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BY E-MAIL ONLY

NASAA Legal Department
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Re: Response to Request for Public Comments to the Revised Financial Performance Representations Commentary (“FPR Commentary”)

Dear Sirs and Madame,

I hereby wish to submit the following comments to the FPR Commentary which was published on September 14, 2016. The comments are divided into two categories: Significant Issues and Other Comments. Within each category the comments are organized in the order of the FPR Commentary.

Before delving in to specific comments, however, an over-reaching observation is necessary: the level of detail of the FPR Commentary may have unintended and unfortunate consequences. Because of the diverse industries and businesses that use the franchise model it is very hard to prepare rules that will fit all franchise systems. In drafting FDDs it is frequent that franchisors have to answer required disclosures in the negative because they do not apply to their system. The general nature of the Item 19 disclosure requirements make it possible for franchisors to present financial information for their franchise system as needed. The restrictions imposed by the FPR Commentary will likely have limited impact on most franchisors, but for some brands and for certain instances in the life of a franchise system, the FPR Commentary will force franchisors to either provide unintentionally misleading FPRs, or to abstain from providing FPRs at all. There are various situations that may lead to such unintended situations.

One example is the franchise system that is undergoing significant change. Franchisors may periodically do major overhauls of their systems, add new variations (e.g. adding a kiosk or drive-through option to a sit-down restaurant franchise) or add new brands to their offering. Often times the franchisor uses company-owned outlets to experiment with new models and variations. In that situation, can a franchisor use company-owned outlet data only to provide an FPR for the new variation? It likely has many franchise locations operating under its original model, so arguably this would not be permitted.

A similar situation may arise where a company has been in business for a long time and has many outlets, but is new to franchising. It may have many years of reliable data for company-owned locations, but very limited data for franchisees. Under the FPR Commentary it may be forced to use unreliable data for franchise locations in order to be allowed to use reliable data for company-owned locations.
Yet another example stems from the definition of an operational location. While, as a general rule, one year may be a good period of time for determining whether a location is stabilized, that is far from always the case. For example, brands may experience better than average performance in the first year of operation because of the novelty of the brand/location. In that situation it is likely not advisable to use data for that first year of operation, yet the FPR Commentary doesn’t address this issue.

Franchising comes in so many different shapes and forms and covers so many different industries that it would be better to clarify that the FPR Commentary is intended to provide general guidance only. Where the circumstances for a particular franchise system do not fit the standard mold assumed by the FPR Commentary, franchisors should be allowed to depart from it. Because of the general obligation to always have a reasonable basis for any FPR such departures should not expose franchisees to undue risks.

1. Significant Issues

Definitions

“Company-owned outlet”

1) Is the reference to outlets “managed by the franchisor” supposed to only cover “managed outlets” as that term is defined? Or does it include e.g. franchisee-owned outlets managed by the franchisor or its affiliates? If something else than “managed outlets” is intended, this should be clarified.

2) It is clarified in Q&A 19.7 that “managed outlets” can be treated as franchise outlets or as a separate category, but this is not clear from the definition of company-owned outlet. To avoid potential double counting of an outlet as both a company-owned outlet and as being in a different category, the definition should clarify that the inclusion of managed outlets is optional, subject to Q&A 19.7. This is assuming “managed by franchisors” only refers to “managed outlets.”

3) If outlets “managed by the franchisor” include franchise outlets managed by the franchisor or its affiliates the definition of company-owned outlets should be revised to clarify this. For example, in hotel franchises, the franchisor may have a hotel management affiliate which franchisees may use. The hotel management affiliate would typically be operated as a separate entity and franchisees would not be given any material benefits because of their choice of management company (making it inappropriate to include those outlets in the definition of company-owned outlet).

“Operational franchise outlet”

1) The inclusion of data from outlets that are not yet considered “operational” is not addressed anywhere. Such data alone may not provide a reasonable basis for an FPR, but information regarding newly opened outlets may provide prospective franchisees valuable information about ramp-up periods and likely revenue during such ramp-up periods. It should be clarified
that data regarding “non-operational” outlets can be included in an FPR to contrast with data for operational outlets.

