November 8, 2004

Mr. Donald S. Clark
Federal Trade Commission
Room H-159 Annex W
600 Pennsylvania Avenue N.W.
Washington, D.C. 20580

Dear Secretary Clark:

Thank you for the opportunity to comment on the recently published Franchise Rule Staff Report and for allowing Illinois to participate in the development of this new FTC Franchise Rule over the past nine years. Your and your staff's high level of cooperation with the Illinois Attorney General's Office continues to be appreciated.

Illinois Attorney General Response To August 2004 FTC Staff Report R51103 Re: Proposed Revision of FTC Franchise Rule

Reading the FTC Staff Report reinforced two observations I have made over the past nine years. First, that the original drafters of the UFOC and its revisions showed great foresight in producing a well reasoned, legislative solution to a very real problem. These Guidelines, Instructions and Examples have held up very well over many years. The limited changes to the UFOC that are now proposed is a tribute to the authors of that document.

Second, the FTC and its staff undertook the monumental task of combining the almost thirty year old Franchise Rule, the multi-state UFOC document, and the extensive experience of franchisors, franchisees and regulators, which is already worthy of accolades. Regardless of how may comments are submitted seeking further improvements, the product so far is a model of sensitivity and consideration of opposing views, without losing sight of the goal to regulate, but not unnecessarily impede the prosperity of either franchisors or franchisees.

The comments that follow draw upon the extensive experience of Illinois Examiners in reviewing thousands of UFOC filings and include their valuable suggestions as to how the disclosure document can be improved.

COMMENTS

Definitions

"Action" p. 19: Interpreting this new definition to include both "filed" and "served" complaints is appropriate. However, it might be beneficial to use the term "filed" in the definition.

"Disclosure" [Attach. B, p. 3]: Language from the UFOC Instruction 150 should be added to this definition. ". . . in plain English, that is understandable by a person unfamiliar with the franchise business."

"Financial Performance Representation" p. 24-25: This definition does not make clear if "industry data" or an affiliate's performance can be part of, or the exclusive source of, financial performance. This disclosure should have a reasonable basis that indicates what a prospective franchisee might earn from the franchise system the prospect is buying into. Please also see discussion of Item 19 provisions on page 6 of this letter.

p.29: With reference to publicly filed financial reports, it would seem appropriate to state in the definition, or preferably under Item 19, that financial statements filed with governmental agencies are excluded from the financial performance disclosure requirements. Publicly filed reports by franchisors would be of interest to prospects to reassure them that the franchisor is a viable company and would be more reliable than media representations, but Item 19 is intended to help prospects estimate how well they might do in a particular system by comparison to existing franchisees.

"Franchise Seller" p. 45 - 49: the discussion about this definition indicates a reasonable view of what constitutes a broker and the conclusion that "broker" would be explained in the Compliance Guides. However, there is sufficient confusion about franchise brokers that a definition belongs in the Rule. For example, in Illinois there are too many people that think that there is some category of brokers that make referrals and therefore need not be registered. The Broker can be very influential in the decision making process of prospects and can pre-sell buyers before they ever talk to a franchisor. Having a separate definition of "broker" or making reference to such activity in the "Franchise Seller" definition would be superior to explaining such an entity in the Compliance Guides.

Another example is the franchisor that sells broker franchises, but thinks that it does not have to register because it - the franchisor - is a broker. That same franchisor then fails to tell its broker franchisees that certain states require broker registration. Some brokers

believe that registering in their state as a "business broker" is sufficient, but such registration statutes often do not authorize franchise broker activity. These broker franchisors are growing and need to be included in definitions.

We support the idea that the repeated sale of franchises by franchisees should bring them under the definition of a franchise seller or, if a definition is provided, as a broker.

"Franchisee" p. 49: To be consistent with "Franchisor" the definition of franchisee should include a statement that a franchisee that sells franchises is also a subfranchisor.

"Person" [Attach. B, p. 5]: Potential franchisors have argued that a joint venture should not be considered a franchise, despite the fact that it could be considered a partnership and fall under the new definition "other entity" category. "Person" should specifically include "joint venture."

"Required Payment" p. 63: last paragraph of this definition proposing "an express prohibition barring a franchisor from failing to furnish a copy of its disclosure document to a prospective franchisee early in the sales process, upon reasonable request." Also see Staff Report p. 77 recommendation. This is an appropriate measure to implement, but my question is whether this is a preemption issue, or would the states continue to enforce their minimum disclosure period, while this early disclosure requirement would provide more protection to prospects, but only be enforced by the FTC.

