

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

**1. Necessity for Collecting the Information**

In 1978, the Commission issued the original Trade Regulation Rule on Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. Part 436 ("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 purchasers often found it difficult to obtain reliable information about proposed franchise and business opportunity investments and to otherwise verify the representations of the sellers and brokers offering them for sale.

Revisions to the Rule were promulgated on March 30, 2007,<sup>1</sup> and took final effect on July 1, 2008 after a one-year phase-in. As amended, the Rule continues to require 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 14 calendar 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.

Among other things, the amended Rule accomplishes five objectives. First, the amended Rule addresses the sale of business format and product franchises exclusively.<sup>2</sup> Second, the amended Rule minimizes prior inconsistencies between federal and state disclosure requirements by merging the Rule's disclosure requirements with the Uniform Franchise Offering Circular ("UFOC") disclosure format accepted by the 15 states that have franchise registration and

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<sup>1</sup> 72 Fed. Reg. 15,444 (Mar. 30, 2007).

<sup>2</sup> The current clearance under OMB Control Number 3084-0107 covers the disclosure and recordkeeping requirements of the original Franchise Rule, 16 C.F.R. Part 436, which applied both to the sale of franchises and of business opportunity ventures. The disclosure and recordkeeping requirements applicable to business opportunity ventures are now separately set forth in 16 C.F.R. Part 437, and are covered under recently assigned OMB Control Number 3084-0142. The portion of the prior clearance applicable to business format franchisors under Part 436 retains the pre-existing OMB Control Number 3084-0107.

disclosure laws.<sup>3</sup> Third, the amended Rule requires the disclosure of more information on the quality of the franchise relationship, such as litigation franchisors initiate against their franchisees and the existence of any franchisee associations. Fourth, the amended Rule recognizes new technologies by permitting franchisors to furnish disclosures electronically, whether by CD ROM, email, or access to a Web site. Finally, the amended Rule reduces compliance costs by creating new disclosure exemptions for sophisticated investors and for sales to franchisor “insiders” who are already familiar with the franchise system’s operations.

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

Prospective franchisees use the disclosures required by the amended Franchise Rule to become better informed about the proposed investment and to 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) preserve and offer to show prospective franchisees the background material upon which the claim is based. This allows the prospective franchisee to form an independent 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 the basis for the claim is reasonable.

## **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 has amended the Rule to permit franchisors greater latitude in using new technologies, in particular the Internet, to further reduce compliance costs. Franchisors are now able to reduce significantly printing and distribution costs through the expanded use of email and the Internet to furnish disclosure documents. The Rule also permits the use of electronic signatures and electronic recordkeeping.

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<sup>3</sup> Prior to July 1, 2008, when the amended Rule took effect, some 95 percent of all franchisors used the UFOC disclosure format. As required by the amended Rule, and permitted by all state franchise laws, franchisors now must use the Franchise Disclosure Document (“FDD”) disclosure format.

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

The fifteen states with franchise disclosure laws similar to the Rule previously required the use of the UFOC disclosure format, and would not accept disclosures in the format prescribed by the original Franchise Rule.<sup>4</sup> The amended Rule directly avoids any possible duplication. Since it took effect on July 1, 2008, the FDD disclosure format prescribed by the amended Rule has provided a single disclosure that can be used in all of the franchise registration states because it incorporates the UFOC requirements.

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

Unlike most state franchise disclosure laws, the Rule does not require the franchisor to register or file disclosure documents with the government as a prerequisite to the offer or sale of a franchise. Thus, compliance with the Rule does not invoke the fees usually associated with registering or filing state 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 is 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 adequate alternative to the Rule. The Rule's purpose is to ensure that all prospective franchisees receive valuable presale information about proposed franchise investment opportunities. The amended Rule, like the original Rule, does not require frequent updates of the disclosures it mandates. Disclosures must be updated only once a

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<sup>4</sup> The Commission permitted the use of the UFOC while the original Franchise Rule remained in effect, in lieu of the Rule's disclosure format. Consequently, there was never any requirement that franchisors prepare one disclosure document for federal use, and another for use in franchise registration states.

year, unless there is a material change during the year in the information required to be disclosed. If a material change occurs during any quarter of a franchisor's fiscal year, only a quarterly attachment updating the FDD is required to reflect that change.

