California
Fair Political
Practices Commission

July 14, 1988

Robert Westmeyer
County Counsel
County of Napa
1195 Third Street, Room 301
Napa, California 94559-3001

Re: Your Request for Advice
Our File No. I-88-218
Your File No. 180.031

Dear Mr. Westmeyer:

This letter is in response to your letter of June 3, 1988. Your letter requests advice on behalf of Napa County Planning Commissioner Guy Kay. Because your letter seeks only general guidance as to Mr. Kay's duties under the Political Reform Act (the "Act")[1] and does not present a pending decision for analysis, we treat your letter as one seeking informal assistance.[2]

QUESTION

Why are the materiality standards contained in Regulation 18702.2 different for corporations traded on large American stock exchanges than for corporations which are privately held or which may be foreign conglomerates, not traded domestically?

1/ Government Code Sections 81000-91015. All statutory references are to the Government Code unless otherwise indicated. Commission regulations appear at 2 California Code of Regulations Section 18000, et seq. All references to regulations are to Title 2, Division 6 of the California Code of Regulations.

2/ Informal assistance does not provide the requestor with the immunity provided by an opinion or formal written advice. (Government Code Section 83114; Regulation 18329(c)(3).)

CONCLUSION

Unlike privately held corporations and foreign conglomerates, corporations which are widely traded in this country are more likely to be held by numerous individuals in an official's jurisdiction. Therefore, the appearance of a conflict of interest is lessened because the economic interest is shared with individuals otherwise unrelated to the business or to the decision.

FACTS

Mr. Guy Kay is a member of the Napa County Planning Commission. Mr. Kay is also an officer and employee of Beringer Brothers winery, located in Napa County. Beringer Brothers is owned by a subsidiary of Nestle Company, a large European conglomerate. You and Mr. Kay believe that Nestle Company is of a size that would qualify for inclusion on the Fortune 500 list if it were a domestic corporation traded on one of the major stock exchanges.

ANALYSIS

The Act requires that public officials disqualify themselves from making, participating in or influencing governmental decisions in which they have a financial interest. An official has a financial interest in a governmental decision when the decision will have a reasonably foreseeable material financial effect on the official, a member of the official's immediate family, or on:

> (a) Any business entity in which the public official has a direct or indirect investment worth one thousand dollars ($1,000) or more.
>
> (b) Any real property in which the public official has a direct or indirect interest worth one thousand dollars ($1,000) or more.
>
> (c) Any source of income, other than gifts and other than loans by a commercial lending institution in the regular course of business on terms available to the public without regard to official status, aggregating two hundred fifty dollars ($250) or more in value provided to, received by or promised to the public official within 12 months prior to the time when the decision is made.
>
> (d) Any business entity in which the public official is a director, officer, partner, trustee, employee, or holds any position of management....
>
> Section 87103.

Mr. Kay is an officer and employee of Beringer Brothers. (Section 87103(d).) Beringer Brothers is also a source of income to him. (Section 87103(c).) Hence, decisions which will have a reasonably foreseeable material financial effect on Beringer Brothers will require his disqualification, unless the effect will be substantially the same as the effect on a significant segment of the public. (Section 87103; Regulation 18703.)

For purposes of determining whether disqualification will be required, the effect on a wholly owned subsidiary will be considered to be an effect on its parent. (Regulation 18706.) In determining whether the effect of a decision will be "material", we would examine the effect of the decision in light of the larger (parent) entity.

Regulation 18702.2 distinguishes between large, publicly traded corporations and other corporations which are privately held or (as with Beringer Brothers' parent, Nestle Company) which are foreign corporations not publicly traded in the United States. You have questioned the basis for this distinction.

The concept of materiality is a relative one. It is not defined in the Act. However, the Commission has long had a regulation addressing this issue.3/ In its original form, the regulation contained a general and subjective definition:

> (a) The financial effect of a governmental decision on a financial interest of a public official is material if, at the time the official makes, participates in making or attempts to use his or her official position to influence the making of the decision, in light of all the circumstances and facts known at the time of the decision, the official knows or has reason to know that the existence of the financial interest might interfere with the official's performance of his or her duties in an impartial manner free from bias.
>
> Former Regulation 18702(a).

3/ The Commission is charged with primary responsibility for interpreting and implementing the Act. (Section 83111.) The Commission is also empowered to adopt rules and regulations to carry out the purposes and provisions of the Act. (Section 83112.)

This very subjective self-determination by public officials proved unworkable. Few, if any, public officials would admit to being biased by a financial interest in a pending decision. However, the ultimate goal of the conflict-of-interest disqualification law is to prevent even the appearance of a conflict of interest. (Witt v. Morrow (1977) 70 Cal.App.3d 817.)

