Information presented to the Commission at the 5-20-15 LAFCO hearing.

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Memorandum

To: PUBLIC AGENCY CLIENTS

From: BEST BEST & KRIEGER LLP

Date: May 11, 2015

Re: SUMMARY OF CHANGES TO FPPC REGULATIONS RE: CONFLICT OF INTEREST ANALYSIS AND MATERIALITY STANDARDS

In March, 2015 the Fair Political Practices Commission (FPPC) completed a months' long project to revise and simplify its regulations pertaining to Government Code section 87100 (the Political Reform Act (PRA)) and, specifically the "reasonably foreseeable" financial effect standard and the "materiality" standards related to the various "financial interests" which can give rise to a prohibited conflict of interest. The FPPC also simplified the Eight Step Process for determining when a conflict of interest exists under the PRA, condensing it to a Four Step Process.

The Public Policy and Ethics Compliance Group has provided memos over the past number of months as these revised and amended regulations became effective. The purpose of this memo is to summarize all of these revisions in this one memo to ease in the application of the newly amended regulations to your operations and decisions. (Additionally, many of the amended regulations have been renumbered since being revised, and this memo will refer to the new regulation numbers.)

"Reasonably Foreseeable" Financial Effect (Regulation 18701)

The first step in the process to determine whether a financial interest could give rise to a prohibited conflict of interest is assessing whether the financial effect of the governmental decision is "reasonably foreseeable." (As part of its revision process, the FPPC revised the "basic rule" for determining whether a public official has a prohibited conflict of interest from the former "Eight Step Process" to a simplified "Four Step Process,"[1] which

[1] Reg. 18700 provides: "(d) To determine whether a public official has a prohibited conflict of interest under the Act, apply the following:
(1) Step One: Is it reasonably foreseeable that the governmental decision will have a financial effect on any of the public official's financial interests? To determine if the financial effect is reasonably foreseeable, apply Regulation 18701. If the answer is no, there is no conflict of interest under the Act. If the answer is yes, proceed to Step Two.
(2) Step Two: Will the reasonably foreseeable financial effect be material? To determine if the reasonably foreseeable financial effect is material, apply Regulation 18702. If the answer is no, there is no conflict of interest under the Act. If the answer is yes, proceed to Step Three.

jettisoned the "direct"/"indirect" interest dichotomy.)

For a number of years, there was some confusion about what the term "reasonably foreseeable" meant. Over time, this phrase was interpreted as "substantially likely," which in practice required a very high degree of probability before disqualification of an official was triggered. Amended Regulation 18701 lowers this threshold for explicitly involved economic interests and states:

> "A financial effect on an economic interest is presumed to be reasonably foreseeable if the economic interest is a named party in, or the subject of, a governmental decision before the official or the official's agency.
>
> An economic interest is the subject of a proceeding if the decision involves the issuance, renewal, approval, denial, or revocation of any license, permit, or other entitlement to, or contract with, an economic interest. (See Regulation 18705.2(a)(1)-(6).)"

However, when an economic interest is not explicitly involved in the decision (as described above), the financial effect can still be considered reasonably foreseeable if it is a "realistic possibility." In other words, if the financial result cannot be expected, absent extraordinary circumstances not subject to the public official's control, then it is not considered "reasonably foreseeable."

The following six factors, as summarized, should be used to guide one's analysis in specific circumstances:

1. Consider the extent the financial effect is contingent upon intervening events, not including future public agency actions.
2. Consider whether the public official should anticipate the financial effect on his or her economic interest as a potential outcome of the decision under normal circumstances.

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(3) Step Three: Can the public official demonstrate that the material financial effect on the public official's financial interest is indistinguishable from its effect on the public generally? To determine if the material financial effect on any of the public official's financial interest is indistinguishable from its effect on the public generally, apply Regulation 18707 et seq. If the answer is yes, there is no conflict of interest under the Act. If the answer is no, proceed to Step Four.

(4) Step Four: If after applying the three step analysis and determining the public official has a conflict of interest, absent an exception, he or she may not make, participate in making, or in any way attempt to use his or her official position to influence the governmental decision. To determine if the public official is "making, participating in making, or in any way attempting to use his or her official position to influence a governmental decision," apply Regulation 18704. If the public official will be called upon to make, participate in the making, or use his or her official position to influence a governmental decision in which he or she has a financial interest as determined under Step One through Step Three, he or she will have a prohibited conflict of interest."

