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Strategic Advice and Guidance
Based on Real World Experience

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Federal Trade Commission

Mr. Steven Toporoff
Attorney

Ms. Eileen Harrington
Associate Director,
Division of Marketing Practices, and

Mr. J. Howard Beales, Ill
Director,
Bureau of Consumer Protection

Re: Comments on Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule, Disclosure Requirements and Prohibitions Concerning Franchising (1 6 CFR Part 436), Dated August 2004

Dear Mr. Toporoff, Ms. Harrington and Mr. Beales:

MSA is a management consulting firm with a primary focus on franchising, licensing and other distribution strategies. We routinely work with emerging and established franchisors on strategic and tactical issues including those related to their offering of franchises. We also provide counsel to potential franchisees on their acquisition of franchises. Our firm is frequently involved in assisting clients with the resolution of franchise disputes and litigation support.

I am a frequent speaker at programs for the International Franchise Association, universities, law schools, retail and professional organizations and have lectured and written for the ABA Franchise Forum and the IFA's Legal Forums. I have published numerous articles on franchising; including article related to the offering and purchasing of franchises and I am often quoted in the media. Together with the late Dave Thomas, Founder of Wendy's, I am the co-author of Franchising for Dummies, published by Wiley Publishing, Inc.

I am on the Board of Editors of LJN's Franchising Business & Law Alert, a member of the Strategic Advisory Board of the Wayne Huizenga Graduate School of Entrepreneurship of Nova Southeastern University, Fort Lauderdale, FL and on the Board of Advisors of the Women's Franchise and Distribution Forum.

MSA is a member of the International Franchise Association's (IFA) Supplier Forum (SF) and I serve on the SF's Board of Directors as a Past Chairman. I am a member of the Board of Directors of the IFA, the first professional services provider ever directly elected to the association's board. I am a trustee of the International Franchise Association's Educational Foundation and am a member of several IFA and SF committees.

I have completed the requirements and have been awarded the designation of CFE (Certified Franchise Executive) by the International Franchise Association's Education Foundation (IFAEF). I am a member of the American Institute of Certified Public Accountants, New York State Society of CPAs, an associated member of the American Bar Association, the International Foodservice Manufacturers Association (IFMA), the American Academy of Certified Consultants and Experts and the American College of Forensic Examiners.

The comments in this letter are based upon our extensive experience in franchising and do not necessarily reflect the views of my firm's clients or any of the organizations in which we are in a leadership position.

Our Comments

Thank you for providing the opportunity to comment on the Proposed Revision of the FTC Franchise Rule. We appreciate the significant effort put into this project by the FTC's staff and while we have concerns over certain proposed changes, we support much of what has been proposed and are limiting our comments to a few selected areas that most troubled us. We recognize the strength of the franchising community in communicating other concerns and respect the process the staff will undoubtedly follow in taking those collective comments and making appropriate changes to the final revised Rule.

The purpose of disclosure in franchising is to provide necessary information to prospective franchisees in a uniform format. It is not intended to unnecessarily impede on the rights of the franchisor in their establishment of the terms of the underlying offering or the relationship they choose to establish with their franchisees. The Staff Report certainly met the spirit of that purpose.

The brilliance of the original Rule was that it did not overreach into managing the relationship but instead focused on pre-sale disclosure. There is little disagreement that presale disclosure has significantly benefited the growth of franchising by substantially eliminating fraud and the uncertainty of the relationship which previously existed and which gave rise to the necessity of the Rule nearly 30 years ago.

The Rule's focus on pre-sale disclosure and its avoidance of drifting into the trap of attempting to make fungible the diverse types of industries that employ franchising or, trying to require a sameness among the offerings of the various businesses that share those industry segments has enabled these enterprises to emerge and grow and, as a result, for franchising to prosper. As a result of the Rule, enormous wealth and opportunities for franchisees and franchisors has been created. Through the healthy growth and stability of franchising, to a great extent the result of the Rule, a significant number of jobs have been created directly in franchise systems as well as in the businesses that support franchising's efforts.

So as not to leave the impression that we believe in some utopian or benevolent governmental involvement in franchise regulation, it is important to note that not all of the rules that govern franchising in the United States have been as beneficial as the Federal Rule. But, with the exception of the occasional overreaching state legislative actions over the years and some overzealous state regulators who choose to effectively make new laws in their jurisdictions through their quixotic interpretations of the statutes and, which it can be argued, has actually proven on occasion to be more damaging than beneficial to the prospective franchisees they were hired to protect, clear and substantial presale disclosure has generally succeeded. The trend toward a lessened regulatory burden in the states is a comforting phenomenon that one would hope will accelerate over the next decade because of the changes to the Federal Rule. The adoption of a recommendation to adopt the UFOC format as the federal standard is also highly beneficial for a host of reasons, not the least being clarity for prospective franchisees examining various opportunities.

