

**Supporting Statement**  
**Trade Regulation Rule on Disclosure Requirements and**  
**Prohibitions Concerning Franchising and**  
**Business Opportunity Ventures**  
**(OMB No. 3084-0107)**

As detailed below, the FTC is requesting that OMB extend the clearance for the existing Trade Regulation Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures ("Franchise Rule"), 16 C.F.R. Part 436. In addition, the FTC also seeks OMB clearance for the rule changes that have been proposed in the ongoing rulemaking proceeding.

**1. Necessity for Collecting the Information**

In 1978, the Commission issued the Franchise Rule after concluding that lengthy investigations and a rulemaking proceeding revealed evidence of widespread deceptive and unfair practices in the sale of franchises and business opportunities. The Commission's investigation disclosed that prospective franchisees often found it difficult to obtain reliable information about proposed business investments and to otherwise verify the representations of franchisors and franchise brokers.

To correct these problems, the Rule requires franchisors and franchise brokers to furnish to prospective investors a disclosure document that provides information relating to the franchisor, the franchisor's business, the nature of the proposed franchise relationship, as well as additional information about any claims concerning actual or potential sales, income, or profits for a prospective franchisee ("financial performance claims"). The franchisor must also preserve the information that forms a reasonable basis for such claims.

The Rule requires all disclosures to (1) be made at least ten business days before any sale and (2) use disclosure documents that comply with the form and content set forth in the Rule. The Rule requires that all disclosures of material facts be made. It does not regulate the substantive terms of the franchisor-franchisee relationship. Nor does it require registration of the offering or the filing of any documents with the Commission in connection with the sale of franchises.

As outlined further in section 8 below, the Commission has begun a rulemaking proceeding to amend the Franchise Rule. See 64 FR 57294 (1999) (Notice of Proposed Rulemaking). The Staff Report on the Proposed Revised Franchise Rule (Aug. 25, 2004) ("Staff Report"), which is available online at [www.ftc.gov](http://www.ftc.gov), sets forth the staff's recommendations to the Commission on various proposed amendments to the Franchise Rule. The Commission did not review or approve the staff report prior to its issuance. See 69 FR 53661 (2004) (Notice Announcing Publication of Staff Report). Among other things, the Rule amendments discussed in the Staff Report would accomplish five goals. First, the staff has recommended that the amended Rule address the sale of business format and product franchises exclusively. The existing requirements for business opportunity ventures would be renumbered as a separate rule limited to business opportunities only. See Staff Report at 13 and n.42. Accordingly, the burden

for business opportunity ventures will remain the same.<sup>1</sup>

Second, the amended Rule would reduce inconsistencies between federal and state disclosure requirements. Fifteen states have franchise disclosure laws similar to the Rule. These states use a disclosure document format known as the Uniform Franchise Offering Circular (“UFOC”). Staff estimates that about 95 percent of all franchisors use the UFOC format. The amended Rule would incorporate nearly all of the UFOC disclosures, thereby harmonizing federal and state disclosure laws.

Third, the amended Rule would require the disclosure of more information on the quality of the franchise relationship. Among other things, franchisors would disclose litigation initiated against franchisees involving the franchise relationship and franchisee-specific trademark associations.

Fourth, the amended Rule would update the rule to address new technologies. Specifically, it would permit franchisors to furnish disclosures electronically. This includes transmission via CD ROM, email, and access to a Web site.

Finally, the amended Rule would reduce compliance costs by expanding exemptions from disclosure. Specifically, the amended Rule would create new exemptions for sophisticated investors and for sales to managers and others within the franchise system who are already familiar with the franchise system’s operations.

## **2. Use of the Information**

### **a) Existing Franchise Rule:**

Prospective franchisees use the required disclosures to (1) become better informed about the proposed investment and (2) verify representations made by a franchisor.

