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

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**Subject:** Determining the Material Financial Effect of a Decision on an Official's Financial Interest in a Source of Income, Source of Gift, or Personal Finances; Amendments to Regulations 18705, 18705.3, 18705.4, and 18705.5; Repeal of Regulations, 18704, 18704.1, 18704.5

**Date:** January 5, 2015

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## Summary

A public official is prohibited from making, participating in making, or attempting to influence a governmental decision if it is reasonably foreseeable that the decision will have a *material* financial effect on the official, an immediate family member, a source of income, a source of gifts to the official, a business entity in which the official has a financial investment or holds a specified position, or on any real property in which the official has a direct or indirect interest. (Gov. Code, §§ 87100 and 87103, subd. (a) through (e).)<sup>1</sup> Recent amendments to regulations have established new materiality standards for decisions affecting real property and business entity interests. The current amendments establish new materiality standards for the last three financial interests identified in the Act: an official's source of income, source of gift, or his or her personal or family finances.

## Conflict of Interest Project

The proposed regulations are part of the Commission's ongoing project to revise and streamline the Act's conflict of interest regulations. (Regs. §§ 18700-18709.) To date, the following regulatory changes have been adopted: (1) consolidated the conflict of interest analysis from an 8-step to a 4-step process; (2) amended the meaning of "reasonably foreseeable" to provide better guidance; and (3) modified the standards to determine if there is a "material financial effect" on an official's interest in real property or a business entity.

To establish materiality under the current regulations, the first step is to determine whether an official's financial interest is "directly" or "indirectly" involved in the government decision. (Regs. §§ 18704 & 18704.1) If the interest is directly involved, generally, the

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<sup>1</sup> The Political Reform Act (Act) is set forth in Title 9 (Government Code Sections 81000 through 91014), and all further statutory references are to this code. The Commission's regulations are contained in Division 6, Title 2 of the California Code of Regulations, and all regulatory references are to this source.

financial effect is presumed material unless the decision will have *no* financial effect (i.e., one-penny rule). (See Former Regs. §18705.1(b)(1).)

As explained throughout this revision process, the tests used to determine a “material” financial effect were based on bright line measurements, established under a belief that this method was the only way to provide certainty in determining if a conflict of interest existed. For example, for real property determinations, we drew a line at 500 feet and said, on this side of the line, the property is directly involved and the one-penny rule applies, while on the other side of the line no materiality standards were established.

The application of these bright line rules essentially lead to the same ultimate conclusion—if the interest was directly involved in the decision, there was a conflict; if it was indirectly involved in the decision, there was not. Basically, the rules were simplified to determine a conflict by a fixed formula or automation. Under that system, we rarely advised that a decision’s financial effect on an “indirectly involved” interest was material, and we are unable to find a conflicts case that did not involve the use of the presumption of materiality under the one-penny rule.

Recent amendments to the real property and business entity materiality tests have eliminated the two-pronged “directly involved/indirectly involved” determination, along with its corresponding presumptions of materiality (one-penny rule) and non-materiality. Now, there still is a conflict if a financial interest is directly part of a decision unless it can be established that decision will have no measurable financial effect. However, in other situations, all available facts will be examined under a test that applies a prudent person standard to determine if the decision will have a material financial effect on the public official’s interest.

### **Proposed Materiality Regulations**

As we did with the business entity and real property interests, sources of gifts and sources of income will no longer be analyzed under the “directly” or “indirectly” involved test, and the corresponding regulations will be deleted. The surviving elements of these regulations are combined into one materiality standard for each financial interest at issue. (Proposed Regs. §§ 18705.3 & 18705.4.)

With respect to a financial interest in personal finances, the current rule provides that an official is always directly involved in a decision that has *any* financial effect on his or her personal finances. (Regs. §18704.5.) This regulation is also being repealed and replaced by a specific test for personal finances provided in proposed Regulation 18705.5.

Finally, we are modifying the rebuttable presumption rule to clarify that a financial effect is not considered material under any of the standards if the financial effect is nominal, inconsequential, insignificant, or immeasurable. (Proposed Regs. § 18705.)

Accordingly, the four amended regulations under consideration are 18705.3, 18705.4, 18705.5 and 18705, which are discussed below.

