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FAIR POLITICAL PRACTICES COMMISSION
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To: Chair Miadich, Commissioners Cardenas, Hatch, and Hayward

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Subject: Repeal and Adoption of Regulation 18702.1

Date: July 8, 2019

Requested Action and Summary of Proposed Action

Staff requests the repeal of existing Regulation 18702.1 and the adoption of proposed, new Regulation 18702.1. Existing Regulation 18702.1 sets forth the materiality standards applicable to a governmental decision's financial effect on a public official's financial interest in a business entity. In order to improve the existing regulation's clarity and guidance, new Regulation 18702.1 would update those materiality standards by incorporating new bright-line materiality standards applicable to a decision's effect on an official's interest in a business not explicitly involved in the decision.

New Regulation 18702.1 would also establish new materiality standards for a decision's effect on a real property interest of a business in which an official is interested, and reestablish the "Small Shareholder Exception" applicable to an official's investment interest in a business of \$25,000 or less which makes up less than one percent of the business's shares. In addition to these changes, new Regulation 18702.1 would also make other clarifying changes as discussed below.

The proposed repeal of existing Regulation 18702.1 and adoption of new Regulation 18702.1 arise out of the notion that the inclusion of bright-line materiality standards applicable to decisions' effects on officials' financial interests in businesses will result in a more accurate assessment of whether a disqualifying conflict of interest exists with respect to a decision affecting such an interest.

Discussion

Background

The Political Reform Act's (the "Act")¹ conflict of interest provisions ensure that public officials 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).) The Act

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.

prohibits a public official from making, participating in making, or attempting to use his or her official position to influence a governmental decision if it is reasonably foreseeable that the decision would have a material financial effect on one or more of the official's financial interests distinguishable from the decision's effect on the public generally. (Sections 87100 and 87103.) Under the Act, a public official has a financial interest in a business entity if:

- The official has a direct or indirect investment in the business entity worth \$2,000 or more.² (Section 87103(a).)
- The official is a director, officer, partner, trustee, employee, or holds any position of management with the business entity. (Section 87103(d).)

At the Commission meeting on March 21, 2019, Commissioner Hatch expressed concern that the existing materiality standards applicable to a governmental decision's effect on an official's interest in a business, set forth in existing Regulation 18702.1, may require redress because the materiality standard applicable to large corporations not explicitly involved in the decision did not account for instances that may significantly affect a large corporation but may not result in a change to its stock value. Additionally, the Commission has previously raised concerns with the existing materiality standards of Regulation 18702.1 and have asked staff to further consider revisions establishing bright-line materiality standards to improve the regulation's clarity.

At the Commission meeting on May 16, 2019, when the proposed repeal and adoption of Regulation 18702.1 were presented to the Commission for approval to provide notice of the proposed changes to the Office of Administrative Law, staff presented the Commission with options for the value thresholds of new Regulation 18702.1's bright-line materiality standards. The Commission, however, did not appear to reach a consensus on the appropriate thresholds for those materiality standards at that meeting. Accordingly, we present those options for the Commission's ongoing consideration, including new options suggested by Commissioners at that meeting.

The Existing Regulation

Existing Regulation 18702.1 sets forth the materiality standards applicable to a governmental decision's reasonably foreseeable financial effect on a public official's financial interest in a business entity. Subdivisions (a)(1) through (7) of existing Regulation 18702.1 provide that a decision's effect on an official's interest in a business is material if the business takes certain specified actions, or if the business is subject to the authority of the official's agency with respect to the decision. Subdivision (b) of the existing regulation sets forth a broad and general materiality standard applicable to a decision's financial effect on an official's financial interest in either a publicly traded or privately held business: the effect is material if it "would contribute to a change in the price of the business entity's publicly traded stock, or the value of a privately-held business entity."

² This type of financial interest in a business entity is sometimes referred to as an "investment interest."

