National Cooperative Business Association

November 10, 2004

Federal Trade Commission/Office of the Secretary
Room H-159 (Annex W)
600 Pennsylvania Avenue, NW
Washington, DC 20580

RE: Franchise Rule Staff Report, R511003

To Whom It May Concern:

On behalf of the National Cooperative Business Association, I submit the following comments on the Franchise Rule Staff Report R511003 issued by the Federal Trade Commission on September 2, 2004 for the "Trade Regulation Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures." These comments pertain specifically to the recommended elimination of the express exclusion of "cooperative associations" from the Rule.

NCBA is a national membership association representing cooperatives of all types, including agricultural cooperatives and purchasing cooperatives for independent retailers and distributors. We are the only national association representing purchasing cooperatives as a group. Our cooperative members will be directly affected by the changes proposed in the Staff Report.

On pages 251-252, the Staff Report recommends that the Commission remove the current Franchise Rule's four exclusions, as originally proposed in the Notice of Proposed Rulemaking in 1999 (64 Fed. Reg. 57,294, Oct. 22, 1999).

NCBA strongly disagrees with this recommendation and urges the Commission to retain the co-op exclusion in the Rule to provide continuing legal and regulatory clarity and to ensure that public notice and comment processes are followed should the Commission's interpretation of the Rule's exclusion of co-ops change at a future date. The disadvantages of eliminating these express exclusions far outweigh the marginal gain from any streamlining that might be achieved.

The Importance of Cooperatives for Retailers

As independent retailers compete in an increasingly concentrated market against large, public companies, the number of purchasing cooperatives has grown and they are increasingly a key tool for the survival of independent businesses. NCBA estimates that at least 50,000 independent businesses are members of purchasing cooperatives. Purchasing cooperatives include those for independent agricultural input suppliers, book sellers, construction material distributors, floor covering stores, groceries, hardware stores, industrial equipment sellers, pharmacies, recreational

equipment stores, and many others. In fact, many purchasing cooperatives are owned and controlled by restaurant and fast food franchisees, allowing them to reduce input costs for goods they are required to use by the franchisor, helping to mitigate the power imbalance between franchisees and franchisors. All of these cooperatives exist not to make a profit, but instead to reduce costs and improve services for business owners, providing them with a competitive edge in the market place.

The Cooperative Structure Stands in Stark Contrast to Franchises

Purchasing cooperatives are not franchises, but some bear similarities to them. In order to reduce ambiguity of the Franchise Rule, 16 CFR §436.2(a) defines the term "franchise" and identifies in 436.2(a)(4) commercial relationships it specifically excludes. Among the exclusions identified in the current Rule is "membership in a bona fide "cooperative association."

Cooperative associations are later defined in 16 CFR 436.2(l) as either "an association of producers of agricultural products authorized by section 1 of the Capper-Volstead Act, 7 USC 291; or (2) an organization operated on a cooperative basis by and for independent retailers which wholesales goods and furnishes services primarily to its member-retailers."

NCBA supports the current exclusion that makes clear, despite some seeming similarities, cooperatives serving farmers and retailers are not franchises. The ownership and governance structure of a purchasing cooperative stands in stark contrast with a franchise. A franchisor, usually a publicly traded company owned by outside investors, has the contractual ability to control the operation of the franchisee. The ability to set the terms of the contract is exclusively in the hands of the franchisor, which also enjoys the financial gain from the franchise.

By contrast, purchasing cooperatives are owned by their retailer-members, and as a result do not exhibit the power and control imbalance that exists in a franchisor/franchisee relationship. The retailers themselves, not outside shareholders, own and control the purchasing or shared services business, hire and fire the co-op CEO through a board they directly elect, set the co-op business's strategic direction, and determine its policies and procedures for member participation in the co-op. To the extent that a cooperative sets terms for member use of the co-op brand, for marketing or other services, or member conduct, those terms are set by the member-owners themselves to ensure the ongoing value of the cooperative. In addition, as owners of the cooperative, the retailers alone share in any financial gain or losses of the cooperative.

The exclusions currently provided for in 16 CFR §436.2(a)(4) make these structural distinctions clear for those who may not be familiar with the cooperative structure and the nature of member-ownership.

