



December 27, 2022

Submitted Online through <https://www.regulations.gov>

Dianna Seaborn, Director  
Office of Financial Assistance  
U.S. Small Business Administration  
409 Third Street, SW  
Washington, DC 20416

**RE: Matter No. RIN 3245-AH87**  
**Affiliation and Lending Criteria for the SBA Business Loan Programs**  
**13 C.F.R. Parts 120 and 121**

Dear Director Seaborn:

The Franchise and Business Opportunities Project Group<sup>1</sup> of the North American Securities Administrators Association (“NASAA”) appreciates the opportunity to respond to the U.S. Small Business Administration’s (“SBA”) request for comments on whether to make changes to various regulations governing SBA loan programs found in 13 C.F.R. Parts 120 and 121 (the “Proposal”).<sup>2</sup>

### Who We Are

Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA’s membership includes the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. In the U.S., NASAA is the voice of state securities agencies responsible for grass-roots investor protection and efficient capital formation. NASAA develops model statutes, rules, and guidelines for adoption by individual states, and NASAA members also participate in cooperative enforcement projects, information-sharing, and training and education of state administrators.

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<sup>1</sup> The following comments reflect the views of the Franchise and Business Opportunities Project Group, and do not necessarily represent the views of NASAA.

<sup>2</sup> The Proposal is available at <https://www.federalregister.gov/documents/2022/10/26/2022-23167/affiliation-and-lending-criteria-for-the-sba-business-loan-programs>.

Several NASAA members<sup>3</sup> administer and enforce state franchise registration and disclosure laws. As part of those duties, those states require that Franchisors file their Franchise Disclosure Documents (“FDDs”) with state franchise agencies prior to offering or selling in the state. Those states also employ franchise examiners to review and comment on those FDDs before the state grants the Franchisor a registration of its franchise offering.

More than 30 years ago, NASAA established a standing committee, now called the Franchise and Business Opportunities Project Group (the “Franchise Project Group”), to address issues relating to franchises and business opportunities. The Franchise Project Group studies and makes recommendations to NASAA about model acts, statements of policy, and interpretive commentaries that will benefit investors of franchises and business opportunities and those industries.

The Franchise Project Group welcomes the opportunity to comment on the statements made in the Proposal<sup>4</sup> regarding SBA lending programs.

- 1. SBA proposes to specifically remove the principle of control of one entity over another as a separate basis for finding affiliation because the concept of control has proven particularly burdensome for applicants and lenders to understand and implement.**

Navigating the various SBA loan programs is complex, and the franchise business model is nuanced. Consequently, all prospective Franchisees should work with a lender who is familiar with the franchise business model and who has experience lending to Franchisees.

The Small Business Act,<sup>5</sup> mandates that the SBA makes its business loan programs available only to independently owned and operated small businesses. To determine whether an SBA loan applicant is an independent small business, the SBA must analyze whether there are any other parties with which the loan applicant may be affiliated who may exert control over the loan applicant. Unlike an independently owned small business, in the franchisor / franchisee relationship Franchisors reserve contractual rights to protect the brand and system. Due to those contractual rights (which differ from brand to brand), the control issue must be assessed in light of the actual reserved contractual rights. Under the current SBA rule, if a Franchisor’s control is excessive, the prospective Franchisee ceases to be independent, and the affiliation policy must be applied to verify the loan applicant is an independent small business. In franchise loan applications, the SBA must review the franchise agreement and other related agreements to identify provisions where control by the Franchisor could render the applicant dependent on the

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<sup>3</sup> California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, Virginia, Washington, and Wisconsin.

<sup>4</sup> The numbered statements summarize policy arguments set forth in the Proposal; namely, Section 1 at 64725 and 64727-28, Section 2 at 64727, Section 3 at 64728, and Section 4 at 64724.

<sup>5</sup> 15 U.S.C. § 632(a)(1).

Franchisor.

The SBA has already reduced its excessive control analysis to four common areas in franchise agreements, and a Franchisor may easily resolve any concerns of excessive control by adding the SBA Form Addendum to its franchise agreement. The Franchisor is then added to the SBA Franchise Directory. The current process is streamlined, transparent, and uniform for participating lenders to implement. For this reason, NASAA disagrees that the affiliation analysis is too burdensome for applicants and lenders. As such, NASAA supports keeping the principal of control of one entity over another as a separate basis for finding affiliation and keeping the analysis limited to the four common areas.

