



NASAA

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November 12, 2004

Federal Trade Commission  
Office of the Secretary  
Room 159 (Annex W)  
600 Pennsylvania Avenue, NW  
Washington, D.C. 20580

Via Electronic Delivery

**RE: Franchise Rule Staff Report, R511003**

Dear Secretary Clark:

The North American Securities Administrators Association, Inc. (NASAA)<sup>1</sup> appreciates the opportunity to respond to the Federal Trade Commission's request for comments regarding the Franchise Rule Staff Report (the "Staff Report") on the FTC's Trade Regulation Rule on Disclosure Requirements and Prohibitions concerning Franchising, 16 C.F.R. Part 436 (the "Franchise Rule").

**NASAA**

NASAA is the oldest international organization devoted to investor protection. It is an association of state, provincial and territorial securities administrators from the United States, (including the District of Columbia and Puerto Rico) Canada and Mexico. NASAA develops model codes and guidelines for adoption by individual member jurisdictions. Members also participate in cooperative enforcement projects, information sharing, and training and education of member administrators.

Several NASAA members administer and enforce state franchise registration and disclosure laws. As a result, NASAA established a project group, the Franchise Project Group, to address issues relating to franchises and business opportunities. The NASAA Project Group is the successor to the NASAA Franchise and Business Opportunity Committee. That Committee authored the current Uniform Franchise Offering Circular ("UFOC") Guidelines and previous versions of those guidelines. The Franchise Project Group studies and makes recommendations to NASAA about model acts and statements of policy that it believes will benefit investors of franchises and business opportunities

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<sup>1</sup> NASAA is the association of the 65 state, provincial and territorial securities regulatory agencies of the United States, Canada and Mexico. NASAA serves as a forum for state regulators to work with each other in an effort to protect investors at the grassroots level and to promote fair and open capital markets.

and those industries as a whole. NASAA members also participate in joint enforcement activities with the Federal Trade Commission to bring actions to halt unlawful practices by franchisors, sellers of business opportunities and promoters of fraudulent investment vehicles.

### **General Comments**

NASAA commends the Commission staff for its thoughtful, insightful and reasoned proposal for revising the FTC's Franchise Rule. The Staff Report is an exceptional work product. NASAA especially welcomes the staff's recommendation for the Commission's Franchise Rule to mirror the UFOC Guidelines, which NASAA promulgated in 1993. As the Commission is aware, for nearly 10 years, the UFOC has been the required model for franchise disclosure documents in the 15 franchise registration states and has been the preferred disclosure format throughout the United States.

NASAA agrees with the Commission staff that the additional disclosures suggested in the Staff Report would benefit prospective franchisees. We also agree that some disclosures currently required in the UFOC Guidelines could be stated more clearly, and we concur with many of the clarifications that Commission staff proposed. In most cases, these additional disclosures and clarifications further our shared goal of ensuring that prospective franchisees receive meaningful disclosure about a franchise offering.

NASAA and the states also share the Commission's hope for increased uniformity in the field of franchise disclosure. In page 296 of the Staff Report, the staff says, "It is our hope that NASAA and the states would adopt the revised Rule, further reducing inconsistencies between federal and state law." Indeed, NASAA and the states would support to reducing inconsistencies to the greatest extent possible. To that end, NASAA will seriously consider the updated disclosure format proposed in the revised Rule.

In light of our desire for greater harmonization of federal and state franchise laws, NASAA urges the Commission to finalize a new Franchise Rule as soon as possible. NASAA's consideration of the disclosure document proposed in the Staff Report depends upon the Commission's timely finalization of the proposed Rule. An expeditious conclusion to the rulemaking process would be a great step forward toward achieving the goals of uniformity and the enhanced protection of franchisees.

### **Specific Comments to Proposed Franchise Disclosure Document**

The following comments are made by the NASAA Franchise Project Group and do not necessarily reflect the views of NASAA.

#### **A. Cover Page**

##### **Proposed Section 436.3**

##### **1. Reference to Items 5 and 7 Fees.**

In the Staff Report, the FTC staff recommended that the Commission adopt the following language for the Cover Page of the franchise disclosure document:

The total investment necessary to begin operation of a [franchise system name] franchise is [the total amount of Item 7], including the [total amount in item 5] that must be paid to the franchisor.