"Sale of a Franchise" p. 63: Regarding the first sentence stating that the "Rule's disclosure obligations are triggered only if there is a franchise sale." If the FTC Rule looks backwards from a completed sale to determine when disclosure is required, the early disclosure provision above, under "Required Payment," appears even more desirable.

"Material" p.68: The NPR proposal for revising this definition was acceptable, which is why comments were not submitted by Illinois, but dropping the definition is unacceptable. The foundation of franchise laws was securities legislation and "materiality" was a term of art then and remains so now with regard to what might reasonably influence an investment decision. Case law is available to explain what materiality means, but this disclosure document is intended to inform prospective franchisees who should not have to do legal research to understand what is material.

The following definition is intended to give regulators something to point to when frequent materiality disagreements arise. This would buttress existing state definitions and help to decide what is relevant in documents, oral statements and litigation decisions. It would also avoid the automatic question courts may entertain as why the FTC purposely removed any definition of "material:"

"Material" means influential, significant or important with regard to prospective

franchisees' purchase decisions; a franchisor's fulfillment of obligations to prospects and franchisees; and determining whether a party's reliance upon regulations or representations was reasonably placed.

The current Staff Report is replete with the use of "material" or "materiality" because it is an important and frequently used term. It deserves its own definition, even if it further evolves through Commission case law.

The Disclosure Document

Cover Page p. 89: The Staff Report states that the Commission declined to adopt the two, currently required, UFOC Guidelines risk factors for choices of venue and law, which, in light of the proposed Cover Page requirements, would not seem to prevent states from continuing to require these risk factors. The stated reasoning for not adopting these risk factors was that the Item 17 disclosure is repetitive of these risk factors. However, Item 17 does not explain the impact of an out-of-state venue and application of another state's laws like a risk factor would. Risk factors should not be overused, but choices of law and venue need more emphasis than single word entries at the end of a long list in Item 17.

Would the Cover Page be improved by prioritizing the required information so that, by order of importance, things like the contact list would appear on page two or toward the end of the requirements and risk factors would appear early on the first page? Would having a FTC page and a separate state Cover Page be useful or would it diminish the impact of the most important information?

Item 1 (a) (4) [Attach. B, p. 11]: The name of the franchisor agent should also be required in addition to the business address.

(a) (5): The examples of types of business organizations in parenthesis should include "members with a controlling interest in the franchisor, " which would apply to LLC members. Also, the date of the organizations's inception should be required. The amended requirement would be "The type of business . . . (for example, corporation, partnership, members with a controlling interest in the franchisor), date of inception and the state in which it was organized."

(a) (6) (vi): The description of competition should specifically include affiliates.

Item 2 p. 102: Broker disclosure has been dropped in the Staff Report, but this recommendation should be reconsidered. The prospect should have a source in the UFOC or an addendum to know that it is dealing with a broker authorized by the franchisor. The discussion on p. 102 points out that the broker is not relied upon for future performance under the contract, but the broker meets prospects at a critical time, when the decision to buy a franchise and which one to select can be greatly influenced by the broker. (See

"franchise seller" discussion on page 2 above).

[Attach. B, p. 12]: The list of persons and their positions that are to be disclosed should include "members" after "partners."

Item 3 p. 108: The Staff Report proposes that franchisors be able "to omit settled litigation where the settlement is favorable to the franchisor or otherwise neutral." Unless a matter has been filed and settled during the allowed period for disclosure amendments, a franchisor should also be required to report the favorable settlement of a dispute listed in Item 3. If this is not done, the previously listed matter would simply disappear from the litigation list. To do so may automatically raise unnecessary questions from a state examiner. It should also be advantageous for a franchisor to cite a favorable outcome.

(1) [Attach. B, p. 13]: Compare the language in (1) with (2) on p. 14 regarding an affiliate. The affiliate in (1) might sell franchises that do not use the principal's mark, but are under the control of the principal. Particularly where the affiliate has been selling franchises or distributorships for years and a new, separate concept is being offered by the principal, the new buyers should know about the affiliates litigation as a prediction of how they will be treated by the principal. This should be dealt with by changing (1) as follows: ". . . , an affiliate who offers franchises in any line of business; and any person . . . ."

Item 4 (1) [Attach. B, p. 15]: Consider adding "member" to the list of entities required to provide disclosure, which would include LLC members. This would be preferable to assuming that "partner" would include LLC members.

