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Theresa Leets, Chair of Project Group
Bill Beatty, Co-chair of the Section
Erin Houston, Co-chair of the Section
NASAA Franchise and Business Opportunity Project Group

Re: Public Comment on a Proposed Franchise Broker Registration Act ("Franchise Broker Act")

To: Franchise Broker Act Project Group

Based on my lengthy involvement in franchising, I have observed and commented for some time on the negative impact some brokers and FSOs have had on franchising. Thank you for advancing the creation of a broker registration and disclosure requirement which I think is long overdue.

As is found for franchisors, there should be no debate that there are responsible third party franchise sellers that unfortunately will be impacted by the further regulation of brokers and FSOs. The fact that there are responsible brokers and FSOs does not lessen the need to evaluate this part of franchising and understand more fully its benefits and risks.

Franchisors use third party sellers to increase their rate of growth. However, the fees paid to third party sellers generally cause an increase in the required investment by the franchisee while at the same time lowering the revenue available to the franchisor to provide initial and continuing support. I fully expect that this Franchise Broker Act will be a first step in the evaluation of the benefits and risks of third party sellers and that likely there will be a need for a careful, and impartial, examination of third party seller practices in franchising in the future. If that occurs, and if it discloses inherent problems in parts of the third party seller group of companies, then a determination of acceptable practices and what practices need to be eliminated will be required.

My comments that follow are clarifications and changes that I believe should be considered to improve third party seller disclosure.

Section 2: Definition of Franchise Broker and Franchise Broker Representative

I take exception to using the term broker and broker representative and prefer the more encompassing term of Third Party Seller. Brokers make up only a portion of the third party seller community. Based on my experience and observation, while there are issues with the practices of many brokers, the more critical issues of practice will be found in the Franchise Sales Organizations (FSO) community.

There is no doubt that the current definitions included in the Act will lead to unnecessary litigation. Regulations need clarity and the definitions used in the proposed Franchise Broker Registration Act are anything but clear. It is obvious that the drafters of the proposed Act came to the same conclusion as they felt the need to develop a set of hypotheticals in an attempt to illustrate the difference between a broker and a broker representative. The definitions and clarifications instead only served to raise additional questions. In speaking to several other franchise professional with similar spans of franchise experience and knowledge as I have, there was a universal sentiment that the definitions, as drafted, are problematic.

To be effective, and to limit the need for future clarification (especially given the likelihood that additional methods for franchise recruitment will be developed over time), all third party sellers and organizations should be governed by the Act. In my opinion it would be far clearer and easier to define those persons and entities that are excluded without the unwieldy attempt made to distinguishing between a broker and a broker representative. If a broker and a broker representative have a common form of disclosure, I don't understand why that precise distinction is even necessary.

However, there is a material differences between the purpose and function of a Franchise Sales Organization and those of a broker. Requiring the same disclosure and registration process for all of them, may lead some advocates to push for lowering the threshold of information included, even if a prospective franchisee might find that information beneficial. Therefore, if a single disclosure format is proposed, the included information should aim for the higher bar of disclosed content as I outline later.

The Act excludes an Area/Franchise Representative from requiring a broker disclosure because they would be disclosed in a franchisor's FDD and listed on the receipt page. I lobbied for including an Area/Franchise Representative in California SB919 and I recommend the same here, as discussed below.

Area/Franchise Representative

An Area/Franchise Representative is a contractually defined relationship where in exchange for a payment by the Area/Franchise Representative to the franchisor, a person or entity will market a franchisor's franchise opportunity to prospective franchisees and will provide the franchisor's franchisees in their territory with initial and ongoing training and support. The Area/Franchise Representative is paid a commission when a franchise is sold, generally based on a percentage of the initial franchise fee paid to the franchisor and will also be paid a percentage of the continuing royalty paid by the franchisee during the term of the relationship. Other forms of payment and compensation are also possible.

The Area/Franchise Representative is an independently owned and managed business operating under an agreement with generally one but sometimes more than one franchisor. While frequently an individual, an Area/Franchise Representative may be an entity that employs or engages staff that participate in the recruitment and servicing of franchisees for the franchisor.

