FRANCHISE COUNCIL OF AUSTRALIA

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Submission to Franchising Taskforce Regulatory Impact Statement

The Franchise Council of Australia (FCA) welcomes the opportunity to provide comment on the Franchising Taskforce (the Taskforce) Regulatory Impact Statement. In preparing its response to the RIS, the FCA consulted widely with a range of members and member groups, including the FCA Franchisee Advisory Committee, Chief Executive Syndicate groups, and state chapter committees.

The FCA is the peak sector body for franchising in Australia, representing over 500 member brands, covering an estimated 35,000 plus franchisees who have right of access to FCA services, information and advice through their franchise system's membership, in addition to the opportunity to contribute to the development of FCA policy and advocacy including the preparation of this submission.

The FCA has constructively contributed to previous opportunities to provide input to the Taskforce process, including establishing the state of the sector, its employment and economic figures, and existing regulatory framework. The FCA is transparent and open about its operations, including listing its member brands on its website, and board director's member company brand and qualifications.

As the final milestone in engaging input to its stakeholder engagement, the RIS presents an important opportunity to take an evidence-based analysis of how different proposals would positively or negatively impact on the sector, and how these outcomes would more broadly affect Australia's economy and employment.

RIS principles

The FCA notes the six principles as set out early in the RIS paper, and acknowledges they essentially represent a distillation of the issues raised by the Joint Parliamentary Inquiry (JPI), and of the various viewpoints provided to the Taskforce as part of its consultation process. Accordingly, although comments can be made concerning these Principles, there is little point in debating them. The FCA does however, provide the following general feedback on the Principles:

- There are a wide variety of franchise models, with varying degrees of business interdependence and control and differing fee structures. Many of the proposed reform options fail to properly consider all types of franchise models and fee structures. The current framework was the subject of very recent comprehensive expert review and the benefits of the 2015 changes have not yet fully been realized.

- Recent ACCC guidelines on specific expectations concerning marketing fund disclosure, and enforcement action against a franchisor (Ultratune) where conduct did not meet Franchising

Code requirements, are welcome. Similar ACCC action in other areas of concern is likely to yield similar outcomes, without the need for further legislation.

- Legislation must find a balance, not try to regulate every aspect of a fluid business relationship.

- There is little justification for new laws given many identified issues would be a breach of existing laws, or be capable of being addressed via increased regulatory oversight.

- Government funding for awareness and education should form part of any reform initiative, as lack of franchisee understanding seems to be an apparent root cause of many issues.

- The impact of challenging economic conditions, anti-competitive and unfair conduct by major shopping centre landlords, energy costs, penalty wage rates in small business and increased on-line and general competition have a far greater impact on franchisor and franchisee profitability than any franchisor / franchisee issue. The FCA favours a separate, economy wide national code to address on commercial leasing arrangements.

- There has been some discussion on harmonizing the franchising and oil codes. The FCA believes the terminations provisions in special circumstances in the franchising code should be aligned with those in the oil code. Any proposed amendments to the oil code should be addressed separately to the current review of the franchising code. The FCA does not support a repeal of the oil code.

Disclosure

- A disclosure document that complies with the Franchising Code specifications already provides an extensive amount of information concerning the franchisor, all establishment and operating costs of the franchise, contact information for all current and former franchisees and key franchising issues. There is already a significant compliance cost in producing and updating the disclosure document, so considerable caution should be exercised before imposing additional obligations.

- A prospective franchisee must take some responsibility for undertaking their own investigations, including reading the information provided and obtaining legal and financial advice. Other elements of due diligence, such as speaking to existing franchisees and simple internet searches, can be undertaken with minimal effort and cost.

- Advice is important to get the most out of information provided. Excessive simplification of disclosure documentation will reduce the quality of information provided, and encourage even fewer franchisees to obtain advice. It is naïve to think a franchisee can make an informed decision on a complex business purchase without obtaining advice.

- Franchisors cannot be expected to provide tailored financial information for every individual franchise transaction, or “all information” a franchisee may require. This often would not be possible, and even if possible the compliance burden would be prohibitive. Part of the due diligence obligation must rest with the franchisee as part of fair risk sharing, particularly as franchisees often have superior local market knowledge.

- Where an existing franchised business is sold actual historic trading information should be provided unless for some compelling reason it is not possible to do so. There is an opportunity to consider how this can be better facilitated by the sector or under the Code.

- There is support for an inexpensive industry based registry to better ensure base level Franchising Code compliance and provide better data concerning sector performance, trends and demographics. Disclosure documents and franchise agreements must be kept confidential and not able to be publicly accessed. The ACCC is seen as having a conflict of interest in running a registry, but could use registry information very effectively in enforcement role to act more proactively. (For example checking if disclosure documents have been updated by the due date, and sending a form of "please explain" letter to franchise systems that may not have complied.)

Advice / Cooling Off

- It is rare to receive a complaint concerning the shortness of cooling off or disclosure timeframes. The far bigger concern is franchisees not reading documentation and not seeking advice at all.

- Although the franchise sector now accepts and works with cooling off arrangements, a good case could be made for the cooling off provision to be removed. Further extension of cooling off arrangements will cause more problems to franchisors, franchisees, financiers and other third parties than it solves.

- The insertion of some sort of a proviso linking cooling off to signing formal lease documents creates unnecessary confusion, and would make finance arrangements unworkable.

