

## FINAL STATEMENT OF REASONS FOR RULE CHANGES UNDER THE FRANCHISE INVESTMENT LAW

As required by Section 11346.2 of the Government Code, the California Corporations Commissioner ("Commissioner") sets forth below the reasons for the adoption of Sections 310.100.4 and 310.114.4 and the amendments to Section 310.101 of Title 10, of the California Code of Regulations (10 C.C.R. Sections 310.100.4, 310.101 and 310.114.4).

The Department of Corporations ("Department") regulates the offer and sale of franchises pursuant to the Franchise Investment Law ("FIL"). Under the FIL, it is unlawful to offer or sell a franchise unless the franchise is registered by the Department, or is exempt from the Department's review. On September 10, 2004, Governor Schwarzenegger signed AB 2921 (Chap. 458, Stats. 2004), which made several important changes to the FIL. The changes to the Commissioner's rules in accordance with AB 2921 are as follows: (1) Section 310.100.4 will specify the content of the disclosures provided to the franchisees that is to be used for certain offers and sales of franchises on terms different from the terms of the registered offer, as specified in Corporations Code Section 31109.1; (2) Section 310.101 will modify the existing exemption form to allow for an exemption for the offer or sale of a franchise to certain accredited and suitable purchasers, as set forth in Corporations Code section 31109; and (3) Section 310.114.4 will specify the requirements to be used when a franchisor delivers a franchise disclosure document by electronic means, as set forth in Section 31119, as amended.

### **SECTION 310.100.4**

Corporations Code Section 31109.1 was recently enacted to provide an exemption from registration for certain offers or sales of franchises on terms different from the terms of the registered offer. In order to qualify for this exemption, certain information must be provided to the prospective franchisee. Section 310.100.4 sets forth the content that must be provided to a prospective franchisee when relying on an exemption from registration under Corporations Code Section 31109.1.

The new provision requires a list of the changed information to be disclosed to the prospective franchisee in the appendix to the franchisor's offering circular. This form is added to the regulations to specify the information that must be provided to a potential franchisee in order to qualify for the exemption under Section 31109.1, and to allow the prospective franchisee to determine how the material negotiated terms differ from the registered terms.

This change clarifies the process and conforms to existing procedure.

### **SECTION 310.101**

Corporations Code Section 31109 was recently enacted to provide an exemption from registration for the offer or sale of a franchise to certain accredited and suitable

purchasers. The current regulation contains a “Notice of Exemption” under Corporations Code Sections 31101, 31104, or 31108. The amendments modify the existing exemption form and instructions to include the new exemption available under Corporations Code Section 31109. The amendments are necessary to allow for the new exemption available under this statute.

The modifications involve merely adding Section 31109 as one of the available grounds to qualify for exemption. In addition, the amendment to Section 1, subsection (a), under “INSTRUCTIONS FOR COMPLETING AND FILING NOTICE OF EXEMPTION”, amends the last sentence to clarify that Section 31108 also applies.

This change clarifies the process and conforms to existing procedure.

#### **SECTION 310.114.4**

Corporations Code Section 31119 was recently amended to allow a franchisor to deliver a franchise disclosure document by electronic means. Section 310.114.4 specifies the requirements necessary for delivery by electronic means.

As a preliminary note, the Department understands that other regulatory agencies (e.g., Federal Trade Commission) are studying the need for additional and modernized standards to govern the disclosure of franchise documents in electronic format. Accordingly, the Department will monitor the impact of rule 310.114.4 and work with interested parties next year to determine if further rulemaking is necessary and appropriate.

Subsection (a) states that electronic delivery of franchise disclosure documents is permissible as long as it meets all of the requirements set out in the rule. This is necessary to inform the franchisor that all of the requirements listed must be satisfied in order to disclose by electronic means.