3. Consider whether the public official has an economic interest of the type typically affected or of the type expected to have a financial effect on businesses and individuals similarly situated to the public official's economic interests.
4. Consider whether the financial effects on a public official's economic interest would compromise the official's ability to act in the public interest.
5. Consider whether it creates an advantage or disadvantage for one of the official's economic interests.
6. Consider whether a similarly situated person to the public official would be tempted to consider his or her own economic self-interest.

Given these new and revised factors, much of this analysis remains subjective and will require additional guidance from the FPPC in the form of future advice letters as to the degree to which this threshold has been lowered.

Materiality Standards

The second step to determine whether a financial interest could give rise to a prohibited conflict of interest is assessing whether the reasonably foreseeable financial effect of the governmental decision is "material." The FPPC has greatly simplified the "materiality" standards for each of the five (5) financial interests defined by the regulations, and provided a single overarching definition that "notwithstanding the specific definitions of materiality provided for the five financial interests, the financial effect of a governmental decision is not material if it is nominal, inconsequential, or insignificant." (Reg. 18702.) With this stroke of the pen, the FPPC eliminated the so-called "one penny rule"---a very demanding standard---which held that it was the public official's burden to overcome or rebut the presumption of "materiality" and demonstrate that it was not reasonably foreseeable that the governmental decision would have even "one penny" of impact on the official's financial interest. Thus, this change effectively raises the threshold for when a financial effect will be "material" and result in a "prohibited" conflict of interest.

Real Property (Regulation 18702.2)

The amended "materiality" standard for an interest in real property, including leasehold interests, retained "direct" effects on the property itself, incorporated some of the considerations formerly available to rebut the presumption of non-materiality for indirectly involved property interests, and adopted a "catchall" provision derived from common law conflict of interest principles, i.e., whether the governmental decision would "cause a reasonably prudent person... to believe that the... decision was of such a nature that its reasonably foreseeable financial effect would influence the market value of the official's property." (Reg. 18702.2 (a)(12).) As previously noted, the "direct"/"indirect" effect dichotomy was otherwise abandoned.

The amendment retained the "500 foot" rule (Reg. 18702.2 (a)(11)), which presumes an effect is material if the decision affects real property within 500 feet of the property line of the official's property, but now provides that the FPPC may provide written advice allowing an official to participate under the "500 foot" circumstances if the FPPC determines that there are sufficient facts to indicate there will be no reasonably measureable impact on the official's property. This standard appears to be more lenient than the "one penny" rule, but we will have to await the FPPC's application of this new standard in upcoming advice letters. The revision also eliminated HOA property as "real property" in which a public official has a financial interest. (Reg. 18702.2 (d)(4).) This will affect the measure of the "500 foot" rule in some circumstances, since it will now be measured from the official's residence, not the HOA property.

However, even outside the "500 foot" circumstance, a decision could be deemed material under the common law derived "market value" provision (above) or, if it "would change the development potential of the parcel of real property" (Reg. 18702.2 (a)(7)) or "would change the character of the parcel of real property by substantially altering traffic levels or intensity of use, including parking, of property surrounding the official's real property parcel, the view, privacy, noise levels, or air quality, including odors, or any other factors that would affect the market value of the real property parcel in which the official has a financial interest." (Reg. 18702.2 (a)(10).)

The amendment to the real property materiality standard also adopted new exceptions for decisions solely concerning repairs, replacement or maintenance of existing streets, water, sewer, storm drainage or similar facilities, and the adoption or amendment of a general plan.

Business Entity (Regulation 18702.1)

The regulation governing the materiality standard for the financial effect of a governmental decision on a business entity was significantly altered from a qualitative assessment based on a complicated "numbers game," which the FPPC recognized required officials to "[i]gnore the forest, go out and count the trees," to a qualitative assessment of whether the effect is of a "sufficient magnitude" that it will affect an adjustment in the value of the business.