An Area/Franchise Representative shares many of the attributes of a subfranchisor, with the material difference being that they are not required to have an independent Franchise Disclosure Document as the franchise agreement is signed with the franchisor. While the relationship with Area/Franchise Representatives are required to be disclosed in several sections of a franchisor's FDD, material information that is now proposed for a broker disclosure document will not be made available to the prospective franchisee through a franchisor's FDD. In addition, if the Area/Franchise Representative have employees or independent contractors as part of their organization, and those parties market the franchise opportunity as part of their duties, those individuals will generally not be included in the franchisor's disclosure.

Like with other franchise relationships, franchisors will rightfully argue that they are not vicariously liable for the bad acts of an independently owned and managed Area/Franchise Representative. As such, the notion that they should be excluded from providing a broker disclosure and not be required to have a mandated minimum financial capability and insurance, simply because they are identified in the franchisor's FDD, makes little to no sense to me.

Franchise Sales Organizations (FSO)

Similar to an Area/Franchise Representative, an FSO (aka Franchise Development Companies) provide outsourced franchise sales and support for franchisors with the distinction that an FSO manages the entire franchise recruitment and sales process including, but not limited to presenting to prospective franchisees a franchisor's Franchise Disclosure Document and managing discovery days, validation calls and other methods used in marketing franchises. FSO's work as an intermediary with a franchisor's brokers and other franchise lead generation sources.

FSOs generally require a franchisor to pay an upfront fee, monthly management fees, sales commissions and an ongoing revenue share. Monthly management fees, generally range between \$5,000 to \$20,000 with sales commissions ranging between 40% to 50% of the franchisee's initial franchise fee for leads generated by the FSO and between 15% to 30% if the lead is generated by a broker who also earns a commission. Minimum sales commissions, which are frequently imposed, may skew the percentages higher.

In addition to the initial sales commission, FSOs will also receive, indefinitely, a portion of the royalty paid by the franchisee which can be in the range of 0.5% to 1% of a franchisee's gross sales. This percentage of gross revenue, in some emerging or troubled franchise systems, may be higher than the net earnings of a franchisor and will be due regardless of whether the system is operating at a loss. FSOs may also require equity in the franchisor which can range from 10% to 50% dependent on the age of the system and negotiations.

Franchisees who have been defrauded during the franchisee recruitment process should be able to recover against an Area/ Franchisee Representative, FSO, or any third party franchise seller, if that party engaged in any improper or deceptive practices.

For third party sellers, like FSOs, that manage the entire franchise recruitment process and who provide to the prospective franchisee the franchisor's FDD, I believe, in addition to not providing any materially misleading or false information, they also have a duty to verify the accuracy of material parts of the franchisor's FDD, including but not limited to Items 7, 19 and 20.

Section 3: Prohibited Practices

Consideration should be made to adding to additional prohibited practices to those currently included:

- Third party sellers should be prohibited from paying directly or indirectly to any franchisee a commission or other compensation for their participation in the franchise sales process.
- FSOs should be barred from disclaiming liability for inaccuracies in the franchisor's FDD, including but not limited to Items 7, 19 and 20.

Section 4: Registration

Paragraphs (2) and (3): The International Franchise Association (IFA), which NASAA recognizes as the largest trade association representing franchisors, franchisees and franchise suppliers, in addition to supporting NASAA's initiative to pass this Franchise Broker Registration Act, is also the recognized leader in franchise related education. Paragraphs 2 and 3 envision a requirement for initial and continuing training, testing and certification for third party sellers under this Act.

It is in the interest of franchising in general to maintain the highest standards of education and testing in all aspects related to franchising. I would strongly suggest that similar to the role played by the AICPA for accountants and the ABA for lawyers, NASAA work in conjunction with the IFA for all initial and continuing training and certification as follows:

- The IFA develops the Uniform Broker Examination in partnership with NASAA.
- The IFA accredits schools or conducts directly courses of study for third party sellers initial and continuing education. Accredited schools or others will conduct and grade the Uniform Broker Examination.
- Third party sellers will be required to have a defined number of hours of continuing education each year as established by NASAA or, as an alternative, achieve and maintain the IFA's Certified Franchise Executive (CFE) certification.
- Appropriate additional fees will be required by third party sellers to compensate for the required training and certifications, as you will find for any other professional.