In this period of global uncertainty it is somewhat important to note that franchising has had enormous influence on global stability as one of our nation's most important exports has been the concept of American franchising. It is hard to push back on the notion that where wealth and jobs are created societies benefit through the growth of a stable middle class and the availability of consistent high quality products and services. Franchising has proven that the concept of the Great American Dream of business ownership and the creation of wealth is a highly exportable commodity that translates well into all languages.

I am pleased that the FTC's staff clarified in the recommendations that the Rule does not impact international transactions. However the Rule does have significant international impact and benefit. Our enormously successful example of how to imperfectly manage the interface between government and private enterprise allows for fairness and entrepreneurship to co-exist mainly because the rule focuses on presale disclosure rather than on governmental mandates fashioned from a bureaucrat's concept of a fair relationship between the parties. This can have significant and overpowering benefit to a world seeking stability.

Franchisees in the Selling Process

In our opinion, the proposal does not deal effectively as it relates to existing franchisees included in the selling process.

The proposal states:

> "This proposal is sufficiently narrow to exclude existing franchisees who may refer potential franchisees to the franchisor because they are not under contract with the franchisor to sell franchises."

The problem is that many franchisors routinely pay a referral fee to franchisees that refer or are involved in discussing the franchise opportunity with prospective franchisees. The referral fees paid may be modest or they could be significant. Where the franchisee is passive in the franchise sales process (i.e. providing brochures) the size of the fee is irrelevant since they did no more that provide space for the franchisor to advertise the offering.

However, issues may occur when franchisees provide unit financial or other information to prospective franchisees, which is a common occurrence. Indeed, most publications focused on providing information to prospective franchisees, including my own work, Franchising for Dummies, recommends that prospective franchisees look to existing franchisees as a source of such information. This information is essential to the prospective buyer and nothing in the rule should impede that free flow of information.

Where franchisors pay success or other fees to franchisees for referring prospects and the franchisee also provides information on financial and unit performance, we are concerned as to the impact this has on a franchisor's Item 19, Financial Performance Representations responsibilities. The Staff Report actually makes the existing situation worse because of the changes proposed.

Some practitioners have suggested that this issue can be addressed through the establishment of some threshold of materiality. We do not think that it is realistic to establish a threshold of materiality, as that needs to be measured not as a percent of the fee remitted to the recipient but rather to how material the recipient views the fee. We also do not believe it is realistic to place a burden on the existing franchisee to interpret the rule since they are not routinely involved in the selling process. As stated nothing in the Rule should impede the free flow of this important and necessary information.

We recommend therefore that the revised rule enable a franchisor, as is generally practiced today, to continue to disclose that it compensates existing franchisees for their involvement in the selling process. We also recommend that the revised Rule provide that a disclosure of a referral fee program create a safe harbor for franchisors and franchisees as it relates to franchisees being able to provide unit information outside of the franchisor's Item 19, Financial Performance Representations, regardless of the amount paid by the franchisor to the franchisee.

Brokers

We are concerned with the Staff Report's treatment of brokers, especially as it relates to the elimination of broker disclosure. Our concern is heightened given the elimination of the first personal meeting requirement. While we appreciate that the proposed changes are attempting to eliminate certain areas that some might consider impediments to preparing the disclosure documents, we do not believe it is the role of the FTC to create an unfettered sales process, no matter how much our clients or our firm would welcome that. The role of the FTC in this franchise sales process is to provide reasonable protection to prospective franchisees by overseeing how information is provided and we are concerned that the Staff Report in this area lessens that protection significantly.

There are no recognized standards that brokers need to meet other than those that might be contained in the FTC Rule and the various states that regulate franchise sales. It is important to remember that brokers are generally perceived by prospective franchisees as independent, third party experts in franchising whose purpose is to help them, as a client of the brokerage firm, select the best franchise for them. This perception is enhanced by their general avoidance of even the nomenclature of Franchise Broker, as well as their web site and other marketing materials. The lack of disclosure in franchisor's disclosure document will only enhance this misperception and puts prospective franchisees at considerable risk.

