The Case (for and) against Multi-level Marketing

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Chapter 3: MARKET SATURATION AND COLLAPSE – how established MLMs skirt two major flaws in their systems

Chapter contents

Chapter summary

This chapter expands on the concepts related to market saturation and collapse introduced in Chapter 2. The impossible math of endless chains is explained and illustrated. Chain letters are explained and how they evolved into pyramid schemes, which were later enhanced with the introduction of products. However, this did not mitigate the financial losses suffered by participants, but instead increased them, as multitudes of participants had to share a smaller piece of the revenue pie.

Market saturation and collapse happens in MLM, but the companies have found ways to circumvent the damage by getting participants to absorb the losses. As an endless chain recruitment system, MLM is flawed, uneconomic, and fraudulent. It is also extremely viral and predatory.

At any point in an endless chain selling scheme, all those on the bottom of the pyramid are left in a losing position, which is the vast majority of participants. MLM is a mathematical trick played on the unwary.

The impossible math of endless chains

A distinguishing characteristic of multi-level marketing (MLM) is an endless chain of recruitment. Each new recruit is empowered and motivated by a recruitment-driven and top-weighted compensation plan to recruit others in a "downline" of participants beneath them, and these recruits motivated to recruit more recruits under them, and they still more, ad infinitum.

Recruitment of participants in an endless cannot continue indefinitely.

All of the hundreds of MLM programs I have analyzed are endless chain selling schemes. In every case, an underlying assumption in their compensation plans is an infinite market and a virgin market – neither of which exists. This is illustrated in an MLM that requires two persons to be recruited by each participant in order to be rewarded the promised commissions and/or overrides from the purchases of those beneath them in the pyramid of participants. And each of them must do the same, ad infinitum.

To show how saturation is inevitable, in a binary pyramid one person recruits two people, each of them two more, and they two more, etc., as follows:

1x2=2
2x2=4
4x2=8
8x2=16
16x2=32
32x2=64
64x2=128
128x2=256
256x2=512
512x2=1,024
1,024x2=2,048
2,048x2=4,096
4,096x2=8,192

. . . and so on until by the 32nd person in the chain of recruitment, the total number of recruits exceeds the population of the earth. Of course, it happens much more quickly if three or more participants are recruited by each new recruit.

The point is that no matter when any endless chain selling scheme is halted or reaches a point of saturation, all those on the bottom are left in a losing position, which is the vast majority because of the pyramidal stacking of participants at the bottom who don't get paid. MLM is a mathematical trick played on the unwary.

The precedence of chain letters.

For decades, consumers have been warned against "pay-to-play" chain letters sent through the mail. As the Federal Trade Commission warns in its online article: "The Lowdown on Chain Letters":

> Everybody's received them - chain letters or email messages that promise a big return on a small investment. The promises include unprecedented good luck, mountains of recipes, or worse, huge financial rewards for sending as little as $5 to someone on a list or making a telephone call. The simplest chain letters contain a list of names and addresses, with instructions to send something - usually a small sum of money - to the person at the top of the list, remove that name from the list, and add your own name to the bottom of the list. Then, the instructions call for you to mail or email copies of the letter to a certain number of other people, along with the directions of how they should "continue the chain."
>
> *The theory behind chain letters is that by the time your name gets to the top of the list, so many people will be involved that you'll be inundated with whatever the chain promises to deliver.* . .
>
> Whether you receive a chain letter by regular mail or email - especially one that involves money - the Federal Trade Commission reminds you that:
>
> *Chain letters that involve money or valuable items and promise big returns are illegal. If you start one or send one on, you are breaking the law.*
>
> Chances are you will receive little or no money back on your "investment." Despite the claims, a chain letter will never make you rich.
>
> Some chain letters try to win your confidence by claiming that they're legal, and even that they're endorsed by the government. Nothing is further from the truth.

The U.S. Postal Inspection Service offers the following warning about chain letters on its website at – www.usps.gov/websites/depart/inspect:

> A chain letter is a "get rich quick" scheme that promises that your mail box will soon be stuffed full of cash if you decide to participate. *You're told you can make thousands of dollars every month if you follow the detailed instructions in the letter.*
>
> A typical chain letter includes names and addresses of several individuals whom you may or may not know. You are instructed to send a certain amount of money -- usually $5-- to the person at the top of the list, and then eliminate that name and add yours to the bottom. You are then instructed to mail copies of the letter to a few more individuals who will hopefully repeat the entire process. The letter promises that if they follow the same procedure, your name will gradually move to the top of the list and you'll receive money -- lots of it.
>
> There's at least one problem with chain letters. They're illegal if they request money or other items of value and promise a substantial return to the participants. Chain letters are a form of gambling, and

sending them through the mail (or delivering them in person or by computer, but mailing money to participate) violates Title 18, United States Code, Section 1302, the Postal Lottery Statute.. . .

