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FAIR POLITICAL PRACTICES COMMISSION
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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 Amendments to Regulation 18702.1

Date: May 06, 2019

Requested Action and Summary of Proposed Action

Staff requests approval to notice proposed amendments to Regulation 18702.1 for adoption on or after June 13, 2019, the scheduled date of the Commission's June meeting. Existing Regulation 18702.1 sets forth the materiality standards applicable to a government decision's financial effect on a public official's financial interest in a business entity. The amendments clarify that a decision's reasonably foreseeable effect on an explicitly involved entity is material. For entities not explicitly involved, the amendments would incorporate new bright-line materiality standards into the regulation to improve its clarity and guidance. Under the amendments' additional materiality standards applicable to business entities, a decision's effect would be material if the value of the effect on the entity's annual gross revenue, assets or liabilities, or expenses exceeded certain specified thresholds.

The amendments would also incorporate new materiality standards into the regulation which would apply to a business entity's interest in real property if the official knows or has reason to know that the entity has an interest in real property. Under these new materiality standards, a decision's effect on the entity's real property is material if the real property is explicitly involved in the decision, or there is clear and convincing evidence that the decision will have a substantial effect on the real property.

In addition, the amendments would reestablish the "Small Shareholder Exception" for a decision's effect on an official's investment interest in a business entity of \$25,000.00 or less. If this exception applies, a decision's effect on the official's investment interest in a business entity may only be found material under the materiality standards applicable to a decision's effect on an interest not explicitly involved in the decision.

A final version of the proposed amendments to Regulation 18702.1 is not up for consideration at this meeting. The proposed language for the amendments included with this memo is intended to facilitate discussion, and to allow the Commission to provide guidance and instruction to staff prior to the presentation of the amended regulation for approval at a subsequent Commission meeting.

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 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 entity, set forth in existing Regulation 18702.1, may require redress because the materiality threshold for large corporations not explicitly involved in the decision was too broad in instances that may significantly effect a large corporation but may not result in a change to the entity's 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 standards to improve the regulation's clarity. The proposed amendments to Regulation 18702.1 attempt to address these concerns.

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. Existing Regulation 18702.1(a)(1)-(7) provide that a decision's effect on an official's interest in a business entity is material if the business entity takes certain specified actions, or if the business entity 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 governmental decision's financial effect on an official's financial interest in either a publicly traded or privately held entity, if the "effect would contribute to a change in" the stock price of the publicly traded entity or the value of the privately held entity.

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.

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

Addition of New “Bright-Line” Materiality Standards

In response to Commissioner Hatch and others’ concerns that the existing materiality standards of Regulation 18702.1 do not adequately assess the materiality of a decision’s effect on a business entity not explicitly involved in the decision, the amendments to Regulation 18702.1 would establish new, bright-line materiality standards to provide additional clarity and guidance regarding when an effect on an official’s interest in an entity not explicitly involved in the decision is material. Specifically, the amendments to Regulation 18702.1 would:

- Add new subdivision (a)(3) to the regulation, which would provide that a decision’s reasonably foreseeable effect 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 [OPTION 1: \$1,000,000 or \$2,500,000] or [f]ive percent of the entity’s gross annual revenues [OPTION 2: and the increase or decrease is at least \$10,000].”
- Add new subdivision (a)(4) to the regulation, providing that a decision’s reasonably foreseeable effect 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 [OPTION 1: \$250,000 or \$500,000] or [o]ne percent of the entity’s gross annual revenues [OPTION 2: and the change in expenses is at least \$2,500].”

More specifically, under proposed subdivision (a)(3), a financial effect on a business entity would be deemed material if the decision would result in an increase or decrease of the entity’s annual gross revenues, or the value of the entity’s assets or liabilities, in an amount equal to or more than (1) \$1,000,000 or \$2,500,000 or (2) five percent of the entity’s annual gross revenues if the change is at least \$10,000.

In establishing these thresholds based upon the entity’s gross revenues, the proposed amendments address the fact that whether an effect is material will differ depending on the size and value of an entity. For instance, a \$50,000 increase in revenue might be material to a small, local business entity, but comparatively negligible to a large corporation. By implementing the high threshold amount (proposed as either \$1,000,000 or \$2,500,000) Regulation 18702.1 would also establish a bright-line rule that any decision affecting a business entity by the high threshold amount is deemed to have a material financial effect on that entity regardless of its size.

Under the proposed amendments, a decision’s financial effect on a business entity would be 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 (1) \$250,000 or \$500,000 or (2) one percent of the entity’s annual gross receipts if the change is at least \$2,500. 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 materiality standards applied to business entities.

We emphasize that staff proposed threshold amounts are intended primarily for discussion. While staff has attempted to determine reasonable amounts based upon varying entity sizes and prior bright-line materiality standards, the Commission may choose any amount they deem appropriate which is consistent with the statute. However, staff does specifically identify two option points.

The first option is the amount of the high materiality threshold. Generally, the high threshold will only apply to large entities, and the amount should be one which a reasonable person would find material regardless of the size of the entity. The lower the amount, the more likely an official with an interest in a large entity is to be disqualified.

The second option is whether to include a low threshold amount. Establishing the low thresholds means that officials with interests in very small entities are less likely to be disqualified from decisions with small and less easily ascertainable effects on the entities.

Addition of New Materiality Standards for a Decision’s Effect on an Entity’s Real Property

The amendments to Regulation 18702.1 would also add new subdivision (a)(5) to the regulation, which would provide that a decision’s reasonably foreseeable effect on a business entity is material if the “official knows or has reason to know that the entity has a an interest in real property” and “[t]he property is explicitly involved under Regulations 18701(a) and 18702.2(a)(1) through (6)” or “[t]here is clear and convincing evidence that the decision would have a substantial effect on the property.”

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 entity contained a previous iteration of the “Small Shareholder Exception.” Historically, if this exception applied, an official was not disqualified from the decision only because the entity was directly (or explicitly) involved in the decision. A small shareholder would be disqualified only if it was foreseeable that the decision’s effect was material under a standard applicable to an entity not directly (or explicitly) involved in the decision.³ In the January 2015 amendment of the former regulation that set forth the materiality standards applicable to a decision’s effect on a business entity, that exception was eliminated without explanation. (See former Regulation 18705.1, as amended in January 2015, and documents related to those amendments’ adoption.)

The amendments to Regulation 18702.1 would reestablish a new iteration of the “Small Shareholder Exception” in new subdivision (b) of the amended regulation. Under this new iteration of the Small Shareholder Exception, a decision’s effect on an official’s interest in a business entity which meets the criteria of the exception would not be material solely on account of the entity being explicitly involved in the decision; instead, the decision’s effect on the entity would be material only if it was material under the amended regulation’s materiality standards applicable to a decision’s effect on an entity 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.

Summary

The proposed amendments to Regulation 18702.1 would incorporate new, bright-line materiality standards into the regulation to improve clarity and guidance. The amendments would also clarify that a decision's effect on an official's interest in an explicitly involved business entity is material; establish a new materiality standard for a decision's effect on real property of entity in which an official is interested; and reestablish the "Small Shareholder Exception" applicable to an official's investment interest in an entity of \$25,000 or less.

The proposed amendments to Regulation 18702.1 reflect the notion that the addition of new, bright-line materiality standards applicable to decisions' effects on officials' financial interests in business entities will result in a more accurate assessment of the existence or absence of a disqualifying conflict of interest with respect to those financial interests.

Attachments:

Proposed Amendments to Regulation 18702.1

Chart of Amended Regulation 18702.1's Application to Various Business Sizes