## **1. Regulation 18705.3 – Source of Income**

Under the current regulation, the financial effect of a governmental decision on an official's source of income is material if the source is directly involved, i.e., the one-penny rule. For sources of income that are indirectly involved, the materiality standard depends on the nature of the source. If the source is: 1) a business entity, the business entity materiality standard applies; 2) a nonprofit or government entity, materiality is based on the gross annual revenues of the entity and the impact on its finances, including assets and liabilities; and 3) an individual, it is material if it impacts the individual's assets and liabilities by \$1,000 or more, or the individual's real property interest pursuant to the real property materiality standard.

The regulation proposes three main changes: (1) it divides sources of income into two categories, i.e., income from the sale of goods and services versus income from the sale of personal or real property; (2) it eliminates the numerical materiality test for nonprofits, government agencies and individuals; and (3) it adds the retail sales exception. Each change is discussed below.<sup>2</sup>

### **Income from the Sale of Goods and Services versus Income from the Sale of Personal or Real Property**

The proposed regulation treats income an official receives from his or her business or occupation, including a salary, differently than it treats income received from non-business or non-employment activities, such as a one-time sale of property (e.g., anything from the sale of your house to the sale of a used item at a yard sale). This distinction is categorized as income from the sale of goods and services versus income from the sale of personal or real property. The main reason for the distinction is that the first category presupposes a closer relationship with the source of income (ongoing business or employment), while the second category is for situations where the official presumably has had limited or no direct contact with the source. Staff believes the importance attached to each source (and to the degree of scrutiny given each) should be measured accordingly. (Proposed Regs. 18705.3 (a) and (b).)

Proposed subdivision (a) provides the materiality test where the income is from the sale of goods and services (i.e., the official's business or profession). The subdivision is divided based on whether the source is a party to the proceeding, an individual, a nonprofit or a business entity. If the source is a party, similar to the current "directly" involved test, the financial effect is presumed material. As for the other situations, the financial effect is considered material if the individual or nonprofit will receive a measurable financial benefit or loss, or if the decision would contribute to a change in the overall value of the business entity. If the official knows or has reason to know that the individual or nonprofit has an interest in a business entity or real

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<sup>2</sup> Although staff initially proposed eliminating the "nexus" test set forth in current Regulation 18705.3 in the 45-day notice language, at this time staff proposes to maintain the test in its current form. During the Interested Persons meeting held in December, staff received several comments regarding eliminating or revising this test that deserve further review. Staff will continue to look for ways to improve upon this test and may return to the Commission with a proposal at a later date.

property that will be affected by the decision, the same test that corresponds to those interests in Regulations 18705.1 and 18705.2 would apply.

Proposed subdivision (b) provides the materiality test where the income is from the sale of the official's personal or real property. In these situations, the financial effect of the decision is material only if the official knows or has reason to know the source is involved in the decision or owns a business or real property that will be affected by the decision. Once it is determined that the source is involved or has an interest, the same test that corresponds to those interests in Regulations 18705.1 and 18705.2 would apply. Again, this distinction from subdivision (a) is based on the presumption that the official has limited contact with the source and may be unaware of the source's financial interests.

### **Elimination of Numerical Materiality Standard for Nonprofits and Government Agencies**

As discussed above, the proposed regulation simplifies the materiality test for indirectly involved sources of income that are individuals, nonprofit entities (or property of nonprofit entities) and eliminates the test for governmental entities. Similar to the recently rescinded language formerly used to establish materiality for business entities, the current language is cumbersome and even more difficult to determine for nonprofits than it had been for business entities. In addition, we were unable to determine when, if ever, it applied to a government agency or why effects on government agencies should be considered in a conflicts analysis. Therefore, the proposal eliminates the numerical materiality tests, and uses one materiality test to determine if the decision will have a measurable financial benefit or loss on the source of income.

### **Retail Sales Exception for Business Customers**

The third change to the regulation moves the retail sales exception for business customers, which is established under Section 87103.5 and currently defined as a public generally exception under Regulation 18707.5, directly into the source of income materiality regulation.

New subdivision (d) applies the retail sales exception by defining the phrases used in the statute, "significant segment of the public generally" and "not distinguishable from the income received from other customers." (Section 87103.5.) The proposed language establishes a simplified test to offer a more reasonable opportunity to determine when the statute applies. The relocation places the exception, which is essentially a source of income exception more than a "public generally" exception, within the more appropriate source of income regulation.