Item 5 [Attach b, p. 16]: The first sentence should be clarified by requiring specific information about what amounts are refundable. Many contracts state what amounts are refundable, while others state that the entire initial fee is earned upon execution of the contract, which hopefully avoids disputes later. The first sentence should be amended: "Disclose the initial fees, any conditions under which these fees are refundable <u>and the amount or percentage of fees subject to refund.</u>

Item 6 [Attach B, p. 17]: Considering that Item 5 indicates it covers fees "before the franchisee's business opens," Item 6 should, at the beginning of the first sentence, state: "Disclose <u>fees due after the business opens</u>, in the tabular form . . . ." In Table (1): The list of fee types should include computer software and hardware.

Item 8 [Attach. B, p. 21]: Add "affiliates" to the purchase sources named in the first sentence.

Item 10 p. 69 of Attachment B: The Sample Table in Appendix A provides for "Equip. Lease" and "Equip. Purchase," but only one line is provided for "Land/Constr," with no mention of "Leased Space" as was done in Sample Answer 10-2 of the UFOC. "Leased

Space" should include vacant and improved land and should be given a separate line.

Item 19 p. 158 - 171: The Staff Report identifies this as being the most important anti-fraud disclosure and we agree it may be. However, without some important clarifications its value is compromised because the UFOC Item 19 needed some changes. The value to a prospective franchisee from having appropriate financial performance information is to help answer the number one question asked by every prospect - "how much will I make?" The unstated part of the question is "How much will I make <u>in your franchise system</u>?

Illinois looks upon Item 19 earnings claims very favorably, but our experience is that the underlying components of such disclosures can be less than helpful when the franchisor:

1. **Has franchisees, but instead uses affiliates' experience to compile the data.**

2. **Has franchisees, but instead uses "industry data" and company store results.**

3. **Does not trust all of its franchisees' financial reporting and instead melds the gross receipts of its franchisees' sales, with company store expense experience.**

4. **Only uses gross sales, which does not provide a clue that many stores are barely holding on due to unavoidable expenses that reduced net income to the point that franchisees were earning less than minimum wage.**

These approaches do not constitute a reasonable basis for creating a financial performance representation. If the new Rule would tolerate such sources, there should be some direction provided to guide franchisors. For instance:

a. Affiliate information should not be used, but if it is allowed, it should be secondary to in-system franchisee data. If there are no franchises yet, affiliate information should only be disclosed with a clear caveat that the data comes from a different business or franchise system. If there are franchisees, affiliate information should only be used to supplement the distinct, separate data of the franchisees.

b. If industry data is allowed, it should only be supplemental to actual franchisee experience in the reporting system and be clearly identified. Industry data can look great for the industry, but may be worthless to particular franchisees when deciding how well the target system's franchisees are doing or might do.

c. If company store data is allowed to be the basis of an Item 19 representation, a clear statement should be made that a franchised location will have many additional costs not found in a company store and may not receive certain benefits, such as: royalties; ad fund contributions; quantity discounts; preapproval required for carrying new products; or management support that increases revenue, but does not show up as an expense.

d. Melding franchisee and company store data should not be allowed, but if it is there should be clear indications for the source of each financial entry.

e. High sales figures are no indication of future performance if the prospect does not know the projected expenses. If gross sales are allowed as a stand alone source of data, there should be a clear statement that the sales figures will only be of value to the prospect after the prospect researches what the costs will be.

Ideally the Rule should give examples of data sources that can be used to form a reasonable basis for disclosure and list examples of sources that would not be reasonable. The current UFOC Guidelines and Instructions are confusing and the proposed Rule is an improvement (particularly by not suggesting affiliates as a source), but if left unchanged the Rule will miss an opportunity to rectify some of the problems identified above.

Item 20 p. 172 -197: First, accolades to NASSA and the FTC staff for vastly improving Item 20. The proposed charts do an excellent job of revealing important events and providing bases for asking key questions of the franchisor as to the recent history of the system and even particular sites. Coupled with the site history for particular locations being looked at by prospects, the picture available to buyers is virtually complete. However some changes might be improvements that simplify the tables:

If the following is true regarding Total Outlets [Attach. B pp. 49, 52 & 73]:

Table 1, Col. 3 = (Table 3, Col. 3) + (Table 4, Col. 3)
AND
Table 1, Col. 4 = (Table 3, Col. 9) + (Table 4, Col. 8)

The other columns of Tables 3 and 4 have varying effects on the number of outlets at the end of the year. A termination, non-renewal or reacquisition may not have any affect on the total outlets because a new or existing franchisee, or the franchisor, is operating the site and no site closing took place. A better approach would be to move Columns 3 and 9 of Table 3, and Columns 3 and 8 of Table 4 into Table One, which would replace Table One's Columns 3 and 4. This provides a more complete "big picture" in Table One and eliminates four columns in Tables 3 and 4 where total outlet information was not that helpful. This would leave Tables 3 and 4 with the more specific information as to activities during the year, only some of which had an effect upon the outlet totals.