The main thing to remember is that a chain letter is simply a bad investment. You certainly won't get rich. You will receive little or no money. The few dollars you may get will probably not be as much as you spend making and mailing copies of the chain letter.

Chain letters don't work because the promise that all participants in a chain letter will be winners is mathematically impossible. . . .

Do not be fooled if the chain letter is used to sell inexpensive reports on credit, mail order sales, mailing lists, or other topics. The primary purpose is to take your money, not to sell information. "Selling" a product does not ensure legality. . .

Pyramid schemes

In case the reader has not already caught the significance of this information on chain letters, all pyramid schemes, including product-based pyramid schemes or MLMs, are built on the same principle as are chain letters – an endless chain of recruitment. And just like chain letters, the fundamental flaw in the system is that mathematically they don't work[1], except for those at the beginning of the recruitment chain (who position themselves at the top of a pyramid of participants for pay purposes) – at the expense of a revolving door of recruits who follow. A revolving door of new recruits at the bottom are being sold a ticket on a flight that has already left the ground.

It is interesting that in the Koscot case[2], the court noted, "The Commission has previously condemned so-called "entrepreneurial chains" as possessing *an intolerable capacity to mislead.*[3]" This capacity has been demonstrated in literally thousands of MLMs (many now defunct) fashioned after the model of entrepreneurial chains which the FTC has allowed following the 1979 "Amway decision." Unfortunately, this warning of an "intolerable capacity to mislead" was set aside in favor of Amway's "retail rules" which would supposedly mitigate the effects of the underlying flaws of any entrepreneurial chain, or MLM. However, the "retail rules" were not enforced.

Classic no-product pyramid schemes and product-based pyramid schemes. Some try to draw a distinction between classic pyramid schemes and MLM. But technically, it is a "distinction without a difference"[4] - except for the obvious introduction of products into the pyramids of participants in an MLM program. That is why I coined the term "product-based pyramid schemes" to distinguish MLMs from classic no-product pyramid schemes.

MLM is characterized by the recruitment of an endless chain of recruits into pyramids of participants who buy products to "play the game." Those on the top are enriched by the losses of those at the bottom.

[1] VanDruff, Dean, *"What's Wrong with Multi-level Marketing,"* available from his web site at www.vandruff.com/mlm

[2] **In re Koscot Interplanetary Inc., 86 F.T.C. 1106, 1181 (1975), aff'd.,Turner F.T.C., 580 F. 2d 701 (D.C. Cir. 1978)**

[3] **Holiday Magic, Inc., Docket No. 8834, slip op. pp. 11-14 [84 F.T.C. 748 at pp. 1036-1039] (Oct. 15, 1974); Ger-Ro-Mar, Inc., Docket No. 8872, slip op. pp. 8-12 [84 F.T.C. 95, at pp. 145-149] (July 23, 1974), rev'd in part 518 F.2d 33 (2d Cir. 1975).**

[4] Letter dated February 25, 2000, from Bruce Craig to Robert Pitofsky, Chairman of the FTC – and the official who drafted the Commission's Amway opinion in 1979

Market saturation and collapse

Total saturation or market saturation? In the 1979 case, Amway successfully argued to an FTC administrative law judge that total saturation, theoretically associated with a pyramid scheme, had never happened and was not possible.[5] However, *it is important to draw a distinction between* *<u>total saturation</u>* *and* *<u>market saturation</u>*. In a city of 100,000 people, one would not expect that it could support 100,000 direct selling distributors. *Any expectation of such total saturation would be absurd unless everyone was selling only to himself/herself.*

However, it may be realistic for such a city to support 10-20 distributors, with each having a market of 5,000-10,000 prospects to whom to direct his or her sales efforts. *Not being market analysts or statisticians, the FTC attorneys handling the 1979 Amway case entirely missed this distinction between total saturation and market saturation. With intense sales and marketing efforts in a given area, market saturation can occur rather quickly.*

It is important to draw a distinction between *total saturation* and *market saturation*. A city of 100,000 people surely could not support 100,000 direct selling distributors. Any expectation of such total saturation would be absurd unless everyone was selling only to himself/herself. On the other hand, *market saturation* may be reached with only 10 or 20 distributors.

