RESPONSE TO REQUEST FOR COMMENTS REGARDING A PROPOSED FRANCHISE COMMENTARY ON FINANCIAL PERFORMANCE REPRESENTATIONS

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Submitted jointly by:

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Commentary 19.6 permits a franchisor with operational franchisees to disclose gross profit or net profit, provided that the franchisor adjusts its results (and explains the adjustments) to reflect franchisee costs. Although not listed in Commentary 19.6, Commentary 19.7 states that these adjustments "must be based on data from franchised outlets, or at least on franchisee experience."

Response: We believe section 19.6 is skewed towards a substantial, mature franchise system with a detailed knowledge of its franchisees' operations, a substantial infrastructure and the human resources to dedicate to research, compilation and analysis of system data. As practitioners who generally represent smaller and mid-sized franchise systems, we observe that there are many franchisors that do not meet this profile and for which it will be difficult at best to make all of the adjustments seemingly required under this commentary.

By way of illustration, many franchisors of younger systems have not developed extensive supplier/distributor relationships. They may permit franchisees to source locally a variety of products (e.g. produce, dairy products, etc.) used in the operation of the franchise, requiring that the products meet certain standards and that the franchisor have an opportunity to approve the product and the supplier. The franchisor is unlikely in this scenario to know pricing structures or discount practices used by these franchisee-selected suppliers. But it is charged under the commentary to either attempt to collect and analyze cost information voluntarily provided by franchisees/suppliers or to forego making the FPR for lack of a reasonable basis on which to identify and make the required adjustments. The same level of effort is required merely to ascertain if differences in the franchisee cost experience are actually material.

Commentary 19.10 and Commentary 19.7 underscore this reading of Commentary 19.6. Commentary 19.10 assumes the availability of system data in properly instructing the franchisor to identify the source of its data. Commentary 19.7 sets forth the rationale for denying a franchisor without operational franchises the ability to make a FPR based on gross or net profit, seemingly concluding that a franchisor with franchisees has cost experience that a franchisor without franchisees does not. Again, many franchisors may have only anecdotal information about a variety of franchisee costs. Quantifying adjustments to franchisor data on that basis raises obvious and substantial risks. The prudent franchisor may simply forego the FPR rather than devote the resources required to collect and analyze the kind of hard data necessary to form a reasonable basis. The net effect of the commentary may well be a disincentive to what NASAA hopes to promote, which is the delivery of useful information to the prospect.

A more reasonable approach is to limit required adjustments to those that can be made with a higher degree of certainty, such as payments for royalties, ad fees and recurring payments to the franchisor or an affiliate, or more detailed adjustments for the systems which have access to such data either because of extensive control over suppliers or because of updated franchise agreements which require franchisees to turn over every item of cost data in annual reporting to the franchisor, a standard that does not exist today in the vast majority of franchise systems. The footnotes afford a franchisor an opportunity to explain why the franchisee may experience other differences. Based on our foregoing example, the franchisor might explain that franchisees typically source a variety of products locally and the franchisor does not know how and to what extent their actual costs may differ from the franchisor's. However, their costs may be higher because the franchisor typically negotiates a volume discount ranging from x to y percent below the market price. In that instance, the franchisee is well-served to speak to similarly situated franchisees or comparable business owners in the locale in which they wish to operate. The prospect's due diligence will act as a better barometer than the franchisor has to offer, and the franchisor's ability to provide the suggested information in its FPR will create a flag to draw this element of due diligence to the prospective franchisee's attention.

Lastly, in our experience prospective franchisees for the less mature franchise systems are not as likely to have the level of business sophistication found in prospects for the well-established industry leaders. The consequence of possibly discouraging younger and smaller franchisors from providing pertinent FPR's may be felt most strongly by those for whom a FPR could have the highest value. In contrast, the largest franchisors are among the most likely, under the FTC Rule and in many states, to be able to take advantage of exemptions that allow them to avoid providing an FDD entirely, either based on the size of the prospective franchisee's investment or the size and sophistication of either franchisor or franchisee. These sophisticated buyers are also the most qualified to conduct their own due diligence, while typical buyers in smaller systems may be the most in need of expense information as part of an FPR in order to meaningfully evaluate the opportunity.