The Franchise Project Group recommends that the Commission add the phrase **and any affiliates** at the end of this sentence. Proposed Item 5 of the Staff Report requires disclosure of all “initial fees.” Initial fees are defined in the Staff Report to include “fees and payments received from the franchisor or any affiliate before the franchisee’s business opens.” This definition of initial fees is a significant improvement from Item 5 of the UFOC Guidelines, which does not state specifically that a franchisor must disclose to the franchisee the fees payable to a franchisor’s affiliates as well as to the franchisor.<sup>2</sup>

The Franchise Project Group recommends that, for consistency, the FTC should amend the above disclosure to clarify that, on the cover page, the franchisor must disclose amounts to be paid to the franchisor and any affiliates. The addition of the phrase “and any affiliates” will make clear that the franchisor must disclose all “initial fees,” in both Item 5 and on the Cover page, under the same definition.

## 2. Risk Factors

The Project Group commends the Commission staff for recognizing that federal preemption of state authority in the field of franchise registration and disclosure laws is not necessary or appropriate. We also commend the staff for recognizing that states that register franchise offerings should not be preempted from requiring state specific risk factors on the cover page of the franchise disclosure document. In that regard, on page 92 of the Staff Report, the staff states that “We also believe it is proper to permit the states and franchisors the greatest flexibility concerning how to include state-specific information, be it in an addendum, separate cover page, or otherwise.”

The Project Group appreciates the staff’s sensitivity to the states’ authority to impose additional risk factors, in appropriate circumstances, on the cover page of the franchise disclosure document. In some cases, states that review franchise disclosure documents may require non-exempt additional state disclosures by a separate addendum, but in other cases, states may require additional disclosures and clarifications to the franchise disclosure document itself. For example, if a state requires a franchisor to make a specific risk factor on the franchisor’s cover page, that risk factor should be made on the

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<sup>2</sup>A Commentary on the UFOC Guidelines issued by NASAA in 1994 states, however, that “Initial fees” includes all fee and payments required by the franchisor and its affiliates before the franchisee’s business opens. *See* NASAA Commentary to the Uniform Franchise Offering Circular Guidelines (1999) Bus. Franchise Guide (CCH) (hereafter “NASAA Commentary”) ¶5790 at 8469.

cover page of the disclosure document, not on a *separate* cover page that is part of an addendum to the disclosure document.

Therefore, the Project Group requests that the FTC confirm, perhaps in compliance guides that accompany the final Franchise Rule, that states may require non-exempt additional state disclosures, including state specific risk factors, in the franchise disclosure itself, and that there should be only *one* cover page to the document that includes both federal and non-exempt state disclosures.

**B. Item 1: The Franchisor and any Parent, Predecessors, and Affiliates**  
**Proposed Section 436.5(a)**

The Franchise Project Group suggests that the Franchise Rule be amended to require identification of the majority shareholder of any privately-held corporation. Based on the law enforcement experience of several NASAA members, in the case of privately held corporations, the majority shareholder, who may or may not be otherwise disclosed, has the opportunity to control every aspect of the franchisor. The identity of this person or entity is, therefore, material information that a franchisee should have in order to make an informed decision about a franchise system.

**C. Item 3: Litigation, and Item 4: Bankruptcy**  
**Proposed Sections 436.5 (c) and (d)**

In the Staff Report, in the discussion of proposed Item 3 of the franchise disclosure document, the staff recommends that the Franchise Rule be amended to require that a franchisor disclose certain litigation regarding “the franchisor, a parent who guarantees the franchisor’s performance, a predecessor, an affiliate who offers franchises under the franchisor’s trademark, and any person identified in [Item 2].”

With regard to a franchisor’s parent’s litigation, the Commission staff’s recommendation is new, and a departure from the proposed Item 3 described in the Commission’s 1999 Notice of Proposed Rulemaking (“NPR”). In the NPR, the staff proposed disclosure of all parent litigation. The staff has reconsidered the requirement to disclose litigation regarding a franchisor’s parent in all cases but has recommended that disclosure be required when the franchisor’s parent guarantees the franchisor’s performance. On page 104 of the Staff Report, the staff explains this recommendation: “Where a parent induces franchise sales by promising to back the franchisor financially or otherwise guarantees performance, the parent’s prior litigation history is material and should be disclosed.”