Supply Chain

- Although there is conceptual support for improvements to protect against abuses, the general view is that current arrangements (with enhanced ACCC monitoring and enforcement activity) strike a fair balance and it would be very difficult to take further legislative action without substantial risk of unintended consequences that would disadvantage franchise systems and ultimately harm the competitive advantage of franchisees:-
    - Current arrangements already include disclosure of rebates and incentives;
    - Exposure drafts of previous reforms to the Franchising Code in this areas were withdrawn when specific examples were provided to show they were unworkable;
    - Freedom from exploitation is already provided by good faith obligation and prohibitions on unconscionable conduct;
    - The fundamental alignment between franchisor and franchisee revolves around mutual business success, which cannot occur if conflicts of interest are not managed.

- There are many different supply chain arrangements. A "one-size-fits-all" legislative solution would be extremely challenging to draft let alone implement. There are many different types of rebates and supply chain payments paid for different reasons, including payments or rebates:-
    - made by suppliers to facilitate the establishment of the supply chain;
    - as consideration for services provided by the franchisor in supply chain coordination;
    - based on the volume of total network purchases from a supplier or of a product;
    - as incentives for individual stores or areas;
    - for promotional purposes or to fund specific marketing activities;
    - for prompt or early payment of supplier invoices;
    - for accounting or payment services rendered by the franchisor;
    - for quality assurance, inspection, testing or other services rendered by the franchisor

- Prohibition of rebates where a franchisor sets maximum prices ignores the complexity of rebates and incentives. At a policy level it also contradicts the desire to offer the best prices to consumers and prevent some franchisees from inflating the sale price to consumers.

- Concerns expressed to the Franchising Inquiry on this issue were isolated, and there does not appear to be any evidence of a widespread problem justifying legislative intervention.

Maximum pricing is rarely imposed, but recommending maximum prices gives consumers clarity and helps ensure franchisees do not charge excessive prices in local markets.

- Anecdotal information on alleged abuses in supply chain arrangements is often emotive and frequently inaccurate, as it is important "to compare apples with apples". For example a complaint that a franchisee can purchase soft drink on special at a supermarket at a lower price than it is supplied to a franchisee ignores:-
    - Delivery being in to store at a convenient time for franchisees to receive it;
    - The supply chain needs to meet requirements of all franchisees in the network, not just one store;
    - Time cost of a franchisee travelling to and from supermarket;
    - Credit terms provided by suppliers;
    - Different sizes of products and mix, and how this integrates into store refrigeration and display requirements;
    - Supply chain integrity under food handling laws and quality assurance requirements, including refrigeration;

- It is vital for franchisees that supplier arrangements are kept confidential so that franchisors are able to secure the best deals for their system. Similarly it is a team game, and to enjoy the best terms franchisees must commit to their approved suppliers.

- Supply chain efficiency is not only related to price, but must also take into consideration other factors such as quality, safety, logistics and delivery reliability.

- The critical issue for franchisees is not whether rebates exist, but whether the supply price to the franchisee is fair market value and competitive. This should be the focus of any regulation, and indeed is within the scope of both good faith and unconscionable conduct.

Capital Expenditure / Unilateral Variation

- Modifying the Code to define significant capital expenditure and provide legislative rights for franchisees to recoup the value of significant capital expenditure would be a regulatory overreach into the market and would have a substantial impact on a number of businesses. For example food retail, which is already struggling across the economy in franchised and non-franchised systems to adapt and respond to changing consumer demands and trends. Franchisors need to retain the ability to be nimble enough their system to pivot investment strategies and priorities to keep pace with current and emerging consumer demands, or quickly become redundant in their business model. The current Code provisions require franchisors to anticipate and disclose anticipated capital expenditure, and prohibit a franchisor from requiring a franchisee to undertake significant capital expenditure unless it has been disclosed, agreed, required by law or objectively justified.

- Unilateral variation of agreements is already covered in legislation dealing with unfair contract terms, and should not be included or repeated in the Code. There is no reason to single out franchise systems.

- Franchise systems need the ability to introduce unilateral variations to contracts, especially where the system has long term contracts in place. Inability to change and innovate is the biggest threat to any business, and changes to the law would inhibit or prevent franchisors from keeping pace with innovation and could make their entire operating system and brand redundant.

- Some franchise models, such as those in financial services, constantly have new products and services, and need to be able to introduce unilateral variations.

Dispute resolution

- The current mediation based framework works well, is low cost and has been remarkably successful. Nothing should be done to undermine the effectiveness of the current framework. In Australia, mediation has an over 80% success rate.

- The option of conciliation may be appropriate in some cases where a more directive input from the facilitator is required to achieve an outcome. Arbitration is universally opposed by franchisors, franchisees and experienced advisors. It would detract from the mediation based framework, and would be less certain and potentially just as costly as the court process.

- The court system works quite efficiently, particularly when supported by enhanced ACCC intervention and support of franchisee complainants.

FCA analysis and member feedback

Principle 1

Principle 1: Prospective franchisees should be able to make reasonable assessments of the value (including costs, obligations, benefits and risks) of a franchise before entering into a contract with a franchisor

- Option 1: No change to the current status quo. Argument is that last changes were only introduced to code in 2015 and have had insufficient time for effects to be fully felt, noting average franchise agreement is 5 years.

- Option 2: Electronic and hard copy disclosure. Franchisors would be required to provide disclosure documentation in electronic form. Feedback is that statements would be more likely to be read in that format.

- Option 3: Separate information statement. Under this option it would be made clear the information statement should be provided as a separate document to the rest of the disclosure material.

Summary of Feedback

A disclosure document that complies with the Franchising Code specifications already provides an extensive amount of information concerning the franchisor, all establishment and operating costs of the franchise and key franchising issues. Concerns with reform options include the following:-

- There is already a significant compliance cost in producing and updating the disclosure document, so considerable caution should be exercised before imposing additional obligations.

