Via email: dcantone@oag.state.md.us
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27 October 2015

Mr. Dale Cantone, Chair
Office of the Attorney General Division of Securities
200 St. Paul Place, 20th Floor
Baltimore, MD  21202-2020

Mr. Christopher Staley, Counsel
NASAA Legal Department
750 First Street NE, Suite 1140
Washington, DC  20002

Re: Notice Of Request For Comments Regarding A Proposed Franchise Commentary On Financial Performance Representations

Dear Mr. Cantone and Mr. Staley:

One of the more important elements of the Franchise Disclosure Document (FDD) is the election by franchisors to include an Item 19 Financial Performance Representation (FPR). It has been a benefit to prospective franchisees that since the beginning of the 2008 recession the trend has been for more franchisors to include an FPR. Prior to reviewing the proposed changes to the FPR disclosure I fully expected that trend to continue. However, instead of giving careful thought on how to accelerate this trend the regulators have taken a paternalistic view of potential franchisees that will significantly reduce information available to them.

It should be the role of regulators to ensure that potential franchisees have full-access to the information they need to evaluate their decision on whether or not to invest in a franchise opportunity. Instead, taking the position as they have, potential franchisees and their advisors will not have the ability to independently evaluate information potentially available to them. Regulators will instead use their regulatory authority to subordinate franchisor and potential franchisee’s interests in a belief that franchisees and their advisors can’t possibly have the capability to make their evaluations from a robust field of data. The regulators have ensured that prospective franchisees will now be able to receive only a portion of the information franchisors wish to disclose to them and most likely these proposed changes will reverse the beneficial trend toward greater disclosure. Instead of supporting the inclusion of robust information by franchisors to prospective franchisees these changes will instead reduce or eliminate many FPR disclosures by franchisors.

The FDD and included FPR are important. However they should not be construed as, nor should regulators assume, that they are the sole source of information on any franchise
opportunity. The FDD is merely a government-mandated disclosure of important and basic information on every franchise opportunity as provided by franchisors. The information provided should be as robust as possible and regulators should seek ways for franchisors to enhance the information provided, so long as the basis for the information is clearly disclosed. Unfortunately, I believe the proposed modifications to the FPR will reverse that trend and potential franchisees and franchisors will suffer because of it.

There apparently is a continuing belief in the myth, by regulators, of the potential franchisee being unprepared and lacking the capability to make an informed decision prior to choosing a franchise opportunity. However, this sentiment is unsupported by any recent study and even if once true it is not today based on my extensive experience in franchising. Information on franchise system performance is abundant and easily accessible in our information age. As provided for on the cover page of the FDD potential franchisees are advised to engage professional advisors and, in my experience most do, in support of their due diligence. Those that do not do so make that choice at their own peril. However, the majority of potential franchisees should not be denied important information as mandated by the proposed FPR revisions. The regulators apparent and unfounded belief that prospective franchisees and their advisors cannot make educated determinations based on potential information provided to them, even when the information is accurate, fully disclosed, relevant and potentially not available in the detail only a franchisor can provide. This proposed revision would be harmful to the interest of potential franchisees.

As an important disclosure element, and one that is voluntary for franchisors to make, the goal of regulators in this instance should be two fold:

1. To encourage franchisors to include some form of representative FPR in their disclosure document that will benefit a prospective franchisee; and,

2. To provide potential franchisees with the most meaningful, accurate and abundant set of data upon which to base their projected and localized financial performance.

While intending to improve the nature and quality of the information provided to potential franchisees the proposed changes will actually hamper a franchisor’s ability to properly represent their offering. As revised, the FPR will create uncertainty in the accuracy of the information; limit a potential franchisee access to important information they may find useful; create an environment for additional litigation in franchising; limit emerging franchisors ability to attract potential franchisee by hampering their marketability against larger more established franchisors; and will negatively impact the current trend of increased FPR disclosure by franchisors.

Limiting clearly defined and accurate FPR information, of any nature, that a franchisor chooses to disclose, denies potential franchisees the ability to consider relevant information that otherwise would not be available to them. Potential franchisees and their professional advisors should not be denied the ability to include or reject any FPR information franchisors choose to provide to them so long as the information is accurate and the basis of that information is properly disclosed. Only in franchising do regulators take a paternalistic view and assume that only they can determine what investors require for them to make important decisions. Regulators, in presenting these proposed change, show that in their opinion investors do not
have the ability to weigh the importance of information presented to them without their parental guidance. The proposed changes neither serve the interest of small or large potential franchisees nor does it serve the interest of emerging or established franchisors. It merely limits the dissemination of important information and in a meaningful and practical sense will be harmful to each of their interests.

There is much in the proposed revisions that I expect will be objectionable to the majority of professionals in franchising including those that advise potential franchisees. Rather than comment on each of the changes I find objectionable, I will limit my comments to those I feel are most damaging to the interests of potential franchisees and franchisors in general.

19.7 “Question: If a franchisor has no operational franchises can the franchisor make an FPR disclosing gross profit or net profit based on company-owned outlet data alone?”

“Answer: No. A franchisor with no operational franchises cannot make an FPR disclosing gross profit or net profit base on company-owned data alone.”