The Franchise Project Group agrees that it is appropriate to require disclosure of litigation involving a franchisor’s parent. For purposes of both Items 3 and 4, the Project Group sees no distinction between materiality of litigation disclosure of a parent and an affiliate and the project group would always favor fuller disclosure concerning such litigation.

Therefore, the Project Group recommends that the Commission revise Items 3 and 4 of the proposed Franchise Rule to require a franchisor to disclose litigation and bankruptcy of any person or entity, whether a parent or affiliate, who guarantees the franchisor's performance.

**Item 8: Restrictions on Sources of Products and Services**  
**Proposed Section 436.5(h)**

With respect to Item 8 of the proposed Franchise Rule, on page 22 of Attachment B, the Project Group recommends that the Commission move footnote 5 from its current position to the end of Section 436.5 (h)[Item 8](6)(i). This suggestion is made purely for the sake of clarity.

Footnote 5 on page 22, relating to the "precise basis" disclosure of Item 8, states that figures for this disclosure should be taken from "the franchisor's most recent annual audited financial statement..." However, from the list of figures comprising the precise basis disclosure in Section 436.5(h)(6), only the very first figure listed at Section 436.5(h)(6)(i), "total revenue," is required to be listed in an audited financial statement. The other figures, listed in Section 436.5(h)(6)(ii), (iii), and (iv), are not generally found in a franchisor's annual audited financial statement.

**E. Item 15: Obligations to Participate in the Actual Operation of the Franchise Business**

**Proposed Section 436.5 (o)**

In the NPR, the Commission staff stated that the text of proposed Item 15 was intended to be identical to Item 15 of the UFOC Guidelines. The Staff Report reflected that staff intended Item 15 under the proposed Franchise Rule to be identical to UFOC Item 15. As currently drafted, however, Item 15 in the Staff Report requires less disclosure than the comparable disclosure under the UFOC Guideline. Specifically, in the reorganization of the text, proposed Item 15 limits the disclosures regarding whom a franchisee may hire as an on-premises supervisor, and that person's required successful completion of training, to franchisees who are individuals but not franchisees who are business entities. Based on the staff's discussion of the revision of this item, this omission appears to be inadvertent.

In addition, The Project Group recommends that the final Franchise Rule should clarify that Item 15 requires disclosure of all agreements regarding the franchise that apply to the franchisee's owners. The NASAA Commentary discusses that UFOC Item 15 requires this disclosure. *See* NASAA Commentary, ¶5790 at p. 8479-3. There is no comparable provision in the Staff Report regarding this disclosure.

**F. Item 19: Financial Performance Representations**

**Proposed Section 436.5(s)**

In Item 19 of the proposed Franchise Rule disclosure, the Commission staff suggests

that if a franchisor furnishes financial performance information according to [Item 19], the franchisor may deliver to a prospective franchisee a supplemental financial performance representation about a particular location or variation, apart from the disclosure document.

The Project Group suggests that the Commission clarify, at least in compliance guides that will accompany the final Franchise Rule, what is meant by a “variation” on a financial performance representation. Specifically, the Project Group is concerned that this language not be construed so broadly as to allow franchisors making an Item 19 disclosure to make a supplemental disclosure of a “variation” that does not relate to the underlying Item 19 disclosure.

### **G. Item 20: Outlets and Franchisee Information** **Proposed Section 436.5(t)**

The Project Group applauds the staff for accepting NASAA’s suggestion to revise Item 20. The Project Group remains concerned, however, about the impact that confidentiality clauses (or “gag clauses,” as they were called in the NPR) may have on a prospective franchisee’s ability to obtain meaningful information about a franchise system from perhaps the most useful sources, existing and terminated franchisees.

In light of the continued prevalence of confidentiality clauses in franchising, the fact that these clauses are antithetical to the most basic tenets of franchise disclosure, and the fact that the effect of these confidentiality clauses will not be limited under the proposed Franchise Rule, the Franchise Project Group suggests that on page 57 of Attachment B, the proposed disclosure that currently reads:

Franchisors may also disclose the number and percentage of current and former franchisees who during each of the last three years, signed agreements that included confidentiality clauses and may disclose the circumstances under which such clauses were signed,

be revised to:

Franchisors **must** also disclose the number and percentage of current and former franchisees who during each of the last three years, signed agreements that included confidentiality clauses and **must** disclose the circumstances under which such clauses were signed (Emphasis supplied).

