



STATE OF CALIFORNIA
FAIR POLITICAL PRACTICES COMMISSION
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MEMORANDUM

To: Commissioners Cardenas, Hatch and Hayward

From: Brian Lau, Acting General Counsel
Sukhi K. Brar, Senior Commission Counsel

Subject: Prenotice Discussion Regarding Amendments to Regulation 18700.2 - Parent, Subsidiary, Otherwise Related Business Entity: Defined.

Date: June 11, 2018

Requested Action

Staff requests approval to notice draft Regulation 18700.2 for adoption at the Commission's August 16, 2018, meeting. As proposed, amendments to Regulation 18700.2 will provide clarification on when an official has a financial interest in a parent, subsidiary or otherwise related business entity for purposes of the Political Reform Act's conflict of interest provisions.

Background

The Act's conflict of interest provisions prohibit an official from making, participating in making, or using his or her official position to influence a decision in which the official has a financial interest. (Section 87100.) An official has a financial interest in the decision, if it is reasonably foreseeable the decision will have a material financial effect on the official or on specified interest, including a business entity, in which the official has an investment of \$2,000 or more (Section 87103(a)); a source of income of \$500 or more in the 12 months prior to a decision (Section 87103(c)); and a business entity in which the official is a director, officer, partner, trustee, employee, or holds any position in management (Section 87103(d)).

Historically, the Commission has determined that an official with an interest in a business entity also has an interest in a parent, subsidiary, or related business entity. This is based on the fact that under Sections 82034 and 87209 an "investment" is any financial interest or security interest of more than \$2,000 in a business entity, and a "business position" is any business entity in which the official is director, officer, partner, trustee, employee, or manager, if the business entity, or any subsidiary, or otherwise related business entity does business in the jurisdiction. Former Regulation 18703.1(c) expressly stated that "[a]n official has an economic interest in a business entity which is a parent or subsidiary of, or is otherwise related to, a business entity in which the official has one of the interests defined in [Section] 87103(a) or (d)." However, this language was removed from Commission regulations in 2014.

Current Regulation 18700.2, however, still defines parent, subsidiary, and otherwise related business entities for purposes of Section 82034 and 87209 of the Act. Moreover, in defining various interests under the Act, Regulation 18700 still directs officials with an interest in a business entity to refer to the definition of parent subsidiary, and otherwise related business entity in Regulation 18700.2. (Regulation 18700(c)(6)(A)(C) and (D).) Accordingly, staff has continued to advise that an interest in a business entity may include an interest in a parent, subsidiary, or otherwise related business entity depending on the factual circumstances. (See *Chmura* Advice Letter, No. I-17-051, and *Pelletier* Advice Letter, No. I-17-144.)

Lastly, at the October 2017 Commission meeting, Commissioner Hatch raised concerns with the current definition based on its application in Enforcement Case No. 17/453. Because Commissioner Hatch was concerned that it may not have been clear whether a corporation was a parent corporation of the business entity in which the respondent had an interest in, Commissioner Hatch requested that staff examine Regulation 18700.2 and whether an official should be disqualified if the parent corporation has not identified the subsidiary or related business in its annual Form 10-K or 20-F Reports with the Securities and Exchange Commission.

Discussion and Summary of Proposed Actions

Staff has drafted proposed Regulation 18700.2 in response to Commissioner Hatch's concerns. Specifically, proposed subdivision (d) would establish two exceptions to the general rule that an official with an interest in a business entity also has an interest in a parent, subsidiary, or otherwise related business entity.

The first exception provides that an official does not have an interest in a parent, subsidiary, or otherwise related business if the official owns less than 5% of the shares of a corporation and is a passive shareholder. This was a suggestion made by Commissioner Hatch and is based on the SEC rule that requires that a direct or indirect ownership of more than 5% of a publicly traded corporation be disclosed on SEC Schedule 13D beneficial ownership report within ten days of when such interest is acquired. The term "beneficial owner" is defined under SEC rules and includes any person who directly or indirectly shares voting power or investment power (the power to sell the security).