- There are a wide variety of franchise models, with varying degrees of business interdependence and control and differing fee structures. Any reform options would need to consider all types of franchise models and fee structures. In many cases the franchisor does not have further additional information it could safely provide.

- How does franchisor avoid liability under Australian Consumer Law misleading or deceptive conduct if required to provide turnover or profit projections, particularly as revenue and profit are substantially impacted by franchisee factors such as business skills, aptitude for business, work ethic, customer service skills, rostering and cost management?

- A prospective franchisee must take some responsibility for undertaking their own investigations, including reading the information provided and obtaining legal and financial advice. Other elements of due diligence, such as speaking to existing franchisees and simple internet searches, can be undertaken with minimal effort and cost.

- Advice is important to get the most out of information provided. Excessive simplification of disclosure documentation will reduce the quality of information provided, and encourage even fewer franchisees to obtain advice.

- The ACCC has recently issued specific guidelines on its expectations concerning marketing fund disclosure, and taken enforcement action against a franchisor (Ultratune) where conduct did not meet Franchising Code requirements. As a consequence all franchisors are on notice of higher compliance expectations and are responding accordingly. Similar ACCC action in other areas of concern is likely to yield similar outcomes, without the need for further legislation.

- Franchisors cannot be expected to provide tailored financial information for every individual franchise transaction, or "all information" a franchisee may require. This often would not be possible, and even if possible compliance burden would be prohibitive. Part of the due diligence obligation must rest with the franchisee as part of fair risk sharing, particularly as franchisees often have superior local market knowledge.

- Comments concerning the size and complexity of disclosure documents tend to overstate the problem, as size is caused by annexures not substantive content of the disclosure document. There are opportunities for improvement, but this is better handled calmly by industry working groups of franchisors and franchisees, not through further urgent legislative change.

- Electronic disclosure can enhance efficiency, but there are also opportunities for abuse. Key is informed franchisee decision making. Electronic disclosure should not be mandated or prohibited. Some feel franchisees should be entitled to insist on non-electronic disclosure if they wish.

- Code already seems crystal clear that Information Statement should be provided separately to the disclosure document, but if further clarification is felt to be warranted then no objections.

<u>Other Feedback</u>

Option 1.1.2 – increased and formal financial disclosure. A seller of an existing franchised business would be required to provide greater level of financial information.

There is widespread concern with franchisors being potentially held responsible for information provided by franchisees to other franchisees. The franchisor should not be made responsible for financial information provided by the seller unless the seller is the franchisor.

There is also concern in selling new territories where no prior business exists, as finding a "comparable franchisee" for the purpose of financial information disclosure would be challenging. Financial services franchisors give the example of franchise operating costs varying substantially due to factors including, but not limited to, franchise location, size of premise, number of employees, mix of business sources (self-generated vs referrer network).

As a result, in selling franchise territories (new or existing), operating expenditure would be very difficult to estimate due to differences in how incoming franchisees would want to structure and resource their businesses.

There is a general view that where an existing franchised business is sold actual historic trading information should be provided by the seller unless for some compelling reason it is not possible to do so. For franchisor to franchisee sales this can be managed by the franchisor as seller relatively simply. Sales from franchisee to franchisee are more challenging, as responsibility should sit with the seller franchisee, not the franchisor. Often the franchisor will not have direct access to the seller franchisee's financial information. It may be better and easier to require disclosure of available historic sales and trading information rather than prescribing that copy BAS statements must be provided.

The FCA would seek clarification on what kind of information – for example not breaching commercial in-confidence. Similarly feedback is that franchisees should be expected to seek this information as part of their own due diligence obligations, and cannot expect to pass all obligations to the seller when similar rules do not apply to the sale of non-franchised businesses. Again a franchisee should fairly be expected to obtain legal and financial advice as part of such an important decision.

The Franchising Code already contains provisions dealing with existing site and territory disclosure, so there is some uncertainty as to the full nature of the problem. Also, in some instances such as greenfields sites, information may not be available. Franchisor should not be liable for information where the information is provided by a seller of a business who is not the franchisor – ie seller is a franchisee. Franchisee to franchisee sales are a concern, as franchisor is often not aware of nature or extent of disclosure of prior trading information.

Currently the Australian Consumer Law prohibition on misleading or deceptive conduct, and the reverse onus of proof in relation to statements made as to a future matter (eg: forecast revenue) means franchisors are rarely comfortable to provide estimates of future revenue. If making revenue projections could be made exempt from misleading conduct action, this would lead to better quality of information being provided. Currently there is too great a risk on franchisors trying to estimate revenue, as they have to prove they have reasonable grounds if they do so.

Option 1.1.2 – provision of the ACCC's franchisee manual to prospective franchisees when they provide the disclosure document.

No major objections, though some skepticism of the utility and ACCC franchisee manual would need to be updated to ensure it is current, and is in simple and plain terms (not legalistic language). The FCA Franchisee Manual has recently been updated, addresses a broader range of issues and could be used in addition or as an alternative.

Option 1.1.2 leasing disclosure. This would mean franchisors have to provide more information about the nature of a leasing arrangement associated with a franchise business.

While the FCA is pleased that the taskforce has identified leasing as a burden and mitigating factor of hardship on businesses that was not addressed by the parliamentary inquiry, it still does not address the root cause. It is landlords that possess a power imbalance, and arbitrarily change the costs and terms of a leasing arrangement that a franchisor often has no power to dispute. The franchisor can only provide the franchisee with the information available to them at that particular time, and may not be able to foresee arbitrary changes to those terms. A better way to address the current power imbalance experienced by both franchisees and franchisors on unfair commercial leasing arrangements would be the introduction of a national code for commercial leasing.