First, however, the amended regulations maintained an "automatic trigger" of presumed materiality whenever the business entity:

"(1) Initiates the proceeding in which the governmental decision will be made by filing an application, claim, appeal, or request for other government action concerning the business entity;

(2) Offers to make a sale of a service or a product to the official's agency;

(3) Bids on or enters into a written contract with the official's agency; [2]
(4) Is the named manufacturer in a purchase order of any product purchased by the official's agency or the sales provider of any products to the official's agency that aggregates to $1,000 or more in any 12-month period;
(5) Applies for a permit, license, grant, tax credit, exception, variance, or other entitlement that the official's agency is authorized to issue;
(6) Is the subject of any inspection, action, or proceeding subject to the regulatory authority of the official's agency; or
(7) Is otherwise subject to an action taken by the official's agency, the effect of which is directed solely at the business entity in which the official has an interest."

(Regulation 18702.1 (a).)[3]

For governmental decisions not specifically set forth in the "automatic trigger" subdivision, the regulation focuses upon whether the decision is of a "sufficient magnitude" that it will affect an adjustment in the value of the business entity. The regulation prescribes that the financial effect of a governmental decision on a business entity 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."

The regulation goes on to provide the following examples:

"Examples of decisions that may be applicable include those that:

(1) Authorize, prohibit, regulate or otherwise establish conditions for an activity in which the business entity is engaged;
(2) Increase or decrease the amount of competition in the field in which the business entity is engaged;
(3) Increase or decrease the need for the products or services that the business entity supplies;
(4) Make improvements in the surrounding neighborhood such as redevelopment projects, traffic/road improvements, or parking changes that may affect, either temporarily or permanently, the amount of business the business entity receives;
(5) Decide the location of a major development, entertainment facility, or other project that would increase or decrease the amount of business the entity draws from the location of the project; or

[2] The Government Code section 87100 and Government Code section 1090 implications of agency staff making a contract with a business entity where an agency official has a "prohibited" and disqualifying conflict of interest will be the subject of an upcoming program memo.

[3] The regulation makes an exception for any financial effect on a business entity that occurs "as a result of a travel payment made for food, lodging, transportation, or fuel, authorized by an agency in the course of carrying out an agency function, to a business entity that provides such services to the general public" and directs that an assessment under such circumstances be made under the rubric set forth in subdivision (b) of the regulation.

(6) Increase or decrease the tax burden, debt, or financial or legal liability of the business entity."

(Regulation 18702.1(b).)

Source of Income (Regulation 18702.3)

Under the prior iteration of the regulation, a decision had a material financial effect on a source of income when the source was directly involved, unless there was no financial effect (the "one-penny" rule). When a source of income was indirectly involved, different materiality standards applied depending on the nature of the source. If the source was a business entity, the business entity materiality standards applied. If the source was a nonprofit or government entity, materiality was based on the gross annual revenues of the entity and the impact on its finances. If the source was an individual, the effect was material if it impacted the individual's assets and liabilities by $1,000 or more, or had a material effect on the individual's real property, applying the real property materiality standards.

The amended regulation makes three major changes to the source of income materiality standards: (1) it divides sources of income into two categories, income from sale of goods and services, and income from the sale of personal or real property; (2) it eliminates the numerical materiality tests for businesses, nonprofits and individuals; and (3) it adds a retail sales exception.

The creation of two categories for sources of income (sale of goods and services, and sale of personal or real property) is meant to distinguish income an official receives from his or her business or occupation, including salary, from income the official receives from non-business or non-employment activities. The rationale is that the first category suggests a closer, likely on-going relationship with the source of income, while the second category suggests a limited or one-time contact with the source.

New subdivision (a) provides the materiality standards when the source of income is the sale of goods and services. The subdivision provides different standards depending on whether a source is a party to the proceeding, an individual, a nonprofit or a business entity. If a source is a party to the proceeding, the financial effect is presumed material. If the source is an individual or a nonprofit, the financial effect is considered material if the source will receive a measurable financial benefit or loss. If the source is a business entity, the financial effect is material if the decision would contribute to a change in the overall value of the business. If the official knows or has reason to know that the individual or nonprofit has an interest in a business entity or real property that will be affected by the decision, the materiality tests for those particular interests (Regs. 18702.1 and 18702.2) apply.