Paragraph (1) requires that prior to electronic delivery of disclosure documents, the franchisor must advise the prospective franchisee of the formats in which the disclosure document is available and any prerequisites or conditions necessary for obtaining or reviewing it in a particular format. This is taken from the Staff Report on the Proposed Revised FTC Franchise Rule (“FTC Proposed Revised Rule”), issued by the Federal Trade Commission on August 25, 2004. The requirement is necessary to ensure that prospective franchisees, prior to disclosure, know whether or not they will receive a disclosure document in a form they can easily use.

Paragraph (2) sets forth the requirements for the actual disclosure document. Item (A) requires that the disclosure document be delivered as a single, integrated, document or file. This requirement comes from the North American Securities Administrators Association Statement of Policy Regarding Electronic Delivery of Franchise Disclosure Documents (“NASAA Statement of Policy”), which was approved on September 14, 2003. The requirement is necessary to prevent piecemeal and confusing disclosures by the franchisor.

Item (B) requires that the disclosure document have no extraneous content beyond what is required by law. The requirements in this section were taken from both

the NASAA Statement of Policy, and from the FTC Proposed Revised Rule. Subsection (i) specifies that the disclosure document may contain devices or tools for manipulating electronic documents or enabling the recipient to receive and view the document. This regulation allowing the document to contain navigational features is necessary to aid the prospective franchisees in reading the disclosure document. Subsection (ii) defines prohibited extraneous content to include multimedia tools and links to external documents or content. This prohibition is necessary to prevent franchisors from calling attention to favorable portions of a disclosure document or to distract prospective franchisees from damaging disclosures.

Item (C) requires that the document be delivered in a form that permits the recipient to be able to store, retrieve, and print the disclosure document. This requirement is taken from both the NASAA Statement of Policy, and from the FTC Proposed Revised Rule. The requirement is necessary to ensure that prospective franchisees can retain a copy for future reference, as well as to ensure that prospective franchisees can show a copy to their advisors, if they wish to do so.

Item (D) requires that the disclosure document conform as to its content and format to the requirements of the law. This is taken from the NASAA Statement of Policy, and is necessary to ensure that the franchisor is in compliance with all relevant laws.

Paragraph (3) requires the franchisor to be able to prove electronic delivery and to maintain records of electronic delivery. These requirements were taken from the NASAA Statement of Policy and FTC Proposed Revised Rule. Item (A) requires that the franchisor be able to prove it delivered the disclosure document electronically in compliance with the requirements of the regulations, and that it delivered the document in a timely manner. This requirement is necessary to ensure that the prospective franchisee actually received the disclosure document, and that it received the disclosure document in a timely manner. Item (B) requires that the franchisor must keep records of its electronic delivery and make the records available to the Department of Corporations upon demand. This requirement is necessary to ensure the availability of evidence for the Department in its law enforcement actions.

Subsection (b) defines “delivery” and is taken from the NASAA Statement of Policy. This subsection is necessary to ensure that the prospective franchisee actually receives the disclosure document.

Subsection (c) defines methods a franchisor may use in demonstrating proof of delivery, and is based in part on the FTC Proposed Revised Rule. This subsection is necessary to ensure that the prospective franchisee has actually received the disclosure document, and to provide the franchisor with suggested methods to satisfy the proof of delivery requirement.

Subsection (d) states that the regulation does not change or waive any other requirement of law concerning registration or presale disclosure of franchise offerings. This subsection is taken from the NASAA Statement of Policy, and is necessary to clarify that franchisors remain subject to all other relevant laws.

This change clarifies the process and conforms to existing procedure.

## DETERMINATIONS

The Commissioner has determined that the adoption of the regulation does not impose a mandate on local agencies or school districts, which require reimbursement pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.

## ALTERNATIVES CONSIDERED

No alternative considered by the Department would be more effective in carrying out the purpose for which the regulation is proposed or would be as effective and less burdensome to affected private persons or would lessen any adverse impact on small businesses.