Overlapping market saturation. In addition, sales distribution from competing companies add to the saturation of any given market for any given set of products. So though total saturation may not have been reached with only 20 distributors, the town could be said to have reached market saturation from the efforts of distributors from multiple MLM companies recruiting in an area. By now many communities in the USA have experienced dozens, if not hundreds, of over-lapping MLM recruitment campaigns since 1979.

In Utah County, Utah, is found the highest concentration of headquarters of MLM companies in the U.S. In a randomized survey of consumers we conducted there in 2004, we found *four MLM distributors to every one MLM customer* who was not a distributor. Many residents complained of being approached over and over by MLM participants, including family members that they otherwise respect.

Ultimate vs. continuous collapse. Another important distinction is to be made between ultimate collapse and continuous collapse. In the case of no-product pyramid schemes, participants race to cash in on the scheme before it either collapses or is shut down by law enforcement.

For persons familiar with the inherent flaws of a system that features recruitment of an endless chain of participants as its only customers, such schemes are fairly easy to recognize for what they are. It is a closed system that merely transfers money from those at the bottom to those at the top, and thus a money trap for all who join - with the exception of a tiny percentage that have obtained positions at the top of the pyramid.

Mathematically, approximately 90% of all participants in classic 8-ball (1-2-4-8) no-product pyramid schemes are guaranteed to suffer financial loss. This is because no matter how long it continues recycling through its series of pyramids, there will always be 87.7% to 93.3% beneath the person on the top who receives all the money - depending on the number of those cashing in at the top decide to start a new pyramid. So, as programs that promise unending or infinite expansion in a finite marketplace, pyramid schemes of all kinds are inherently flawed, unfair, and deceptive. In time, the public, the media, and law enforcement stiffen their resistance to further expansion, recruiting becomes difficult, and the scheme either collapses or is shut down by authorities.

[5] Robert L. Fitzpatrick, *Pyramid Nation: The Growth, Acceptance and Legalization of Pyramid Schemes in America*, page 39.

In the case of MLMs, (as with market saturation) the more successful MLMs escape total collapse by recycling a stream of new recruits through new markets and new products. In effect, collapse is continuous, with any losses being born by the new recruits. Meanwhile, instead of collapsing, the company continues to grow, as long as it can continue this recycling process. Eventually, if the MLM can hang on long enough, a whole new generation awaits a newly repackaged "opportunity" and the MLM is able to continue by exploiting their losses. This is what has happened with Amway and Nu Skin.

It should be noted that the loss rate for product-based pyramid schemes is much higher than for no-product schemes – in which all the money goes to the person at the top. In contrast, in MLMs, or product-based schemes, a portion of the revenues are siphoned off for payments to products and infrastructure. And what remains is shared with thousands, or even hundreds of thousands of participants, very few of whom are paid enough to exceed even minimal expenses, in addition to "pay-to-play" purchases necessary to progress or qualify for commissions. This will be discussed at length in Chapter 4.

Survey of households in a saturated market

In the aforementioned survey of households in Utah County, we found more interesting statistics. In the preceding year, 6.9% of households (about one in 15) had been approached to buy MLM products – without being sold an "opportunity" connected with the purchases, usually at "opportunity meetings." Only 1.1% actually made purchases from an MLM company.[6]

During the same period, 56% of households in Utah County had been approached to participate in an MLM "opportunity," and 4.6% actually joined. again, four "distributors" per customer suggests a market of distributors selling to "distributors," not a market of direct sellers selling to legitimate customers.

The 8 R's of MLM durability

The more established MLMs have managed to avoid collapse and grow massive downlines (pyramids) of participants, resulting in greater damage than no-product schemes. Whether or not deliberately planned as a survival strategy by the company's executives, I have observed what I call the "8 R's of MLM durability":

1. *Rewards.* The profitability for the MLM company and the payout to TOPPs (top-of-the-pyramid promoters) is so great that they will routinely misrepresent both products and the "opportunity" and will go to great lengths to keep the scheme going, including all of the following:
2. *Ruse.* MLMs have been enormously successful in positioning themselves as direct sales programs that are exempt from laws against pyramid schemes. Even many regulators, the Better Business Bureau, educators, and the media will be quick to condemn a no-product pyramid scheme, but will exonerate a far more exploitive product-based pyramid scheme (MLM).

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As this paper demonstrates, *a recruiting MLM company is actually an institutionalized pyramid scheme.* Recruits in the hierarchy of "distributors become unwitting agents in collecting pyramid investments (in the form of "incentivized purchases) that fund the company and enrich top "distributors."

Another ruse is the idea touted by MLM'rs is that their program "eliminates the middleman." In fact, the MLM guarantees that their program will create a whole network of thousands of middle-men to be paid off. No wonder their prices are so high.