Blank Tables 1 - 5 appear in the body of the Rule [Attach. B, p. 49 - 56], but, samples are provided for in the Appendix [pp. 70 - 74]. These Sample Tables should all be moved into Item 20.

"Last event" reporting is not a viable solution (See Attach. B, p. 50 (2). Of much greater interest is how many times each event occurred, rather than trying to balance the

transactions with the total outlets column. The instruction reference before Table Two, which applies to Tables 2 - 5, calls for the use of a footnote where a single outlet changes ownership two or more times during the same fiscal year that would explain the preceding events - because each change of ownership is to only be reported once in the tables. Where there is a termination or non-renewal, followed by new ownership, there may be no record of the termination and no footnote because there were not two or more ownership changes, according to the franchisor. A prospect would want to know how frequently terminations and non-renewals take place, separate from the beginning and ending outlet totals. The prospect or the prospect's advisor could then decide what questions to ask the franchisor and franchisees to determine if there was a true problem within the system.

In Table No. 3 for instance (p. 52 of Attach. B), it would be more informative to report all terminations, all non-renewals and all reacquisitions during the year, regardless of whether more than one entry applies to a single outlet. If footnotes are to be used to reflect multiple ownership changes at one site, the Sample should include such a situation.

Franchisee Associations p. 191 - 197: Incorporation should not be the only type of organization that qualifies for inclusion in the franchisor's disclosure document. The reason expressed in the Staff Report (p. 197) is that this "would exclude unorganized groups of isolated franchisees." Franchisees may be isolated because of the franchisor's efforts and being incorporated is not necessarily a touchstone for finding "organization." The other provisions protecting franchisors, such as the franchisee association being required to ask for recognition annually and there being no need to amend during the year for recognition of a new association, are sufficient without limiting the form of business organization to corporations.

Item 21 (1) p. 198 - 204: If there is a guaranty from a parent, affiliate or other entity, the guarantor should be the source of financial statements in the disclosure document, with franchisor financials being optional. If the franchisor has sufficient cash flow and assets to service its franchisees and continue its business, parent financials need not be required. Subfranchisor financials are important and should be included, since a franchisee's relationship with the system may be totally centered around the subfranchisor. The hiring of an Area Manager to fulfill several obligations of the franchisor should be revealed in the disclosure document, but their financial statements would not seem necessary since the franchisor remains the primary entity to fulfill contract obligations.

Audited Financial Statements p. 200 - 204: The reference to preparing financial statements according to GAAP, "or as permitted by the Securities and Exchange Commission" appears to hold out a possible safe harbor that would permit skipping U.S. GAAP. This is currently not the case and will not be for the foreseeable future. The SEC Rule Releases discuss a very narrow use of "Non-GAAP Financial Measures," but even in these situations, reconciliation to the most directly comparable U.S. GAAP financial

measure is still required. Examples appear in Regulation G (and FD); amendments to Item 10 of Regulation S-K and to Item 10 of Regulation S-B, and all speak of reconciliation. The release of Regulation G included a warning that a materially deficient disclosure, even with compliance with Regulation G, may rise to actions under Rule 10b-5.

The non-GAAP financial measure refers to a registrant's historical or future financial performance, financial position or cash flow and which excludes or includes amounts that would have been excluded or included under the most directly comparable measure presented according to GAAP.

It would be less confusing to simply substitute permission to reconcile foreign GAAP to U.S. GAAP by restatements and through footnotes, than to refer to accounting principles permitted by the SEC.

One more clarification is required. The proposed accounting requirements make clear that U.S. GAAP is the standard, but no mention is made as to who can certify compliance. In Informal Staff Advisory Opinion 02-4, footnote 1cites 44 Fed. Reg. At 49,981 for the requirement that financial statements be prepared by an independent "or" licensed public accountant "permitted under law of such person's State to prepare opinions on audited statements." The opinion's use of the word "or" was probably unintended, since the requirement should be "independent and licensed public accountant." It would seem appropriate to require preparation by an independent, state certified public accountant (CPA) and clearly indicate so in Item 21. There was no mention in the proposed Rule as to requiring compliance with Generally Accepted Auditing Standards (GAAS), although Opinion 02-4 does indicate that compliance with GAAS is required.