If the franchisor chooses to make financial performance claims, disclosures are necessary for analyzing the credibility of those claims. For example, a franchisor might represent to a prospective franchisee that the franchisee should expect annual sales of \$500,000. Without the Rule, the franchisee may have difficulty in assessing the accuracy or reliability of the claim. To make sure the franchisee can accurately assess the claim, the Rule requires the franchisor to: (1) indicate the number and percentage of franchises whose performance equaled or exceeded the claim; and (2) save and offer to show prospective franchisees the background material upon which the claim is based. This allows the prospective franchisee to form an independent

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<sup>1</sup>The FTC staff is also considering proposed rule changes that would revise the requirements for business opportunity sellers. If the Commission decides to issue a Notice of Proposed Rulemaking for those rule changes, the staff will seek PRA clearance for any changes in the PRA burden resulting from those proposed changes.

judgment about the reliability of the claim. It also discourages the use of unrealistic financial performance claims, because the franchisor knows that the franchisee can determine whether an earnings claim is credible by examining the background material. The Rule also requires that any background material must be shown to the Commission in the course of any compliance investigation so that the Commission may evaluate whether or not the basis for the claim is reasonable.

**b) Proposed amendments:**

Proposed amendments to the Franchise Rule under consideration would also require franchisors to disclose additional information about the nature of the franchise relationship. These new disclosures pertain to: (1) franchisor-initiated litigation; (2) the use of confidentiality clauses; and (3) trademark-specific franchisee associations. Franchisors also would be required to make specific warnings regarding, for example, financial performance information and, if applicable, exclusive territories.

**3. Consideration to Use Improved Information Technology to Reduce Burden**

Since the Rule went into effect in 1979, the expanded use of computers has reduced the time needed to generate initial disclosure documents, prepare updates, and audit financial statements. Consistent with the aims of the Government Paperwork Elimination Act, 44 U.S.C. § 3504 note, the Commission is considering amending the Rule to permit franchisors greater latitude in using new technologies, in particular the Internet, to further reduce compliance costs. Franchisors would be able to reduce significantly printing and distribution costs through the expanded use of email and the Internet to furnish disclosure documents. The proposed Rule would also permit the use of electronic signatures and electronic recordkeeping.

**4. Efforts to Identify Duplication/Availability of Similar Information**

Fifteen states have franchise disclosure laws similar to the Rule. These states use a disclosure document format known as the Uniform Franchise Offering Circular ("UFOC"). In order to ease compliance burdens on the franchisor, the Commission has authorized use of the UFOC in lieu of its own disclosure format to satisfy the Rule's disclosure requirements. Commission staff estimates that 95 percent of all franchisors use the UFOC format. When that format is used, the franchisor is not required to prepare an additional federal disclosure document. Thus, there is no duplication of information. Indeed, the Commission has proposed adopting the UFOC format, albeit with a few additional disclosures pertaining to the franchise relationship.

**5. Efforts to Minimize Burden on Small Businesses**

Unlike state franchise disclosure laws, the Rule does not require the franchisor to register or file disclosure documents with the government as a prerequisite to a sale. Thus, compliance with the Commission's Rule does not invoke the fees usually associated with registering or filing

disclosure documents, a consideration that might be especially important to small businesses.

Also, since August 1998, Commission staff have participated in an alternative law enforcement program initially organized by the National Franchise Council and now operated by the International Franchise Association (“IFA”), based in Washington, D.C. The IFA's members include many small businesses in addition to some of the country's largest franchisors. Under the alternative law enforcement program, a firm accused of violating the Franchise Rule will be given three options: (1) sign a consent decree in U.S. district court, (2) be sued by the FTC, or (3) go to the IFA for training, compliance monitoring, and, where appropriate, mediation of franchisee claims. Firms do not need to be IFA members in order to participate. The FTC oversees the program, deciding which types of violations are appropriate for a referral to the IFA, as well as the terms of compliance monitoring. In addition, aggrieved franchisees may seek money through the third-party mediator. The program is limited to disclosure problems only, and does not cover hard-core fraud cases. The FTC will continue to handle all serious fraud cases and many disclosure cases through traditional law enforcement, including seeking injunctions, redress, and civil penalties, where warranted. Because the FTC's law enforcement resources are limited, the alternative law enforcement program greatly assists the Commission in enforcing the Rule and increasing compliance.