Commentary 19.7 prohibits a franchisor with no operational franchises from disclosing gross profit or net profit information based on company-owned outlet data.

Response: We understand why NASAA has concluded that franchisee data is superior and may be more accurate for prospective franchisees. However, in the absence of franchisee data, we believe that it is better for prospective franchisees to have access to information about what a company-owned unit experiences in terms of expenses than to have no such disclosure.

Item 7 is not necessarily a very good predictor of the ongoing expenses an operating unit will experience once it emerges from the initial phase of operations. Many units experience growth over time which is accompanied by increased wage expenses, higher inventory costs, or maintenance expenses to keep the unit in good shape, which may not appear in Item 7. As a result, a "mature" operating unit experiences different expenses that may not be easy or possible to extrapolate from Item 7.

We recommend permitting a franchisor with no operational franchises but one or more operational company-owned units to disclose gross profit or net profit, provided that the franchisor complies with the modification steps described in Comment 19.6 (for expenses such as royalties, advertising contributions, purchases from the franchisor and other items which may be different from the franchisor's expenses) and the franchisor further issues an admonition, which might read, for example:

> The disclosed expenses are developed based on our experience in our own unit(s). We have shown the impact of routine costs you will pay to us [including royalties and advertising contributions], but you may experience different or higher expenses as a franchisee.

Commentary 19.20 prohibits the use of any admonition about the FPR other than the specific language provided in the Commentary.

Response: In general, we support this admonition and the reduction of lengthy disclaimers. However, as noted above, the Commentary assumes that franchisee expense data is more reliable than franchisor expense data, without exception. We are aware of some exceptions and suggest that NASAA's Commentary explicitly permit a footnote or other "admonition" by the franchisor in situations where the franchisor has reason to believe that franchisee expense data is not more reliable than franchisor information or requires an explanation to provide a fair representation.

Hypothetical #1:

- Particularly in California, wage and hour laws and classification rules are extremely complex. In the restaurant industry, many chefs and front of house "managers" do not meet the applicable test to be treated as exempt employees because they spend too much of their typical workday doing the work equivalent to other employees (preparing food, waiting tables, seating customers). However, these rules are poorly understood and it is less expensive to designate certain senior employees as exempt, so in some instances business owners do so.
- In the current political and legal environment, franchisors are hesitant to closely police or override the way that their franchisees are choosing to classify or pay employees.
- Even if several franchisees in a system have been sued for wage and hour claims, this litigation is not reportable by the franchisor in the FDD unless the franchisor is also sued, so it may be invisible to prospective franchisees.
- The result is that a franchisor may know that its franchisees' labor costs are lower than they should be. The franchisor's own labor costs may be a more accurate disclosure of what a prospect should budget.

  May the franchisor in this hypothetical present a footnote, a recommendation, or an "admonition" that the prospect should budget higher labor costs, without such language being a prohibited disclaimer?

Hypothetical #2:

- A system has only multi-unit operators, each benefitting from the cost savings created by owning multiple units. The franchisor identifies several small territories that can only accommodate a single unit and begins to sell those single units to franchisees.
- Alternatively, a system has only very large, highly experienced franchisees who own multiple brands and have access to discounts on certain purchases, but the franchisor begins selling to less sophisticated franchisees.

  May the franchisor in this hypothetical present a footnote or an "admonition" of any kind that the prospect's expenses may be higher than those illustrated? In relation to **Commentary 19.6**, must the franchisor use its existing franchisee data to modify its own gross profit or net profit disclosures, or may the franchisor factor in higher expenses based on research regarding what a single unit franchise owner is likely to experience?

Respectfully submitted,

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