The logic of the difference between the explanation for allowing the disclosure of gross sales in 19.5 but denying the inclusion of cost information in 19.7 escapes me. Assuming that emerging franchisors cannot adequately assess and disclose any expected material variation in their operating costs and those of potential franchisees while assuming that those same differentials are absent in gross sales, given the potential that a franchisor may have been able to increase unit sales in a similar fashion by increasing local advertising, is illogical.

It must also be recognized that under the rule franchisors are allowed to provide to potential franchisees non-percentage cost information in a separate document. Denying a franchisor the ability to provide, in a proper format, material information on its unique operations while allowing a franchisor to disseminate additional non-disclosure information is a clear indication to me that regulators have a limited understanding of how potential franchisees make their determination or their belief in the capacity of potential franchisees and their advisors to determine potential economic performance. It supports my assertion in regulator’s belief that potential franchisees cannot make independent decisions without their assistance.

19.7 also states that franchisors with franchisees can “adjust its company-owned outlet cost data to reflect the costs that franchisees may incur”. As anyone who has made projections knows, even if the conditions for every assumption are true and the anticipated events occur as expected, the results may be different and those differences may still be material. There are simply too many variables including markets, locations, labor costs, real estate costs, market critical mass, management and staff capabilities that make any of the adjustments expected by regulators beneficial to either the franchisor or the potential franchisee. The adjusting of actual cost information by franchisors is as illogical as allowing franchisors to adjust their sales performance. These subjective determinations will result in unavoidable litigation should the assumptions made by the franchisor not be achieved by the franchisee, whatever the reason. It is far more preferable for a franchisor to disclose actual historic performance and simply disclose that the franchisee’s performance may vary, and why. If enacted as written, our firm will simply recommend to our clients that they not provide any cost information due to the potential litigation risk and the difficulty in presenting modified cost information that will be relevant to potential franchisees under varying market conditions.
Finally, 19.7 puts the emerging franchisor in a material disadvantage to established franchisors by prohibiting them from disclosing the financial performance of their company owned operations including their gross and net profits. This prohibition also denies the potential franchisee access to essential information that a franchisor may wish to make available to them and is only available from them.

It must be assumed that franchisees will seek comparable cost information. However franchise systems are not fungible. As required by 19.7 potential franchisees will be required to make their own financial performance projections based on information available elsewhere and that information may not be accurate or comparable to the franchisor’s unit performance. 19.7 in a practical sense compounds the problem that regulators are trying to avoid and will be detrimental to the interests of the potential franchisees they seek to paternalistically protect. It is alarming to me that regulators still hold the apparent belief that potential franchisees and their advisors can’t intelligently choose and localize from the information available to them.

19.18 “Question: Must forecasts (projections) be based on historical data?”

“Answer: Yes. Projections cannot be based on mere hypothetical situations or expectations. Historical results may be adjusted based on changes in the market (for example, when current rents are higher or lower than historic rents) but the projections still must be based on historical data.”

I am again at a loss to understand the regulator’s reasoning here. From their example, I must assume they believe that cost trends in material elements such as rent or labor are uniform throughout the United States and that it is not possible for costs to go up in some sections of the country while declining in others or simply saying the same elsewhere. There are variables in every market and regulators apparently do not comprehend this basic fact of business.

Projections are not generally used by franchisors in making an FPR, and my firm does not generally advise our clients to include them in disclosures. However, when they are included it is a requirement that the basis for the franchisor’s assumptions must be provided so that the reader can make an informed evaluation. So long as the basis for the included projections are disclosed it is irrelevant whether they are based on historic performance. This is an arbitrary and unproductive determination and serves no practical purpose.

New product and service additions, anticipated labor changes and other material performance expectations are not based solely on historic information. In the real world they rarely are and even should they be, historic performance with changes in management, economic conditions, market limitations, franchisee performance, competitive conditions can’t possibly be an accurate reflection of future events any more accurately than other determinants. Should a franchisor chose to provide beneficial information and discloses the basis for that projected information to prospective franchisees, the purpose of limiting that information to adjusted historic information makes little practical sense as it does not improve the accuracy of future performance.

MSA Worldwide has historically been a proponent of including a Financial Performance Representation in a franchisors disclosure document whenever practical and when we believe the information will be beneficial to the reader. We work with our clients to include FPRs
whenever possible. Where allowed, we are also proponents of the inclusion of initial period performance information, as we believe that this early performance information may be relevant to new franchisees in understanding their open period’s potential operating results. That option will now denied to franchisors and unavailable to the potential franchisee with the exception of their contacting and receiving that information from existing franchisees. That information can never be as robust as that provided by franchisors.

Personally I would hope in time that all franchisors would include an FPR. I also believe that requiring a mandatory FPR should be considered down the road, as the information included in a properly constructed FPR is important. However, as proposed, our advice to clients will likely change in many situations. The proposed limitations will limit a franchisor’s ability to provide to prospective franchisees significant and important information that they believe is material and relevant. Paternalistically, these proposed changes limit for prospective franchisee and their advisors, their choice on what information they should be allowed to evaluate. I would expect that other professional advisors would also have similar reservations to my own.

If adopted I would anticipate that fewer and less complete FPR disclosures will be included going forward. The results of this proposed regulatory change will be unfortunate as the trend to increased and, more substantial FPR disclosures will be reversed. Potential franchisees will suffer because of these changes and I would hope, in their entirety, that these changes not be enacted and that a more reasoned and beneficial approach be considered.

Respectfully,