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**To:** Chair Miadich, Commissioners Cardenas, Hatch, and Hayward

**From:** Dave Bainbridge, General Counsel, Legal Division  
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**Subject:** Proposed Adoption of Regulation 18702.3 – Materiality Standard: Financial Interest in a Source of Income

**Date:** July 8, 2019

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### **Requested Action and Summary of Proposed Action**

Staff proposes the repeal and adoption of Regulation 18702.3, pre-notice discussion having occurred at the May Commission meeting. The proposed regulation would establish bright-line materiality standards for sources of income, where the income results from the sale of goods, services, real property, and personal property. The amendments would also clarify and broaden the “nexus” test to apply to the official’s spouse. Adopting these amendments would replace non-descript regulatory language with clearer standards and fix recurring issues involving the scope and application of Regulation 18702.3. Barring exceptional circumstance, the proposed bright-line rules would give official’s a clearer understanding of whether a governmental decision’s financial effect on a source of income is material. This would be a marked improvement, as some materiality standards currently featured in Regulation 18702.3 provide insufficient guidance for officials attempting to determine whether a governmental decision would have a material financial effect on a source of income.

### **Discussion**

#### **I. Background**

The Political Reform Act’s (the Act) 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 87100 states, “[n]o public official at any level of state or local government shall make, participate in making or in any way attempt to use his official position to influence a governmental decision in which he knows or has reason to know he has a financial interest.” Under Section 87103, a public 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” on the official, a member of his or her immediate family, or on certain enumerated interests. These enumerated interests include “[a]ny source of income, except gifts or loans by a commercial lending institution made in the regular course of business on terms available to the public without regard to official status, aggregating five hundred dollars (\$500) or more in value provided or promised to, received by,

the public official within 12 months prior to the time when the decision is made.” (Section 87103(b).)

## **II. The Existing Regulation**

### *A. Income from the Sale of Goods, Services, or Personal or Real Property*

Regulation 18702.3 provides the materiality standards for interests in sources of income. The regulation establishes two general categories of sources of income. Subdivision (a) pertains to income from the sale of goods and services, while subdivision (b) addresses income from the sale of personal or real property. Aside from circumstances where the source of income is expressly involved in a governmental proceeding before the public official, neither subdivision establishes clear, bright-line rules for determining the materiality of a governmental decision’s financial effect on a source of income.

Under subdivision (a)(2), the financial effect of a governmental decision on an official’s financial interest in a source of income, where the income is derived from the sale of goods or services, is material if “[t]he source is an individual that will be financially affected under the standards applied to an official in Regulation 18702.5 . . . .” Under Regulation 18702.5, however, a financial effect on personal finances is material if the individual will “receive a measurable financial benefit or loss from the decision.” Regulation 18702.5 provides no definition for the term “measurable financial benefit or loss.”

Similarly, Regulation 18702.3(a)(3) also provides that a financial effect on a source of income that is a non-profit organization is material where the non-profit “will receive a measurable financial benefit or loss . . . .” Again, however, there is currently no express threshold or definition for the term “measurable financial benefit or loss.”

The existing regulation also does not address situations where the source of income is a governmental entity. The Political Reform Act excludes from the definition of “income,” “[s]alary and reimbursement for expenses or per diem, and social security, disability, or other similar benefit payments received from a state, local, or federal government agency . . . .” (Section 82030.) Accordingly, the vast majority of public officials who receive money from a government entity, including elected officials and rank-and-file employees, do not have an economic interest in the governmental entity that has hired them as a “source of income.” Under certain circumstances, however, funds received by an individual from a government entity may be considered “income.” For example, if a public official contracted with a government agency to provide investment advisory services regarding the agency’s public pension fund, based on the Act’s definition of “income,” that public official would have a source of income interest in the government agency he contracted with. However, Regulation 18702.3 currently provides no guidance regarding such circumstances.

### *B. The Nexus Test*

Regulation 18702.3(c) establishes an alternate “nexus” test for materiality. That standard provides, “[a]ny reasonably foreseeable financial effect on a person who is a source of income to a public official is deemed material if the public official receives or is promised the income to

achieve a goal or purpose which would be achieved, defeated, aided, or hindered by the decision.” The rationale for the nexus test is that when an employee earns a salary to accomplish a purpose that may be advanced by what he or she does as an official, we presume that the private employer is benefiting from the actions of the employee in his or her official capacity. Based on the current regulatory language, which refers only to income promised or received *by the public official* for the purpose of aiding or hindering a goal, we have previously advised that the nexus test does not apply to an official’s spouse. (*Dorsey* Advice Letter, no. I-02-335.)

### **III. Proposed Bright-Line Rule Amendments**

If adopted, amendments to Regulation 18702.3 would implement bright-line rules that would help more easily determine the materiality of a decision’s financial effect on an official’s source of income under the Act.