#### **6. Consequences of Conducting Collection Less Frequently**

Any reduction in compliance is not an appropriate alternative to the Rule. The purpose of the Rule is to ensure that all prospective franchisees receive valuable presale information about proposed investments. However, as discussed above, staff is currently experimenting with a program that involves third party mediation.

#### **7. Circumstances Requiring Collections Inconsistent with Guidelines**

The collection of information in this Rule is consistent with all applicable guidelines contained in 5 C.F.R. § 1320.5(d)(2).

## **8. Consultation with Outside Sources**

The Commission has had a long history of seeking outside input regarding the Rule, beginning first with its extensive proceeding when it issued the Rule. The final rulemaking record contained more than 300,000 pages of comments and exhibits from industry, consumers, public officials, and academicians. At the time the Rule was issued, the Commission also published proposed compliance guidelines for public comment. Commenters represented a wide range of interests and expertise, from franchisees or prospective franchisees, franchisors, state government officials, trade associations, and law firms. As a result of the comments, the guidelines were extensively redrafted; final guidelines were published on August 24, 1979.

In 1995, the Commission conducted a review of the Franchise Rule as part of its systematic rule review program. Among other things, the Commission sought comment on: (1) the continuing need for the Rule; (2) the costs and benefits of the Rule; and (3) what changes, if any, should be made to the Rule to reduce the burdens and costs imposed on the firms subjected to its requirements. In response, the Commission received numerous comments from franchisors, franchisees, trade associations, law firms, and academicians. The Commission also held two public workshop conferences on the Rule, in which 56 individuals participated in round table discussions on the Rule or otherwise made statements for the record. All of the comments and the transcripts of the public workshop conferences were placed on the public record.

Subsequently, the Commission published an Advance Notice of Proposed Rulemaking (°ANPR°) in the Federal Register, announcing its intention to consider amending the Rule. See 62 Fed. Reg. 9115 (February 28, 1997). In the ANPR, the Commission summarized the comments received in response to the 1995 request for comment on the continuing need for the Franchise Rule. The commenters overwhelmingly expressed continuing support for the Rule, stating that pre-sale disclosure is a cost-effective way to disseminate material information to prospective franchisees that otherwise might be unavailable. Pre-sale disclosure is also necessary to prevent fraud and to reduce the level of post-sale franchise relationship disputes. Most commenters stated that the Rule's benefits outweigh the costs. Id. at 9115-16.

Through the ANPR, the Commission also sought comment on a number of issues that might reduce franchisors' compliance burdens, including: (1) whether application of the Franchise Rule should be limited to the sale of franchises to be located only in the United States; (2) whether franchisors should be able to comply with the Franchise Rule through the Internet and other electronic media; (3) whether the Commission should create appropriate exemptions to lessen compliance burdens; and (4) whether all of the Rule's disclosures are appropriate for the sale of business opportunities.

In response to the ANPR, the Commission has received 167 comments in writing, through e-mail, and through a telephone message line. In addition, the Commission has held six public workshop conferences on the Franchise Rule throughout the United States. Sixty-four individuals participated in the workshops, including franchisees and franchisee representatives, franchisors, business opportunity sellers and representatives, state franchise and business

opportunity regulators, and computer consultants. The workshop conferences generated transcripts totaling 1,548 pages.

In 1999, the Commission proposed a revised disclosure law that would, among other things, reduce many inconsistencies between federal and state disclosure laws, permit the use of electronic disclosure, and increase exemptions to the Rule. 64 Fed. Reg. 57,294 (October 22, 1999) (“Notice of Proposed Rulemaking”). At the same time, the Commission also proposed several additional disclosure items (mostly to give more material information about the state of the franchise relationship) and minor recordkeeping requirements. The Notice of Proposed Rulemaking had a detailed discussion of the PRA burden of the proposed changes, including estimated changes in hours and costs. 64 Fed Reg. at 57,326-328. In section 8.b below, staff has updated its estimate of the burden of the proposed changes. In addition, the Notice of Proposed Rulemaking solicited comment on PRA estimates, but no comments were received on that issue.