New “Bright-Line” Materiality Standards

As noted above, new Regulation 18702.1 would establish bright-line materiality standards applicable to a decision’s effect on an official’s financial interest in a business that is not explicitly involved in the decision in order to improve the regulation’s clarity and guidance. Specifically, proposed, new Regulation 18702.1 would:

- Revenues: Add new subdivision (a)(2) to the regulation, which would provide that a decision’s reasonably foreseeable effect on an official’s interest in a business that is not explicitly involved in the decision is material if the “decision may result in an increase or decrease of the entity’s gross annual revenues, or the value of the entity’s assets or liabilities, in an amount equal to or more than:
 - “(A) [(DECISION POINT 1: High Threshold) \$500,000 or \$1,000,000 or \$2,500,000]; or
 - “(B) Five percent of the business’s annual gross revenues [(DECISION POINT 2: Low Threshold) and the increase or decrease is at least \$10,000].”
- Expenses: Add new subdivision (a)(3) to the regulation, providing that a decision’s reasonably foreseeable effect on an official’s interest in a business that is not explicitly involved in the decision is material if the “decision may cause the entity to incur or avoid additional expenses or to reduce or eliminate expenses in an amount equal to or more than:
 - “(A) [(DECISION POINT 3: High Threshold) \$100,000 or \$250,000 or \$500,000]; or
 - “(B) One percent of the entity’s annual gross revenues [(DECISION POINT 4: Low Threshold) and the change in expenses is at least \$2,500].”

By establishing these thresholds for materiality based on the business’s annual gross revenues, new Regulation 18702.1 addresses the reality that whether a decision’s financial effect on a business not explicitly involved in the decision is material often differs depending on the size and value of the business. This is primarily accomplished by considering the impact a decision may have as a percentage of the business’s annual gross revenues. For instance, a single decision’s effect on a local small business may be material, and its effect on a large multinational corporation may not be material, due to the vastly different size of the two businesses. In addition, the high and low thresholds (identified as “Decision Points”) in subdivisions (a)(2) and (a)(3) are designed to provide bright-line standards that will accurately determine whether a decision’s effect on a business not explicitly involved in the decision is material regardless of that business’s size.

The high thresholds of subdivisions (a)(2)(A) and (a)(3)(A) establish bright-line rules providing that any decision affecting a business by the applicable high-threshold amount, or more, would be deemed to have a material financial effect on the official’s interest in that business. These high thresholds were designed to assess whether a decision’s effect on a large business entity, such as a multinational corporation, is material, and they are unlikely to apply to a decision’s effect on a medium or small sized businesses because they will often exceed those businesses’ total value. The Commission should determine whether to include the high threshold requirement and, if so, the dollar amount of that

threshold. The Commission may choose any dollar amount it deems an appropriate threshold over which a decision's effect would be deemed material regardless of the size of the business.

The percentage thresholds of subdivisions (a)(2)(B) and (a)(3)(B) establish bright-line rules which provide that any decision affecting a business by more than either of the specified percentages (five percent in subdivision (a)(2)(B), and one percent in subdivision (a)(3)(B)), would have a material financial effect on the official's interest in that business. These thresholds, based on the value of the effect as a percentage of the value of the business, assess materiality for small and medium sized businesses proportionally based on the value of the particular business at issue, and are unlikely to apply to a decision's effect on a large business because they would be even higher with respect to that business than the high thresholds of subdivisions (a)(2)(A) and (a)(3)(A).

To avoid these percentage thresholds resulting in too many disqualifications of officials with interests in small businesses, optional language in subdivisions (a)(2)(B) and (a)(3)(B) require the effect to be of a minimum value to be material (\$10,000 in subdivision (a)(2)(B), and \$2,500 in subdivision (a)(3)(B)). The Commission should determine whether to include the low threshold, and, if so, the dollar amount of that threshold. The Commission may choose any dollar amount it deems an appropriate threshold below which a decision's effect would not be deemed material regardless of the size of the business.

We now apply the materiality standards of proposed, new Regulation 18702.1 to various hypothetical scenarios to illustrate how those standards would apply in different factual circumstances.

Example 1: Percentage Thresholds.

A city councilmember owns and operates a medium sized insurance brokerage with annual gross revenues of \$1,000,000. The decision at issue is whether the city council should adopt an ordinance regulating cannabis businesses given that the ordinance will require those businesses to purchase and carry insurance to be permitted.

New Regulation 18702.1(a)(2) provides that a decision's reasonably foreseeable financial effect on an official's business interest that is not explicitly involved in the decision is material if the decision may result in an increase or decrease of the business's annual gross revenues, or the value of the business's assets or liabilities, in an amount equal to or more than: (A) [\$500,000 / \$1,000,000 / \$2,500,000]; or (B) five percent of the business's annual gross revenues and the increase or decrease is at least [\$10,000]. The decision's reasonably foreseeable financial effect on an official's interest in a business is also material under subdivision (a)(3)(B) if the decision may cause the entity to incur or avoid additional expenses or to reduce or eliminate expenses in an amount equal to or more than: (A) [\$100,000 / \$250,000 / \$500,000]; or (B) one percent of the entity's annual gross revenues and the change in expenses is at least [\$2,500].