## **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 the extensive proceeding that resulted in the Rule's issuance. The final rulemaking record contained more than 300,000 pages of comments and exhibits from industry, consumers, public officials, and academicians. When issuing the Rule, the Commission also published proposed compliance guidelines for public comment. Commenters represented a wide range of interests and expertise, including franchisees or prospective franchisees, franchisors, state government officials, academics, 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 subject 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 roundtable discussions 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.<sup>5</sup> 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 it, 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.<sup>6</sup>

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<sup>5</sup> 62 Fed. Reg. 9,115 (Feb. 28, 1997).

<sup>6</sup> 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 the Rule's disclosures were appropriate for the sale of business opportunities.

In response to the ANPR, the Commission received 167 comments in writing, through e-mail, and through a telephone message line. In addition, the Commission 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 voluminous transcripts.

In 1999, the Commission issued a Notice of Proposed Rulemaking for amendments to the franchise rule intended, among other things, to reduce many inconsistencies between federal and state disclosure requirements, permit the use of electronic disclosure, and increase exemptions to the Rule.<sup>7</sup> 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. Although the Notice of Proposed Rulemaking sought comment on staff's PRA estimates, no comments were received on that issue.

The Commission also sought public comment on the Staff Report on the Franchise Rule.<sup>8</sup> In September, 2004, the Commission published a notice in the *Federal Register* announcing the availability of, and seeking comment on, the Staff Report, which the Commission had not reviewed or approved.<sup>9</sup> Forty-five commenters submitted comments on the Staff Report. In addition, the Commission sought public comment on its 2005 PRA clearance request for the Rule, which included PRA burden estimates for the transition to the amended Rule,<sup>10</sup> but no comments were received.

Finally, the Commission sought public comment regarding its latest PRA clearance request for this Rule. See 73 Fed. Reg. 40,580 (July 15, 2008). The Commission received no

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<sup>7</sup> 64 Fed. Reg. 57,294 (Oct. 22, 1999).

<sup>8</sup> Bureau of Consumer Protection, *Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 C.F.R. Part 436)* (Aug. 2004) ("Staff Report").

<sup>9</sup> 69 Fed. Reg. 53,661 (Sept. 2, 2004).

<sup>10</sup> 70 Fed. Reg. 28,937, 28,940 (May 19, 2005); 70 Fed. Reg. 51,817 (Aug. 31, 2005).

comments. Pursuant to PRA implementing regulations under 5 CFR Part 1320, the Commission is providing a second opportunity for public comment on its burden analysis, 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 of the amended 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**

**Estimated annual hours burden: 16,750 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 2,500 sellers of franchises covered by the Rule, with perhaps about 10% of that total reflecting an equal amount of new and departing business entrants.<sup>11</sup> Staff's burden hour estimate reflects the incremental burden that part 436 may impose beyond the information and recordkeeping requirements imposed by state law and/or followed by franchisors who have been using the UFOC disclosure

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<sup>11</sup> This is one-half of the number used in the 2005 clearance request, when both franchises and business opportunities were covered by the Rule, and reflects the fact that business opportunities are now separately covered by Part 437 and a separate OMB clearance. This number appears to be consistent with the number of business format franchise offerings registered in compliance with state franchise laws, and listed in franchise directories.

format nationwide.<sup>12</sup> This estimate likely overstates the actual incremental burden because some franchisors, for various reasons, may not be covered by the Rule (*e.g.*, they sell only franchises that qualify for the Rule's large franchise investment exemption of at least \$1 million).<sup>13</sup>

For October 31, 2008 to October 31, 2009, the first twelve months of prospective 3-year renewed PRA clearance, staff estimates that the average annual disclosure burden to update existing disclosure documents will be three hours each year for the 2,250 established franchisors, or 6,750 hours (3 x 2,250), and 30 hours each year for the 250 or so new entrant franchisors to prepare their initial disclosure documents, or 7,500 hours (30 x 250). These estimates for the amended Rule are based on staff's prior estimates for the original Rule, and further adopt the analysis of the 2005 clearance request and the Statement of Basis and Purpose ("SBP") for the amended Rule.<sup>14</sup>

As discussed in the 2005 Notices and the SBP, as under the original Rule, covered franchisors also 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 an additional cumulative total of 2,500 hours per year for covered franchisors (1 hour x 2,500 franchisors).

