

## Fair Political Practices Commission

### Memorandum

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

**From:** Zackery P. Morazzini, General Counsel  
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**Subject:** Conflicts of Interest: Determining the Material Financial Effect of a Decision on a Business Entity in Which an Official Has a Financial Interest (Regulations 18704, 18704.1, 18705.1)

**Date:** November 10, 2014

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#### Summary

A public official is prohibited from making, participating in making or in attempting to influence a governmental decision if it is reasonably foreseeable that the decision will have a *material financial effect* on, among other things, any business entity in which the official has a direct or indirect investment worth \$2,000 or more, or in which the official is a director, officer, partner, trustee, employee, or holds a management position. (Gov. Code, §§ 87100 and 87103, subd. (a) & (d).)<sup>1</sup> The proposed regulations establish new standards to determine if there is a “material financial effect” on the business entity at issue.<sup>2</sup>

#### Problems with Current Law

To establish materiality under current law, the first step is to determine whether the business entity in which a public official has a financial interest is “directly” or “indirectly” involved in the government decision. (Regs., §§ 18704 & 18704.1) If the business entity is directly involved, generally, the financial effect is presumed material unless the decision will have no financial effect (i.e., one-penny rule). (Regs., §18705.1(b)(1).)

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<sup>1</sup> The Political Reform Act (Act) is contained in Government Code sections 81000 through 91014, and all further statutory references are to this code. The regulations of the Fair Political Practices Commission are contained in sections 18110 through 18997 of title 2 of the California Code of Regulations, and all further regulatory references are to this source.

<sup>2</sup> This proposal is part of the ongoing project to revise and streamline the regulations implementing the Act’s conflict of interest provisions. (§§ 87100-87105.) To date, the Commission has adopted the following regulatory changes as part of this project: (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 standard to determine if there is a “material financial effect” on an official’s interest in real property.

If the business entity is “indirectly” involved in the government decision, materiality is determined under a complicated formula that takes into account Fortune 500 listings, New York Stock Exchange listings, NASDAQ or American Stock Exchange listings, and companies that are not listed on one of those exchanges; merged with amounts of net income for the company, then calculating to the exact dollar a materiality threshold according to the size of the company, based on the exact dollar increase or decrease for the company’s gross revenues, or the company’s avoiding or incurring or additional expenses, and the increase or decrease to the value of the company’s assets resulting from the governmental decision. For example, for the biggest companies the financial result is not material unless it is at least ten million dollars, for the smallest companies, the effect is not material unless it is at least \$20,000.

Staff submits that the current formulas are unnecessarily complicated, ineffective, and in most cases, almost impossible to determine with any degree of accuracy. For example, how can anyone really know what an indirect financial effect of \$10 million on the “gross revenues” of Walmart or Exxon/Mobil even looks like or how material it really is? For its last fiscal year, Walmart had total net sales of \$473.1 billion, or 47,310 times the \$10 million threshold or, what would be an effect of about a .002 percent. Is that really material?

At the other end of the spectrum is the smallest business entity, those that are not listed on any stock exchange and have net annual income of less than \$750,000 per annum. The overwhelming majority of the conflicts questions that come up involve this group – public officials with a day job seeking advice as to whether they can vote on a matter that may have some financial effect on their business, or officials with a part-time business or a spouse’s business seeking advice on the parameters of what they can and cannot participate in under their governmental duties.

For officials subject to this standard our advice is, essentially, that they can receive a benefit up to \$20,000 per annum in increased revenue as a result of a governmental decision before we consider the financial effect to be material enough to be disqualifying. This makes little sense in a system where one is required to report an investment at the \$2,000 level but allowed to profit at a level ten times that amount. It seems even more significant when we compare it to the threshold we use for an effect on an individual instead of a business entity, which is a mere \$250.

In any event, even at this level, quite often the same problems exist in guessing the eventual amount of the financial effect. Neither the official nor the public is served by this approach. No empirical evidence exists whatsoever to support the concept that materiality and disqualification concerns are subject to precise quantifications.

