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BUSINESS LAWYERS

October 13, 2016

Via Email
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Re: Proposed NASAA Franchise Commentary on Financial Performance Representations

Dear Sirs and Madam:

We again appreciate the opportunity to provide comments on the revised franchise commentary on financial performance representations (FPRs) proposed by the North American Securities Administrators Association (NASAA) on September 14, 2016 (the "Revised Commentary"). We value NASAA's continued efforts to clarify the guidelines and incorporate some of the feedback we and other industry members previously provided in response to NASAA's October 1, 2015 commentary. We respectfully request that NASAA give further consideration to several of the proposed guidelines that still could potentially harm franchisees and have a discriminatory effect on emerging franchisors.

As the following comments will demonstrate, we remain concerned that certain of the proposed guidelines: (i) unduly limit emerging franchisors' ability to present relevant financial data to prospective franchisees; (ii) create compliance difficulties by requiring franchisors to supplement actual results with less reliable projections (or, alternatively, hurt prospective franchisees by depriving them of crucial information); and (iii) touch upon issues better addressed through additional disclosures and mandatory statements.

Who We Are

I am the founding partner of FisherZucker, LLC, a boutique law firm specializing in franchise law. We represent over 130 franchise brands—both those well-established and those new and emerging—as well as master, multi-unit and single unit franchisees. I am the former chair of the IFA Legal Symposium Task Force, and I have previously served on the IFA's board of directors and its Executive Committee. I currently sit on the IFA's Research Committee, Franchisee Inclusion Task Force, and the FranPAC Advisory Board. Additionally, our firm has hosted the Springboard Conference for emerging franchisors for the past four years in Philadelphia. This has provided us with an extensive understanding of the concerns and obstacles that face these new and smaller franchise systems as they attempt to grow their brand.

Background to Proposed Commentary

As we noted in our 2015 response, we have observed NASAA and the FTC consistently encourage franchisors to disclose financial performance information in order to provide franchisees

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with a crucial resource in evaluating a franchise opportunity. When drafting the 2008 FTC Franchise Rule, the FTC recognized that "financial performance information is the most material information prospective franchisees need to make an informed investment decision," and that "more disclosure regarding performance would benefit the marketplace and competition."[1] The FTC also recognized that prospective franchisees seeking out franchise systems that disclose financial performance data would create market forces compelling competitive franchisors to do the same.[2]

As compared to NASAA's 2015 proposal, the Revised Commentary strikes more of balance between the push for financial performance representation and fairness to franchisees and franchisors. However, we believe that the Revised Commentary contains guidelines that could limit the disclosure of this important information and create a drastic barrier to entry for new and emerging franchisors (particularly those with fewer than ten outlets). We are also concerned that requiring franchisors to supplement actual data with speculative projections (with respect to standardizing company-owned and franchisee data) is more misleading than requiring franchisors to make clear disclosures regarding the source of the underlying data. Accordingly, we respectfully submit that there is room for further modification and improvement within the Revised Commentary to encourage more robust FPRs while still protecting the rights and interests of franchisees.

Comments on 19.9: Gross Sales FPR Based on Company-Owned Outlets Alone When Franchisor Has No Operational Franchise Outlets and 19.10: Gross Profit or Net Profit FPR Based on Company-Owned Outlets Alone

In the Revised Commentary, 19.9 permits franchisors without operational franchise outlets to disclose a gross sales FPR based on company-owned outlet data so long as the franchisor also discloses "material financial and operational characteristics of the company-owned outlets that are reasonably anticipated to differ materially from future operational franchise outlets."

As amended, 19.10 permits a franchisor to make "an FPR disclosing gross profit or net profit based on company-owned data alone," regardless of whether the franchisor has any operational franchise outlets so long as the franchisor has a reasonable basis to do so. However, franchisors must supplement this disclosure with (a) gross sales data from franchised outlets (regardless of whether the franchisor has reliable franchisee data), (b) actual costs incurred by company-owned outlets, and (c) most notably, information or adjustments that "reflect all actual and reasonably expected material financial and operational differences between company-owned outlets and operational franchise outlets."

