly involve an official's economic interest.

The proposed Regulation 18702 would contain the general standard and the "road map" listing of the specific standards. In addition, it provides a clarification that disqualification is not required if the effect on the official's interest is not distinguishable from the effect on the public generally.

2. Proposed Regulation 18702.1 - This proposed regulation would amend the existing Regulation 18702.1, which deals with decisions directly involving an official's economic interest.

The proposed Regulation 18702.1 contains numerous changes for clarity and consistency with the other regulations in the package.

In addition, in subdivision (a)(1), the proposed Regulation 18702.1 includes a provision borrowed from the existing Regulation 18702: the requirement that an official disqualify whenever there is a "nexus" between the purpose of the decision and the purpose for which the official receives income. This provision prevents an official from being paid privately to advance a policy or proposal which the official then advocates or adopts in his or her official capacity. Under the regulation, a nexus exists if the official receives income to achieve a goal or purpose which would be achieved, defeated, aided, or hindered by the decision.

The proposed Regulation 18702.1, in subdivision (a)(3), clarifies when decisions directly involving real property in which the official has an interest will necessitate disqualification. It explicitly includes certain redevelopment decisions where the official owns property in the redevelopment area. These decisions are the major ones which involve establishing or amending the redevelopment plan. (See subdivision (a)(3)(D).) This is in keeping with the court's ruling in the Downey Cares case. (Downey Cares v. Downey Community Development Com. (1987) 196 Cal. App. 3d 983.)

The current provisions in the regulation requiring disqualification whenever a decision will affect the income or assets of the official or his or her immediate family are retained. Also retained are the current provisions requiring disqualification when a business entity or other source of income is directly involved in the decision, such as seeking a license, permit or contract, etc. (See subdivisions (a)(4) and (a)(1) respectively.)

Lastly, the current provisions in the regulation regarding decisions directly involving business entities in which the official has an investment interest would be modified. The change would exclude from automatic disqualification those circumstances in which the official owns less than \$10,000 in stock in a very large corporation traded on a national stock exchange. In those circumstances, the standards for determining materiality for decisions which indirectly involve the business entity would be applied. (Regulation 18702.2.)

3. Proposed Regulation 18702.2 - The proposed regulation makes minor amendments to the current regulation. Most of these amendments are for the purpose of clarity and to make the wording of the regulation consistent with the other regulations in the package. However, two substantive changes have been made.

The first is in subdivision (c) of proposed Regulation 18702.2. This change in reference has been made to make it easier to determine whether a business entity falls within the provisions of the subdivision. Using the Pacific Stock Exchange list and the Eligible Securities List maintained by the Department of Corporations is easier than utilizing the current regulation. This change has been developed in consultation with the legal staff at the Department of Corporations.

The second substantive change is of more consequence. It has been pointed out that under the current regulation even the largest of all privately-held companies is subject to the materiality standard applied to companies listed on the National Association of Securities Dealers National Market (NASDAQ) list. That standard is considerably lower than the standard applied to New York and American Stock Exchange and Fortune 500 companies. Some have felt that the disparity of this standard compared to the treatment for the largest publicly-traded companies, which appear on the Fortune 500 lists, was too great. The language inserted into subdivision (d) of the proposed regulation lessens this disparity by making the largest privately-held companies subject to the same materiality standard that applies to companies listed on the New York or American Stock Exchanges. This is still a lower standard than for the publicly-traded Fortune 500 companies, but it is a higher standard than now applies. The staff feels that this is a fair compromise.

4. Proposed Regulation 18702.3 - This proposed regulation is entirely new; however, it would replace the provisions of current Regulation 18702(b)(2). The proposed regulation has been the subject of the greatest amount of discussion between the staff and the League's representatives. The resulting product has been carefully worked out to try to provide the maximum amount of guidance in determining when an official may or may not participate in decisions which affect the official's real property.

The proposed Regulation 18702.3 contains a series of standards. Subdivision (a) provides that disqualification is required when the decision involves another's real property located within a 300-foot radius of the official's property, unless the decision will have no financial effect on the official's property. The 300-foot radius is taken from planning law, which requires notice to owners of property within 300 feet of the subject property. An official would also be disqualified if the decision involves construction of or improvements to public facilities such as water, sewer or streets, which will result in the official's property receiving new or substantially improved services.