### **Proposed Materiality Regulation**

As noted above, currently Regulations 18704 and 18704.1 serve as the first step to determine materiality based on whether the business entity is “directly” or “indirectly” involved in the government decision. This step is being eliminated within the standard analysis. The surviving elements of these two regulations are now being combined into one business entity materiality section, Regulation 18705.1.

- ***Situations where the business entity was previously defined as “directly” involved***

Situations where the business entity was formerly considered directly involved are specifically identified and set forth under proposed subdivision (a)(1-8) of Regulation 18705.1. If any of the listed circumstances exist, the financial effect is deemed material. This replaces the current “directly involved” test in Regulations 18704 and 18704.1, finding materiality when a business entity is a “named party in” or the “subject of” a proceeding.

There are certain protections under proposed subdivision (a)(4) to avoid a materiality finding for decisions that have a de minimis financial effect on the business entity - such as trips by the official’s agency to buy coffee at Starbucks® or office supplies at Staples®, or to renew the contract on the Pepsi® vending machine in the break room. The proposed language recommends limiting a materiality finding to purchases or sales from a business entity that aggregate to \$1,000 or more in any 12-month period.

Additionally, subdivision (a)(8) proposes an exception for any financial effect on a business entity as a result of travel payments made to airlines, hotels, restaurants, automobile rental businesses, and gas stations authorized by the official’s agency in the normal course of business. These payments would be reviewed under a different standard so as to avoid situations that would create a conflict of interest for merely using the agency credit card to fill up the tank on the state car when traveling.

- ***Materiality standard for all other cases where the business entity was previously defined as “indirectly” involved***

The remainder of the proposed regulation addresses the materiality standard for all other situations in which the governmental decision may have a financial effect on a business entity in which the public official has an investment interest or a business position interest. (Section 87103(a) or (d).) Rather than imposing predetermined materiality thresholds based on the size of the company or its net income, the proposal applies a “prudent person” standard based on the surrounding factors.

The language states that the financial effect of the governmental decision is material “if a prudent person with sufficient information would find it is reasonably

foreseeable that the decision's financial effect would contribute to a change in the price of the business entity's publicly traded stock, or the value of a privately-held business entity." To provide guidance, the regulation also offers several examples of common situations that are likely to raise concerns, including creation of additional competition; an increase or decrease in the need for products or services; better or worse environmental conditions on either a temporary or permanent basis that affect the conditions that attract customers to the business; the location of other facilities or businesses that may aid or hinder the amount of business the entity attracts; or any increases or decreases to the tax or other financial elements of the business.

Rather than complicated formulas with arbitrary limits, the new standard considers the financial effect based on all relevant factors, such as the nature of the business or the circumstances surrounding the decision – e.g., loss or gain of customers to a restaurant after the relocation of a basketball arena from the suburbs to a city's downtown district, or the impact to a plastic bag manufacturer from decision to ban plastic bags from grocery stores. In other words, if there is sufficient evidence to establish that an official's business entity that is closer to a renewal project would appreciate faster than those farther away, it would support a finding of a material financial effect on the official's business without the "need to give specific dollar amounts or percentage increases of the appreciation." (*Witt v. Morrow* (1977) 70 Cal.App.3d 820, 822.)

The proposed standard provides both officials and the public with a better understanding of when circumstances create a conflict or the appearance of a conflict that would require disqualification. (See *Witt v. Morrow, supra*, 70 Cal.App.3d at p. 823 ["it is not just actual improprieties which the law seeks to forestall but also the appearance of possible improprieties"].) This practical approach furthers the Act's goals by alerting officials to potential conflicts and by promoting the public's confidence in the fairness of governmental decisions.

#### **Conforming Amendments: Regulations 18704 and 18704.1**

These two regulations serve as the current method to determine materiality based on whether the interest is "directly" or "indirectly" involved. Because we are addressing only business entity materiality at this time, we are eliminating language from the two regulations applicable solely to business entities. The remainder of the regulation will need to remain in place to guide the evaluation of "source of income" and "source of gift," pending appropriate modification of those two elements at a future date.

#### **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 18704

Proposed Regulation 18704.1

Proposed Regulation 18705.1