The existing Rule has been flawed for a number of years as it only required disclosure at the first personal meeting. The reality of the marketplace is that most discussions between brokers and prospective franchisees do not generally take place in face to face meetings. Rather these meetings take place over the phone, through web based conferences or other less direct means. Throughout this active sales period, often many months in length, the broker or franchisor under the existing Rule is under no obligation to provide the prospective franchisee with a disclosure document. Several brokerages routinely hold face to face meetings today with prospective franchisees, but do not consider those for the purpose of selling a franchise and therefore do not provide the required disclosure, under the present situation.

The positioning of brokers as Independent Consultants has an extraordinary impact on improving the franchise sales closure rate for franchisors and is one of the reasons that the use of brokers has dramatically increased in the past few years. It is our belief that:

- The manner in which brokers represent their relationship with the prospective franchisee;
- The nomenclature they use in describing their practices;
- The method and timing of the information they provide their prospective franchisee “client’s”
- The conducting of psychological tests on prospective franchisees;
- The way they represent the scoring and importance of the psychological tests they administer;
- The resultant recommendations they make relating to which franchise opportunities they claim are right for the prospective franchisee
- The failure to disclose differing rates of compensation they receive from their franchisor clients which could materially impact their recommendation;
- Their failure to disclose which companies they represent;

all effectively contribute to a pre sold atmosphere well before the franchisor meets with the prospect. The motivation of the prospective franchisee to follow the advice of the broker is so compelling by the time they meet the franchisor as to make the lack of timely information on the franchisor and disclosure related to the brokerage and the individual brokers, as envisioned in the Staff Report, dangerous.

We recommend that the definition of a broker be included in the Rule and not as envisioned only in the Compliance Guide. We are concerned that Broker disclosure has been eliminated in the Staff Report, and strongly believe that this decision should be reversed.

Prospective franchisees should have some way of knowing that the broker is actually representing the franchisor. Also, while the prospective franchisee may not be relying on the broker for any future performance, their activities in the selling process may be the most significant in establishing the relationship in the first place.

It is important to strengthen pre-sale disclosure by providing the necessary information early in the process rather than weakening that protection as provided for in the Staff Report. While changing from a ten day and five day business day rule to a simpler fourteen day calendar day is an attractive enhancement, the elimination of the first personal meeting rule does not benefit the prospective franchisee and indeed increases their risk. We strongly recommend the retention of the first personal meeting rule and further recommend a timely disclosure to prospective franchisees of a franchisor's disclosure documents, once the broker has made a recommendation to the prospective franchisee of a particular franchisor.

It is important for all sales personnel, including brokers, to meet some reasonable standards of disclosure. We believe these should include, at a minimum, disclosure of their personal employment, litigation and bankruptcy history. As it relates to the brokerage companies themselves, we believe it is essential that they disclosure to prospective franchisees issues similar to franchisors regarding employment history, litigation, bankruptcy and regulatory actions. However, we agree with the Staff Report that this information should not be included in a franchisor's disclosure documents.

We recommend that individual brokers and brokerage companies be required to present to a prospective franchisee, at a minimum, the disclosure information discussed above at the commencement of any active relationship between the broker and the prospective franchisee. We also recommend that a receipt from the prospective franchisee be obtained retain in the broker's files.

Disclosure to Prospective Franchisees on Transfers

We believe the staff should reconsider their recommendation that the franchisor provide a disclosure document to a prospective franchisee their request when the prospective franchisee is merely obtaining existing rights and underlying business from an existing franchisee.

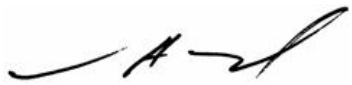
In most instances the disclosure document will contain misleading information as it relates to the agreement the prospective franchisee will be assuming. Information related to investment in the business will undoubtedly be incorrect as will a score of other issues, including fees that may have changed. It creates unintended litigation risks from which the franchisor may not be insulated.

Closing

It is important to recognize the achievement of the FTC staff in preparing this proposed revision to the Rule. Since the original Rule was promulgated, franchising has matured dramatically and the market in which it exists, including competitive forces, types of offerings, complexities of transactions and technology been equally significant. The Staff Report as taken these into account in an extraordinarily manner and should be congratulated for not only their effort, but their achievement.

I appreciate the opportunity to provide my comments to the proposed changes contained in the Staff Report. Should my assistance be required in answering any questions or providing any clarification on the above, please let me know.

Sincerely,



Michael H. Seid
Managing Director