## ADDENDUM, REGARDING PUBLIC COMMENTS

No request for hearing was received during the 45-day public comment period, which ended on February 7, 2005. Accordingly, no hearing was scheduled or held.

## COMMENTS RECEIVED DURING THE 45-DAY COMMENT PERIOD

COMMENTOR: E-mail and facsimile dated February 4, 2005, from John G. Haraldson, Esq., an independent contractor for Taco Bell Corp., on behalf of the Franchise Law Committee of the Business Law Section of the State Bar of California, with a letter signed by Stafford Matthews and Robert Brown.

COMMENT 1: The commentor states that clarification is needed in the general instruction for persons claiming the "sophisticated franchisee" exemption by specifying that a franchisor need only file for an exemption once in any calendar year under the exemption claimed, even if multiple franchises are sold to one or more franchisees.

RESPONSE: The Department has decided to provide clarification language in Part 1 (a) of the Instructions for Completing and Filing the exemption notice. This language will clarify that the notice for each claimed exemption must be filed only once for each calendar year, even if franchises are sold to one or more franchisees under the exemption claimed for that calendar year.

The Department is adopting the change because this clarification helps filers understand the requirements of Corporations Code Section 31109(e):

"The franchisor files with the commissioner *a notice of exemption* and pays the fee prescribed in subdivision (f) of Section 31500 prior to any offer or sale of a franchise in this state *for which the exemption is claimed during any calendar year in which one or more franchises are sold*, excluding any material modification." (emphasis added)

Because similar language is set forth in Sections 31101, 31104 and 31108, this change also clarifies the application of these sections, as well.

COMMENT 2: The commentor makes note that Corporations Code Section 31500(f) should be amended to include references to Sections 31104, 31108, and 31109.

RESPONSE: The Department will consider requesting the Legislature amend Section 31500(f) of the Corporations Code to include references to Sections 31104, 31108, and 31109, because the fees reference therein apply to Sections 31104, 31108, and 31109 as well as 31101.

COMMENT 3: The commentor states that proposed Section 310.114.4(a)(3)(B) obligates a franchisor to keep records of its electronic delivery of disclosure documents but it does not specify the length of time or the acceptable format for record retention. The Franchise Law Committee recommends that the retention period be set at four years and retained in any format that creates a record that is capable of retention, retrieval, review and be rendered into a clearly legible tangible form.

RESPONSE: The Department has decided not to adopt the change requested. Section 310.114.4(a)(3)(B) simply applies existing retention requirements to disclosure documents delivered electronically. The length of time necessary for retention, and the format of these documents is a business decision that each franchisor must make, consistent with law.

COMMENT 4: The commentor states that the term "return email" as used in proposed Section 310.114.4(c) as proof of delivery that a franchisor delivered a franchise disclosure document by electronic delivery is not clear. E-mails may be filtered out as spam or deleted as junk mail without being opened. The Franchise Law Committee recommends an electronic or written confirmation showing that the recipient opened the e-mail containing the disclosure document.

RESPONSE: The Department has decided to adopt the change requested by clarifying in Section 310.114.4(c) that a reply e-mail from the recipient, *or another form of written confirmation of receipt from the prospective franchisee*, may be used to satisfy the requirements of Section 31109.1.

However, we are not modifying the rule to allow an opened e-mail to satisfy the requirement of confirmation of the franchisee's receipt. Simply showing that the e-mail was opened does not definitely demonstrate that the attached disclosure document was received. For example, spam mail can inadvertently be opened and deleted without the recipient reading or even being aware of its contents. A reply e-mail from the recipient, or another form of written confirmation of receipt from the franchisee is required in order to ensure delivery of disclosures to the franchisee.

COMMENTOR: E-mail and facsimile dated February 7, 2005, from Lee J. Plave, DLA Piper Rudnick Gray Cary US LLP, on behalf of the International Franchise Association, with a letter signed by John Gay.