3. *Repeated investments* ("pay to play"). Although the cost of signing up as an MLM distributor is usually less than $100, the cumulative investment, in strongly incentivized ongoing purchases to "stay in the game," may amount to hundreds or even thousands of dollars over several months. Products are often sold on a subscription basis by automatic bank withdrawal to maintain cash flow and upline residuals. Often purchases are far beyond the needs of the buyers and are stockpiled or given away. Usually such purchases are discontinued when the person withdraws from the scheme.
4. *Recruitment of a revolving door of replacements.* MLM recruitment is conducted as "body shops." Those who drop out on the bottom levels are constantly being replaced with new recruits who believe the promises of wealth and time freedom – or a little additional income for persons who are struggling to make ends meet (which almost always sets them further behind financially).

A revolving door of recruits replace dropouts.

In actuality, the potential losses from the collapse of an MLM company is transferred to the stream of new recruits who buy into the program and leave, believing they "failed to work the system correctly" – not that the system has failed them. They were led by recruiters to believe that they were purchasing expensive products to take advantage of the "opportunity of a lifetime" and that failing to succeed would be no one's fault but their own.

5. *Re-pyramiding*. When MLM company officers see that the "pyramid" is about to collapse, they start a new division, introduce new products, or enter a new geographic region, all within the same corporate umbrella.

This makes possible a whole new "ground floor opportunity" to participate in the "hyper growth" of the company, or to "ride the wave of opportunity." This is what Amway has done with Quixtar - and Nu Skin has cycled through numerous countries and several product divisions, including Nu Skin, IDN, Big Planet, Pharmanex, and Photomax.

MLMs can spread virally across borders worldwide

6. *Rationalization and self-blame.* Self-deception is common in MLMs, making it the perfect con game. The very people who are being victimized are often its most ardent promoters – until they run out of resources and quit. They seldom complain to

regulators, having been taught that any failure is their fault for not having tried hard enough, rather than the fault of the MLM. They may also fear self-incrimination for their own recruiting efforts – or retaliation from or to their upline or downline, which may include close friends and relatives.

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7. *Retail "rules."* The trick for a recruitment-driven MLM seeking to evade regulatory scrutiny is to create the illusion that retailing is being done by establishing "rules" for minimum retailing with which distributors must comply – which are satisfied cosmetically so as not to arouse the attention of regulators. Compliance with these rules is not independently audited, nor are they reinforced by corresponding incentives in the compensation plan. MLM rule-making is ineffective without correcting problems in the compensation plan itself. You get the behavior you reward.
8. *Recognition and credibility.* The MLM company may go to great lengths to enhance its legitimacy and its credibility. They may donate heavily to influential politicians and parties, to the Olympics, and to worthy, highly visible causes. Their support for these causes is given top billing at opportunity meetings and often given recognition by an unwitting press. And celebrities are hired to speak at MLM conventions. Top MLM officials and founders have been honored by university and civic groups.

MLMs hire celebrities to tout their programs.

Effects of unlimited MLM recruitment

Why MLM's explosive growth? The recruitment incentives of an MLM or product-based pyramid scheme is what accounts for its explosive growth – until it collapses or is shut down by authorities. Unlike chain letters or Internet report chains, very intensive person-to-person recruiting drives recruitment-driven MLMs, with each new recruit under pressure to recruit numerous others to recover his/her costs of participation – let alone profit. Recruitment-driven MLMs are like a fast-growing cancer – *viral and predatory***.**

Each new recruit has a personal stake in advancing the scheme so that he or she may profit from an expanding downline. New recruits are taught to "be a product of the products" and to set the example of model recruiting and purchasing in suggested amounts so that others will duplicate their recruiting efforts and purchases, carrying them to success on the backs of downline participants.

Since the upline's income is dependent on the recruiting success of downline participants, the upline is motivated to promote aggressive recruitment. And new recruits expect help with their recruiting from their uplline in order to qualify for commissions and advancement in the scheme. This pressure from above and below can create explosive growth in recruitment and purchases by participants and sympathetic family members.

Not only are participants promised huge rewards for recruiting large downlines, but also the compensation plan penalizes them for not doing so. Participants might even be taunted for “leaving money on the table.” The pay plan serves as a constant reminder that their income could be multiplied many times over by increasing the body count of recruits and by achieving volume triggers to move up through the various payout levels.

