Regulatory Update

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Current Hot Topics
Registrations, Renewals, and Amendments

Availability of Online Documents

Time’s Up!
Registrations, Renewals, and Amendments

Registration of Brokers

Time’s Up!
Registrations, Renewals, and Amendments

New Rhode Island Tax Requirements

Time’s Up!
Registrations, Renewals, and Amendments

Blacklining Documents

Time’s Up!
Registrations, Renewals, and Amendments

Expediting Renewal Applications

Time’s Up!
Registrations, Renewals, and Amendments

Expediting Pre-effective Amendments

Time’s Up!
Registrations, Renewals, and Amendments
Registrations Subject to Comments That May Not Be Deemed Material

Time’s Up!
Registrations, Renewals, and Amendments

Renewal Periods

Time’s Up!
Registrations, Renewals, and Amendments
Eliminate Information Not Required by the Rule/Guidelines

Time’s Up!
Registrations, Renewals, and Amendments
Include All Agreements in Item 22

Time’s Up!
Specific Disclosure Requirements

Risk Factors

Time’s Up!
Specific Disclosure Requirements

Item 3 – Litigation (and Arbitration)

Time’s Up!
Specific Disclosure Requirements
Conforming Items 5, 7, and the Cover Page

Time’s Up!
Specific Disclosure Requirements

Item 10 – Financing Agreements

Time’s Up!
Specific Disclosure Requirements

Item 12 – Required Disclosures

Time’s Up!
Specific Disclosure Requirements

Item 13 – Disclosure of Affiliate Agreements
Specific Disclosure Requirements

Item 21 – Financial Statements
Specific Disclosure Requirements

Item 22 – State Addenda
Miscellaneous Other Issues

Notice of Violations

Time’s Up!

Time’s Up!
Miscellaneous Other Issues

Franchisee Acknowledgments and Disclaimers
Financial Performance Representations Generally

State and federal law begin regulating “earnings claims”

• Historically, before 2008, only 20% of franchisors included this information in their disclosure documents.

With the Amended Franchise Rule, adopted in 2007, the FTC eliminated some of the restrictions on providing “financial performance representations.”

• In the last few years, more than half of all FDDs contain an FPR.
Key requirements for FPRs:

• The franchisor must have “a reasonable basis” for the information provided.

• The information must be included in Item 19 of the FDD.

• The material basis for the FPR must be explained in the FDD.
Many issues revolve around what is “a reasonable basis.”

From a state examiner perspective:

1. The figures should be based on results that have been achieved in this system in the past.
   - Not pure hypotheticals.
   - Not what competitors have done.
Many issues revolve around what is “a reasonable basis.”

From a state examiner perspective:

2. Since prospective franchisees will rely on this information in putting together their own projections, the results should be achievable in the future.
   • Not a guarantee that all franchisees will achieve these results.
   • Not based on models that are no longer offered.
   • Not based on economics that do not exist for franchisees today.
Examples of Potentially Troublesome FPRs

1. **Surveys** – Financial information gathered from submissions to franchisor from voluntary franchisee surveys.
   - Did a sufficient % of franchisees respond to make the information a representative sample of the system?
   - Is this the most reliable information available?
   - Does the franchisor have a level of confidence that information is accurate / the survey is valid?

If any answer to any of these questions is no, there is an issue as to whether the information is misleading and/or there is a reasonable basis for using this information.
Apply Basic Statistic Concepts

**Census**  survey of the entire population being measured

**Random Sample**
A subset of a statistical population in which each member of the subset has an equal probability of being chosen

**Validity**
The accuracy of measurement in the context of sample representativeness
Sample Survey: 9%

Part II of this financial performance representation reflects the sales, certain expenses and income for the period from January 1, 2015 through December 31, 2015 for 18 franchised @ Warehouse participating in our survey for 2015. We surveyed all @ Warehouse franchisees regarding their business expenses for 2015.

<table>
<thead>
<tr>
<th># of Survey Respondents</th>
<th># of Warehouses</th>
<th>Sales Per Metro Shop*</th>
<th>Metro Shops</th>
<th>Sales + DIW Income**</th>
<th>COGS</th>
<th>Gross Profit***</th>
<th>Gross Margin %</th>
<th>Royalties &amp; Fees</th>
<th>Automobile</th>
<th>Labor</th>
<th>Communications</th>
<th>Advertising &amp; Marketing</th>
<th>General Office</th>
<th>Insurance</th>
<th>Occupancy</th>
<th>Shipping &amp; Postage</th>
<th>Other Above Line Expenses</th>
<th>EBITDA $****</th>
<th>EBITDA %</th>
</tr>
</thead>
<tbody>
<tr>
<td>18</td>
<td>18</td>
<td>$1,086</td>
<td>1,207</td>
<td>$1,497,155</td>
<td>$787,403</td>
<td>$709,753</td>
<td>47%</td>
<td>$142,369</td>
<td>$24,538</td>
<td>$205,998</td>
<td>$11,689</td>
<td>$23,120</td>
<td>$7,759</td>
<td>$8,306</td>
<td>$35,594</td>
<td>$16,349</td>
<td>$14,756</td>
<td>$218,654</td>
<td>15%</td>
</tr>
</tbody>
</table>