The Exclusions are Necessary for Continuing Legal and Regulatory Clarity

The 1999 NPR, which similarly proposed the elimination of the exclusions, noted they were originally included in the Rule because the Commission recognized that, although these commercial relationships were not franchises, they could be "*perceived* as falling within the definition of a franchise." The NPR proposed eliminating these explicit exclusions because they "no longer serve a useful purpose." The only evidence provided to support that contention,

however, was the statement that the franchise community has become familiar with the rule, including the definition of "franchise," so the exclusions were no longer necessary.

As the staff report notes, comments to the NPR disagreed with that contention, which incorrectly assumed that the only users of the Commission's regulations are those *already* covered by the rule—the franchise community. In fact, the public, business owners, and the legal community also look to the regulations to clarify its application to a potential venture or business relationship. These parties are far less likely to be familiar with the franchise rule's coverage and/or the structure of cooperatives. This is reinforced by several of the parties commenting on the 1999 NPR in opposition to elimination of the exclusions. They note correctly that the current Rule provides clarity on otherwise ambiguous terms. NCBA agrees with these comments.

Confusion about Cooperatives Persists

It is an unfortunate reality that cooperatives are *not* very well understood by the public at large, by the legal profession, by business professionals or, in some cases, by regulators. Though some 120 million Americans belong to cooperatives and even more do business with them, surveys show that many do not understand the specific structure of cooperatives, how cooperatives operate and, most importantly, how they differ from investor-owned businesses. A 2003 statistically representative survey of more than 2,000 consumers found that only five percent of adults "very familiar" with the organization of cooperatives. Only 42 percent say they are "somewhat familiar." Fifty-two percent said they were "not very familiar" or "not at all familiar" with cooperative organization.

Moreover, some purchasing and agricultural cooperatives bear some similarities to franchises, particularly those that supply products to the co-op members through the co-ops joint purchasing efforts; have developed national branding efforts with service marks, trademarks and national promotions; provide advice on meeting quality standards; and provide marketing and other promotional assistance. To those unfamiliar with the distinct difference between the role a co-op member plays as the cooperative's owner and the role of a franchisee vis-à-vis the franchisor, a franchise disclosure rule may be perceived as applying to cooperatives.

The reality is that the Commission's original conclusion still stands: cooperatives could still be perceived as falling within the definition of a franchise.

Staff Report Recognizes the Usefulness of Exclusions

In response to the comments to the 1999 NPR, the Staff Report reverses the Commission's initial contention that the exclusions "no longer serve a useful purpose"—the original justification for eliminating the exclusions. Specifically, the Staff Report now concludes that the *"exclusions may still serve a useful purpose, explaining to practitioners the distinctions between business arrangements that may appear to be franchises"* (p. 252.) As noted in the Staff Report, businesses have relied on the explicit definition of franchises and the clear exclusion of cooperatives.

Despite this recognition, the Staff Report continues to arbitrarily recommend the removal of the exclusions. The Staff Report explains that the removal of the exclusions is intended to "streamline" the rule rather than to terminate the exclusions or "signal a substantive change in Commission policy." (p. 251)

The Report suggests that identifying the exclusions in Compliance Guides rather than in the Rule itself is sufficient for demonstrating the Commission's intent that these four relationships continue to be excluded from the definition of franchise. Unfortunately, the Report provides no evidence justifying that conclusion. It states only:

> *"…we are convinced that the proper place for such an explanation is in the Compliance Guides that will accompany the revised Rule." (p. 252)*

The report fails to address the substantive concerns of commenters that elimination of the explicit exclusion in the Rule also eliminates not only clarity for business owners but also safe harbor for cooperatives that might be confused with franchises.

Clarification of Exclusions in the Compliance Guides is Insufficient

NCBA respectfully disagrees with Staff Report's conclusion that an explanation of the co-op exclusion in the compliance guides alone is sufficient to provide legal and regulatory clarity. Though we greatly appreciate the Commission's intent to retain its policy that cooperatives are not franchises, it is insufficient to clarify that intent in the Compliance Guides alone.