Does unlimited recruiting doom most participants to failure? It is not the recruiting per se that creates the problems, as recruiting is essential in many businesses (e.g., sales and executive recruitment). But unlimited recruiting of participating recruiters, each of whom is empowered and given incentives to recruit other recruiters, who are empowered to recruit still other recruiters, etc., in an endless chain, inevitably dooms the majority of participants to failure and loss. This is not true of real estate or insurance agencies, direct sales, and other legitimate businesses – even recruiting firms.

Any endless chain marketing scheme is an infinite recruiting program in a finite population of prospects – predetermined to failure and losses suffered by nearly all participants, with the exception of a few at the top (or who got in at the beginning) of a pyramid of participants. Therefore, making promises of rewards comparable to earlier entrants is misleading and becomes a primary device for defrauding recruits.

Like territorial franchises, MLMs could conceivably limit recruiting in a given area. But limiting the number of participants is uncharacteristic of MLM; it would dampen the illusion of the potential for huge incomes for new recruits from what is typically portrayed as having unlimited potential. Such restrictions would render any pyramid scheme impotent.

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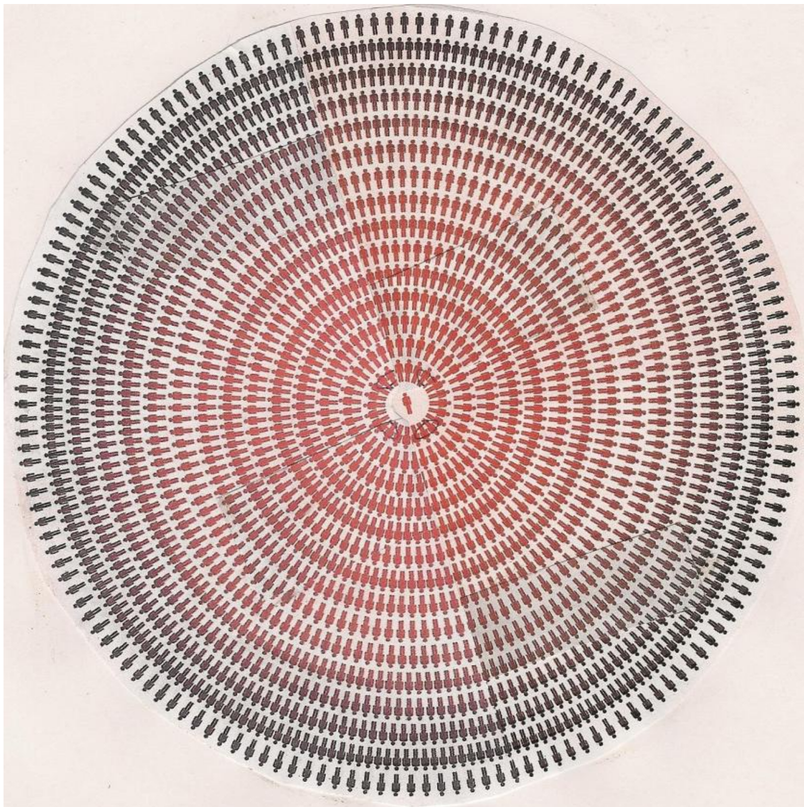
MLM gets even more fraudulent when the compensation plan rewards infinite expansion in time and space. Though not discussed elsewhere, I believe this deserves serious thought by anyone considering MLM participation. Not only does MLM feature an endless chain of recruitment, but commissions and bonuses on downline sales (even to participants) supposedly go on FOREVER.

“Residual income,” or payments-in-perpetuity may work in principle on one level with creative writers, inventors, persons who sell insurance or annuities, etc. But in MLM, while such payments in perpetuity for more than one level increases the financial leverage of the upline, they also increase the mathematical absurdity of the whole system. In MLM, you actually have a system that features infinite expansion in time and space in a marketplace that is finite in time and space. To anyone who understands the math, this makes MLM inherently flawed, unfair, and deceptive.

This almost gets into one’s perception of the size and duration of the universe. When the program reaches market saturation in this world, will space travel make it possible to continue the endless chain of recruitment on other planets? To listen to MLM promoters, one would think so.

Unfortunately, the early FTC warning of “entrepreneurial chains” possessing an “intolerable capacity to mislead” was set aside in favor of Amway’s “retail rules” which would supposedly mitigate the effects of the underlying flaws of any entrepreneurial chain, or MLM. However, the “retail rules” were not enforced.



MLM as a business model – which rewards expansive recruitment, is not only flawed, uneconomic, and deceptive, it is also both viral and predatory, like a fast-growing cancer. There are hundreds of these MLM viruses flooding U.S. markets, resulting in heavy market saturation. Many have spread overseas, and are now plundering vulnerable populations that can least afford it. MLM promoters promise relief from financial want, but their programs result in loss and disappointment for the vast majority of participants.