## **2. Regulation 18705.4 – Source of Gift**

The amendments to the source of gift regulation are straightforward. Following the established pattern, the financial effect of a governmental decision on a source of gift is deemed material if the source is a claimant, applicant, contracting party, or otherwise named or identified

as the subject of the proceeding; if the source is an individual or nonprofit that will receive a measurable financial benefit or loss; or if the source is a business entity, the decision would contribute to a change in the overall value of a business entity.

Additionally, the financial effect of a governmental decision on a source of a gift is material if the official knows or has reason to know that the source is financially affected under the standards applicable to an official under proposed Regulation 18705.5, or the source's business entity or real property interest would be financially affected under the applicable standards applicable in Regulation 18705.1 or Regulation 18705.2, respectively.

### **3. Regulation 18705.5 – Personal Finances**

Regulation 18705.5 addresses the materiality standard for a financial effect on an official's personal finances, which includes his or her immediate family. Unlike other materiality standards for financial interests, there is no directly involved/indirectly involved test for a personal financial interest. A public official is deemed to be directly involved whenever there is a financial effect on his or her personal finances. However, instead of applying the usual one-penny rule to the directly involved official, a \$250 threshold applies in all situations.

In other words, under the former rules, an official would have a conflict if he or she had a business, property, or source of income directly involved in a decision (one-penny rule). But the official would *not* have a conflict of interest if he or she was the subject of any decision where the financial effect was less than \$250 – an amount under the personal finances threshold. For example, an official could use his or her position to dismiss a \$200 parking ticket that an immediate family member received without creating a conflict because the ticket was under \$250. This is illogical.

Consistent with the other materiality standards, the fixed-dollar amount is eliminated and the new language provides that the decision has a material financial effect on the official if the official or the official's immediate family member will receive a measurable financial benefit or loss from the decision.

The remaining amendments seek to simplify and clarify the regulation. Exceptions are provided under subdivision (b) to make sure that certain payments are not included in the personal financial effect examination: (1) to (3) are already contained in the current regulation, and (4) to (5) add new provisions. Finally, subdivision (c) retains the current rule that decisions that have a financial effect on an official's real property or business entity interest must be analyzed under the specific tests for those financial interests, and not the personal finances test.

### **4. Regulation 18705 – Materiality Standards**

Finally, this item includes amendments to the introductory materiality regulation. Subdivision (a) serves as a roadmap to the conflict of interest analysis, directing one to the appropriate regulation corresponding to the interest at issue. These edits are non-substantive.

Subdivisions (b) and (c) are remnants from the Act's first attempts to define materiality. Stripped of their excess verbiage, these provisions essentially provide a "general rule" that a financial effect is material if it is significant (subdivision (b)), and a "special rule" that a financial effect is not material if "the decision will have no financial effect" (subdivision (c)).

Under current subdivision (b), the general rule only comes into play when the "specific provisions" cannot be applied. We are unaware of any instance where someone claimed that the specific provisions could not be applied. Even when we cannot make a determination in our advice letters, we do not fall back on this rule. Accordingly, the general rule has not provided any assistance, and staff proposes that subdivision (b) be deleted.

On the other hand, with the elimination of the one-penny rule during this revision process, the test in subdivision (c) remains significant to rebut any presumption of materiality implicit in the new regulations. The proposed amendments, however, are intended to clarify that the one-penny rule has been eliminated and is not revived by this provision. This issue was discussed at the November Commission meeting. The proposed language provides that notwithstanding the standards in Regulations 18705.1 through 18705.5, the financial effect of a decision is not material if the financial effect is nominal, inconsequential, insignificant or immeasurable.

### **Conforming Amendments: Repeal Regulations 18704, 18704.1 and 18704.5**

The first two regulations serve as the current method to determine materiality for source of income and source of gift interests based on whether the interest is "directly" or "indirectly" involved. In November of last year, we eliminated the business entity reference. Now we are eliminating the remainder of these regulations. With respect to Regulation 18704.5, we also are eliminating it because we no longer will use the directly/indirectly involved process.

### **Conclusion and Recommendation**

Staff submits that these straightforward and commonsense interpretations of the Act will improve the identification of potential conflicts of interest and promote compliance, while moving away from the more difficult and often meaningless standards. Staff recommends that the Commission adopt the proposed amendments.

#### Attachments:

Proposed Regulation 18705  
Proposed Regulation 18705.3  
Proposed Regulation 18705.4  
Proposed Regulation 18705.5