COMMENT 1: The commentor states that the provision in proposed Section 310.114.4(a) requiring a franchisor to advise the franchisee of the formats in which the disclosure document is available prior to furnishing a disclosure document is not necessary; and recommends the term "before furnishing" be changed to read "before or concurrent with furnishing" as a more efficient and effective electronic disclosure.

RESPONSE: The Department has decided not to adopt the change requested, because the franchisee must be made aware of the formats in which he or she may receive the disclosure document prior to actually receiving the document. Primarily, this is to ensure that the format used to deliver the document is one in which the franchisee can readily access and save the document.

Simultaneously stating the format choices with the disclosure may not satisfy the disclosure delivery requirements. For example, if the disclosure document is e-mailed to a prospective franchisee as an attachment, the franchisee may reply that he or she received the e-mail. The franchisee may be unable to actually open the attachment or open all of the attachment in the form sent by the franchisor.

As the regulation is currently written, prospective franchisees have the opportunity to choose the format in which they may store, retrieve and print the document, prior to actually receiving any disclosure. When a franchisee is given the option to choose how to receive the disclosure document, there is an increased likelihood that the franchisee will be able to review the franchisor's offering circular, thereby fulfilling the disclosure requirements.

Rather than adopting the requested changes, we will clarify that the formats and their prerequisites and conditions must be provided before furnishing the disclosure document or making it accessible to the prospective franchisee. This change will clarify the franchisor's ability to provide the information simultaneously so long as the prospective franchisee has complete access to the disclosures after being advised of the formats and their prerequisites and conditions.

COMMENT 2: The commentor states that the provision in Section 310.114.4(a)(3)(A) requiring proof of electronic delivery of the disclosure to the franchisee is redundant and an unnecessary requirement. The International Franchise Association states that California Corporations Code Sections 31119(a) and 31150 are sufficient to accomplish both paper and electronic disclosure. Accordingly, the proof of delivery requirement should be eliminated from the final regulation.

RESPONSE: The Department has decided not to adopt the change requested. Corporations Code Section 31150 requires the franchisor to keep books and records of sales, as specified; it does not expressly specify proof of delivery or disclosure requirements. Section 31119(a) states that the offering circular and related documents must be provided to prospective franchisees. However, Section 31119(a) does not expressly address electronic delivery of documents, where actions such as accidental deletion occur in the blink of an eye and often occur without the recipient's knowledge concerning the contents of the delivery or even its subject matter. For example, an automatic spam or bulk mail command could move an e-mail to a franchisee, containing a disclosure document, into a junk mail folder, which might then be automatically deleted, without the franchisee even being aware of it. However, it is much less likely that a large offering circular package, for example, delivered via certified US Mail, would simply be thrown away without the recipient's knowledge. Consequently, Section 310.114.4(a)(3)(A), which requires proof of electronic delivery of the disclosure to the franchisee, is necessary and not redundant.

Finally, we note that the proposed rule is consistent with NASAA's guideline.

COMMENT 3: The International Franchise Association states that treating electronic disclosure differently than paper disclosure is inconsistent with the Electronic Signatures in Global and National Commerce Act. This Act preempts states from issuing regulations proposed in Section 310.114.4(a)(3)(A).

RESPONSE: The Department has decided not to adopt the change requested. The Department has broad authority to enact regulations to carry out the disclosure requirements of the law. Furthermore, the regulations proposed in Section 310.114.4(a)(3)(A) do not treat electronic disclosure differently than paper disclosure. For both paper and electronic disclosures, the law requires potential franchisees to receive pertinent information prior to entering into binding agreements relating to franchising. Corporations Code Section 31109.1, for example, requires that the franchisor actually receive the disclosure documents. If the franchisor cannot show that the document was received by the proposed franchisee electronically, then the franchisor cannot demonstrate compliance with Section 31119. For example, showing that an e-mail was delivered to an e-mail inbox, without the franchisee being aware of receiving it, does not ensure disclosure as required by law. The franchisee must receive the disclosure document, whether it is in paper format or electronic format. There is no differential treatment under the law between the two formats.

