

GUST ROSENFELD P.L.C.

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Via email.

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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 ("FPR Commentary")

Dear Mr. Cantone and Mr. Staley;

This letter states the comments of the Franchise Department of Gust Rosenfeld, PLC on the FPR Commentary. In general, we support the standardization of financial performance representations in Item 19 but we have the following comments and concerns:

1. **Definitions.** Could the definition of company-owned outlets include units owned directly or indirectly by an owner or officer of the franchisor? Such owner or officer might not have the majority control to be technically considered an affiliate. We represent several brands that classify such outlets as affiliate locations and other brands that classify such outlets as franchisee outlets. This issue could be clarified by adding the following sentence: "Company-owned outlets would typically not include outlets owned by an officer or owner of the franchisor if such outlets are operated under a franchise agreement and a payment structure that is similar to the structure imposed on franchisees. If, however, outlets owned by an officer or owner of the franchisor are operated under a different pay structure or management structure than franchisees, then those outlets could be listed a company-owned outlets. The basis for either determination should be reflected as a footnote to the applicable table of information.
2. **Question 19.1.** You state that cost information as a percentage of revenues may only be provided if it "complies with the requirements of Item 19." Do you mean that it may only be provided if the cost information as a percentage of sales is already included in

the franchisor's Item 19? This would be the most conservative interpretation. However, we have some clients that may argue that it means that a franchisor may provide the information on a statement outside of the FDD that contains all the disclosures and requirements of Item 19 as long as the underlying revenues on the statement are appropriately included in the FDD itself. A suggested clarification is: "only if expenses as a percentage of sales is included in Item 19 in full compliance with Item 19's requirements."

3. **Question 19.4.** Our clients would find this answer to be confusing and inconsistent with the answer to Question 19.5. To our clients, whether or not a franchisor has operational franchises should not determine whether the franchisor has a "reasonable basis" in presenting the historical information. To them, this information is either appropriate to present to franchisees or it is not appropriate. We suggest a revision to the answer in this section to clarify that the reason it is not appropriate is really that the franchisee information might be different. The answer could state: "No. A franchisor with operational franchises has no reasonable basis for making a gross sales FPR based on company-owned outlet data alone because operational franchisees' data is likely to not support the company-owned outlet data and if so, then presenting only the company-owned outlet data is potentially misleading to prospective franchisees. If the operational franchisee outlet information supports the company-owned outlet information, then it should be included in Item 19."
4. **Question 19.6.** Adjusting the company-owned outlet data for material operational differences from franchised outlets will be difficult and costly to implement if an adjustment for "costs unique to franchised outlets" is required. Indeed, this approach would lead franchisors to make financial projections instead of relying upon known historical data. This exposes franchisors to potential liability on the projections. This approach would also require a substantial investigation into the actual costs of all operational franchisees in order to distinguish and then project how those costs would apply from the known costs of company-owned outlets. Many of my clients would not undertake such an investigation of an outlet on a regular basis unless that outlet was failing. On the other hand, it would be fairly understandable and at least "doable" for our clients to adjust for royalties, advertising fund contributions and other known fees named in Items 5 and 6 that are not paid by the company-owned outlets. We suggest that the adjustment be limited to fees disclosed in the FDD. Otherwise, none of our clients would consider including a "net profit" FPR in its FDD. This would limit potentially helpful information for franchisees.
5. **Question 19.6.** Please state whether the "gross sales data from operational franchises" that must be included must be presented in a specific manner such as in a chart separate from the company-owned outlet information or in footnotes. Our concern is that one state examiner might require this information in a chart and another might require the information in a footnote or another manner. Suggested language could be "Gross sales data from operational franchises may be presented in a separate chart, in a footnote or in another manner in Item 19, as long as such presentation is not misleading."

6. **Question 19.8.** This commentary would permit a franchisor to merge the data of both types of outlets if the franchisor can “demonstrate” that the franchised and company-owned outlets have gross sales that are not materially different. Please clarify where and how the franchisor must make this demonstration. For example, must the franchisor have this information in its own records and available as supporting documentation for a franchisee or an examiner or is another method intended such as a separate letter to regulatory examiners? We suggest that the wording be changed to “... franchisor can substantiate in its own records that the franchised and company-owned outlets...”

7. **Question 19.12.** Our franchise practice also represents franchisees. We have seen Item 19 information that excludes revenue information from locations that are operating longer than a year but that are in default of the franchise agreement or are “not in compliance” with the franchisor’s operational standards. We recommend that this Commentary address whether such exclusions are permitted. We are concerned that permitting the exclusion of locations that are not in compliance is another way of presenting a subset of information on the best-performing outlets. We would recommend that this exclusion be prohibited. We can understand not including an outlet that is in default as that information may be not representative of the remaining franchisees but we still have some concerns with this approach.

8. **Questions 19.18 and 19.19.** Can the historical data used to make financial projections be only from company-owned outlets if the franchisor also has operational franchises? You state that the historical results must be from outlets substantially similar to the type of outlet offered in the FDD but the underlying source of the historical information is not stated. A suggested addition is: “The historical data used for financial projections must not be misleading. If a franchisor has both company-owned outlets and operational franchises, then information from only company-owned outlets may only be used for the financial projections if considering the historical information from operational franchisees as well would make the financial projections misleading.”

We appreciate the opportunity to comment and applaud any effort to standardize franchise disclosures.

Sincerely

/Christina M. Noyes/

Christina M. Noyes
For the Firm