When a decision affects another's property which is more than 300 feet from the official's property, but within 2,500 feet of the official's property, the regulation provides standards for determining whether the effect will be material. The primary standard is the effect on the fair market value or the rental value of the official's property. The noticed regulation contains a range of values (\$2,000 to \$15,000). At the meeting you will be asked to select one value as the standard. The staff recommends that you select \$10,000 as that value.^{3/} Subdivision (d) of the proposed regulation provides some factors to consider in determining whether the requisite change in value is likely to occur.

Subdivision (b) of the proposed regulation provides that a decision will not have a material financial effect when an official's property is located more than 2,500 feet from the subject property, unless certain criteria are met. First, there must be specific factors present which make it likely that the value of the official's property will be affected by the requisite amount. Furthermore, the official's property must be affected differently from most of the surrounding properties within a 2,500-foot radius of the official's property. This provision provides for some degree of certainty that an official is not disqualified from participating in decisions affecting another's property which is located a substantial distance from the official's property unless there are specific circumstances which dictate disqualification.

Subdivision (c) merely is a catch-all for dealing with those decisions affecting real property which are not site-specific or which directly involve an official's property but are excluded from coverage under proposed Regulation 18702.1. For example, a decision to amend the set-back requirement for a particular zone would not have a "subject property" from which to measure a radius. Under such circumstances the basic monetary test would apply.

^{3/} The attached letter from San Jose City Attorney Joan Gallo urges that you adopt the regulation package and select "amounts which are reasonable in today's economic environment and substantial enough to be reasonably predictable."

The attached letter from Mayor Lewis E. Graham, II, of Brisbane also urges that you "select a value at the higher range of the scale . . ." That letter raises some related issues regarding definition and application of the "public generally" exception. That definition is contained in another, separate regulation and is not before you now.

5. Proposed Regulation 18702.4 - This proposed regulation is new and addresses a set of circumstances not directly addressed by the current regulations. The proposed regulation governs when an official is required to disqualify because the decision will affect real property in which the official has a leasehold, as opposed to an ownership, interest. It focuses on those changes which will affect the lessee's use of the property. It also provides a standard for determining materiality when the decision does not directly involve the leased property but does involve property nearby. Again, a range of dollar values has been included. The staff recommends that you adopt the \$250 amount.

6. Proposed Regulation 18702.5 - This regulation is entirely new. The current regulation contains no guidelines on when an effect from a decision is material as to a nonprofit entity. The current regulation merely applies the term "significant" in place of "material." The proposed Regulation 18702.5 parallels the structure of the regulation governing effects on business entities. It sets up a series of criteria based upon the monetary size of the nonprofit entity. Very large nonprofit entities such as Stanford University and the University of Southern California would be subject to the same materiality standards as Fortune 500 companies. Smaller nonprofits would be subject to lower standards.

7. Proposed Regulation 18702.6 - This regulation is also entirely new. Like the regulation on nonprofits, this regulation for the first time establishes standards for determining materiality for effects on individuals who are sources of income or gifts to the official. Under the current regulations, the term "significant" is substituted for the term "material." The proposed regulation would establish some monetary standards; again, it contains a range from \$500 to \$2,500, from which you will be asked to select an amount. The staff recommends that you select \$1,000.

Comments

As of the date of this memorandum only three written comments have been received. They have previously been mentioned and copies are attached. In addition, one telephone comment has been received, from former Commission staff attorney Lee Rosenthal. Mr. Rosenthal was concerned about the regulation dealing with redevelopment decisions. He said he would take the matter up with Lou Green, representative from the League of Cities. Mr. Green advises me that he did talk with Mr. Rosenthal. To date, I have had no further communication from Mr. Rosenthal, although he had told me he might write. It is possible that his concerns have been allayed.

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Conclusion

This package of regulations represents a comprehensive approach to the process of determining whether a particular decision's reasonably foreseeable effect will be material as to an official's economic interest. It is the culmination of many hours of cooperative effort by the staff and representatives from the League of Cities and the County Counsel Association.

A copy of the proposed regulations, together with a copy of current Regulation 18702, which will be repealed, is attached. A chart was prepared for the pre-notice discussion to facilitate the presentation and a copy of it is attached as well.

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Attachments