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*Re:* Comments on NASAA Proposed Commentary on  
Financial Performance Representations

Dear Mr. Cantone and Mr. Staley:

1. Introduction.

This letter provides comments on the Proposed Commentary on Financial Performance Representations.

2. Overall Comment

Because the proposed commentary is intended to be NASAA comments, rather than legislation or rulemaking, it should be presented as commentary and thus generally should not be in absolute form. Absolute statements such as “no” and “must not” should be avoided in favor of statements to the effect that NASAA believes franchisors “generally should not” or “most often should not, in the absence of a good reason to the contrary.” This is because the questions and answers cannot consider every possible situation and scenario. The comments may be largely or generally applicable, but there can be circumstances where the absolutes in the comments would not apply. This will be demonstrated by some of the further comments in this letter, below.

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3. Comment on Question 19.1.

The proposed prohibition of including operating expenses as a percentage of a stated level of revenue, and characterizing that as a financial performance representation, is an over-extension of the regulation of Financial Performance Representations, into disclosures of cost information. Many franchisors establish fees that are a percentage of revenue. Franchisors often establish the following fees as a percentage of revenues:

- royalty for use of the franchisor's system;
- contribution to a common national or regional advertising fund;
- contribution to a regional or local cooperative fund;
- required expenditure by the franchisee for advertising in the franchisee's locality

The Item 7 table requires a franchisor to provide an estimate of the franchisee's expenses for a reasonable start-up period of time, usually 3 months. The table requires the franchisor to provide these estimates in the form of a high-low range of dollar amounts. Where the franchisor establishes charges as a percentage of revenue, the franchisor is still required to provide dollar estimates.

However the estimates in the table of costs or expenses, are not intended to be representations of how much a franchisee can or will earn. They are estimates of how much money a franchisee is likely to expend. It is even more apparent that they are not revenue estimates when it is considered that these estimates are only for a start up period of an initial few months.

Therefore, these estimates of costs should not be considered to be representations of performance. And NASAA should not extend the regulation of Financial Performance Representations into regulation of disclosure of cost estimates which impact franchisor's ability to accurately provide full disclosure in Item 7.

If NASAA maintains the proposed comment, then NASAA needs to avoid an internal conflict in its regulation and include guidance how a franchisor may complete the Item 7 table consistent with commentary 19.1.

4. Comment on Question 19.4.

Comment 19.4 overlooks numerous possibilities where it may be appropriate for a franchisor to disclose gross sales data of company-owned outlets alone. Here are four examples:

- (i) A company has operated company-owned outlets for many years and has a substantial number of company owned outlets. The company treated each outlet as an independent accounting entity, tracking that outlet's revenues and expenses.

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Now after many years the company decides to offer franchises. In its initial FDD it includes an FPR. During its first year of offering franchises it sells a small number of franchises. Under the commentary in this factual scenario the company would have to remove its FPR after selling one franchise that has been operational for more than one year. That would be unfortunate because it would deprive prospective franchisees of valuable information.

- (ii) A company has operated a business for many years. Over those many years it has offered franchises in a separate line of business that the company was not engaged in. For example, a company that operates its own company-owned chain offering and selling one product; and has a franchise system offering and selling a different product. Now the company decides to offer franchises that will offer the same product as the company has sold from its company owned locations. Under the commentary, in this factual scenario the company would not be permitted to offer an FPR on gross sales from company-owned outlets because it also has franchisees. That would be unfortunate because it would deprive franchisees of valuable information.
- (iii) A company charges franchisees only flat fee royalties and flat fee advertising fees and no percentage royalties. The company does not require its franchisees to report sales information. The company also operates its own company-owned locations. Therefore the company does not know the sales or results of its franchisees. But the company does know the results of its own company owned locations. Under the commentary in this factual scenario the company would not be permitted to offer an FPR on gross sales from company-owned outlets because it also has franchisees. That would be unfortunate because it would deprive franchisees of valuable information.
- (iv) A company that has operated company owned locations for many years, acquires a third party franchise system. The company does not know or may not have confidence in the reported sales data of the acquired system. But it does know the results of its own company owned locations. Under the commentary in this factual scenario the company would not be permitted to offer an FPR on gross sales from company-owned outlets because it also has franchisees. That would be unfortunate because it would deprive franchisees of valuable information.

The above is not every possible scenario in which a company with both company owned locations and franchised locations, should be able to present FPR on just company owned locations.

Therefore the commentary should not be stated in terms of absolute prohibitions, but should be phrased to indicate that generally NASAA believes there would not be a reasonable

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basis, but the commentary should permit exceptions when a franchisor may have a reasonable basis in circumstances that NASAA has not considered or cannot now foresee.

5. Conclusion

NASAA cannot foresee every possibility. The commentary should state general principles but not absolutes and should respect and permit franchisors more room and flexibility to establish reasonable bases for information that is provided, consistent with the FTC Rule requirements.

Very truly yours,

LEWITT, HACKMAN, SHAPIRO,  
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By:



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