Option 1.1.3 simplified disclosure requirements. This would mean that franchisors need to provide all information that is materially relevant to a franchisee to assess the franchise business in a concise disclosure document.

Franchisors are only obliged to provide specific information thoughtfully considered by the current Code disclosure requirements, not "all information". This would tip the balance too far in franchisor disclosure, particularly as many franchisors do not have "all information". Franchisees should fairly be expected to make their own inquiries before making a substantial business investment decision. The disclosure document supports this process, including by providing contact details for current and former franchisees as well as details of all establishment and operating costs.

Although simplification has conceptual appeal, most feedback is that the current disclosure information is useful and manageable for franchisors to provide. The preferred approach is to provide educational materials to assist franchisees to conduct their due diligence using the material provided.

Feedback is that disclosure documents are very lengthy, some over 300 pages, and that franchisees may not read through all of the information. Counter to that is that it may be dangerous to take out information which is still important in order to make an informed decision. This is where expert business and legal advice is important.

Problem 1.2 – concerns as to the reliability of information provided to prospective franchisees.

- Option 1.2.1 – status quo. Franchisors would still need to provide detailed disclosure document, maintain the document, and update it within four months after end of FY.

- Option 1.2.2 a) – franchisors required to verify financial information and introduce a national franchise registry. Government would require franchisors to verify financial statements. It would also establish a national franchise register. Statement would include 'to the best of the franchisors knowledge'.

- Option 1.2.2 b) – national franchise registry.

- Option 1.2.2. c) – third party brokers. Franchisors would be prohibited from including 'no agent' and 'entire agreement' clauses in franchise agreements so as to avoid any responsibility for representations made by third party brokers acting for the franchisor.

- Option 1.2.3 – pre-entry education.

<u>Summary of Feedback</u>

- Surveys show franchisees that seek advice are happy with quality and quantity of disclosure. Disclosure document information is a starting point for due diligence, not a comprehensive list of all relevant information. Franchisors are already banned from making false or misleading representations by the ACL. Other problem is that franchisors don't always possess or have access to all information.

- ACCC enforcement action requiring provision of more meaningful information re marketing funds has been successful and could be broadened to other types of information. Current laws appear to provide ample protection if enforced.

- Some franchisor feedback notes that financial information provided by franchisees can also be an issue, with asset values and capacity to fund the business overstated. Legislation must find a balance, not try to regulate every aspect of a fluid business relationship.

- As noted in comments above concerning problem 1.1.2, where an existing franchised business is sold actual historic trading information should be provided unless for some compelling reason it is not possible to do so. For franchisor to franchisee sales this can be managed by the franchisor as seller relatively simply. Sales from franchisee to franchisee are more challenging, as responsibility should sit with the seller franchisee. State legislation concerning the sale of small businesses (such as s52 of the Victorian Estate Agents Act) also applies to these transactions, so care needs to be taken to avoid any legislative duplication.

- Franchisors are concerned about any requirement to "verify" financial information unless that also enables franchisors to state without liability that information is "unverified". Franchisors are rarely in a position to underwrite the accuracy of the franchisee's data, and indeed often do not actually know what information has been provided by one franchisee to another.

- Support for an inexpensive industry based registry to better ensure base level Franchising Code compliance in order to provide better academic understanding about sector trends and demographics. Support to allow prospective franchisees to compare systems before making a commitment to a particular brand. ACCC seen as having a conflict of interest in running a registry, but could use information very effectively in enforcement role to act more proactively.

- No major objections but feedback is that brokers generally behave appropriately, and are usually used only in the early phases of advertising and screening. So objections are hard to understand given franchisors are ultimately liable for their agents. Lawyers query whether "no agent" or "entire agreement" clauses mentioned would actually protect a franchisor.

- Strong support for additional resources in education, including FCA proposals regarding enhanced education of legal and financial advisers and efforts to reduce cost of legal and financial advice to franchisees. FCA has advocated that franchisors who compel their franchisees to undertake pre-entry education have fewer instances of disputes in the franchise system. There are several free training courses already available to franchisees and supported by ACCC. Therefore would not lead to onerous financial obligations on franchisees. Proposed website may assist here, with FCA able to provide valuable content including the Franchisee's Guide. Government funding for education should form part of any reform initiative.

Problem 1.3 – Potential franchisee might be unaware of which information is crucial to inform their decision to enter an agreement.

- Option 1.3.1 – status quo, parties continue to access pre-entry education and generic advice.

- Option 1.3.2 – new government online educational resource. Proposed website would include bringing together existing information and educational material relevant to conducting due diligence to start a franchise business. Dispute resolution and general rights and obligations of parties in sector included. Different stages of franchise relationship ie due diligence. Different languages available. Business and financial literacy skills training. FCA supportive.

- Option 1.3.3 – mandate all prospective franchisees to receive legal and financial advice before entering into an agreement. FCA supportive under certain circumstances – first time not seasoned franchisees and financial threshold of $60,000 or more. This was not a recommendation in the parliamentary inquiry report and the FCA considers this good progress for the taskforce to have now identified the value of pre advice for franchisees.

General feedback is that it is hard to accept this as a fair justification for increasing franchisor disclosure obligations, noting the comprehensive Franchising Code disclosure process already includes:-

1. Provision of the Information Statement, which contains clear warnings and offers direction for obtaining further information;

2. The mandatory detailed statement on page 1 of every disclosure document;

3. The extensive amount of information concerning the franchisor, the franchise, contact details of current and former franchisees and all establishment and operating costs that needs to be included in the disclosure document; and

4. The clear recommendations for prospective franchisees to obtain legal and financial advice, and the obvious benefits that doing so would deliver.