### **H. Item 21: Financial Statements** **Proposed Section 436.5(u)**

#### **1. U.S. GAAP**

In proposed Item 21 of the Staff Report, the Staff recommends that franchisors be required to include financial statements “prepared according to United States generally

accepted accounting principles, or as permitted by the Securities and Exchange Commission, or as revised by any future government mandated accounting principles.”

The Project Group is concerned that the phrase “or as permitted by the Securities and Exchange Commission” may create uncertainties. At present, the Securities and Exchange Commission (“SEC”) allows financial statements prepared by certain foreign public companies using non-U.S. GAAP to reconcile those statements to U.S. GAAP. The Staff Report appears to contemplate that franchisors, whether or not public companies, be allowed to reconcile foreign financial statements to U.S. GAAP, to the extent permitted by the SEC for public companies. The SEC rules allowing reconciliations for foreign statements in this circumstance are part of a comprehensive regulatory scheme that does not apply to franchisors, unless they are public companies.

The Project Group agrees that franchisors should be allowed to utilize foreign financial statements that are reconciled to U.S. GAAP. The reference “as permitted by the SEC,” however, is confusing and, if retained, should be clarified.

In addition, the Project Group suggests that the first sentence of proposed Item 21, Section (1) be revised to clarify that the requirement for U.S. GAAP statements applies to all financial statements, not just the financial statements discussed in Section (1) of Item 21.<sup>3</sup>

## **2. Future Government Mandated Accounting Principles**

The Project Group is concerned that the phrase “or as revised by any future government mandated accounting principles” may need clarification. The Staff Report reflects that this phrase was added because the staff recognizes the possibility that American accounting principles may change. The above phrase, however, does not relate to American accounting principles. The term “government” is broad and can relate to any government, not just the U.S. government. At a minimum, therefore, the phrase should be revised to discuss future **U.S.** government mandated accounting principles.

## **3. GAAS**

Proposed Item 21 in the Staff Report states that “financial statements must be audited by an independent certified public accountant using generally accepted auditing principles.” The Project Group recommends that this revision be revised to refer to generally accepted United States auditing **standards**, rather than principles. This terminology is used in the Staff Advisory Opinion 02-4, quoting the Statement of Basis and Purpose accompanying the current Franchise Rule, 43 Fed. Reg. 59,614, 59,680 n. 433 (December 21, 1978), and is the correct terminology used in the accounting

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<sup>3</sup>As currently written, proposed Item 21, Section (1) states “Include the following financial statements prepared according to United States [GAAP].” The word “following” may be confusing as it could be construed to apply only to the four subsections following Section (1), rather than to both Section 1 and Section 2 of Item 21. The disclosure could be clarified by conforming to Item 21 of the UFOC Guidelines, which begin by stating “Prepare financial statements according to GAAP [United States GAAP].”

profession and the financial community.

#### **4. Updates**

The UFOC Guidelines require specifically that more recent unaudited financial statements prepared in accordance with GAAP be included in the franchise disclosure document if the audited financial statements precede the application date by more than 90 days. In the Staff Report, the only financial statements required are audited financial statements as of the date of the franchisor's fiscal year end. The Staff Report would require franchisors to revise the disclosure document within 120 days of the end of its fiscal year, to prepare revisions each quarter to reflect any material changes, and to include its 1<sup>st</sup> quarterly update in its annual report. It does not specifically require franchisors to update financial statements, except when the franchisor deems the financial statements reflect a material change.

Because a franchisor's financial condition is so critical to the investment decision of prospective franchisees, the Project Group recommends that the final Franchise Rule be revised so that franchisors are required to provide updated financial statements based on the same criteria currently required under the UFOC Guidelines.

#### **5. Phase- In of Financial Statements**

The Project Group requests that the staff provide specific examples of which financial statements are required in specific circumstances. As currently drafted, the disclosure is not clear as to whether the unaudited opening balance sheet is the only required financial statement to be included in the first partial or full fiscal year the franchisor is in the business of offering and selling franchises. *Compare* Item 21(2)(i) with Item 21(2)(iv)(C).