With annual gross revenues of \$1,000,000, the percentage thresholds of Regulation 18702.1(a)(2)(B) and (3)(B) would apply. Thus, the effect on the councilmember's business of the decision regarding the ordinance would be material if the resultant increase or decrease in the business' annual gross revenues, or its assets or liabilities, is five percent or more of the gross revenues (\$50,000

or more) or if the change in expenses is one percent or more of the gross revenues (\$10,000 or more). Additionally, to the extent that there is an effect of the decision on the business other than an effect on its revenue, assets or liabilities, or expenses, that effect may also be material under the materiality standard set forth in subdivision (a)(5), if the decision has will affect the value of the business.

Example 2: Decision Points 1 and 3, High Threshold Amounts. When it is reasonably foreseeable that a decision will result in an increase or decrease of the business's annual gross revenues or its assets and liabilities under subdivision (a)(2), or in the business incurring, avoiding, reducing, or eliminating expenses under subdivision (a)(3), should we establish high thresholds for each of those standards, beyond which the effect would be material regardless of the size of the business at issue?

A "high threshold" would establish a single bright line amount beyond which a decision's effect on a business not explicitly involved in the decision would be material regardless of the size of the business. Establishing a "high threshold" amount is advisable because merely determining materiality based on a financial effect's size *relative to the business's size* would permit officials to take part in decisions involving financial effects that are objectively large and potentially influential, but not so large that they represent five percent of a large business's annual gross receipts. The lower the "high threshold," the more stringent the standard, and the more likely an official will be disqualified from a decision due to the decision's effect on the business entity.

The first major decision(s) for the Commission to make is determining whether to include a "high threshold" amount and, if so, what the amount should be. Staff believes that including a simple "high threshold" amount would improve the current materiality standard, as it would potentially simplify the analysis that an official has to make to determine whether a foreseeable financial effect would be material. The reasoning is essentially that, at a certain point, a financial effect is significant enough to be deemed "material," regardless of the size of the business. It can be thought of as somewhat of a "common sense" standard.

Consider as an example, a city councilmember who manages a national restaurant chain within the city, which has annual gross revenues of approximately \$1,000,000,000. The decision at issue is whether the city council should approve a permit for a competing chain. In light of the size of the national chain, applying the basic percentage tests based upon the business's gross revenues would establish a materiality standard of \$50,000,000 or more for an effect on the business revenues or assets and liabilities (five percent or more of the business's annual gross revenues) and \$10,000,000 or more for a change in expenses (one percent or more of the business's annual gross revenues).

Generally, most people would find an effect on a business material at an amount much less than \$10,000,000 or \$50,000,000. Accordingly, adopting a high threshold, the official will be disqualified if the effect on the business's revenues, assets and liabilities, or expenses exceeds the high threshold. Thus, staff recommends adopting a high threshold of \$1,000,000 for a decision's effect that result in an increase or decrease in the business's annual gross revenues or assets and liabilities, and a high threshold of \$250,000 for a decision's effect that results in a change in the business's expenses. The Commission, however, may determine whether the inclusion of these high thresholds is appropriate, and establish appropriate amounts for each high threshold, as it deems

appropriate. While staff has identified several options for amounts of the high thresholds, for sake of clarity we again note that the lower the high threshold, the more likely an official will be disqualified from a decision due to an effect on a large business entity.

Example 3: Decision Points 2 and 4, Low Threshold Amounts. When it is reasonably foreseeable that a decision will result in an increase or decrease of the business's annual gross revenues or its assets and liabilities under subdivision (a)(2), or in the business incurring, avoiding, reducing, or eliminating expenses under subdivision (a)(3), should we establish low thresholds for each of those standards, above which the effect on a small business would be material?

A low threshold amount, in either subdivision (a)(2)(B) or (3)(B), would establish a single bright line below which an effect on a small business would not be material. The higher the "low threshold," the more permissive the materiality standard with respect to small business and the more likely an official with an interest in a small business will be able to take part in a decision despite a less significant effect on the business.

Accordingly, decision points 2 and 4 ask the Commission whether respective "low thresholds" should be included in the materiality standards of subdivisions (a)(2)(B) and (3)(B), and what should the respective amounts of those low thresholds be if they are included?

Staff believes that the materiality analysis would benefit from including "low thresholds" in each of new Regulation 18702.1's bright-line materiality standards, set forth in subdivisions (a)(2)(B) and (3)(B) respectively. The low thresholds are intended to allow public officials with interests in small businesses to take part in decisions without being disqualified due to minor, but reasonably foreseeable, financial effects on their business.