### Table

<table>
<thead>
<tr>
<th>Outlet Type</th>
<th>Column 1</th>
<th>Column 2</th>
<th>Column 3</th>
<th>Column 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Franchised</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Outlet Type</td>
<td>Year</td>
<td>Outlets at the Start of the Year</td>
<td>Outlets at the End of the Year</td>
</tr>
<tr>
<td></td>
<td>Franchised</td>
<td>2014</td>
<td>198</td>
<td>195</td>
</tr>
<tr>
<td></td>
<td>Franchised</td>
<td>2015</td>
<td>195</td>
<td>192</td>
</tr>
<tr>
<td></td>
<td>Franchised</td>
<td>2016</td>
<td>192</td>
<td>196</td>
</tr>
</tbody>
</table>
Examples of Potentially Troublesome FPRs

2. **Combining information** from various types of outlets

- Service franchises that combine multiple territory franchises with single territory franchises.
- Combining limited service locations with full service locations, when the results differ significantly.
- Geographic location, age of outlet, and other factors differ – combining information may be permitted if the factors are explained and the factors are reasonable.
Combining information from various types of outlets

**Wrong Way**

All Franchises Combined

<table>
<thead>
<tr>
<th>Number of Years in Operation</th>
<th>Number of HomeCare Businesses</th>
<th>Average Annual Gross Sales(4) per Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over 9 years(1)</td>
<td>10</td>
<td>$1,878,614</td>
</tr>
<tr>
<td>6 to 8 years(2)</td>
<td>41</td>
<td>$1,253,577</td>
</tr>
<tr>
<td>3 to 5 years(3)</td>
<td>43</td>
<td>$935,782</td>
</tr>
</tbody>
</table>

**Right Way**

**Multi-Territory**

<table>
<thead>
<tr>
<th>Number of Years in Operation</th>
<th>Number of HomeCare Businesses</th>
<th>Average Annual Gross Sales(7) per Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over 9 years(1)</td>
<td>9</td>
<td>$1,962,343</td>
</tr>
<tr>
<td>6 to 8 years(2)</td>
<td>22</td>
<td>$1,488,931</td>
</tr>
<tr>
<td>3 to 5 years(3)</td>
<td>28</td>
<td>$1,083,169</td>
</tr>
</tbody>
</table>

**Single Territory**

<table>
<thead>
<tr>
<th>Number of Years in Operation</th>
<th>Number of HomeCare Businesses</th>
<th>Average Annual Gross Sales(7) per Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over 9 years(4)</td>
<td>1</td>
<td>$1,125,054</td>
</tr>
<tr>
<td>6 to 8 years(5)</td>
<td>19</td>
<td>$981,063</td>
</tr>
<tr>
<td>3 to 5 years(6)</td>
<td>15</td>
<td>$660,659</td>
</tr>
</tbody>
</table>
Combining information from various types of outlets

Providing one AUV for all types, with no breakout of differing types, would never be appropriate in this instance given the varying sales levels.
Examples of Potentially Troublesome FPRs

3. **FPRs with incomplete information**
   - The Rule specifies certain information must be included.
   - FPRs that do not include the required NASAA admonition (or that seek to disclaim the information contained in the FPR).
   - An FPR that uses terms not defined or defined differently than contained in the FDD and agreement
   - Test the numbers! Are there obvious categories of expenses missing? Do the raw numbers tie to percentages charged or disclosed in the footnotes?
Examples of Potentially Troublesome FPRs

4. **FPRs contained in advertising and marketing materials**
   - The FPR must be reasonable and truthful, and backed by substantiating written information.
   - The number and percentage of outlets that obtain or surpass the level must be included.
   - The time period measured must be included.
   - There must be a clear and conspicuous admonition that a new franchisee’s results may differ.
Examples of Potentially Troublesome FPRs

4. **FPRs contained in advertising and marketing materials** (cont’d)

   - Details concerning the claim must be included in Item 19.
   - Any information prohibited in Item 19, such as by the new FPR Commentary, would be prohibited in an advertisement – like disclosing only the top X%.
Examples of Potentially Troublesome FPRs

5. **State examiner comments to a filed FPR**

   - FAQ 38 – When one state requires a change, there is a presumption that the FPR may be defective if not changed in other states.
The Newly Adopted FPR Commentary

Adopted May 8, 2017. It is effective the later of:

• 180 days after adoption, which is November 4, 2017, and
• For franchisors having an FDD with an effective date of May 8, 2017 or earlier, 120 days after their next fiscal year end.