(2) [Attach. B, pp. 59 - 60]: The phase-in minimum for a start-up franchise system does not require enough information. For (2) (i) in the chart, the requirement should be:

> **"An unaudited opening balance sheet and, if one or more months of operations have taken place, an unaudited Profit and Loss Statement."**

This would provide needed support for the balance sheet and most new businesses will be preparing monthly or more frequent internal P & L Statements anyway.

Also, (2) (ii) on the chart should be expanded to include:

> **"Audited balance sheet and Profit and Loss Statement opinion as of . . . ."**

Annual and Quarterly Updates p. 219 - 225: Although the issue of when a prospective franchisee must be provided with updated information was previously discussed, some of the resulting conclusions still need clarification. On pages 220 and 224 the importance of

timely disclosures is emphasized and the potential for very material changes to be omitted during the respective quarter, before reporting is required, is also reviewed. The ultimate conclusion was that Section 5 of the FTC Act and common law fraud principles will cover this situation, and may obligate the franchisor to alert prospective franchisees about changes not reflected in their quarterly updates. Having effective disclosure is of sufficient importance that the pertinent language in, or specific reference to, Section 5 should be a part of the Rule update requirements. The unsuspecting franchisor, and certainly the unsophisticated franchisee, should be told directly in the Rule that there may be an additional reporting obligation for significant changes that occur before the quarterly reporting is due.

The Illinois amendment requirement (815 ILCS 705/11) is "within 90 days of the occurrence of any material change . . ." Although the time period is equal in time to the FTC quarter year amendment, these deadlines will obviously not coincide. Will this be an example of preemption, where Illinois' amendment requirement will automatically become quarterly? In different fact situations, Illinois law or the FTC Rule may be more protective of franchisees, depending on the occurrence and filing deadline dates.

On pp. 224 - 225: The previously proposed continuing update requirement is now only retained as to financial performance representations. Of equal value to the prospect are dramatic financial, corporate or legal (class action or fraud suits) changes that affect the franchisor's ability to maintain the system. Financial Performance should not be the only topic requiring prompt disclosure (much sooner than quarterly).

Exemptions p. 225 & 226: Perhaps the clarification in footnote 721 that:

> **"[F]ranchisors exempted from disclosure under the revised Rule would nonetheless have to prepare and disseminate UFOCs in the 15 franchise registration states"**

is sufficient, but a clear notice in the Rule itself would be helpful to let franchisors, prospects and franchisees know that varying state exemptions may require a disclosure circular despite a Rule exemption. The Illinois exemptions for a "large" franchisor or franchisee are not self-executing and still require filing, approval and disclosure through a UFOC (contrary to Staff Report footnote 756).

Large Investment Exemption - Meaning of "Investment" p. 242: The Staff Report indicates that the $1 million "threshold should be determined by the investment made at the time of sale." We know the threshold does not include real estate, but is it limited to payments made to the franchisor? What about purchases from third parties (equipment, fixtures, vehicles, interior decorating . . .)? Is this to be minimum costs necessary to open for business? These clarifications are needed in the Rule itself.

P. 243: To qualify for the sophisticated investor exemption, the Staff Report at footnote 781 proposes that at least one individual in the investor-group be an investor at the threshold

level and in support, SEC Regulation D is cited. However, Reg. D requires that <u>all</u> equity owners be "accredited investors." Why is it unnecessary for each member of an investment group to meet the minimum sophisticated investor requirement to qualify for the exemption?

Proposed Section 436.9(h) p. 265: Substitution of material contract provisions without notice to the prospect should certainly be prohibited, but instead of using the proposed "reasonable time" before signing the agreement, why not tie in this prohibition with §436.2(b) Franchisor Obligations [Attach. B p. 7] and require the same seven day review time before the prospect signs the contract?

Phase-in Period - Will there be at least a one year transition from formal approval of the Rule until everyone must comply and will there be an explanation provided that during the transition, disclosure documents may only be prepared according to one format - the current UFOC or the new Rule with appropriate state compliance in registration states; or for non-registration states the format could be the current Rule or the new Rule; but never a combination of formats in any state?

Appendices: Sample Tables are provided for Items 10 and 20 at the end of the disclosure document and after the Instructions, Exemptions, Prohibitions and Severability [Attach. B, pp. 69-74]. Each Table should appear at the end of its respective Item, not in separate appendices.

Addendums: Any references to addendums in the instructions should include the requirement that if an addendum would change the agreement, it must be signed and dated by the parties. The use of an addendum should be specified as one method of complying with state required disclosure (amending the document itself being the other method).

Sincerely,

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