As an example, we consider a city councilmember who owns and operates a real property management business, which manages two residential rental units and has annual gross revenues of \$40,000. The decision at issue is whether to convert a nearby vacant lot into a neighborhood park. In this scenario involving a small business, we do not consider the potential high thresholds or the basic percentage thresholds of subdivisions (a)(2) or (3). Assuming the Commission adopts the low threshold of \$10,000 for an increase or decrease in a business's annual gross revenues or assets and liabilities in subdivision (a)(2)(B), and the low threshold of \$2,500 for a change in a business's expenses in subdivision (a)(3)(B), five percent of the business's annual gross revenues would be \$2,000 and one percent would be just \$400. Both of which are less than the minimum values for a material effect provided by each of those low thresholds. Therefore, under Regulation 18702.1(a)(2)(B) and (3)(B), the effect on the councilmember's business of the decision regarding the neighborhood park ordinance would be material only if the resultant increase or decrease in the business' annual gross revenues, or its assets or liabilities, is \$10,000 or more, or the change in its expenses is \$2,500 or more.

New Materiality Standards for a Decision’s Effect on a Business’s Real Property

New Regulation 18702.1 would also add subdivision (a)(4), establishing new materiality standards for a decision’s effect on a real property interest of a business in which the official at issue is interested. New Regulation 18702.1(a)(4) provides that a decision’s reasonably foreseeable financial effect on a business is material if the “official knows or has reason to know that the entity has an interest in real property” and either the “property is explicitly involved under Regulations 18701(a) and 18702.2(a)(1) through (6)” or there “is clear and convincing evidence that the decision would have a substantial effect on the property.” These new materiality standards are designed, in part, to better address the scenario, raised by Commissioner Hatch at the March 21, 2019 Commission meeting, in which a large corporation not explicitly involved in the decision at issue is substantially affected by the decision although the decision may not result in a change to the large corporation’s value.

Other Effect on Value

Under new Regulation 18702.1(a)(5), a financial effect may also be found to be material if the decision would affect the business’s value in some way other than an effect on the entity’s annual gross revenues, assets or liabilities, expenses, or real property interests.

Reestablishment of the “Small Shareholder Exception”

For more than a decade, until January 2015, prior versions of the materiality standards applicable to a decision’s effect on an official’s interest in a business contained a previous iteration of the “Small Shareholder Exception.” Historically, if this exception applied, the official would not be disqualified as a result of the business in which he or she was interested being directly (or explicitly) involved in the decision; the official would be disqualified only if it was reasonably foreseeable that the decision’s effect would be material under a standard applicable to a business indirectly (or not explicitly) involved in the decision.³ That exception was eliminated by the January 2015 amendment of the former regulation that set forth the materiality standards applicable to a decision’s effect on a business entity. (See former Regulation 18705.1, as amended in January 2015, and documents related to those amendments’ adoption.)

New Regulation 18702.1 sets forth a new iteration of the Small Shareholder Exception in subdivision (b). Under this new iteration, a decision’s effect on an official’s investment interest in a business, which has a value of \$25,000 or less and is less than one percent of the business’s shares,⁴ would not be material solely on account of the business being explicitly involved in the decision; instead, the decision’s effect on the business would be material only if it is material under the regulation’s standards applicable to a decision’s effect on a business not explicitly involved in the decision.

³ Note that the term “directly” was replaced by the term “explicitly” in the 2015 amendments to the conflict of interest regulations.

⁴ The \$25,000 or less, and less than one percent thresholds of the new Small Shareholder Exception are based on the pre-2015 version of the regulation. In staff’s experience, these thresholds worked well in practice.

Summary

Proposed, new Regulation 18702.1 would incorporate new, bright-line materiality standards into the regulation to improve its clarity and guidance; establish new materiality standards for a decision's effect on a real property interest of a business in which an official is interested; set forth the updated materiality analysis of a decision's reasonably foreseeable financial effect on a business interest in light of the regulation's inclusion of the new materiality standards; clarify that a decision's effect on an official's interest in an explicitly involved business entity is material; and reestablish the "Small Shareholder Exception" applicable to an official's investment interest in a business of \$25,000 or less which makes up less than one percent of the business's shares. Staff respectfully requests that the Commission adopt proposed, new Regulation 18702.1.

Attachments:

Proposed Repeal of Existing Regulation 18702.1

Proposed Adoption of New Regulation 18702.1