New subdivision (b) sets out the materiality standard for income from the sale of personal or real property. In these situations, the financial effect of the decision is material only if the official knows or has reason to know the source is involved in the decision or owns a

business or real property that will be affected by the decision. If the source is involved or has an interest, the materiality standards for those interests (Regs. 18702.1 and 18702.2) would apply. The materiality standard for sale of personal or real property differs from that described in subdivision (a) for sale of goods and services because it is likely that an official selling personal or real property has limited contact with the source of income and may be unaware of the source's financial interests.

The amended regulation also eliminates the numerical materiality tests for indirect sources of income that are individuals or nonprofits (or property of nonprofits). In place of the numerical tests, one materiality test is used to determine whether a governmental decision will cause a measurable financial benefit or loss to the source of income. The amended regulation also eliminates the materiality test for governmental entities, because the FPPC was unable to determine exactly when the test applied to governmental agencies and why effects on governmental agencies should be considered in a conflicts analysis.

Lastly, the new regulation moves the retail sales exception for business customers, established under Government Code section 87103.5 (previously defined as the "public generally exception" under Regulation 18707.5), directly into the source of income materiality regulation, as new subdivision (d). The new subdivision applies the retail sales exception by defining the phrases used in Section 87103.5, "significant segment of the public generally" and "not distinguishable from the income received from other customers." Subdivision (d) is meant to provide a more reasonable opportunity to determine when the retail sales exception applies.

Source of Gift (Regulation 18702.4)

The amended regulation simplifies the source of gift materiality standard. The financial effect of a governmental decision on a source of gift is deemed material if the source is a claimant, applicant, contracting party, or otherwise named or identified as the subject of the proceeding; or, if the source is an individual or nonprofit that will receive a "measurable financial benefit or loss"; or, if the source is a business entity, the decision would contribute to a change in the overall value of a business entity. This new regulation includes the same "measurable financial benefit or loss" test used in the amended source of income regulation described above.

Additionally, the financial effect of a governmental decision on a source of gift is material if the official knows or has reason to know that the personal finances of the source would be financially affected under Regulation 18702.5, or the source's business entity or real property interest would be financially affected under Regulation 18702.1 or Regulation 18702.2, respectively.

Personal Finances (Regulation 18702.5)

The amended regulation revises the materiality standard for the financial effect of a governmental decision on an official's personal finances, which includes his or her immediate family. The prior personal finances materiality standard did not contain the directly involved/indirectly involved test and "one-penny" rule found in the prior source of income and source of gift materiality standards. Instead, under the prior regulation, an official was deemed to be directly involved whenever there was a financial effect on his or her personal finances over the $250 threshold.

Consistent with the amended regulations for source of income and source of gift, the amended personal finances regulation eliminates the fixed-dollar amount as a threshold, and provides that a decision has a material financial effect on the official's personal finances if the official or his or her immediate family member will "receive a measurable financial benefit or loss" from the decision. This revision likely imposes a lower threshold than the current $250 threshold as a financial benefit of less than $250 certainly can be "measurable."

New subdivision (b) provides exceptions to ensure that certain payments are not included in the personal financial effect analysis. Exceptions set out in subsections (1) through (3) were contained in the prior regulation, and continue to provide that a personal financial effect does not include:

"(1) Any establishment of or change to benefits provided under an employment or retirement policy for employees or retirees if the financial effect of the decision applies equally to all employees in the same bargaining unit or other representative group.

(2) Payment of any travel expenses, to the extent allowed by law, incurred while attending meetings as an authorized representative of an agency.

(3) Stipends received for attendance at meetings of any group or body created by law or formed by the official's agency for a special purpose, so long as the selecting body posts on its website a form provided by the Commission that includes: a list of each appointed position eligible for a stipend, the amount of the stipend for each position, the name of the public official who has been appointed to the position, the name of the public official, if any, who has been appointed as an alternate, and the term of the position."

Subsections (4) and (5) add two new exceptions: use of agency-provided property in carrying out official duties, and any personal reward received from use of a personal charge card or membership rewards program, respectively.

Subdivision (c) retains the rule that decisions that will have a financial effect on the official's business entity or real property must be analyzed under the standards for those interests (Regs. 18702.1 and 18702.2), and not the personal finances test.

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