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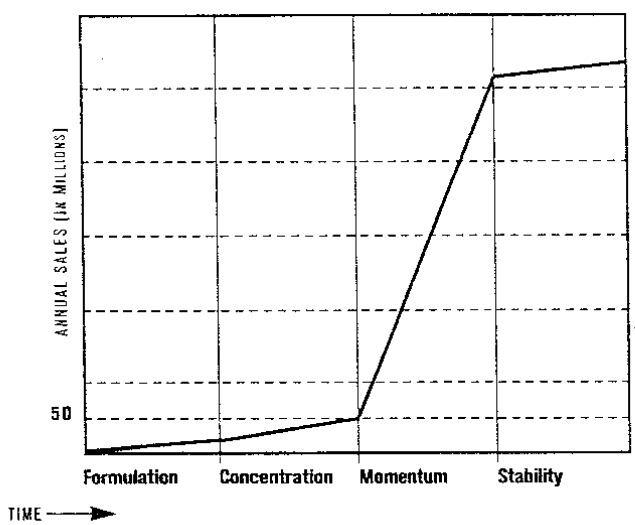
The business press is easily fooled. From time to time, an MLM company makes a list of fastest growing companies in a state or in the country. What few business writers understand is that this is to be expected with any recruitment-driven MLM, or product-based pyramid scheme. Even MLM promoters and defenders acknowledge the rapid growth of MLM in the "momentum phase," followed by a leveling off period. What few acknowledge is that the leveling and decline periods are part of the natural progression from rapid momentum to market saturation and ultimate collapse – at least for most MLMs.

Dr. Charles King of the University of Illinois at Chicago has proposed the "curve of prosperity" that is experienced my MLM firms[6]. He suggests that they go through stages in a growth cycle from formulation to concentration, then from to momentum to stability. However, he fails to mention the phase of market saturation and collapse, unless measures discussed above are taken to replace the high percentage of dropouts.



The curve of (MLM) prosperity

[6] "The Curve of Prosperity," Dr. Charles King, *Success Magazine*, June, 1993.

Conclusions

MLM is inherently flawed, unfair, and deceptive – and both viral and predatory. A fundamental flaw in all MLMs are compensation systems that empower and motivate each participant to recruit other participants in an endless chain of recruitment. MLM assumes both infinite and virgin markets – neither of which exists in the real world. They are therefore inherently flawed, deceptive, and profitable only for founders and a few at or near the top of the pyramid of participants. They are also extremely viral and predatory.

Markets quickly become saturated, and the MLM would collapse except for the ability of promoters to cycle through more recruits who shoulder any potential losses. So the MLM is in a state of continuous collapse, which is borne not by the company, but by new recruits.

Again, this makes MLM as a business model profitable primarily for the first ones in who position themselves at or near the top of a pyramid of participants for pay purposes. So purchases made by a revolving door of hopeful new recruits enrich those at the top at the expense of the vast majority of participants who are positioned in a losing position beneath them in the pyramid of participants. MLM is an unfair and deceptive practice, far more so than any other packaged home business or income opportunity.

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Chapter 4: PRODUCTS AND PRICES – questionable MLM product claims – and overpriced products

Chapter contents

Industry claims of legitimate customers

Most recruits are "just customers." When anyone challenges an MLM spokesman about the high attrition (dropout) rates of participants, the typical response is that the majority of recruits join because they like the products and can get them wholesale by becoming a distributor (or "representative," "associate," "IBO," etc.).

We will examine this claim by looking at the types and quality of MLM products and how experts view them. We will also show how their prices compare with prices of similar products at standard retail outlets.

Careful review of hundreds of MLM product offerings reveals questionable product claims and overpriced products. Of course, there are exceptions to the usual patterns that we see. For example, not all MLMs sell "pills, potions, and lotions." And occasionally an MLM offers a product at a competitive price – but this would only be a rare and secondary product, not the core set of products that participants are expected to buy.

Pills, potions, and lotions.

Experts are critical of "pills, potions and lotions" typically offered by MLM companies. Questions about product claims persist: Do the "pills, potions, and lotions" typically sold by MLM companies meet the claims of promoters? Are their prices competitive with standard retail outlets? And are MLM products merely disguised investments in a product-based pyramid scheme?