The second exception states that an official does not have an interest in a parent, subsidiary, or otherwise related business entity if parent corporation is required to file annual Form 10-K or 20-F Reports with the Securities and Exchange Commission and has not identified the subsidiary or related business on those forms or its annual report.

Just as significantly, proposed subdivision (c) is added to the regulation to clearly state that an official with a financial interest in a business entity also has an interest in a parent, subsidiary, or otherwise related business entity except as provided in subdivision (d).

Lastly, in the definition of "otherwise related business entities" in subdivision (b)(3)(A) and (B), the phrase "the same person or a majority of the same persons:" is replaced with "the same

person or persons together” to clarify that business entities are considered otherwise related only when the same person or people own a controlling interest in two or more businesses or the same person or people own 50 percent or more ownership interest in two or more businesses. This would apply to businesses other than a parent corporation as defined in subdivision (b)(1).

Staff Recommendation: Staff recommends adoption of the proposed amendments with the exception of the optional language provided in (d)(1), which would create an exception for those owning less than 5 percent ownership in a corporation’s stock. While the SEC may not have a high level of interest in disclosure of a corporation’s passive shareholder, an interest of less than 5 percent of a corporation’s stock, can be a considerable investment amounting to millions or billions of dollars. This is significant when determining conflicts of interest for the Act’s purposes.¹ Accordingly, staff recommends the adoption of proposed Regulation 18700.2 with the deletion of subdivision (d)(1). Alternatively, the Commission could also limit the exception proposed in subdivision (d)(1) by implementing a monetary threshold. For example, subdivision (d)(1) could be revised to read, “The official’s only interest is that of a shareholder and the official is a passive shareholder with less than 5 percent of the shares of the corporation and a total investment of less than (insert dollar threshold here)”.

¹ For example, Alphabet, Inc, the parent corporation of Google, has a market value of \$739 billion as of May 2018. Five percent of this value would be approximately \$37 billion.

1 Amend 2 Cal. Code Regs., Section 18700.2 to read:

2 **§ 18700.2. Parent, Subsidiary, Otherwise Related Business Entity: Defined.**

3 (a) For purposes of Section 82034 and Section 87209, in determining if a business entity
4 has an interest in real property or does business or plans to do business in the jurisdiction, or has
5 done business in the jurisdiction at any time during the two years prior to the time any statement
6 or any other action is required under the Act, the business entity includes a “parent,”
7 “subsidiary,” or “otherwise related to” another business entity as those terms are defined in
8 subdivision (b) below.

9 (b) Parent, Subsidiary, Otherwise Related Business Entity, defined.

10 (1) Parent - A business entity is a “parent” if it is a corporation that controls more than 50
11 percent of the voting stock of another corporation. The parent corporation is also a parent to any
12 subsidiaries of the corporation that it controls.

13 (2) Subsidiary - A business entity is a “subsidiary” if it is a corporation whose voting
14 stock is more than 50 percent controlled by another corporation. The subsidiary corporation is
15 also a subsidiary to any corporation that controls its parent corporation.

16 (3) Otherwise related business entity. Business entities, other than a parent corporation as
17 defined in subdivision (b)(1), are otherwise related if:

18 (A) The same person or ~~a majority of the same~~ persons together direct or control each
19 business entity; or

20 (B) The same person or ~~a majority of the same~~ persons together have a 50 percent or
21 greater ownership interest in each business entity.

1 (c) An official with a financial interest in a business entity also has an interest in a parent
2 or subsidiary of the business entity or an otherwise related business entity except when the
3 business entity meets the criteria provided in subdivision (d).

4 (d) An official with a financial interest in a business entity does not have an interest in a
5 parent or subsidiary of the business or an otherwise related business entity if:

6 [(OPTIONAL) (1) The official's only interest is that of a shareholder and the official is a
7 passive shareholder with less than 5 percent of the shares of the corporation.]

8 (2) The parent corporation is required to file annual Form 10-K or 20-F Reports with the
9 Securities and Exchange Commission and has not identified the subsidiary or related business
10 entity on those forms or its annual report.

11 Note: Authority cited: Section 83112, Government Code. Reference: Sections 87100, 87102.5,
12 87102.6, 87102.8 and 87103, Government Code.