Most recently, the Commission sought comment on the Staff Report on the Franchise Rule. Bureau of Consumer Protection, *Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 436)* (Aug. 2004) (“Staff Report”). In September, 2004, the Commission published a notice in the *Federal Register* announcing the availability of, and seeking comment on, the Staff Report. 69 FR 53661 (Sept. 2, 2004). The Commission, however, has not reviewed or approved of the Staff Report. Forty-five commenters submitted comments on the Staff Report, which are currently being reviewed.

Finally, the Commission has also sought public comment in connection with its latest PRA clearance request for this Rule. See 70 Fed. Reg. 28941 (May 19, 2005) (no comments were received), and is doing so again contemporaneous with this submission.

**9. Payment or Gift to Respondents**

Not applicable.

**10. Assurances of Confidentiality**

No assurance of confidentiality is necessary, since franchisors do not register or file any documents with the Commission. To the extent that information covered by a recordkeeping requirement is collected by the Commission for law enforcement purposes, the confidentiality provisions of Sections 6(f) and 21 of the FTC Act, 15 U.S.C. §§ 46(f), 57b-2 will apply.

**11. Sensitive or Private Information**

Under the provisions in the Rule, a franchisor must disclose certain franchisees' names, business addresses and telephone numbers. Disclosing this information lets prospective franchisees conduct their own due diligence investigation of the franchisor's claims, in particular financial performance claims. No other information about individual franchisees must be disclosed. For example, franchisors who choose to make a financial performance claim based

upon the earnings history of current franchisees need not identify in the disclosure document the individual franchisees whose information formed the basis of the earnings claim, or the earnings of any individual franchisee or franchised location.

## **12. Burden Estimate**

### **(a) Existing Franchise Rule:**

Estimated annual hours burden for existing Franchise Rule: 33,500 hours

Based on a review of trade publications and information from state regulatory authorities, staff believes that, on average, from year to year, there are approximately 5,000 American franchise systems, consisting of 2,500 business format franchises and 2,500 business opportunity sellers, with perhaps about 10% of that total reflecting an equal amount of new and departing business entrants.

Staff has calculated burden based on the above estimates. Some franchisors, however, for various reasons, are not covered by the Rule in certain situations (e.g., when a franchisee buys bona fide inventory but pays no franchisor fees). Moreover, fifteen states have franchise disclosure laws similar to the Rule. These states use a disclosure document format known as the Uniform Franchise Offering Circular ("UFOC"). In order to ease compliance burdens on the franchisor, the Commission has authorized use of the UFOC in lieu of its own disclosure format to satisfy the Rule's disclosure requirements. Staff estimates that about 95 percent of all franchisors use the UFOC format. When that format is used, the franchisor is not required to prepare an additional federal disclosure document. The burden hours stated below reflects staff's estimate of the incremental burden that the Franchise Rule may impose beyond information requirements imposed by states and/or followed by franchisors who use the UFOC.

Staff estimates that the 500 or so new franchisors (including business opportunity ventures) require approximately 30 hours each to develop a Rule-compliant disclosure document. Staff additionally estimates that the remaining 4,500 established franchisors require no more than approximately 3 hours each to update the disclosure document. The combined cumulative burden is 28,500 hours.

The franchisor may need to maintain additional documentation for the sale of franchises in non-registration states, which could take up to an additional hour of recordkeeping per year. This yields a cumulative total of 5,000 hours per year for affected entities.

Estimated annual cost burden for existing rule: \$7,190,000

Labor costs are determined by applying applicable wage rates to associated burden hours. Staff assumes that an attorney likely would prepare or update the disclosure document. Accordingly, staff's estimate of the labor costs attributed to those tasks are as follows: (500 new franchisors x \$250 per hour x 30 hours per franchisor) + (4,500 established franchisors x \$250

per hour x 3 hours per franchisor) = \$7,125,000.

Staff anticipates that recordkeeping would be performed by clerical staff at approximately \$13 per hour. At 5,000 hours per year for all affected entities, this would amount to a total cost of \$65,000. Thus, combined labor costs for recordkeeping and disclosure is approximately \$7,190,000.

### **(b) Proposed Rule Amendments**

Estimated increase in annual hours burden for proposed rule amendments: 2750 hours.