**2. SBA believes that affiliation based on ownership alone captures much of the control component, and control as a separate basis for finding affiliation is not necessary.**

The proposed new definition of ownership does not capture the excessive control issue inherent in the franchise business model, under which the Franchisee owns its business but receives assistance and support from the Franchisor. The Franchisor must exert some level of control over the Franchisee's business to enforce the Franchisor's system standards. Thus, using an analysis that looks only at ownership ignores the fundamental structure of a franchise model that involves control by the Franchisor over aspects of the Franchisee's operations. Furthermore, the relationship between the Franchisor and Franchisee is imbalanced in favor of the Franchisor. The Franchisor has all the information about the franchise business model in its possession and will be more skilled at negotiating the transaction, as it brings more resources and experience about franchising generally and its franchise business model specifically. The proposed ownership definition fails to recognize this important dynamic. The current control analysis used to evaluate affiliation plays an important role in protecting the prospective Franchisee's independence.

If the Proposal is adopted and lenders remove the control component from the affiliation analysis, Franchisors will be able to include provisions in franchise agreements that will decrease investor protection. This protection ensures Franchisee independence by preserving the Franchisee's right to transfer the franchise without post-transfer liabilities, as well as the right to sell assets at fair market value.<sup>6</sup> The limitations on Franchisor control imposed by the control component of the affiliation analysis also protect the Franchisee by prohibiting covenants that encumber the Franchisee's real estate and by prohibiting excessive control related to the hiring, firing, and scheduling of employees.

Affiliation based on ownership alone ignores the nuances and complexities of the Franchisor-Franchisee relationship. NASAA opposes a policy that fails to recognize the imbalance of power in the Franchisor-Franchisee relationship, and which diminishes investor protection. It is an unnecessary trade off. The current SBA Form Addendum streamlines lender

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<sup>6</sup> In addition to protecting Franchisee independence, these requirements also protect the loan collateral.

underwriting on this excessive control issue. As such, NASAA believes that control as a distinct basis for finding affiliation serves important policy goals that are not adequately captured by the concept of ownership.

**3. Upon the effective date of this rule, SBA would no longer publish the SBA Franchise Directory**

The SBA Franchise Directory is an effective tool for prospective Franchisees as they perform their due diligence. The SBA Franchise Directory allows the Franchisee to identify whether a Franchisor is eligible to participate in SBA business loan programs. If a Franchisor is listed in the Franchise Directory, then both the lender and prospective Franchisee know the investment meets SBA loan program eligibility requirements. Eliminating this tool would likely create more delays and confusion in processing SBA loan applications, not less.<sup>7</sup>

NASAA notes that Congress and the SBA relied on the Franchise Directory to implement the Paycheck Protection Program (“PPP”), which did not act to waive affiliation requirements but rather recognized that they had already been met by those Franchisors who were already listed on the Franchise Directory.<sup>8</sup> The SBA Franchise Directory allowed Congress and the SBA to be responsive and efficient in an emergency.

The Franchise Directory and its unique SBA Franchise identifier codes provide the SBA the opportunity to actually increase transparency and investor protection by expanding its reporting to include the loan default rate by Franchisor. NASAA notes that the SBA’s Office of Inspector General (“SBA OIG”), the Government Accountability Office (“GAO”), and independent researchers have published reports raising concerns about SBA guarantees of loans to poorly performing Franchisors.<sup>9</sup> There is a need for more transparency, not less. As such, NASAA supports the continuation and expansion of the SBA Franchise Directory and opposes any policy that decreases transparency in Franchisor eligibility for SBA loan programs.

Furthermore, the SBA can better aid, counsel, assist and protect the interests of Franchisees and the integrity of the franchise channel of commerce by clearly and regularly reporting the performance of the SBA loan guarantees. There is a need for greater disclosure of

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<sup>7</sup> The Proposal would require lenders to determine whether a Franchisor is eligible to participate in SBA loan programs. Lenders would be required to review franchise agreements without the benefit of a central repository. Franchise agreements are nuanced, and this move is likely to lead to a less streamlined approach as lenders try to navigate the terms of the franchise agreement.

<sup>8</sup> Congress waived affiliation requirements for businesses operating under North American Industry Classification System (“NAICS”) Code 72 (Accommodations and Food Services) for small businesses operating under a franchise agreement listed on the SBA Franchise Directory.