To the extent that there is any "lack of awareness" by franchisees it must fairly be as a consequence of lack of general understanding of franchising, which is more effectively addressed via education than imposing additional disclosure obligations on the franchisor. Arguably the sort of information that is most "crucial" to a prospective franchisee is the information that relates to the need to obtain legal and financial advice.

A website may assist provided it is properly promoted so prospective franchisees know it exists. This is a challenge, as prospective franchisees are hard to locate. This resource requires an ongoing commitment to Government funding, probably in the order of $1m per annum. Promotion would need to involve paid advertisements in all locations where prospective franchisees were active, such as franchise expos, franchising directories, business opportunity listings and so forth.

Feedback on additional Taskforce questions:

1. What are the critical pieces of information that should be contained in a summary document?

There is not strong support for a summary document, as valuable information would be omitted and all information has a purpose. There is more support for more flexible disclosure, rather than the currently highly prescriptive framework that does not suit all franchise systems. The general view is that disclosure should be viewed in the context of the advice framework, and the utility of the detail to advisors who can assist a prospective franchisee, not in isolation. It is naive to think most prospective franchisees should be able to make an informed business decision without legal and financial advice.

Feedback to the FCA from business advisers is that a list containing contact details of past and present franchisees is the most important piece of information, as it enables a prospective franchisee (and its advisors) at no cost to gain direct insight into the specific franchise. Almost every piece of information contained in the disclosure document has some relevance, and different things may be more relevant to some franchisees than others.

There is strong industry support for mandating legal and financial advice, and for developing mechanisms such as guides, checklists and other materials to simplify the advice process and reduce the potential cost to franchisees.

The market is also developing its own mechanisms to assist, with objective Franchise Ratings now becoming available and plans to possibly establish independent document vetting and franchise system audits. The market for prospective franchisees is highly competitive, and there is a significant shortage of quality candidates.

2. If a national franchise register is established, what information should it contain? What would be the benefits and costs of a national franchise registry?

There are significant and widespread concerns in relation to confidentiality of information, so any registry must safeguard the confidentiality of the disclosure document information and franchise agreement content. Proposals for all disclosure documents to be public documents freely available to all via a registry are not supported by most franchisors.

There are also concerns re ACCC conflict if it were to run a registry, and the ACCC is understandably not keen to be involved at that granular level in franchise sector oversight. Same applies to the ASBFEO.

There is significant concern at the likely cost of any Government run initiative. There is also no appetite for a levy on franchisors or franchisees to fund a Government registry, which presumably would cost many millions of dollars to establish and operate and have significant flow on impacts to franchisors and franchisees.

There is support for the current Australian Franchise Registry, which is independently operated and makes updating of disclosure documents a pre-requisite of registration, but is otherwise simple, low cost and publicly searchable. The registry does not have universal support and is not a panacea for all enforcement woes, and does not involve vetting of documentation or verification of franchise systems. However it does encourage compliance due to the updating pre-condition, and could easily be used by ACCC to better take proactive compliance monitoring and light touch enforcement, such as in relation to failure to update disclosure documentation. In the US and elsewhere an industry run franchise registry has made a substantial contribution to the operation of the franchise sector.

3. There are a number of existing educational resources on franchising. What additional education options for prospective franchisees should be made available? If there was an online educational resource which brought together the available franchising education options, what would its costs and befits be?

It is widely considered that better education is the key to better franchisee decision making, and better franchisor performance. The key problem with franchisee educational activities is the difficulty of finding the prospective franchisees to whom it would prove most valuable. Government commitment to ongoing awareness funding is a vital of improved education and information provision.

The FCA could put together a comprehensive franchisee education program based on its Franchisee Guide, which is already now in electronic format. The FCA also has developed the Franchising Standards and Guidelines as its contribution to franchise sector education.

The sector can fund the development, provision and delivery of relevant content, the key is awareness, which can really only be enhanced by an appropriate Government funding commitment of perhaps $1m per annum.

Principle 2

Principle 2: Franchisees should have time to consider whether the relationship is right for them before committing to an agreement.

- Option 2.1.1: Status quo, with clarification of the operation of existing cooling off requirements in the franchising code. No change, but clarification that cooling off and disclosure periods are

measured in calendar days and that the 14 day disclosure period must begin at least 14 days before the signing of a franchise agreement.

- Option 2.1.2: Extend cooling off to 14 days and modify the circumstances which trigger the commencement of cooling off period. This would extend 7 days to 14 for the franchisee. The FCA is concerned that this would introduce additional elements of uncertainty and costs.

- Option 2.1.3: Extend the disclosure period to 21 days with ability to waive all or part with written agreement from both parties. This would apply to new agreements. While some submissions have said this would provide more time for franchisees to undertake due diligence, it mistakes the intent of this period of time with the cooling off period, which is where due diligence and pre advice should be taking place.

Summary of Feedback

General feedback is that franchisee decision making process seems to be poorly understood. Usually it takes 3-6 months from time of first franchisee interest in a franchise to the time of signing of franchise documentation, and rarely do franchisee complain about time frames. Indeed it is more common that franchisees, once they have made their investment decision, wish to abridge the formal Code timeframes. The FCA has never received a complaint concerning the shortness of timeframes. The far bigger concern is franchisees not reading documentation and not seeking advice at all.

The Code already provides 7 days for cooling off. That is separate to the 14 day disclosure period which operates before an agreement is entered into, renewed or extended. In practice the final franchise documents are typically sent to the franchisee, who then signs when they are ready to do so. Prior to 1998 there were legitimate concerns about high pressure sales techniques where franchisees signed franchise agreements at franchise sales exhibitions and events. This cannot occur under the Code.

