

# PUBLICATION

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## NASAA Issues FDD Commentary Proposal

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As franchisors made the transition from the Uniform Franchise Offering Circular (UFOC) to the Franchise Disclosure Document (FDD), many questions arose regarding the new disclosure requirements. These questions persist even though the disclosure requirements under the Federal Trade Commission's (FTC) Amended Franchise Rule are very similar to those under the 1993 UFOC Guidelines. In an effort to update their guidelines, the North America Securities Administrators Association, Inc. (NASAA) adopted the 2008 Franchise Registration and Disclosure Guidelines as a model for the registration states. Recently, NASAA produced a commentary proposal to their 2008 Registration and Disclosure Guidelines addressing several frequently asked questions. This article provides an overview of the NASAA Commentary proposal.

### Cover Pages

The FTC cover page has been modified under the new guidelines and NASAA requires that no unnecessary modifications be made. NASAA does not allow any additional clarifying information to be included regarding the total investment or allow adjustments to the totals taken from Items 5 and 7. NASAA does not provide much guidance regarding additional risk factors to be included in the state cover page. If a state examiner requires the disclosure of additional risk factors, it is not readily apparent whether the additional risk factor should be included in the franchisor's FDD form or in a state specific addendum. The safest route is to include the risk factor in all FDD's and provide guidance to the examiners that it was required by a particular state.

### Item 1

NASAA allows more freedom to include information in Item 1 than in the Cover Sheet. The franchisor can provide a corporate family tree that represents numerous parent companies. NASAA's guidelines clarify that foreign affiliates that offer franchises or provide products or services must be included in Item 1. NASAA's commentary also clarifies the issue of change of control of a franchise and predecessor. According to NASAA's commentary, a franchisor must disclose a predecessor from whom the franchisor acquired directly or indirectly the major portion of the franchisor's assets; this does not necessary include a former controlling owner. A predecessor does not mean a mere equity owner but instead means that the person contributed operating assets to the franchisor and it operated or franchised a similar business.

### Item 2

NASAA clarified the disclosure standards for third parties with management responsibilities. Franchisors must disclose independent contractors or other persons that have management responsibilities on behalf of the franchisor that relate to the sale or operation of the franchises offered and must provide the required disclosure information for Items 3 and 4.

### Item 3

One interesting change in terminology involves the new term "held liable." The UFOC required disclosure if a person had been the subject of a material action involving securities, franchise or deceptive practices. Disclosure is now required if the person was "held liable." NASAA takes the position that this is not a change in the standard but goes on to state that "held liable" means the person must pay money or take an action adverse to its interest. So it appears the standard has changed despite NASAA's position to the contrary.

NASAA clarified the issue of whether or not material litigation involving intellectual property must be disclosed twice. Disclosing trademark, copyright and patent litigation in Items 13 and 14 does not relieve the franchisor of also disclosing the same litigation in Item 3 if the litigation meets the Item 3 disclosure requirements.

### **Item 8**

NASAA creates a bright line rule for Item 8 and requires all revenue a franchise or its affiliates derive from purchases and leases of products and services to franchisees must be disclosed. A franchisor must also disclose all of franchisee's obligations to purchase or lease goods from the franchisor, its affiliates, designees or suppliers, or under the franchisor's specifications. This makes disclosure necessary if rebates are paid by designated or approved suppliers or by suppliers that comply with the franchisor's specifications.

### **Item 17**

Under the UFOC, the franchisor was required to include a list of franchise relationship laws. Not only is this list is no longer required to be provided by the franchisor but the franchisor is no longer even permitted to include such a list in its FDD. A state that requires a summary of its franchise relationship law allows the summary to be included in its state addendum to the FDD.

### **Item 19**

NASAA focuses on financial performance representations in the commentary and provides answers to several outstanding questions. Although Item 19 no longer includes absolute value costs in the definition of a financial performance representation, including cost information as a percentage of revenues constitutes a financial performance representation and therefore must comply with Item 19. NASAA also condemns submitting a blank "pro forma" profit and loss statement to demonstrate a franchise's cost structure, but goes further and notes that including cost information alone in a pro forma may constitute advertising under state franchise statutes.

If the franchisor opts to include a financial performance representation in Item 19, the franchisor may not include disclaimers of the financial performance representation or state that the franchisee may not rely on the information contained in Item 19.

### **Item 20**

Many questions have arisen regarding franchise system census disclosure in Item 20.

### **Unopened Franchisees**

If a franchisee has signed a franchise agreement but has not opened its unit, the franchisee should be listed in Table 5 and their information should be provided franchisee contact list identified as "not yet opened." If the franchisee has signed a franchise agreement, never opened a location and have not communicated with the franchisor within 10 weeks of the FDD issuance date, then the franchisee should not be included in any chart but listed as a terminated franchisee.

### **Area Developers and Representatives**

Information about area developers is not required and may not be provided in Item 20. However, area development information must be included in Item 1. Franchisors must be careful to ensure that these arrangements are not considered subfranchises, which mean additional disclosure at two levels.

### **Confidentiality Clauses**

If franchisees have signed confidentiality clauses within the prior three fiscal years, the franchisor must make two disclosures. The first disclosure must state that some of its franchisees have signed confidentiality clauses. The second disclosure the franchisor must make is to include the mandated language in Item 20(7) to the effect that discussions with franchisees who have signed such agreements may not produce candor.

## **Amendments**

The FTC and NASAA have not reached a consensus on how to deal with amendments to the FDD. The FTC requires the franchisor to amend the FDD quarterly if there has been a material change, and by supplement instead of amending the core document. Some states require the franchisor to amend the FDD immediately upon the occurrence of a material change and to cease selling in those particular states. This incongruity between state franchise laws and the Amended Franchise Rule forces franchisors to follow the more restrictive state law, and negates the more liberal federal policy. Until a consensus is reached, franchisors will not realize any benefit from the FTC's quarterly amendment concept in registration states.