This ability to disclose profits based on company-owned data is immensely helpful to new and emerging franchisors because it enables them to validate their systems and build name recognition. While the proposed amendments in 19.9 and 19.10 are an appreciated improvement from the corresponding sections in last year's proposal, they continue to place an extensive burden on the franchisor to project differences between company-owned outlets and operational franchise outlets when disclosing a gross profit or net profit based on company-owned data alone. While we can understand a mandatory disclosure that references the fees in Items 5-7 of the FDD, requiring the franchisor to project other financial or operational differences between units invites speculation into an FPR that otherwise is limited to objective, actual data. Franchisors, particularly new and

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[1] 72 FR 15497.
[2] See id. at 15498.

emerging franchisors, often are not yet aware of whether any such differences may exist, and requiring them to guess at this information increases the uncertainty regarding the FPR.

As discussed above and in our comments last year, these requirements effectively require a franchisor to provide speculative projections by taking historic financial performance data and qualifying it based on these financial and operational differences. Providing projections creates a risk that a franchisee may hold a franchisor accountable to such projections. Because of the inherent risks, franchisors are likely to refrain from making an FPR when they must also provide these additional disclosures. The result of franchisors refraining from making FPRs is that prospective franchisees actually receive less information and are ultimately harmed by the proposed requirement as opposed to benefiting from it.

Alternative Proposal: Use of Affirmative Disclaimers

Last year, we included an alternative proposal that we present again and urge its reconsideration. We understand and appreciate NASAA's concerns that underlying FPRs of company-owned gross or net profits may not accurately represent franchisee results due to additional costs imposed on franchisees. These concerns, however, do not need to be addressed through the incorporation of projections, but rather can be sufficiently alleviated with clear, explicit, and affirmative disclaimers to the FPR that precisely explain those concerns to prospective franchisees.

When a franchisor wishes to disclose gross profit or net profit from company-owned outlet data alone, we submit that a franchisor should be permitted to do so with the following disclaimer conspicuously included:

> **These results are solely based on data from company-owned outlets and may not accurately reflect the results of a franchised outlet. Company-owned outlets may achieve higher gross profit or net profit than franchised outlets. Company-owned outlets may also be exempt from certain costs such as royalties, advertising fees, and other fees or costs unique to franchised outlets, as disclosed in Items 5 through 7.**

If the franchisor in question has operational franchised outlets, the franchisor should be required to include the disclaimer above, as well as an additional affirmative disclaimer:

> **You should contact the current and former franchisees listed in an Exhibit to this document to understand how their individual financial performance compares to the information contained within this Item 19.**

We maintain our position that by requiring these mandatory disclosures in the above situations, NASAA can follow the FTC insofar as its policy is to allow prospective franchisees to assess the weight of the disclosures for themselves.[3]

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[3] See id. at 15499.

<u>Comments on 19.11: FPR Merging Data from Both Franchise Outlets and Company-Owned Outlets</u>

19.11 permits a franchisor to make an FPR that includes merged data from franchise outlets and company-owned outlets only under certain conditions. A franchisor may merge data if (a) the franchisor "has such a small number of total franchisees that the identity of franchisee(s) whose data is being reported is discernable," and (b) the outlets have gross sales "that are not materially different."

Regarding what constitutes a small enough number of outlets to be able to merge data, footnote 9 states that it will vary depending on the franchise but that ten or more outlets is presumed to be a sufficient number to require separation of data. This requirement is vague, which increases the difficulty of franchisor compliance. Furthermore, the commentary gives no explanation as to what factors help determine when a franchisor may or may not merge data. While we can appreciate the underlying concern, we respectfully submit that franchisors should be permitted to merge data so long as the franchisor (a) represents that the company-owned outlets are representative and materially similar to the franchised outlets, and (b) clearly discloses the number of company-owned and franchised outlets included in the FPR.

<u>Comments on 19.13: Best Performing Outlets</u>

19.13 requires that a franchisor disclosing data from a subset of its best performing outlets must also include data from "one or more corresponding subsets of its lowest performing outlets." 19.13 further states that this requirement exists even when a franchisor presents system-wide performance information.

NASAA's concern with preventing a franchisor from using only data from its best performing outlets is legitimate because such a representation by a franchisor could be misleading. However, in an instance when a franchisor uses information from its best performing outlets in conjunction with system-wide performance information, a requirement to further include information from its lowest performing outlets is excessive. When a franchisor includes system-wide performance averages, pursuant to 19.16, the franchisor already must disclose the median of numbers in the average as well as the highest and lowest numbers in the range. Because of the 19.16 requirement, an additional requirement for a franchisor to specifically include information from its lowest performing outlets is redundant and unnecessary. Instead of helping prospective franchisees, this requirement inundates them with additional information providing at best a marginal benefit, while also creating an additional burden on franchisors.

