

## Fair Political Practices Commission

### Memorandum

**To:** Chair Remke, Commissioners Casher, Eskovitz, Wasserman, and Wynne

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

**Subject:** Proposed Amendment to the Conflict of Interest Regulations – Adoption of Regulation 18700.3: Definition of Parent, Subsidiary, or Otherwise Related Business Entity; Amendment of Regulations 18703.1 and 18438.5

**Date:** July 7, 2014

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#### **Proposed Commission Action and Staff Recommendation:**

Adopt new Regulation 18700.3 defining “parent, subsidiary, or otherwise related business entity” (formerly defined in 18703.1) pursuant to Section 82034 of the Political Reform Act (the “Act”)<sup>1</sup>, repeal Regulation 18703.1, and amend Regulation 18438.5 to add subdivision (b), which expressly adds the current definition found in Regulation 18703.1 into Regulation 18438.5, in the place of the current cross reference.

#### **Introduction:**

This item continues staff’s examination of potential revisions to the Act’s regulations that establish materiality standards in its conflict of interest analysis and is part of the overall continuing project to revise and simplify the Act’s conflict of interest regulations. After addressing new materiality standards with respect to real property interests at the April Commission meeting, the next project was to address new materiality standards for financial effects on business entities. However, before reaching that point, staff discovered a problem in the current regulation (18703.1) defining “business entities” which created a broader disqualification obligation than that supported by the statute. The effect of this broadening was to create more than one materiality standard to be applied to the same decision involving that single investment.

Additionally, the existing language used to define “otherwise related business entity” is so vague as to be next to impossible to determine when and if it applies in any given situation.

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<sup>1</sup> 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.

This item serves as a short preliminary step to correct the existing problems before moving on to revise the materiality standards for business entities.

**Review and Discussion:**

The Act's basic conflict of interest law is stated in Section 87100 as follows:

“No public official at any level of state or local government shall make, participate in the 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 87103 states that an official has a financial interest in a governmental decision whenever:

“...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:

- (a) Any business entity in which the public official has a direct or indirect *investment* ...
- (b) Any real property in which the public official has a direct or indirect interest ...
- (c) Any source of income ...
- (d) Any business entity in which the public official is a director, officer, partner, trustee, employee, or holds any position of management.
- (e) Any donor of, or intermediary or agent for a donor of, a gift or gifts ...” (Emphasis added.)<sup>2</sup>

Finally, Section 82034 defines “investment” as an:

“... interest in or security issued by a business entity, including ... common stock, preferred stock, rights, warrants, options, debt instruments, and any partnership or any other ownership interests owned directly, indirectly, or beneficially by the public official, or other filer, or his or her immediate family, if the business entity *or any parent, subsidiary, or otherwise related business entity* has an interest in real property in the jurisdiction, or does business or plans to do business in the jurisdiction, or has done business within the jurisdiction at any time during the two years prior to the time any statement or other action is required under this title.”

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<sup>2</sup> The threshold to qualify as a financial interest under (a) through (c) is \$2,000. For gifts it is currently \$440.

The concluding sentence of this section states that the term “‘parent, subsidiary or otherwise related business entity’ shall be specifically defined by regulation of the commission.”<sup>3</sup>

The term is used in the statute solely for the purpose of establishing that a business has property in the jurisdiction or is doing business in the jurisdiction when it has certain significant interests in or relationships with other entities that are operating or own property in the jurisdiction. Simply put, a business operating outside the official’s jurisdiction, may never-the-less be presumed to be in the jurisdiction if a parent, subsidiary or otherwise related business entity is operating in the jurisdiction. The use of the term is strictly limited to determining when an entity has enough of a presence in the jurisdiction so as to be impacted by a decision made by an official who has an investment interest in the business entity.

Section 87209 also provides a corresponding rule for business positions in a business entity under Section 87103(d), limiting the financial interest to those business entities, or “any parent, subsidiary, or otherwise related business entity” with a business or property ownership connection to the jurisdiction.

Current Regulation 18703.1 goes well beyond the language of Section 82034 by creating separate investment interest in a separate business, beyond the business in which the official owns stock or holds a position as contemplated by the statute. Rather the current rule *creates* an independent interest in each and every parent, subsidiary, or otherwise related business entity to the business in which the identifiable statutory investment interest is held.

Regulation 18703.1(c) states:

“(c) Parent, Subsidiary, Otherwise Related Business Entity. An official has an economic interest in a business entity which is a parent or subsidiary of, or is otherwise related to, a business entity in which the official *has one of the interests defined in Government Code section 87103(a) or (d).*” (Emphasis added.)

In other words, the current regulation splits the one actual investment interest or business position interest held by the official into interests in multiple entities depending on how many different entities are somehow connected to the company in which the actual investment or business position is held.

Aside from the fact that the regulation goes well beyond the authority of the statute by creating these additional financial interests, it creates problems related to any

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<sup>3</sup> “Business Entity” is separately defined in Section 82005 essentially as “...any organization or enterprise operated for profit...”

conflict of interest analysis. Even if one could ascertain all the related interests that spring from the one investment interest or position, since as a separate interest each entity would require a separate analysis and a potentially different materiality test depending on the size of the different business entities, it is virtually impossible to determine with any degree of certainty in many situations where the process begins and ends and whether or not a conflict exists.

Compounding the problem even further is the current language defining otherwise related business entities. While the current language may provide some useful guidance to someone in determining when contributions are to be aggregated for the purpose of determining contribution limits, they are not very helpful in determining when someone could be subject to a conflict of interest.

### **Proposed Regulation 18700.3**

Newly proposed Regulation 18700.3 provides a definition for parent, subsidiary, or otherwise related business entity for the purpose of determining when a business entity owns property or has a business connection to a jurisdiction without creating a separate financial interest in each of the related entities. The definition of “parent” and “subsidiary” remains essentially the same. The definition of “otherwise related business entity” has been simplified to apply in two situations currently addressed in Regulation 18703.1 where the same person owns or controls each entity. Other conditions such as commingled funds, shared offices, resources, and personnel and “otherwise regular and close working relationship” has been eliminated as too difficult to determine and too vague to apply in conflicts situations.

### **Repeal Regulation 18703.1**

The proposed amendments would eliminate subdivision (c) of Regulation 18701.3, which creates potentially disqualifying interests not identified in the statute, for the reasons stated above. It would also eliminate subdivision (d), as new definitions are made applicable for conflict purposes under proposed Regulation 18700.3.

The current language in subdivision (c) and (d), which is currently referenced in Regulation 18438.5, an unrelated regulation that applies to aggregating contributions, would be moved into a new subdivision (b) under that regulation and used solely for its purposes.<sup>4</sup> In proposing changes to the conflict of interest analysis herein, staff did not intend to alter any provisions relating to a determination when contributions are to be aggregated under Section 84308. Consequently, incorporating the current existing definition into Regulation 18438.5 (in place of the current cross reference) essentially maintains the status quo analysis under Section 84308. However, the Commission may wish to examine the possibility of developing new language to specifically address that

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<sup>4</sup> Regulation 18438.5 establishes that contributions made by a party to a proceeding are aggregated when made by “a party’s parent, subsidiary, or otherwise related business entity” as those terms are defined in the current regulation.

situation and legal staff would offer to work closely with the Enforcement Division staff to address their concerns.

With those proposed changes, the only language of current Regulation 18703.1 that would otherwise remain, the introductory paragraph and subdivisions (a) and (b), is essentially contained in the statute, and no useful purpose is served by leaving it as the only remaining part of the current regulation. Therefore, staff recommends the entire regulation be repealed.