#### *A. Individuals*

Where an official’s source of income is an individual, the materiality of the financial effect would no longer be determined based on whether the individual would “receive a measurable financial benefit or loss from the decision.” Rather, the individual would be deemed materially financially affected by the decision if it would affect his or her “income, investments, or other assets or liabilities (other than an interest in a business entity or real property) by \$1,000 or more . . . .”<sup>1</sup>

#### *B. Non-profit Organizations*

Where the source of income is a non-profit organization, the amendments would also implement bright-line materiality standards. Under proposed Regulation 18702.3(a)(3), a decision’s financial effect on a non-profit governmental source of income would be deemed “material” under two types of scenarios. First, a decision’s financial effect may be deemed “material” based on an increase or decrease in the entity’s annual gross receipts or the value of the entity’s assets or liabilities. Second, and more commonly<sup>2</sup>, a decision’s financial effect may be material if it causes the entity to incur or avoid additional expenses or reduce or eliminate expenses over a certain threshold amount. In each scenario, we would employ a two-step mode of analysis to determine the materiality of a financial effect.

##### *1. Gross receipts, assets or liabilities*

Regulation 18702.3(a)(3) provides alternatives for determining when an increase or decrease in annual gross receipts, or the value of assets or liabilities would result in a material financial effect on the financial interest of an official. The baseline rule would find a financial effect material when the projected effect totaled at least 5% of the organizations’ s annual gross

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<sup>1</sup> Note that an official may also be disqualified from certain decisions affecting an individual, who is a source of income, if the official knows or has reason to know that the individual has an interest in a business entity or property affected by the decision. (See proposed Regulation 18702.3(a)(2)(B) and (C).)

<sup>2</sup> Generally, the proposed threshold for expenses is lower than the threshold for changes in revenue, or assets and liabilities, because direct costs to the company are more concerning and more easily ascertainable. This approach is consistent with former bright-line rules for non-profit and governmental entities.

receipts. In addition to the percentage calculation, the decision points highlight options for minimum and maximum dollar amounts.

*Decision Point 1: When a governmental decision would foreseeably result in an increase or decrease of the organization's annual gross receipts, or the value of the organization's assets or liabilities, should we establish a "high threshold" providing an amount that will be deemed material regardless of the size of the business?*

A high threshold amount establishes a single bright line amount at which the financial effect of a decision will be deemed material regardless of the size of the organization. Establishing a "high threshold" amount is advisable because merely determining materiality based on a financial effect's size *relative to the organization'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 organization's annual gross receipts. The lower the "high threshold" amount, the more organizations will be encompassed within the high threshold amount, subsequently resulting in more financial effects being deemed material.

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 in determining whether a foreseeable financial effect is 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 organization.

As an example, some national-level non-profit organizations have annual gross receipts of over one billion dollars. For an organization of that size, if we only deemed a financial effect to be material if it surpassed five percent of the organization's annual gross receipts, then a foreseeable financial effect on that organization's annual gross receipts, assets, or liabilities would have to be at least \$50,000,000. Both experience and common sense tell us that a financial effect does not have to be that large to potentially effect a public official's judgment, even if the organization itself is large. If a public official who happens to work for a non-profit organization is able to increase (or decrease) the value of the organization by more than \$1,000,000 based on his participation in a governmental decision, it is likely that the public official would stand to benefit from his participation, regardless of the size of the organization. Staff believes that a \$1,000,000 "high threshold" amount would be appropriate, but the Commission may select a different amount as it deems fit.

*Decision Point 2: When a governmental decision would foreseeably result in an increase or decrease of the organization's annual gross receipts, or the value of the organization's assets or liabilities, should we deem that financial effect "not material" when it is equal to or less than a "low threshold" amount?*

A low threshold amount would establish a single bright line amount at which an effect on a smaller organization would not be deemed material. The higher the low threshold amount, the

more likely an official with an interest in a small organization will be able to take part in a decision affecting the organization despite some small financial effects on the organization.

Accordingly, the second decision for the Commission's consideration is whether to include a "low threshold" amount—that is, whether the regulation should require that a foreseeable financial effect be above a certain dollar amount before it may be deemed material, regardless of how that financial effect may compare to the organization's annual gross receipts. In other words, if a governmental decision would have a reasonably foreseeable financial effect of \$5,000 on a non-profit's annual gross receipts, or the value of its assets or liabilities, a "low threshold" of \$10,000 would mean that the financial effect would be deemed not material, even if \$5,000 was more than five percent of the organization's annual gross receipts.

Staff believes that the second analytical step would benefit from including a "low threshold" materiality standard. The "low threshold" standard is intended to allow public officials with source of income interests in small non-profit organizations to continue to take part in governmental decisions without being consistently disqualified due to indirect and small, but reasonably foreseeable, financial effects on their organizations.