2) Just as with company-owned outlets, the question arises whether outlets “managed by the franchisor” must be included, or if the franchisor has the option of including them. If they have to be included both as company-owned outlets and franchise outlets they would be double counted. A reference to Q&A 19.7 would be helpful.

Q&A 19.11 – The exception in this Comment for franchisors with a small number of total franchisees should be expanded to permit merger of both gross sales and gross profits data. If it is subject to the same materiality requirement as the gross sales data the merged information should not be misleading.

Q&A 19.13 – It should be clarified that information about the lowest performing outlet should be comparable to that included regarding the highest performing outlets. For example the lowest performing outlet should be an "operating" outlet and if the other data set refers to outlets that have been in operation for a specific period of time, the lowest performing outlet should be an outlet that also has operated for that length of time. Likewise, if the highest performing outlet is not an outlier, the franchisor should not be required to include a lowest performing outlet that is an outlier.

Q&A 19.23 – Limiting franchisors’ right to include disclaimers may lead to potentially misleading FPRs. For example, many systems have significant outliers, both with respect to high- and low performers. Not being able to clarify to a prospective franchisee that the results of a high performance outlier are unusual could be detrimental to a prospective franchisee. Because of the suggested limitations on subsets for smaller franchise systems a franchisor may, pursuant to the FPR Commentary, not be able to exclude the high-performer from the FPR.

The above example also highlights the need to clarify what constitutes a “disclaimer.” For example, is it a disclaimer to state that the individual results of a franchisee may depend on many factors such as location, local economic conditions and the experience of the franchisee and its management, and other factors that the franchisor identifies? Is it a disclaimer to explain that there is a ramp-up period? Is it a disclaimer to state that a franchised restaurant may experience lower performance once the novelty of the brand wears of in a new location? I suggest that Q&A 19.23 be deleted, or at the very least that a narrow definition of “disclaimers” be included to clarify that franchisors may continue to explain what factors are likely to impact franchisee performance.

2. Other Comments

Definitions

“Company-owned outlet”

1) The inclusion of outlets owned by members of the franchisor’s management in company-owned outlets is potentially misleading and may not always be appropriate. It is common for franchisor’s management team members to be part owners in franchised outlets. Sometimes the ownership interest is minimal. If the inclusion of management-owned locations in the definition of “company-owned outlets” is intended to capture outlets that are treated differently than franchised outlets a more flexible approach is suggested than what
the current draft provides. The definition should be amended to state that outlets owned only in part by a person required to be identified in Item 2 are considered company-owned outlets only if they are treated materially differently than franchise outlets.

**Q&As 19.8 and 19.9** – The FPR Commentary combined some of the Q&As included in the original FPR Commentary. It appears comments 19.8 and 19.9 could be combined, which would make the commentary easier to read. That way, there would be one Q&A covering Gross Sales FPRs, just like there is one for Gross/Net Profit FPRs. The message appears to be that a franchisor without operational franchise outlets may prepare an FPR based on company-owned outlets data alone, while a franchisor with operational franchise outlets must include an FPR based on the franchise outlets if it wants to use a company-owned outlet FPR as well.

**Q&A 19.10** – It should be clarified that franchisors can use footnotes and other text to explain adjustments and supplements made to FPRs in compliance with this Comment, and that this is not a departure from using the same format for the different data sets within the FPR. Likewise, it should be clarified that clarifications that such adjustments do not reflect actual costs incurred by any outlet or franchisee are permitted and not subject to the general limitations on disclaimers in Q&A 19.23.

If you have any questions about the above, please do not hesitate to reach out to me by telephone at 312-345-5004 or email at bkrakus@greensfelder.com.

Very truly yours,

GREENSFELDER, HEMKER & GALE, P.C.

By

Beata Krakus