Part 436 of the amended Rule would also increase franchisors' 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.

Thus, staff estimates the average hours burden for new and established franchisors during the three-year clearance period ahead would be 16,750 ((30 hours of annual disclosure burden x 250 new franchisors = 7,500 hours) + (3 hours of average annual disclosure burden x 2,250 established franchisors = 6,750 hours) + (1 hour of annual recordkeeping burden x 2,500 franchisors = 2,500 hours)).

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<sup>12</sup> Staff estimates that about 95 percent of all franchisors use the UFOC format because the original Franchise Rule authorized use of the UFOC in lieu of the Rule disclosure format to satisfy the Rule's disclosure requirements and reduce compliance burdens.

<sup>13</sup> 16 C.F.R. 436.8(a)(5). This exemption was added by the amended Rule.

<sup>14</sup> 70 FR 28937, 28940 (May 19, 2005); 70 FR 51817, 51819 (Aug. 31, 2005) ("2005 Notices"); 72 FR 15444, 15542 (Mar. 30, 2007). Although the 2005 Notices and the amended Rule's SBP assumed that additional time (cumulatively, 2,750 hours) would be required to prepare disclosures during the transition to compliance with the amended Rule, the one-year transition period ended on July 1, 2008, when the amended Rule took full effect.

**Estimated annual labor cost burden for part 436: \$3,595,000**

Labor costs are derived by applying appropriate hourly cost figures to the burden hours described above. The hourly rates used below are estimated averages.

As stated in the 2005 Notices, staff believes that an attorney will prepare the disclosure document, and at an estimated \$250 per hour. Accordingly, staff estimates that 250 new franchisors will each annually incur \$7,500 in labor costs (30 hours x \$250 per hour) and 2,250 established franchisors will each incur \$750, annually, in labor costs (3 hours x \$250 per hour).

Further, staff anticipates that recordkeeping under part 436 will be performed by clerical staff at approximately \$13 per hour. Thus, 2,500 hours of recordkeeping burden per year for all covered franchisors will amount to a total annual labor cost of \$32,500.

Cumulatively, then, total estimated labor costs under part 436 is \$3,595,000 (((\$7,500 attorney costs x 250 new franchisors = \$1,875,000) + (\$750 attorney costs x 2,250 established franchisors = \$1,687,500) + (\$13 clerical costs x 2,500 franchisors = \$32,500)).

**Estimated non-labor costs for part 436: \$8,000,000**

As an initial matter, in developing cost estimates, Commission staff consulted with practitioners who prepare disclosure documents for a cross-section of franchise systems. Accordingly, the Commission believes that its cost estimates are representative of the costs incurred by franchise systems generally. In addition, many franchisors establish and maintain websites for ordinary business purposes, including advertising their goods or services and to facilitate communication with the public. Accordingly, any costs franchisors would incur specifically as a result of electronic disclosure under part 436 appear to be minimal.

As set forth in the 2005 Notices, staff estimates that the non-labor burden incurred by franchisors under part 436 will differ based on the length of the disclosure document and the number of disclosure documents produced. Staff estimates that 2,000 franchisors (80% of total franchisors covered by the Rule) will print and mail 100 disclosure documents at \$35 each. Thus, these franchisors will each incur \$3,500 in printing and mailing costs. Staff estimates that the remaining 20% of covered franchisors (500) will transmit 50% of their 100 disclosure documents electronically, at \$5 per electronic disclosure. Thus, these franchisors will each incur \$2,000 in distribution costs ((\$250 for electronic disclosure [\$5 for electronic disclosure x 50 disclosure documents]) + (\$1,750 for printing and mailing [\$35 for printing and mailing x 50 disclosure documents])).

Accordingly, the cumulative annual non-labor costs for part 436 of the amended Rule is approximately \$8,000,000 ((\$3,500 printing and mailing costs x 2,000 franchisors = \$7,000,000)



+ (\$250 electronic distribution costs + \$1,750 printing and mailing costs) x 500 franchisors = \$1,000,000).

**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 amended Rule will be approximately \$120,000. This estimate includes attorney, clerical, and other support staff costs.

**15. Changes in Burden**

Staff's current estimate excludes the 2,750 additional hours attributed in the 2005 clearance request to the transition to the amended Rule's disclosure requirements. That transition was completed when the amended Rule took full effect on July 1, 2008.

**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.