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VIA EMAIL/PDF

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NASAA Legal Department
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Re: Notice of Request for Comments Regarding a Proposed Franchise Commentary on Financial Performance Representations ("Notice of Request")

Dear Messrs. Cantone and Staley:

On behalf of the Franchise and Distribution Practice Group at DLA Piper LLP (US), I am submitting the following comments in response to the referenced Notice of Request. While we acknowledge and appreciate the NASAA Franchise and Business Opportunity Project Group's ("Franchise Project Group") avowed purpose and substantial effort to answer "frequently asked questions" about how franchisors can make a Financial Performance Representation ("FPR") under federal and state franchise disclosure guidelines, we are concerned that the substance of the proposed franchise commentary (the "Commentary"), as currently drafted, leaves certain FPR issues unresolved and creates new issues that very well may stymie the delivery of relevant, reliable financial performance information to prospective franchisees. Indeed, we believe the Commentary reverses the trend in franchise regulation over the past 20-plus years to encourage earnings claims/financial performance representations—where the franchisor always has borne the burden of proof that its Item 19 had a reasonable basis—by imposing unnecessary limitations. We therefore suggest that the Franchise Project Group refine certain portions of the Commentary in light of the comments appearing below. We present our comments in order based on the Commentary's presentation.

1. **Effective Date**:

The Commentary's effective date is the later of 180 days after the date of NASAA's adoption or 120 days after a franchisor's next fiscal year end. As it appears that the Commentary's effective date will occur sometime in late 2015 or later, this would mean that franchisors with December 2015 fiscal year ends (as well as franchisors whose fiscal years end in September, October, and November 2015 and whose franchise disclosure documents therefore are scheduled for updating in January, February, and March 2016) need not comply with the Commentary until they prepare their 2017 franchise disclosure documents. Please confirm that interpretation.

Similarly, please confirm that franchisors need not modify their Item 19s if they amend their franchise disclosure documents, due to a material change, before the next scheduled annual update.

2. **Definitions**:

(a) **Company-Owned Outlets**. The definition appears to confirm that substantially similar businesses franchised by the franchisor or its affiliates under another brand—and thus disclosable in Item 20—need not also be included within Item 19.

(b) **Gross Sales**. Must the definition of Gross Sales appear in Item 19 if it already is defined in Item 6?

(c) **Operational Franchises**. Please confirm that the definition of Operational Franchises as franchises that have been fully operational for at least one full year is not intended to preclude a franchisor from including within Item 19 the Gross Sales or other results of franchises operating for less than one full year, regardless of the length of their operations, if the franchisor determines that information otherwise is accurate, relevant, and reasonable. (While this interpretation is implied by Q&A 19.16, confirmation is preferable to avoid uncertainty.)

(d) **Net Profit**. The definition of Net Profit is incorrect. It really identifies EBITDA (but for including depreciation). The definition is inconsistent with the term's usage in Q&A 19.9. While the inconsistency might not be material because the Commentary permits the franchisor to vary the expenses deducted from gross profit as long as it identifies the deductions, the Commentary's explanation of the term should be consistent throughout all Q&As. For even further clarification, the Commentary should expressly allow a franchisor to disclose EBITDA as long as it explains what the term means.

3. **Q&A 19.2**:

This Q&A does not address the situation where a franchisor's sample "pro forma" is not completely blank but includes categories of cost with corresponding figures as a percentage of sales. Because cost information as a percentage of sales remains governed by Item 19 (and presumably would be distinguished from the "cost information alone" referenced in this Q&A), a franchisor should be allowed to include a pro forma in its Item 19 in this limited situation. [Doing so would not give a franchisor the

right under the disclosure laws to prepare the pro forma for the prospective franchisee or otherwise communicate with the prospective franchisee regarding the pro forma in a manner that would contravene Item 19's requirements.]

If the pro forma with cost information as a percentage of sales is not allowed in Item 19, the Q&A should clarify that a franchisor may deliver the pro forma with such cost information included, without having to include the pro forma in the Item 19, as long as the cost information is described in Item 19 in compliance with its requirements.

4. **Q&A 19.6**:

The concept of "adjustment" should be clarified. Clause (b) in the first paragraph of the answer references "actual costs incurred by company-owned outlets that are adjusted to reflect potential material financial and operational differences between company-owned outlets and franchised outlets." The second paragraph of the answer more pointedly requires the franchisor to include "imputed" royalties, advertising fund contributions, other fees not paid by company-owned outlets, and other costs unique to franchised outlets.

"Adjusting" results to impute fees likely to be incurred by franchised outlets but not customarily incurred by company-owned outlets seems straightforward and ascertainable from the franchise agreement itself. However, what is the "adjustment" requirement if both company-owned outlets and franchised outlets incur the same costs but there are material differences in those costs? Furthermore, what if the costs of franchised outlets are actually less than the costs experienced by company-owned outlets? Inserting the latter numbers as adjustments would reflect higher net profit than what the company-owned outlets actually achieved.

The language in this Q&A, confirmed by language in Q&As 19.7 and 19.10, suggests that the franchisor should substitute its *actual*, provable company-owned outlet experience with *estimated*, not-completely-verifiable franchised outlet experience – is that really the intent? If that is the intent, would that not transform the actual historical financial performance representation into some type of projection? Would it be clearer and more accurate, and potentially less misleading, to retain the company-owned outlet information as actually incurred (*i.e.*, an actual historical FPR) and then produce a *separate* presentation (if not incorporated in *separate* line-items within the primary representation) showing the "adjusted" numbers assuming the estimated franchised outlet information was used in the calculation? Such a presentation would be much clearer to, and better understood and evaluated by, the prospective franchisee reviewing it.