COMMENT 4: The commentator states that requiring a franchisor to keep records of its electronic delivery of disclosure documents and make those records available, on demand to the Department of Corporations, is not needed. Franchisors are already required to make records available pursuant to California Corporations Code Section 31401. The International Franchise Association states that Section 310.114.4(a)(3)(B) imposes different requirements to franchisors that provide disclosure by electronic means and is not necessary.

RESPONSE: The Department has decided not to adopt the change requested, because electronic delivery of disclosure documents was not contemplated under Corporations Code Section 31401. Consequently, it is necessary to specifically address these types of records. Section 310.114.4(a)(3)(B) specifies the retention requirements of electronic delivery of disclosure documents.

Furthermore, Section 31401 addresses investigations, discovery, subpoenas and related matters. Section 310.114.4(a)(3)(B), however, allows the Department to verify compliance via review of the franchisor's delivery records without having to instigate an investigation or take enforcement action against the franchisor to do so. The requirements of Section 310.114.4(a)(3)(B) are necessary in order to ensure that electronic delivery disclosure documents are handled appropriately, and that the purpose of disclosure is fulfilled.

Moreover, we note the proposed rules is consistent with NASSA's guideline.

COMMENT 5: The commentator states that Section 310.114.4(c) requires proof of delivery and includes a list of means by which proof of delivery may be demonstrated.

The International Franchise Association would like the regulation to make clear that the list is provided merely for the purpose of illustrating the possible means by which to prove that disclosure was given.

RESPONSE: The Department has decided to adopt the change to the extent that it will clarify in Section 310.114.4(c) that a reply e-mail from the recipient, *or another form of written confirmation of receipt from the prospective franchisee*, may be used to satisfy the requirements of Section 31119. The Department will not state that that "the list is provided merely for the purpose of illustrating the possible means by which to prove that disclosure was given", because this is unnecessary.

#### COMMENTS RECEIVED DURING THE 15-DAY COMMENT PERIOD

No public comments were received during the 15-day public comment period, which ended on November 3, 2005.



## ADDENDUM TO FINAL STATEMENT OF REASONS

The following information is hereby incorporated into the Final Statement of Reasons (FSRs):

### Data Relied Upon

The NASAA Statement of Policy Regarding Electronic Delivery of Franchise Disclosure Documents ("NASAA Statement of Policy") and the Federal Trade Commission Proposed Revised FTC Franchise Rule ("FTC Proposed Revised Rule"), these two documents described in the Initial Statement of Reasons are data relied upon in the adoption of Section 310.114.4.

### Changes to Final Adopted Text

Minor, non-substantive changes were made to the amended proposed text for clarity and for consistency with Corporations Code section 31109.1(a)(2)(A).

### Statement Regarding Comment Period for Amended Proposed Text

The Department of Corporations calculation of the 15-day comment period was only 13 days but, in the opinion of Corporations Counsel, no one was prejudiced thereby:

1. There were only two commenters (Business Law Section of the California State Bar; International Franchise Association).
2. The Department of Corporations adequately responded to all comments raised by the letters submitted by these two groups, and made appropriate revisions to the proposed text based on its response to the comments.
3. The two commenters are highly sophisticated in understanding the Franchise Investment Law and Title 10, California Code of Regulations and apparently had no further comments during the 13-day comment period.
4. Aside from enforcing the letter of the law, nothing constructive would be accomplished by requiring an additional 15-day comment period to resolve this issue.

### Additional Statements, Response to Comments

In response to Comment 1, page 4 of the FSRs, the reference to "sophisticated franchisee" exemption is a term of art used by some persons in the franchising industry to describe the exemption. (E.g., the Corporations Code section 31101 exemption is commonly referred to as the "large franchisor" exemption.)

In response to Comment 3, page 7 of the FSRs, there is no federal pre-emption issue in the opinion of Corporations Counsel.