There are added concerns with Taskforce options to address the issue raised in paragraph 2.2. The insertion of some sort of a proviso linking cooling off to signing formal lease documents creates unnecessary confusion, and would make finance arrangements unworkable. How would financiers know when to hand over funds?

Australia is the only country in the world to have a cooling off period inserted into its franchising legislation. Cooling off periods are common in some consumer transactions where goods may have been purchased without thinking or via door-to-door sales or some pressure sales process. In those cases goods can essentially be handed back fairly simply for a refund. It is much more complex to try and hand back a business, particularly when there are financiers, landlords and suppliers also involved. Although the franchise sector now accepts and works with cooling off arrangements, a good case could be made for the cooling off provision to be removed. Further extension of cooling off arrangements will cause more problems to franchisors, franchisees, financiers and other third parties than it solves.

Lease arrangements are complex and can take a lengthy amount of time to negotiate. Rent is typically set by the landlord, with the franchisor often having minimal bargaining power. If a franchisor signs on for a head lease, and then the franchisee elects to “cool off”, all risk is shifted to franchisor, which often does not have the resources or ability to operate the business from the premises. Feedback from franchisors is they are not prepared to accept this additional risk, and franchisees feel the issue is not of significant concern to them or could be managed in other ways.

Other Feedback

Option 2.2.3 - Provide a new cooling off period of seven days where lease terms are 10 per cent above maximum estimates provided in disclosure documents, so franchisees have the right to reassess their agreement if leasing terms vary significantly from estimates provided in the disclosure documentation.

The FCA may be supportive of this amendment as long as the franchisor does not wear all of the risk. This option may be better suited to industry guidelines rather than legislation.

Option 2.2.4: Improve education and awareness around leasing and franchising.

FCA supports this measure, as long as it is developed in conjunction with a national code of conduct that introduces reform to commercial leasing arrangements and a more level playing field which is currently tipped way too far in favour of landlords.

Options to address problem 2.3: Cooling off rights in transfers, extensions and renewals are unclear.

Option 2.3.1: Status quo is the preferred option. Feedback is that there is no material concern amongst franchisors or franchisees or advisors on this issue, which seems to be well understood in practice.

Option 2.3.2 extending cooling off to transfers, extensions and renewals is unworkable (including for financiers, suppliers and landlords) and would increase investment uncertainty and costs for franchisors and franchisees. Cooling off should only apply to the first investment decision, not other decisions well down the track. Option 2.3.3 of extending the cooling off to transfers only would have the same result and potentially harm existing franchisees by presenting a new level of business uncertainty.

Taskforce Questions:

1. What are the practical implications (costs and benefits) for prospective franchisees and franchisors of increasing cooling off or disclosure periods?

This is likely to add unnecessary delay and uncertainty, and increase the challenges associated with finalizing third party arrangements with landlords, financiers and suppliers. Cooling off already poses issues in terms of franchisees undertaking training and being ready to commence operations. See more detailed comments above concerning this question, and the potential adverse consequences.

2. How easy is it for franchisors to provide reasonable estimates of leasing costs before they are finalized?

Certainly a good indication can be provided, and usually is. The Code already requires a copy of the lease to be provided with disclosure, or as soon as it is made available to the franchisor. However finalization of the actual rent and lease terms and signing the lease is largely out of the franchisor's control. The franchisor and franchisee are trying to coordinate commencement of the franchise with approval for finance, completion of outfitting and equipping of premises, coordination of supply, satisfactory completion of training and in some cases exit of the franchisee from a prior business or employment. Cooling off and formal disclosure periods are already challenging to manage, so additional complications and delays should be avoided if possible.

3. How often are leasing arrangements finalized after the cooling off period expires? What are the implications of having the cooling off period commerce after a lease is finalized?

Principle 3

Principle 3. Each part to a franchise agreement should be able to certify the other party is meeting its obligations and is generating value for both parties.

Problem 3.1: Marketing funds are not always transparent.

- Option 3.1.1: Retain the status quo, noting there are already quite extensive requirements in the Franchising Code introduced as part of the 2015 Code reforms.
- Option 3.1.2: Address inconsistency in the code on the treatment of marketing funds and increase reporting standards.
- Option 3.1.2 a): Improve consistency within the franchising code about the treatment of marketing funds, particularly clauses 15 and 31.
- Option 3.1.2 b): Introduce civil pecuniary penalties for a breach of clause 31.
- Option 3.1.2 c) Increase the frequency and standards of reporting of marketing funds.
- Option 3.1.2 d): require master franchisors to meet requirements of marketing funds. The FCA supports measures to enforce existing compliance obligations.
- Option 3.1.2 e): Clarify the distribution of marketing funds int eh event of franchisor insolvency. The FCA would support greater clarity of marketing statement compliance obligations, without imposing such rigidity that would stifle innovation.
- Option 3.1.3 Increase awareness and provide guidance around existing legal obligations: The FCA is supportive of increasing resources to provide better and more accessible information to franchisees so that they can understand how a system operates from the outset.