We believe that providing system-wide information, as required in 19.16, prevents a franchisor from misleading a franchisee into thinking that all outlets match up with the best performers, and it is our clients' experience that many franchisees specifically want to know how the best outlets are performing because they are confident in their ability to become an above-average operator. As long as franchisors (a) clearly disclose the subset of outlets that they are presenting as top performers, (b) provide system-wide performance information in conjunction with any subset of high performers, and (c) comply with the requirements of 19.16, we respectfully submit that requiring an additional disclosure of the lowest performing outlets (as currently required in 19.13) is counterproductive and unnecessary.

We have a strong belief that franchisees should be able to give the weight that they feel is appropriate to the various items presented in an FDD, including FPRs. However, if NASAA remains concerned that franchisees will not understand that a franchisor has elected to provide its best performers and not its worst performers (despite the checks and balances outlined in the previous paragraph), we would instead recommend an additional mandatory disclosure as opposed to the requirement that franchisors present unwanted data. Specifically, such a franchisor should be required to include a clear warning that the FPR only presents data for high performing outlets and refers the franchisee prospect to the system-wide averages that are also disclosed in Item 19.

Comments on 19.14: Small Number of Company Owned Outlets and Franchise Outlets

19.14 prohibits "a franchisor with fewer than 10 substantially similar company-owned outlets and franchised outlets as of the end of the franchisor's last fiscal year" from making an FPR based "on a subset of those outlets." We stated last year that this guideline was ambiguous, allowing for several interpretations. NASAA's 2016 proposal adds footnote 10, which clarifies that 19.14 "does not mean that a franchisor cannot make an FPR based on data from 10 outlets or fewer, when the franchisor has a reasonable basis for doing so." While this footnote helps to clarify the provision, it fails to cure the underlying issue, which is a disproportionate harm on emerging franchisors.

Within 19.14, the presumption remains that "[a] franchisor with fewer than 10 substantially similar company-owned and franchise outlets . . . has too few outlets to base an FPR on a subset of those outlets." While an FPR can be based on a subset when there is a reasonable basis for doing so, the initial presumption is that such a basis does not exist for smaller franchisors. This presumption is both harmful and discriminatory.

Accordingly, we maintain that the most beneficial route remains allowing the use of subsets when a franchisor with a reasonable basis discloses (a) the nature of the universe of outlets measured, (b) the total number of outlets in the universe measured, (c) the number of outlets from the universe that were actually measured, and (d) any characteristics of the measured outlets that may differ materially from the outlet of the prospective franchisee. As already required, franchisors will only be permitted to create subsets based on clear, objective criteria. By requiring the above information, prospective franchisees can assess how closely their proposed outlet would adhere to those disclosed, while ensuring that emerging franchisors with a legitimate reason for providing an FPR for a subset of outlets will have the means to do so without an increased fear of potential liability.

Comments on 19.16: Average and 19.17: Median

Finally, we have one minor comment regarding the requirement that franchisors provide median, high, and low figures in conjunction with disclosures of averages in an FPR (and the similar requirement that franchisors provide average, high, and low figures in conjunction with disclosures of medians in an FPR). It appears that the requirement to provide the highest and lowest numbers are limited to gross sales, and we respectfully submit that the requirement to provide a median (or an average), should be similarly limited to gross sales, gross profit, or net profit. Often, franchisors will provide detailed profit and loss information with a large number of cost categories, and we believe that requiring median (or average) figures in conjunction with each line item creates an unduly burdensome disclosure obligation that is more likely to obfuscate the underlying data than provide any real benefit to franchisees.

Conclusion

We acknowledge and appreciate the changes that have been made to the 2015 FPR commentary. However, we respectfully submit that further modifications, in line with our recommendations above, would be beneficial to both franchisors and franchisees. We believe these recommendations promote disclosure of pertinent information to franchisees while also considering the burdens that excessive disclosure can place on franchisors, and we request that NASAA takes these suggestions into consideration and revises the commentary accordingly.

Very truly yours,

FISHER ZUCKER LLC

By:__________________________
Lane J. Fisher