Proposed amendments to the Franchise Rule would adopt the UFOC disclosure format in large measure. In addition, franchisors would have to disclose additional information about the state of the franchise relationship. The amended Rule would also increase franchisor's recordkeeping obligations. Specifically, a franchisor would be required to retain copies of receipts for disclosure documents, as well as materially different versions of its disclosure documents. Such recordkeeping requirements, however, are consistent with, or less burdensome, than those imposed by the states.

Staff estimates the increase in burden attributable to the proposed Rule amendments as follows: Each year, approximately 250 new franchisors will require 32 hours each (2 hours more than under the existing Rule) to develop a Rule-compliant disclosure document (increase of 500 hours). Staff also estimates that during the first year that the amended Rule is effective, the remaining 2250 established franchisors will require approximately 6 hours each (3 hours more than under the existing Rule) to update their existing disclosure document to comply with the amended Rule (increase of 6750 hours for the first year). After the first year, however, the time required should be the same as under the existing Rule, as the new disclosure format becomes familiar. Accordingly, the increase in the annual disclosure burden, averaged over the three-year clearance period, will be 2750 hours (500 hours per year for new franchisors + 2250 hours per year for established franchisors).

Estimated increase in annual cost burden for proposed rule amendments: \$688,000, rounded to the nearest thousand.

Labor costs are determined by applying applicable wage rates to associated burden hours. Staff assumes that an attorney likely would prepare the disclosure document. Accordingly, staff's estimate of the increase in labor costs that would be attributable to the proposed Rule amendments, averaged over the three-year clearance period, is as follows: (500 hours per year for new franchisors x \$250 per hour) + (2250 hours per year for established franchisors x \$250) = \$687,500.

### **13. Estimated Capital and Other Non-Labor Costs: \$12,777,000**



Franchisors must also incur costs to print and distribute the disclosure document. These costs vary based upon the length of the disclosures and the number of copies produced to meet the expected demand. Staff estimates that 2,500 business format and product franchisors print and mail 100 disclosure documents per year at a cost of \$35 per document. Staff further estimates that another 2,500 business opportunity sellers print and mail 100 documents per year at a cost of \$15 per document, for a total cost of \$12,500,000.

The franchisor also must provide and disseminate an FTC-required cover sheet that identifies the franchisor, the date the document is issued, a table of contents, and a notice that tracks the language specifically provided in the Rule. Although some of the language in the cover sheet is supplied by the government for the purpose of disclosure to the public, and is thus excluded from the definition of “collection of information” under the PRA, see 5 CFR 1320.3(c)(2), there are residual costs to print and mail these cover sheets, including within them the presentation of related information beyond the supplied text. Staff estimates that 5,000 franchisors complete and disseminate 100 cover sheets per year at a cost of approximately \$.55 per cover sheet, or a total cost of approximately \$277,000.

The proposed Rule revisions could potentially reduce franchisors’ compliance costs significantly, especially the costs association with printing and distributing disclosures documents. As an initial matter, we believe that business format franchisors are most likely to turn to electronic disclosure initially. We estimate that approximately 20 percent of franchisors, or 500 franchisors, would initially make use of this proposal, and each would distribute 50 of their 100 documents electronically. We estimate that the cost to distribute disclosures documents electronically would be reduced to approximately \$5.00, resulting in a net savings of \$750,000 (500 franchisors furnishing 50 electronic disclosure documents each at a savings of \$30 per electronic disclosure document).

#### **14. Estimate of Cost to Federal Government**

Staff estimates that the annualized cost to the Commission (per year over the 3-year clearance renewal being sought) to administer and enforce the Rule will be approximately \$250,000. This estimate includes attorney, clerical, and other support staff costs.

#### **15. Changes in Burden**

The staff has retained its estimate of the burden associated with the existing Franchise Rule (33,500 hours). The staff estimates that the proposed amendments to the Franchise Rule will result in an increase of 2750 hours.

#### **16. Statistical Use of Information**

There are no plans to publish any information for statistical use.

#### **17. Failure to Display of the Expiration Date for OMB Approval**

Not applicable.

**18. Exceptions to the Certification for Paperwork Reduction Act Submissions**

Not applicable.