Paragraph 4: Consideration should be made on the IFA working together with NASAA to develop a formula to be provided to the Directors to assist them in determining the minimum financial requirements and range and types of insurance coverage third party sellers will be required to maintain. This will allow for a level of uniformity that will lessen the burden of this act on the third party seller community.

Paragraph 5: Upon any Director postponing or suspending a registration pending final determination, the third party seller should be required to immediately update their Broker Disclosure Document and notify each Director in each state or jurisdiction in which it has filed for or currently holds certification. As an alternative, a central data base can be developed and maintained. Directors in those states can independently determine the proper action, if any, to take in their state or jurisdiction.

Section 5: Disclosure Obligation

There should be a requirement for the third party seller to receive and maintain a signed acknowledgment of receipt from the prospective franchisee.

Paragraph 2: In my opinion, sustainability should be a higher imperative in franchising than is growth. It is not a recent phenomenon to see fast growing franchisors fail and franchisees unable to recover any losses from the failed franchisor. While I have not seen any studies to show definitively that the amount and types of fees charged by third party sellers is contributing to instability in franchising, anecdotally I believe this to be the case.

There is a debate over the benefits and the risks of working with third party sellers. This proposed Franchise Broker Act will be beneficial as it will create an incentive to improve third party seller performance, eliminate underperforming third party sellers and enable/require/incent franchisors to be more selective in establishing third party seller relationships.

It should be recognized that there are various types of third party sellers and I am not convinced that a one size fits all broker disclosure and certification regimen makes sense. If simplicity is preferred, the higher the bar, the more information provided to prospective franchisees should be the standard as this is the thrust and purpose of this act. Also, this act appears to provide for a fragmentation of the requirements for certification and disclosure from Director to Director. If this is required, it will create enormous burdens on third party sellers and franchisors which needs to be avoided if possible. I also raise the question of whether the third party seller's disclosures should be the same regardless of whether they provide the franchisor's FDD to the prospective franchisee or not.

While it will require additional effort and cost, I believe it is important to err on the side of giving prospective franchisees the necessary information they need to evaluate whether or not to work with a third party seller. Therefore, I propose that the following enhanced information be included in a Third Party Seller disclosure.

Part One – An Overview of Third Party Sellers in General

- Description of a third party sellers relationship with the prospective franchisee (i.e. Broker, FSO, etc.)
- Description of a third party sellers relationship with its franchisor clients
- An overview of the types of third party sellers
- Types of initial and continuing compensation and equity participation by third party sellers
- Information about the educational and certification requirements for brokers
- Questions to ask a third party seller
- Contact information on Federal and State Regulators
- Link to a contact list of Franchisee Lawyers
- Other standard cover page information

Part Two – Third Party Seller Organization Disclosure

- Identifying the type of Third Party Seller being disclosed
- Information on company, its predecessors and affiliates
- Business experience of key executives
- Litigation history
- Bankruptcy history
- Regulatory enforcement
- List of current franchisor clients
- List of franchisor clients in past five years
- Range of total current compensation paid by franchisor to third party seller organization and individual broker by category (initial and continuing)
- Range and frequency of equity participation by third party seller
- Summary of financial information
- Copy of any agreement requested of the prospective franchisee including any fees to be paid by prospective franchisee to third party seller

Part Three – Third Party Seller Individual Disclosure (Prepared by the individual third party seller as an attachment to parts one and two).

- Work history
- Franchise experience
- Litigation history
- Bankruptcy history
- Regulatory enforcement
- Information on third party seller certification including CFE
- Franchise, securities and other professional licenses or certifications ever denied or revoked
- Criminal history, if any
- Names and contact information of franchisees placed in the prior three years
- List of current franchisor clients

- List of franchisor clients in the past five years
- Range of total compensation paid by franchisor individual broker by category (initial and continuing)
- Range and frequency of equity participation by individual broker

As currently proposed in the Act, broker disclosure will not provide the information necessary for prospective franchisees to make an informed decision. In addition, I think it will be difficult for third party sellers and franchisors to administer. I believe NASAA should create a form Third Party Seller Disclosure Document with the intent to request that its adoption be done in a uniform manner regardless of the State.

I appreciate the opportunity to comment and am available to discuss this further if requested.

A handwritten signature in black ink, appearing to be "H" followed by a stylized flourish.