Summary of Feedback

- This is an area where the quality of disclosure has improved, and could further improve. Things have improved since recent ACCC attention to the issue.
- There is general support for the status quo, as it has proven to be effective and with a continuation of ongoing ACCC oversight and enforcement action will improve transparency and address all legitimate concerns:-
    - The Code was amended in 2015 to impose additional obligations on franchisors, including to provide "sufficient details of the funds receipts and expenses so as to give meaningful information about sources of income … and items of expenditure…"
    - The ACCC recently has taken significant educational and enforcement action that leaves franchisors in little doubt of regulatory expectations. This oversight is important and should continue, and indeed demonstrates that the current law works well when enforced and no further legislative change is needed.
- There is no support for increasing the number of audits for marketing statements each year. This would be unworkable given the requirement for an independent audit. Even if possible, it would quadruple current auditing costs, which are borne by the marketing fund, and thereby disadvantage franchisees as well as franchisors.
- Feedback from franchisees is that they do not often read the marketing statement audit for information, or to provide feedback upon. It is seen more as a good governance requirement;

- Additional audits will not address any compliance or transparency concerns;

- The compliance cost would be prohibitive - one mid-sized franchisor provided feedback that this would add around $160,000 in audit and administrative costs alone;

- The substantial penalties awarded in the Ultra Tune case indicate that current penalties appear to be adequate. However there is minimal objection to including in the Code a specific penalty for breach of clause 31 of the Code.

Questions:

4. What would 'meaningful information' look like in terms of marketing fund disclosure?

This question has essentially been answered by ACCC guidance, and the recent court decision in ACCC v Ultra Tune Australia Pty Ltd.

There is an opportunity for the FCA and the ACCC to produce more specific guidance, including template statements, as part of the FCA's Franchising Standards and Guidelines project.

5. How does the benefit of increased frequency of reporting of marketing funds compare to the costs of increased administration?

The administrative cost would be excessive and totally disproportionate to any minimal benefits, for the reasons noted above.

Principle 4

Principle 4. A healthy franchising model fosters mutually beneficial cooperation between the franchisor and the franchisee, with shared risk and reward, free from exploitation and conflicts of interest.

Problem 4.1 Supplier rebates can lead to conflicts of interest.

- Option 4.1.1: status quo

- Option 4.1.2 Address conflicts of interest in the handling of supplier rebates to franchisors by requiring increased disclosure:

- Option 4.1.3 Prohibition of supplier rebates in circumstances where franchisor specifies maximum franchisee sale prices:

Problem 4.2 conflicts of interest in the context of capital expenditure.

- Option 4.2.1 Status quo: The FCA would support greater transparency to address conflicts of interest.

- Option 4.2.2: Modify the code to define significant capital expenditure and provide rights for franchisees to recoup the value of significant capital expenditure:

- Option 4.2.3 Clarify franchisee rights when significant capital expenditure is required: The FCA would be supportive of greater information and clarify on franchisee rights from the outset.

Summary of Feedback

- Although there is conceptual support for improvements to protect against abuses, the general view is current arrangements (with enhanced ACCC monitoring and enforcement activity) strike a fair balance and it would be very difficult to take further legislative action without substantial risk of unintended consequences that would disadvantage franchise systems and ultimately harm the competitive advantage of franchisees:-
    - Current arrangements already include disclosure of rebates and incentives;
    - Exposure drafts of previous reforms to the Franchising Code in this areas were withdrawn when specific examples were provided to show they were unworkable;
    - Freedom from exploitation is already provided by good faith obligation and prohibitions on unconscionable conduct;
    - The fundamental alignment between franchisor and franchisee revolves around mutual business success, which cannot occur if conflicts of interest are not managed.

- This is a very complex area with many different supply chain arrangements. For example some franchise systems rely solely on supply chain revenue and charge no royalties. Another franchise system noted they have over 20 different types of supply chain incentives, all of which are calculated differently. A legislative solution would be extremely challenging to draft let alone implement. For some franchisors organisation of the supply chain is one of their primary obligations, and requires significant resources. Prohibition of supplier rebates in any circumstances is opposed. Prohibition of rebates where a franchisor sets maximum prices contradicts the desire to offer the best prices to consumers and prevent some franchisees from inflating the sale price to consumers.

- Anecdotal information on alleged abuses in supply chain arrangements is often emotive and frequently inaccurate, as it is important "to compare apples with apples". For example a complaint that a franchisee can purchase soft drink on special at a supermarket at a lower price than supplied to a franchisee ignores:-
    - Delivery being in to store at a convenient time for franchisees to receive it;
    - Supply chain needs to meet requirements of all franchisees in the network, not just one store;
    - Time cost of a franchisee travelling to and from supermarket;
    - Credit terms provided by suppliers;
    - Different sizes of products and mix, and how this integrates into store refrigeration and display requirements;
    - Supply chain integrity under food handling laws and quality assurance requirements, including refrigeration;

- It is vital for franchisees that supplier arrangements are kept confidential so that franchisors are able to secure the best deals for their system. Similarly it is a team game, and to enjoy the best terms franchisees must commit to their approved suppliers.

- Supply chain efficiency is not only related to price, but must also take into consideration other factors such as quality, safety, logistics and delivery reliability.

- The critical issue for franchisees is not whether rebates exist, but whether the supply price to the franchisee is fair market value and competitive.

- Lawyers advise that prohibitions on rebates and third party payments would probably be easily circumvented by direct invoicing by the franchisor.

- Modifying the Code to define significant capital expenditure and provide rights for franchisees to recoup the value of significant capital expenditure would have a substantial impact on a number of businesses, particularly in food retail which is already struggling across the economy in franchised and non-franchised systems to adapt and respond to changing consumer demands and trends. Franchisors need to retain the ability to be nimble enough their system to pivot investment strategies and priorities to keep pace with current and emerging consumer demands, or quickly become redundant in their business model.

Problem 4.3 Unilateral variations can lead to conflicts of interest and exploitation.

- Option 4.3.1 Status quo.
- Option 4.3.2 Banning or limiting the circumstances in which franchisors can unilaterally vary franchise agreements.
- Option 4.3.3 Increase awareness around legal rights: The FCA would be supportive of efforts to assist franchisees understand unilateral variation to contracts. This could be incorporated in the due diligence and business education priorities identified in other parts of this RIS.