As an example, suppose a public official had a source of income interest in a non-profit organization with annual gross receipts of \$25,000. Without a low threshold, the official would be disqualified if the decision would affect the non-profits gross receipts by five percent, or \$1,250. However, if a low threshold was established at \$10,000 the official would be allowed to take part in the decision. However, for a larger organization with gross receipts of \$500,000, a low threshold of \$10,000 would be less than the 5 percent standard and would not apply.

Staff also emphasizes that under Regulation 18702.3(a)(1), a reasonably foreseeable financial effect is deemed material when "[t]he source is a named party in, or the subject of, the decision including a claimant, applicant, respondent, or contracting party." Thus, the inclusion of a "low threshold" standard would not allow, for instance, a public official to take part in a series of governmental decisions if the non-profit source of income is a named party or subject of the decision.

## 2. *Expenses*

The materiality determination in subdivision (a)(3)(B) is based on the effect on the organization's expenses. Similar to the analysis in (a)(3)(A), the baseline rule consists of a percentage of the gross receipts and the decision points offer high and low monetary thresholds.

*Decision Points 3 and 4: Whether to include "high" and "low thresholds" when a governmental decision would foreseeably cause a non-profit to incur, avoid, reduce, or eliminate expenses*

The third and fourth decisions presented to the Commission are very similar to the first two decision points. As previously noted, in determining the materiality of a governmental decision's financial effect on a non-profit source of income, the proposed regulation would also examine the extent to which the decision "may cause the organization to incur or avoid additional expenses or to reduce or eliminate expenses . . . ." As with the first decision point,

Decision Point 3 asks the Commission whether we should include a “high threshold” materiality standard when a governmental decision would foreseeably cause a non-profit source of income to incur, avoid, reduce, or eliminate expenses. As with the second decision point, Decision Point 4 asks the Commission whether we should include a “low threshold” materiality standard in such circumstances

For the same reasons discussed above, staff believes that the inclusion of “high” and “low thresholds” would create a clearer, more workable regulation for non-profit sources of income. With respect to subdivision (a)(3)(B), staff believes a “high threshold” of \$100,000 and a “low threshold” of \$2,500 would create an appropriately-sized scope, such that indirect financial effects resulting in a change in expenses above \$100,000 would quickly be recognized as material and disqualifying, while indirect financial effects resulting in a change in expenses below \$2,500 would be considered too small to realistically create a conflict of interest for a public official based on his source of income interest in the non-profit organization.

#### **IV. Proposed Nexus Test Amendment**

The proposed amendments would also broaden the language of Regulation 18702.3’s nexus test to include the official’s spouse. The amended nexus test would be able to address situations where a public official stands to gain income based on his or her spouse’s achievement of a goal that will be affected by a governmental decision before the official. Accordingly, this amendment would harmonize the nexus test with how spousal income and community property is analyzed throughout the rest of the Act, which generally recognizes that an official has a community property interest in the income of a spouse. (See Section 82030(a).)

#### **V. Proposed Subdivision Regarding Government Entity Sources of Income**

In the initial draft of amendments presented to the Commission for pre-notice discussion, government entities were included along with non-profit organizations in proposed subdivision (a)(3). Based on feedback from the Commission and additional consideration, staff now proposes subdivision (d) to address the uncommon circumstances where a government entity qualifies as a source of income under the Act. Subdivision (d) does not establish a materiality standard for such circumstances, but acknowledges those circumstances and clarifies that the focus and concern in such scenarios is not on the decision’s financial effect on the government entity, but on the public official who may stand to gain from the decision. It essentially codifies and explains the analytical approach that is taken today. In most instances, even if a government entity does qualify as a source of income, the public official is not disqualified from taking part in governmental decisions involving that entity due to the “public generally” exception. Under Regulation 18703(e)(7), “[t]he financial effect on a public official’s financial interest is deemed indistinguishable from that of the public generally if the official establishes . . . [t]he decision affects a federal, state, or local governmental entity in which the official has an interest and there is no unique effect on the official’s interest.” In other words, when a government entity constitutes a “source of income,” as defined in the Act, the public official will only be disqualified from taking part in the decision if it would have a reasonably foreseeable, material, and unique effect on the official, as opposed to an effect on the government entity.

## **VI. Other Proposed Amendments**

The amendments would further simplify the materiality analysis process by essentially combining current subdivisions (a) and (b), which presently distinguish income derived from the sale of goods or services versus income derived from the sale of personal or real property. Instead, the categories would be unified, so that the materiality of a governmental decision's financial effect on a source of income is analyzed under the same standards, regardless of how the official's income was earned.

### **Attachments:**

- Proposed Regulation 18702.3 (amended since submission to OAL)
- Repealed Regulation 18702.3