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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 Amendment of Regulation 18702.3 – Materiality Standard: Financial Interest in a Source of Income

Date: May 6, 2019

Requested Action and Summary of Proposed Action

Staff presents the repeal of existing Regulation 18702 and the adoption of amendments to Regulation 18702.3 for prenotice discussion. The amendments would establish unified, 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 clear 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 are not sufficiently descript and provide little guidance that would help an official understand whether a governmental decision would have a material financial effect on a source of income.

Discussion

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).)

The Existing Regulation

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 nonprofit organization is material where the nonprofit “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 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.) Yet, throughout the rest of the Act, it is recognized that an official has a community property interest in the income of a spouse. (See Section 82030(a).) If an official is ordinarily deemed economically interested in a spouse’s income, logically, the nexus test should prohibit an official from taking part in governmental decisions that would achieve, defeat, aid, or hinder a goal where the official’s spouse will be paid to achieve that goal. Accordingly, then, the language of Regulation 18702.3(c) could be broadened or clarified to ensure that the nexus test encompasses such situations.

Proposed Bright-Line Rule Amendments

If adopted, amendments to Regulation 18702.3 would restore a bright line rule by establishing specific monetary thresholds that would help more easily determine the materiality of a decision's financial effect on an official's source of income under the Act.

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"¹

Nonprofit Organizations and Government Entities

Additionally, where the source of income is a nonprofit organization, the amendments would implement a similarly specific monetary threshold for materiality. Under proposed subdivision (a)(3), a financial effect on a source of income would be deemed material where the source is a nonprofit organization or government entity and the decision may result in an increase or decrease of the entity's annual gross receipts, 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 receipts if the change is equal to or more than \$10,000. (See Attachment C.)

In establishing these thresholds based upon the gross receipts, the proposed amendments address the fact that the materiality of a financial effect will differ depending on the size and value of an entity. For instance, a \$50,000 grant might be material to a small, local nonprofit organization, but comparatively negligible to a large, national nonprofit organization. By implementing the high threshold amount (proposed as either \$1,000,000 or \$2,500,000) Regulation 18702.3 would also establish a bright-line rule that any decision affecting a nonprofit source of income by the high threshold amount is deemed to have a material financial effect on that source of income regardless of the size of the entity.

The proposed amendments would similarly find that a decision's financial effect on a nonprofit or government entity source of income 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 (1) \$250,000 or \$500,000 or (2) one percent of the entity's annual gross receipts if the change is equal to or more than \$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 rules for nonprofit and governmental entities. (See Attachment D.)

¹ 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).)

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. 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 represent an amount 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 disqualified from a decision.

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.

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. By incorporating such language, the nexus test would be able to address the situation discussed above, where a public official stands to gain income based on his or her spouse's achievement of a goal that will be affected by the 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.

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
- Repealed Regulation 18702.3
- Materiality Threshold Examples: Gross Receipts or Assets/Liabilities
- Materiality Threshold Examples: Expenses