Legal advisors look first to regulation to provide their clients with legal surety. Few will rely on language in the Compliance Guides alone in advising their clients. In footnote 807 (p. 252), the Staff Report explains that FTC staff can address future questions concerning the definition of the term "franchise" on a case-by-case basis through informal advisory opinions. Industry requests for informal FTC advisory opinions often result from ambiguity in the underlying regulation. Such ambiguity can be avoided by merely retaining the express exclusions in the Franchise Rule itself. Without these explicit regulatory exclusions, legal advisors will likely seek staff advisory opinions regardless of the language of the Compliance Guides—a costly but avoidable burden on both cooperatives and the Commission.

Cooperatives also fear that the lack of regulatory clarity on these exclusions will result in litigation resulting from the Rule's ambiguity and the public's lack of understanding of the cooperative structure.

The Staff Report fails to provide any information or evidence that suggests these concerns are misplaced, and, in fact, concedes the exclusions remain useful. As a result, the Report fails to present a defensible and compelling case for the elimination of the exclusions in the Rule.

Retaining the Co-op Exclusion in the Rule Ensures Public Input in the Event of a Future Policy Change

Additionally, though it is the *current* policy of the Commission that cooperatives are not franchises, that policy could change at a future date. A change in this policy would represent a significant broadening of the Rule's scope and would impose enormous new compliance costs on cooperatives. Thus, such a change in policy should be subject to public notice and comment as provided for in the Administrative Procedures Act. If the exclusions are not explicitly provided for in the Rule itself and included in only the Compliance Guides, the Commission could change this policy with little or no public notice and without important and valuable public comment.

To ensure that the public has an opportunity to comment on any future change in the Commission's interpretation of the term franchise vis-à-vis cooperatives, the exclusion should be retained in the Rule itself.

Eliminating Exclusion Does Little to Streamline the Rule, Runs Counter to the Goal of Narrowing the Rule's Scope and Clarifying its Application

Because the Staff Report concedes that the exclusions continue to serve a useful purpose, the only justification it provides for eliminating them is to streamline the rule itself. Yet, eliminating the co-op exclusion deletes roughly 50 words from a Rule that, under the proposal is nearly doubled in size to more than 14,000 words. The elimination offers an arguably marginal gain in streamlining.

NCBA respectfully suggests that sacrificing regulatory and legal clarity in the name of "streamlining" is inappropriate and inconsistent, and will likely increase burdens on both FTC staff and on cooperatives. Nothing could be more clear and unambiguous than retaining the co-op exclusion.

In fact, the goal of streamlining the Rule does not appear to be the overriding goal of the effort to revise the Franchise Rule. Instead, the stated goal is to

> *"…to ensure that the Franchise Rule continues to provide material information to prospective franchisees so they can make an informed investment decision, while reducing unnecessary costs and burdens on franchisors."*

In fact, one outcome of the proposed changes appears to be a narrowed the scope of the rule (p. 12) capturing only "franchise sales" and excluding "other business opportunities." It is therefore inconsistent with that goal to eliminate exclusions that clarify and maintain a narrow scope for the Rule. In fact, eliminating the four exclusions creates the appearance that the scope of the Rule has been dramatically broadened. Moreover, at the same time the Commission seeks to reduce unnecessary costs on franchisors, as noted above, it will impose them on cooperatives that will be forced to seek clarity on the Rule's application through advisory opinions.

Demonstrating other inconsistencies, in other areas of the Staff Report, changes are recommended in the Rule that would provide greater clarity to franchisors about when and what

they must disclose. For example, p. 77 recommends the adoption of a “bright line” disclosure trigger. It is inconsistent for the Commission to seek greater clarity for those who must comply with the rule, while eliminating legal clarity for those who are not, and should not be covered by the Rule.

Conclusion

The disadvantages of reducing legal and regulatory clarity by eliminating the co-op exclusion far outweigh the marginal benefit to either the public or the regulated community through the minimal streamlining provided. For these reasons identified above, NCBA urges the Commission to retain the current explicit exclusion of cooperatives from any proposal to amend the Franchise Rule.

On behalf of NCBA, thank you for the opportunity to comment on the Staff Report.

Sincerely,

Paul Hazen
President and CEO