Summary of Feedback

- Unilateral variation of agreements is already covered in legislation dealing with unfair contract terms, and should not be included or repeated in the Code. There is no reason to single out franchise systems.
- Franchise systems need the ability to introduce unilateral variations to contracts, especially where the system has long term contracts in place. Examples such as food safety and handling laws, menu innovation, technology changes, wage compliance obligations and emerging new laws on issues like modern slavery mean that without this ability, a franchise system may start to operate outside the law if it was not able to unilaterally vary some of their operating systems.
- Some franchise models, such as those in financial services, constantly have new products and services, and need to be able to introduce unilateral variations.
- A small number of franchise systems have perpetual agreements, so the right to amend them is vital.
- Members felt the universally supported option of maintaining the status quo (option 4.3.1) where franchisee interests are safeguarded by laws prohibiting unfair contract terms could be enhanced by increasing awareness around legal rights (option 4.3.3)
- Specifying under what circumstances variations may occur assumes it is possible to foresee all future technology or regulatory changes or competitive challenges that will necessitate change. Inability to change and innovate is the biggest threat to any business, and changes to the law would inhibit or prevent franchisors from keeping pace with innovation and could make their entire operating system and brand redundant.

- Financial services franchise systems were particularly strident in rejecting this solution. They gave specific recent examples where a prohibition on unilateral variations would have prevented them from making changes to operations manuals required to enforce compliance with new laws and regulations. They commented as follows:-

Being unable to do so could potentially affect our alibility to meet financial services licensing obligations. By way of example, we have had to implement substantial changes in quick succession in recent years to comply with new laws and regulations such as ASIC's Responsible Lending obligations, APRA's macro prudential measures for home lending and AFCA determinations. Significant changes were required to be implemented to franchisee sales processes and procedures, and we would not have been able to implement these changes without making unilateral variations to the operations manual. Some of these changes would not have been possible if we were required to obtain majority support from franchisees

- For most franchise systems the ability to introduce and remove products and services is required to adapt to changing market conditions, meet customers' evolving expectations, and compete effectively for new customers. These changes are typically enacted through changes to the Operations Manual and its associated collateral. Changes to regulated financial products require specialist knowledge across multiple disciplines e.g. Product, Credit Risk, Compliance etc. It would be unreasonable to expect every franchisee to possess this specialist knowledge.
  The prohibition of unilateral variations to Operations Manuals without obtaining majority franchisee support would risk substantially slowing down a franchisor's ability to respond to market changes, to the detriment of the customer and potentially the franchisee.

Questions:

6. What information should franchisors disclose in relation to supplier rebates? Are there any barriers to this?

This needs to be considered on a franchise by franchise basis. Past draft efforts to move beyond current disclosure obligations have been withdrawn when consequences were properly analyzed. The need to maintain supplier confidentiality, avoid disadvantaging franchised businesses compared to non-franchised businesses and the administrative and compliance burden of additional disclosure in this complex area further mitigate against this proposal.

7. If franchisors are required to ensure franchisees get a return on their significant capital expenditure, how might this be done in practice?

Some form of legislative solution would destroy franchising as a free market exercise and would see businesses turn away from franchising. There are currently no guarantees on financial return, or indeed business success, just like there are no caps on franchisee profitability or business goodwill.
Disclosure and advice provides franchisees with the capacity to assess the investment opportunity, and to compare it with others. There are already additional Code requirements in clause 30 concerning capital expenditure.

As with other issues, improved education, and increasing the number of franchisees who obtain legal and financial advice, is the best option.

The FCA Guidelines can also provide additional guidance to franchisors and franchisees as to how to manage change.

8. If franchisees are given a right to review capital expenditure business cases (which must be presented to franchisees by the franchisor under clause 30(2)(e) of the Franchising Code for

expenditure that the franchisor considers necessary for capital investment), how would this right be exercised?

This is challenging given:-

- Discussions and decisions often need to take place in strict confidence, as otherwise competitors can become aware of them and react to them;
- Majority view of franchisees would need to be able to bind all franchisees given the need for consistency;
- The real issue is not the capital expenditure, but the marketplace change that has given rise to the need for such capital expenditure; and
- Not investing is often likely to have serious consequences.

The practical reality is that franchisors cannot implement network change without the support of franchisees. There was little support for any change to the current law, with the automotive sector perhaps being an exception.

This could add significantly to compliance cost and reduce flexibility to respond to a rapidly changing business environment. Unconscionable conduct seems to cover this issue, in that requiring a large capital expenditure if there was no demonstrable return on investment would be unconscionable.

The Franchising Guidelines can provide guidance on how to best manage change and capital investment decisions in franchise networks.

Conclusion

The FCA acknowledges there are serious challenges in franchising that need to be addressed appropriately. A strong emphasis on upholding the law through enforcement of existing compliance obligations by the ACCC must be a key priority. The FCA has previously signaled it would be supportive of an increase in penalties being introduced if the ACCC believes this would assist in its enforcement role. Better education and due diligence, and an improvement to dispute resolution are also key.

The FCA remains concerned about a number of factors presenting to the Australian economy. Margin compression, unfair commercial leasing arrangements, industrial relations, energy prices, digital disruption and reduced profitability are also significantly challenging franchise businesses. The introduction of draconian regulation, especially in the current economic climate, would have adverse consequences on a sector that employs nearly 600,000 Australians, and contributes $184 billion to the economy every year.

The FCA would be pleased to speak further to any of the above points. Please contact the [Redacted] via [Redacted] for further information.

Yours sincerely

Mary Aldred
Chief Executive Officer