So for franchisors having an FDD with an effective date between May 9, 2017 and November 4, 2017, and for franchisors with fiscal year ends of May or June, the Commentary is effective on November 4, 2017. For all others, it is effective 120 days after their fiscal year end.
The Newly Adopted FPR Commentary

Hot Issues

1. The definitions and the defined terms used in the Commentary are not required terms used in the Commentary.
2. Disclosure of gross sales.

Comment 19.04 requires that when you make an FPR disclosing gross sales (regardless of the term you use), you must disclose which items, if any, you are deducting from total revenue, including sales tax, discounts, allowances and returns.

Many franchisors have not done this in the past.
3. The Commentary clarifies when and how company-owned data can be used.

a. Gross sales information

- When the franchisor has no operational franchised outlets – company-owned data alone can be used, but the franchisor must disclose material financial and operational characteristics of those outlets that are expected to differ from future franchise outlets.
3. The Commentary clarifies when and how company-owned data can be used.

a. Gross sales information

• When the franchisor has franchised outlets, company-owned outlets can still be used if they are expected to be reflective of a franchisee’s results, but the franchised outlets must also be taken into account.
3. The Commentary clarifies when and how company-owned data can be used.

b. Gross profit or net profit information

• Once again, company information can be used if expected to be reflective of a franchisee’s results, but any differences anticipated for franchised outlets must be disclosed and shown in the calculations.
3. The Commentary clarifies when and how company-owned data can be used.

c. Merging information from franchised outlets and company-owned outlets

• When data is used from both types of outlets, the data can be merged, but it also must be shown separately.
  – The exception is that if there is such a small number of franchisees that the identity of franchisees whose data is being reported is discernable, they do not need to be shown separately. The presumption is that if there are more than 10 franchisees, the individual numbers would not be discernable and must be separated.
4. Subsets.

a. The concept of subsets was intended to allow franchisors to show financial information from specific types of units that a prospective franchisee may be considering.

- A subset based solely on results is not a type of unit and will not be allowed.
- When there are less than ten total units, there is no reason for a subset.
- Geographic subsets can be appropriate, but describe why and how that subset was selected.
5. Use of averages.

a. When an average is shown, show the median (and vice versa).

b. When average sales are shown, disclose the highest and lowest numbers in the range.

c. If outlets that closed during the year are excluded, disclose the number of outlets that closed during the year, and the number that closed after being open less than 12 months.
6. Permissible forecasts (projections).

a. Projections must be based on ACTUAL past results of THIS system. They can be adjusted or supplemented based on changes that have occurred, but they are still based on historical data from substantially similar outlets operated in this system.
6. Permissible forecasts (projections).

- Not from hypotheticals.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>4-Year Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue</td>
<td>$186,000</td>
<td>$367,560</td>
<td>$464,940</td>
<td>$486,720</td>
<td>$1,505,220</td>
</tr>
<tr>
<td>Royalty</td>
<td>$23,560</td>
<td>$48,305</td>
<td>$62,395</td>
<td>$65,398</td>
<td>$199,658</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$162,440</td>
<td>$319,255</td>
<td>$402,545</td>
<td>$421,322</td>
<td>$1,305,562</td>
</tr>
<tr>
<td>Gross Profit %</td>
<td>87%</td>
<td>87%</td>
<td>87%</td>
<td>87%</td>
<td>87%</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marketing</td>
<td>$14,880</td>
<td>$29,405</td>
<td>$37,195</td>
<td>$38,938</td>
<td>$120,418</td>
</tr>
<tr>
<td>Misc.</td>
<td>$5,340</td>
<td>$10,340</td>
<td>$10,340</td>
<td>$10,340</td>
<td>$36,360</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>$20,220</td>
<td>$39,745</td>
<td>$47,535</td>
<td>$49,278</td>
<td>$156,778</td>
</tr>
<tr>
<td>Net Profit</td>
<td>$132,220</td>
<td>$279,510</td>
<td>$355,010</td>
<td>$372,044</td>
<td>$138,784</td>
</tr>
<tr>
<td>Net Profit %</td>
<td>71%</td>
<td>76%</td>
<td>76%</td>
<td>76%</td>
<td>75.5%</td>
</tr>
</tbody>
</table>
6. Permissible forecasts (projections).
   • Not based on potential results that have never occurred.
   • Not from other systems.