As the court stated in Witt v. Morrow, supra at 823:

> It is not just actual improprieties which the law seeks to forestall but also the appearance of possible improprieties. Any employee, in the public or private sector, wishes to keep his job and maintain good relations with his employer. A person who must make decisions which may affect his employer's purse is in a situation where he may not give full consideration to the merits of the decision.
>
> One cannot serve two masters (Matthew 6:24).

As the Commission has gained experience in administering the Act, it has revised Regulation 18702 to establish more objective and clearer rules as to when disqualification will be required. Ultimately, Regulation 18702.2 was promulgated to establish specific monetary standards to be used in determining whether a decision's reasonably foreseeable effects on a business entity would be considered material.

The previous attempt at objective rules, former Regulation 18702(b)(1) (copy enclosed), suffered from several difficulties. It applied a sliding-scale approach to the determination of materiality.4/ However, the bases for making the determination were often difficult to ascertain. In order to determine whether a financial effect of $50,000 would be considered material, it was necessary to know the gross income or the net income of the business entity in question. A percentage test would then be applied. To accomplish this task, the official would have to consult the business entity in question. That was not always feasible nor practical.

4/ An effect on annualized gross revenues was considered material if it exceeded 1% of the company's annualized gross revenues. However, effects of less than $1,000 were deemed immaterial while effects of more than $100,000 were deemed always material, regardless of the company's gross revenues.

In addition, under former Regulation 18702(b)(1), the maximum financial effect which would not be considered material, even as to the very largest business entities, was a $100,000 effect on annualized gross revenues. Many critics complained that this was simply too small when compared to the largest corporate giants. Because those companies' stocks are widely held by stockholders in virtually every community, it was argued that a $100,000 effect on such companies as Exxon would not create the appearance of a conflict of interest which the Act was intended to prevent. (Witt v. Morrow, supra.)

Consequently, current Regulation 18702.2 was developed to address these concerns. First, it establishes objective criteria based upon gradations in companies' revenues and assets. Second, the determination of which standard applies in a given circumstance is based on readily ascertainable information such as listing on stock exchanges, which monitor company performance. It is easy enough to consult the stock exchange reports in newspapers. The Fortune 500 lists appear annually and are alphabetized and republished in the Commission's Bulletin for ease of access and use. Third, the revised regulation created more tailored guidelines for the broad array of differently sized business entities. Instead of the range from $1,000 to $100,000 contained in the former regulation, Regulation 18702.2 created a range from $10,000 to $1,000,000 with respect to standards for materiality of effects on gross revenues.

Lastly, in establishing the criteria for determining the issue of materiality, the Commission felt it was also important to differentiate between those companies which are widely held and those which are closely held. It was the Commission's view that the appearance of a conflict of interest was diminished when the official's economic interest was shared by others in the community whose only connection with the company was that of shareholder. Closely held companies would not have a number of shareholders in the community. Persons having economic relationships with closely held business entities are either one of a few owners or are employees of the business entity. These are close ties not shared generally by others.

As previously stated, the purpose of the conflict-of-interest provisions of the Act was to instill public confidence that governmental decisions were being made for the public's interest rather than some narrow financial interest of a particular public official.

> Public officials, whether elected or appointed, should 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).

Consequently, current Regulation 18702.2 distinguishes between corporations which are traded on major, national stock exchanges and those which are not. It was recognized that under this structure, a closely held corporation such as Gallo Wine would, despite its size, be treated differently than a similarly sized corporation traded on the New York or American stock exchanges. Similar distinctions are made between smaller business entities which are traded on other exchanges or qualified for public sale and those which are closely held. The regulation maintains a consistency in this regard.

The Commission has recently noticed for consideration a series of amendments to its materiality regulations. Copies of those amendments and the staff memorandum for the pre-notice discussion are enclosed for your review. As you can see from the proposed amendments to Regulation 18702.2 and the staff memorandum, a change has been proposed which will alter the standard applicable to Mr. Kay's employer. This proposed change was initiated as a result of my earlier conversations with Mr. Kay regarding this subject.

Overall, the amendments to Regulation 18702.2 are technical and non-substantive for the purposes of conforming it to other regulations in the package. However, within that context and within the structure of the regulation described above, I have proposed a substantive change to adjust the standard for materiality on large corporations which are not publicly held in the United States to a higher dollar amount -- from a $150,000 effect on annualized gross revenues to $250,000.

I hope that this will mollify Mr. Kay's concerns. However, as you can see from the foregoing discussion, the possible fact that Nestle Company may be held by shareholders in Europe is not persuasive. Furthermore, we have no information on the standards used by any European stock exchanges for determining whether stocks are qualified to be traded on those exchanges.

By contrast, utilizing the New York, American and National Association of Securities Dealers (NASDAQ) standards in the regulation provides assurance that certain criteria must be met and will be monitored. Likewise, the Fortune 500 lists are compiled based upon publicly disclosed data, which provides assurance that certain standards are met. This is not true in the case of foreign corporations or closely held corporations, foreign or domestic.