5. **Q&A 19.7**:

The prohibition in this Q&A denies the prospective franchisee access to the most important information desired by the franchisee at the nascent stages of a franchise program. A franchisor should be able to provide gross profit or net profit information of its company-owned outlets if the franchisor has no reason to believe a franchisee's actual experiences should be materially different and, in accordance with Q&A

19.6, includes the imputed fees not paid by company-owned outlets, as described in the franchise agreement and franchise disclosure document. There really is no substantive basis for allowing gross sales-only financial performance information for company-owned outlets under Q&A 19.5 but not gross profit or net profit information with the same caveats.

A related concern is the unreliability and unpredictability of the franchisee's cost data available to the franchisor, other than for the imputed fees not paid by company-owned outlets as described in the franchise agreement and franchise disclosure document. Why should a single operational franchisee's or a few operational franchisees' experiences, which in the franchisor's reasonable opinion may be completely aberrational and unique, be the lynchpin for providing gross profit or net profit information that the franchisor otherwise believes is reasonable, relevant, and replicable by compliant franchisees based on its own (or its affiliates') operational experience (perhaps with tens or hundreds of units)? And when is the franchisor deemed to have sufficiently *reliable* cost information from its franchisees to provide the types of adjustments called for in Q&A 19.6? And, as noted in the preceding Q&A, what if the costs of a single franchised outlet or only a few franchised outlets are actually less than the costs experienced by multiple company-owned outlets?

Moreover, this absolute prohibition may force franchisors to provide more information *outside* Item 19. A franchisor may furnish cost information to prospective franchisees if stated in dollars or as a percentage of total costs and not as a percentage of sales. Franchisors therefore already may lawfully provide virtually all of the cost information that, combined with the gross sales or net sales furnished pursuant to Q&A 19.5, would enable a franchisee to determine some variation of net profit. Is it not better for the franchisee to have this type of information presented within an Item 19, where it will be accompanied by other required disclosures and explanations, rather than "off-the-books"?

Lastly, Q&A 19.7 disadvantages new franchisors vis-à-vis established franchisors by prohibiting them from disclosing the detailed financial performance of their company-owned outlets, while concurrently denying prospective franchisees access to essential information they want to receive from franchisors and should be entitled to receive from franchisors with the appropriate explanations.

6. **<u>Q&A 19.8</u>**:

If a franchisor separately discloses average franchisee gross sales and average company-owned gross sales and now also must disclose the median gross sales number, is there still a requirement to disclose separately the number and percentage of franchised and company-owned outlets exceeding their respective averages? Must franchised and company-owned outlet performance be measured against system-wide outlet performance if the franchisor chooses also to merge performance information?

In addition, this Q&A implies that if the identity of franchisee(s) is discernable given the small number of franchisees, but the gross sales of franchised and company-owned outlets *are* materially different (however that is measured), the franchisor must choose between providing the information only in segregated fashion (allowing the franchisee(s) to be identified) or not making an FPR at all. That result seems unduly restrictive. There should be other options for addressing that situation.

7. **Q&A 19.10**:

The directions in this answer confirm the uncertainty created by Q&A 19.6. They refer to the franchisor "adjusting actual cost data in an FPR." The franchisor should not adjust *any* actual cost data. Actual cost data for company-owned locations should be presented as actual cost data. If the franchisor has actual franchisee cost data it knows to be different, including for imputed fees like royalties, that information should be presented separately. It should not be used to modify an actual profit and loss presentation.

8. **Q&A 19.12**:

This Q&A focuses on situations where a franchisor prepares an FPR based *solely* on the performance of a subset of a franchisor's best performing outlets. May one conclude, therefore, that a franchisor presenting *system-wide* average and median performance information may also present a particular subset of higher-performing outlets without having to present the corresponding subset of lower-performing outlets? Because system-wide average and median performance information is presented, the prospective franchisee always will have a system-wide performance benchmark against which to measure the results of the higher-performing outlets also provided in Item 19 and is not likely to be misled. There is no reason to prohibit the presentation of accurate, provable financial information in this context (especially since a franchisor already may provide such information in a "supplemental" FPR).

Not allowing such a presentation also presents unique problems in franchise systems with extended ramp-up periods (for example hotels). As long as the franchisor discloses the basis for the subset of stabilized units and it is generally applicable, there should be no reason to include the corresponding lower-performing outlets.

9. **Q&A 19.13**:

What is the basis for determining that 10 outlets is the minimum number? What is the empirical data suggesting that nine or fewer outlets are not statistically significant?

Is this referring to 10 outlets in the aggregate or 10 company-owned outlets and 10 Operational Franchises?

10. **Q&A 19.15**:

Despite the prohibition in Q&A 19.17 of presenting subsets of performance reflecting a material number of "outliers," Q&A 19.15 seems to anticipate and permit presentations including outliers given the new requirement to include the median number. In other words, if the franchisor is presenting system-wide information—and, separately, substantially all company-owned outlet and franchised outlet information— and not limited subsets, there is no need to exclude outliers. Please clarify. Also, there is no definition for the term "outliers."

Does the new obligation to include "median" numbers impact the required disclaimer for "media claims" under the FTC Rule?

Thank you very much for your consideration of these comments.

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Very truly yours,

DLA PIPER LLP (US)

Stuart Hershman