<sup>9</sup> See Office of Senator Cortez Masto, *Strategies to Improve the Franchise Model: Preventing Unfair and Deceptive Franchise Practices* (Apr. 2021) at 17, available at <https://www.cortezmasto.senate.gov/download/04/13/2021/franchise-report-from-the-office-of-senator-cortez-masto-1>.

franchise brands with high SBA loan default rates.<sup>10</sup>

SBA loan default rates is a key data point along with the FDD that (1) serves as a deterrent against fraudulent and deceptive practices in the offer and sale of franchises, (2) helps prospective Franchisees make informed investment decisions, (3) gives consumers a starting point to conduct their own due diligence and verify the accuracy and completeness of information provided to them by Franchisors and their agents, (4) enables consumers to comparison shop and contrast disclosures provided by Franchisors in whom they have an interest, (5) benefits Franchisors by increasing investor confidence in the franchise industry, (6) makes the SBA loan process more accessible to Franchisees, and (7) is helpful to point out low default rates to prospective franchisees.

NASAA recommends that the SBA be more transparent with its data on the performance of SBA loan guarantees, as transparency strengthens the SBA loan programs and makes sustainable franchise business models more competitive.

**4. SBA believes that streamlining and modernizing regulations on lending criteria and loan conditions for its loan programs can better position the SBA and participating lenders to meet the needs of America's small businesses, create jobs, assist with recovery from the COVID-19 pandemic, and grow the economy, fueling American entrepreneurship.**

The SBA loan programs provide a critical source of funding to the franchise industry. As a gatekeeper of capital for franchise investments, it is crucial that the SBA understand the pre-sale disclosure laws and its impact on such laws as it seeks to modernize its regulations. SBA is in a unique position to ensure that small businesses do in fact thrive, by ensuring that the investments made by Franchisees to open small businesses are funneled to franchise systems that are financially sound and have low default rates. Only then will Franchisees be able to create jobs and the franchise industry will be able to assist with recovery from the COVID-19 pandemic and grow the economy, thereby fueling American entrepreneurship. The economy and entrepreneurship will not grow and thrive if loans are made to failing or fragile franchise systems.

Participating SBA lenders will require the Franchisee to provide accurate financial performance data to determine the loan amount and terms. Yet, in many situations the prospective Franchisee will not receive basic financial data from a Franchisor in the sales process. For example, Franchisors are not required to provide a break-even analysis in the FDD. Also, financial performance representations are optional and, if provided, may only provide data about mature outlets.

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<sup>10</sup> See *id.*; see also Letter from U.S. Senators Warren and Cortez Masto to SBA Administrator Isabel Casillas Guzman (Mar. 1, 2022) at 164, available at <https://www.govinfo.gov/content/pkg/CHRG-117shrg47361/pdf/CHRG-117shrg47361.pdf>.

It is incongruous for Franchisors on the one hand to opt not to provide financial performance representations in their FDDs to prospective Franchisees, but on the other hand create and distribute financial data to SBA lenders. There could be legitimate reasons why a Franchisor might not include a financial performance representation in its FDD but still want to provide data to SBA lenders to benefit prospective Franchisees. Yet, the Franchisee has no idea what financial data was given to the lender to qualify for a loan the Franchisee is obligated to repay. NASAA believes the SBA is uniquely situated to protect investors and can do so by simply requiring the Franchisor to disclose the same data to both the lender and the Franchisee as a condition of the SBA loan guaranty. The Franchise Project Group would welcome the opportunity to discuss possible disclosure formats that would meet the needs of lenders while also complying with state and federal franchise requirements.

The SBA loan guaranty also incentivizes lenders to make loans. Without transparency and accountability, lenders will make loans without concern for success or failure, since the lenders make money on the fees and collateral and have little loss exposure. In addition, lenders can collateralize SBA guaranteed loans and sell them on the secondary market. Moreover, bank regulators do not regulate government-guaranteed loans. There are decades of reports noting the need for more oversight.<sup>11</sup> NASAA recommends that the SBA publish regular default reports by franchise brand to increase transparency and accountability. Doing so would help create a robust franchise channel, which would create strong small businesses and sustainable job creation to grow the American economy.

### **Conclusion**

NASAA and the Franchise Project Group stand ready to work with the SBA staff to review issues impacting Franchisees and involving franchise disclosure, and we appreciate the opportunity to comment on this important matter. Should you have any questions, please feel free to contact the undersigned or NASAA's General Counsel, Vince Martinez, at (202) 737-0900.

Very Truly Yours,

*Theresa Leets*

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<sup>11</sup> See Office of Senator Cortez Masto, *supra* note 9, at 13, 17.