After studying over 350 MLM programs, it has become apparent that a typical strategy of MLM sponsors is to produce dietary supplements that supposedly cure or – with appropriate anti-oxidants - prevent every disease under the sun. Most MLM companies I have studied claim to have the latest and greatest supplement that is just not available anywhere else in such high quality for the price. They even claim to "bypass the middle man," when in fact with their endless chain of recruitment, they create thousands of middle men – all hoping for a share of commissions. (See Chapter 8 for typical misrepresentations used in MLM recruitment.

MLMs claim to "bypass the middle man," when in fact with their endless chain of recruitment, they create thousands of middle men – all hoping for a share of commissions.

I consulted three experts on the validity of typical claims by MLM companies about the superior benefits of their products, which are used to justify their high prices. To protect their professional reputations, I am not publishing the full names of two of them.

The first was Lane, a nutritional scientist and the former vice president of product development for one of the leading MLM's, who told me that the product claims of these companies are overblown and misleading. "The modern version of snake oil," he called them. He said the supplement industry is rife with people making fraudulent claims, especially MLM promoters.

Lane was very critical of MLM sponsors who promote products with exotic secret ingredients obtained from some remote island, etc. He suggested what many nutrition experts have recommended - that the best way to get needed vitamins and minerals is from a healthy diet.

The second was Allen, a nutritional formulator who has for many years manufactured supplements for both MLM companies and standard supplement companies that sell to health food stores. "This is a scumbag business," he grumbled. He told of his desire to get MLM promoters to buy quality formulations, using top-quality ingredients. He said that in every case, they chose to cut corners so as to allow plenty of margin to pay their many levels of distributors. For example, if a product sold for $50, they would not pay over $5 in production costs.

The third is Dr. Stephen Barrett,[7] editor of Consumer Health Digest and a medical doctor who has spent many years exposing all kinds of health quackery. He too recommends a healthy diet as the best source of needed nutrients. However, there are special cases where supplementation is needed, and this should be done in consultation with one's doctor.

Dr Barrett has also done much writing and research on supplements available from MLM companies. He has posted dozens of research reports and legal cases related to fraudulent claims by MLMs on mlmwatch.org. An excellent example is one on dietary supplements - see Appendix 4A.

"MLMs offer "the modern version of snake oil," *– nutritionist and former MLM product developer*

"This is a scumbag business" *– nutritional formulator*

Do anti-oxidants extend life and improve general health? A review[8] of dozens of studies delivers a blow to popular antioxidants. Researchers found that the popular antioxidant vitamin E doesn't lead to a longer life. Neither do vitamins A or C. But experts are divided on whether that means you should skip the pills altogether.

Highly touted anti-oxidant supplements may not be anti-anything – just costly

Antioxidant vitamins, including A, E and C, don't help you live longer, according to this analysis of a large sample of studies of these popular supplements. The new review showing no long-life benefit from those vitamins, plus beta

[7] The websites of Dr. Barrett include, among others:
http://www.quackwatch.org (health fraud and quackery)
http://www.mlmwatch.org (multi-level marketing)
http://www.naturowatch.org (naturopathy)
http://www.ncahf.org (National Council Against Health Fraud Archive)

[8] "Vitamins A, C, and E don't help you live longer." MSNBC- Associated Press, Updated: 4:18 p.m. MT Feb 27, 2007

carotene and selenium, adds to growing evidence questioning the value of these supplements.

Some experts said, however, that it's too early to toss out all vitamin pills — or the possibility that they may have some health benefits. Others said the study supports the theory that antioxidants work best when they are consumed in food rather than pills.

An estimated 80 million to 160 million people take antioxidants in North America and Europe, about 10 to 20 percent of adults, the study's authors said. [And in the year prior to this study, Americans spent $2.3 billion on nutritional supplements and vitamins at grocery stores, drug stores and retail outlets, excluding Wal-Mart, according to Information Resources Inc., which tracks sales.]

For the report[9] on antioxidants, the researchers first analyzed 68 studies involving 232,606 people and found no significant effect on mortality — neither good nor bad — linked to taking antioxidants.

However, I have read reports that many nutritional scientists and doctors do take supplements, but usually in modest amounts, not megadoses. They often explain their use of supplements as "insurance" to make sure they get what they may be missing in their diet (anti-oxidants, etc.). But they usually buy reasonably priced supplements and tend to focus on a nutritionally sound diet.

Unique, consumable, and pricey

When I tested the Nu Skin program, the spokesmen at opportunity meetings told us that for products to work in an MLM setting, they must be unique and consumable. They did not openly admit that the reason for the requirement of uniqueness was that the prices were so high that it would be a hard sell if anyone were to make price comparisons with alternate outlets. More on that point later.