If you or Mr. Kay have questions or comments regarding this letter or the enclosed noticed regulations, I may be reached at (916) 322-5901. In the future, if you or your clients have questions regarding specific pending decisions, please feel free to contact this agency for assistance.

Sincerely,

Diane M. Griffiths
General Counsel

By: Robert E. Leidigh
Counsel, Legal Division

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Enclosure

NAPA COUNTY

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June 3, 1988

OUR FILE NO.: 180.031

Robert E. Leidigh
Fair Political Practices Commission
428 J Street, Suite 800
P. O. Box 807
Sacramento, CA 95804-0807

Re: FPPC File No. W-88-110

Dear Mr. Leidigh:

This is in response to your April 29, 1988 letter. I am sorry it has taken so long to respond, but the Conservation, Development and Planning Commission has concluded to scrap the "What is a Winery" ordinance that previously has been forwarded to your office based upon representations by the industry that it may be able to draft a more comprehensive proposal which will be acceptable to all of the persons and businesses concerned. Since that new proposal is not expected to be in a reviewable form until late July or early August 1988, the matter has lost its urgent status.

In response to the other inquiries contained in your letter please be advised that:

(1) We are still in the process of preparing detailed information regarding the financial interests of the various public officials involved, and we will provide that to you when it is available.

(2) The issues we have been discussing are and will continue be an ongoing problem and therefore until the issues are resolved I request that you not close your file.

As previously indicated a new ordinance is not expected to be available until late July or early August 1988 for review purposes. Nevertheless, at least one planning commissioner who works for a European conglomerate has expressed a wish that I obtain a formal written opinion from the FPPC legal staff as to why that portion of Regulation 18702.2(c) relating to Fortune 500 companies that requires gross revenues to increase or decrease by $1,000,000 or more before a conflict is material should not be applicable in his situation. The Commissioner takes this position since his employer, the Nestle Company, is of a size that would qualify for inclusion in the five hundred largest corporations. Indeed, the company probably would qualify for inclusion in the one hundred largest corporations in the United States were it a domestic corporation.

I must admit I believe the Commissioner has a valid point. It seems possible that Regulation 18702.2, due to the manner in which it was written, was either not intended to be applied to foreign corporations or the idea that foreign corporations might own a domestic (i.e. U.S.) subsidiary was never considered. If either possibility is in fact correct the FPPC needs to either enact additional regulations to cover the foreign corporation situation or interpret Regulation 18702.2 in a way which will afford foreign corporations that are extremely large the same rights that similarly sized U. S. corporations enjoy. Thus, for example, if the Nestle Company is listed on a European Stock Exchange which is the equivalent of the New York or American Stock Exchange, it seems to me that the $250,000 increase or decrease in gross revenue should apply; and similarly, if the Nestle Company is one of the five hundred largest European industrial or nonindustrial corporations, the $1,000,000 test should apply. If you believe that is not the case, it is requested that you issue a formal written opinion discussing why that is not the case and why you believe Regulation 18702.2 was intended to apply to both foreign and domestic corporations (i.e. thereby imposing the $150,000 gross revenue test no matter how large the parent foreign corporation might be).

This is a matter of continued concern to at least two planning commissioners who happen to be employed by large European conglomerates that would qualify as Fortune 500 companies were they domestic corporations. Therefore, it would be appreciated if you could issue the requested written opinion in the very near future (i.e., by the end of June 1988).

Thank you very much for your consideration. I look forward to hearing from you.

Very truly yours,

ROBERT WESTMEYER
County Counsel

RW:plg
D:9040

cc: Guy Kay
Will Nord
Kathryn E. Donovan, FPPC General Counsel

California
Fair Political
Practices Commission

June 10, 1988

Robert Westmeyer
Napa County Counsel
1195 Third Street, Room 301
Napa, CA 94559-3001

Re: 88-218

Dear Mr. Westmeyer:

Your letter requesting advice under the Political Reform Act was received on June 7, 1988 by the Fair Political Practices Commission. If you have any questions about your advice request, you may contact Robert Leidigh, an attorney in the Legal Division, directly at (916) 322-5901.

We try to answer all advice requests promptly. Therefore, unless your request poses particularly complex legal questions, or more information is needed, you should expect a response within 21 working days if your request seeks formal written advice. If more information is needed, the person assigned to prepare a response to your request will contact you shortly to advise you as to information needed. If your request is for informal assistance, we will answer it as quickly as we can. (See Commission Regulation 18329 (2 Cal. Code of Regs. Sec. 18329).)

You also should be aware that your letter and our response are public records which may be disclosed to the public upon receipt of a proper request for disclosure.

Very truly yours,

Diane M. Griffiths by Kcd

Diane M. Griffiths
General Counsel

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