#### **6. Potential Diffusion Project**

The Franchise Project Group has been working on a State Franchise Registration Diffusion Project that would distribute the anniversary dates of franchisors' state registrations more evenly throughout the year. The project was initiated because, at present, the anniversary date of the vast majority of state franchise registrations falls in the early spring, a circumstance which imposes workload burdens on the state franchise examiners and results in delays, to the detriment of franchisors and franchisees, in processing the annual registration renewals. This situation arises because either the state law sets the anniversary date of the registration to a date which ranges from 90-120 days from the franchisor's fiscal year-end, or franchisors have themselves secured an anniversary date within this same time frame in order to coordinate their state registration renewals within the FTC Rule's time frame for annual updates.

Under the current proposal, the Project Group is exploring a new method for determining the anniversary date of state franchise registrations (and, thus, the time for filing a state renewal application) for those franchisors whose fiscal year-end is on or around December 31. For example, the expiration date of a state franchise registration could be selected based upon the first letter of the franchisor's principal trademark(s) (e.g., January = A & B, February = C & D,



etc.). Since the new expiration date would not necessarily correlate with the issuance dates of most franchisors' annual audited financial statements, the states are considering a method that would allow franchisors to supplement their disclosure documents by inserting the updated audited financial statement at Item 21, without the need to file an amendment to the state registration. Obviously, we wish to coordinate our proposal with the FTC to be sure that this procedure will not conflict with any FTC requirements.

Such a proposal would not change the requirements for annual updating. Instead, it simply would change the beginning and ending date of the 12-month period covered by the franchise disclosure document. Thus, information will be as timely under the new proposal as it currently is, except for those fiscal year end based disclosures, if required, about the amount of certain franchisor and affiliate supplier revenues from franchisee purchases and information about advertising fund expenditures (and we continue to consider the impact of such a time lapse for disclosure purposes). In this regard, the Project Group suggests that the FTC permit a franchisor to report required information based on its state-assigned anniversary date, rather than a calendar year. Of course, if there were any material changes to updated information during this fiscal year-end disclosure cycle, then both the FTC Rule and state laws would require the franchisor to amend its disclosure document to reflect the new information.

Historically, the FTC has permitted franchise registration states to determine the timing of the annual updates for franchise disclosure documents used in their states. *See*, FTC staff opinion to the Virginia Division of Securities and Retail Franchising issued on June 28, 1980, Business Fran. Guide (CCH) ¶6417 at p. 9858. No Project Group member is aware of any problem related to the use of franchise disclosure documents that are updated on a 12-month cycle not based on the franchisor's fiscal year-end.

Since coordination between NASAA and the FTC is crucial for the success of this project, we believe that it is essential that the FTC, either in the revised rule or in the compliance guidelines that will accompany the revised rule, permit franchisors to annually update their franchise disclosure documents if on a different time frame than the 120 days after fiscal year-end period currently contemplated by revised rule section 436.7(a), but without burdening the franchisor with two separate updates: one to conform to the state-assigned renewal date and the other to comply with the revised rule's 120-day time frame. One option would be to permit the franchisor to substitute an ending date designated by the state for certain fiscal year-end information required by the revised rule. Another option is to permit a franchisor to attach newly issued audited fiscal year-end financial statements to an existing state-registered franchise disclosure document without the need to update the remainder of the disclosure document (except for other material changes, if any).

We believe the proposed change will make the registration renewal process more efficient for both the franchise registration states and franchisors, and will not diminish the value or usefulness of the franchise disclosure document received by prospective franchisees. For these reasons, we urge the FTC to ensure that the revised rule is flexible enough to accommodate a state-assigned registration renewal date.

### **Conclusion**

NASAA and the Franchise Project Group stand ready to work with the Commission staff to finalize a Franchise Rule. We appreciate the opportunity to comment on the Staff Report. Should you have any questions, please feel free to contact Dale E. Cantone, Chair of the NASAA Franchise Project Group.

Sincerely,

A handwritten signature in cursive script that reads "Franklin L. Widmann". The signature is written in black ink and is positioned below the word "Sincerely,".

Franklin L. Widmann, NASAA President, and  
Chief, New Jersey Bureau of Securities