MLM products must be consumable because that was the way to assure repeat business. As was explained in Chapter Two, MLM companies sustain themselves primarily by incentivizing purchases participants must make in order to qualify for commissions and to advance up the various levels in the pay plan.

Also, MLM products must be priced high enough to support the commissions for a bloated multi-level hierarchy of thousands of distributors, in addition to founders and a costly infrastructure.

Price comparisons for nutritional supplements

Prices for typical MLM vitamin and mineral supplements. One of the most common products sold through MLM companies are vitamin and mineral supplements. When one compares what MLM participants pay for such supplements with what is charged at health food stores and supermarkets, some interesting comparisons can be made.

And how do they compare? Not very well. In spite of the claims of MLM/DSA communicators that most MLM participants sign up to buy the products at a discount or to resell them for "a little extra income," the facts do not support either claim. MLM products purchased at wholesale prices are so expensive that few participants sell them at listed retail prices for a profit.

Also, since MLM sponsors have struck a deal with state tax commissioners, requiring sales taxes to be paid on wholesale purchases, and since shipping charges to one's home must be added, the margin between total cost and the retail price is too slim to provide much incentive to sell direct to non-participants.

To check this out, I asked representatives from ten MLM companies for the prices of their "best reasonably priced formulation of multi-vitamin multi-mineral products, with antioxidant protection." Then I made the same request

[9] The study, appearing in a February 2007 Journal of the American Medical Association, was led by the Cochrane Hepato-Biliary Group at Copenhagen University Hospital in Denmark. The Cochrane organization is a respected international network of experts that conducts systematic reviews of scientific evidence on health interventions. Also reported by Associated Press, February 27, 2007.

of ten health food retailers. Interestingly, representatives for each of the health food stores recommended a different product. Here are the results:

- Average cost per person per month (listed retail prices) from MLM sponsors, including Pharmanex, Quixtar, Melaleuca, Shaklee, Usana, Isagenix, Sunrider, Herbalife, Arbonne, and Neways - ***$61.22*** *(not much less at wholesale, after taxes and shipping are added)*
- Average cost per person per month for ten separate products from ten separate retail outlets - ***$11.52*** *(including shipping)*

*So the MLMs charged over **five times** as much!*

In spite of DSA claims of that most MLM participants "sign up to buy the products at a discount" or to resell them for "a little extra income," the facts do not support either claim.

MLM products purchased at wholesale prices are so expensive that few participants sell them at listed retail prices for a profit. MLM prices for vitamins were five times as much as shelf items!

I also spoke with three nutritional formulators who formulate and manufacture supplements for both retailers and MLM companies. Allen, one of the three nutritional formulators I mentioned earlier shared an interesting experience. He said he had formulated vitamin and mineral supplements with production costs billed to MLM companies of about $4-5/month.

This formulator said he made the offer to at least two MLM companies to upgrade to an improved formula with much higher grade ingredients for an additional $2-3/month, making the total cost to the MLM company about $7/month. Though these companies sold these formulations for about $50/month, they would not consider paying the higher cost of production for superior products, as that "would not leave them enough margin."

Superfruit juices. Around the turn of the millennium, several MLM companies began to sell what were called superfruit juices - from faraway and exotic forests and remote mountains. These included mangosteen from Indonesia, noni juice from Tahiti, goji juice from the Himalayas, and acai juice from acai palm trees in Central and South America. Others bottled several fruit juices for a supposedly optimal blend of antioxidant and other health benefits, including increased energy, weight loss, and longevity.

As with nutritional supplements, these superfruit juices were pricey – often from $40 to $70 in a fancy bottle similar to those used for fancy wines. Distributors were encouraged to buy a box of four or more bottles at a time.

Again I visited some retail outlets to make some comparisons. Super-markets were selling a variety of similar formulations of superfruit juices for from $3.09 to $6.99 for smaller 11-15 oz. bottles. Prices per ounce were less than half the prices charged by MLMs.

$50 a bottle - for fruit juice? (MLMs use a fancier bottle.)

I visited two health food stores and I was told of an interesting phenomenon that they had both observed. For several years there was a surge in demand for superfruit juices, coinciding with the selling of similar juices by MLM companies.

Apparently, some health food producers responded by producing similar juices and pricing them at higher prices than they would normally charge for fruit juices because of the supposed high demand. They didn't charge quite as much as the MLMs did, but they were selling quite a few bottles every month at $28 to $33 for a 32-oz. (one quart) bottle. People who had balked at paying MLM prices were going to the health food stores to get it cheaper.

The shelf life of the demand for MLM products coincides with the MLM "business opportunity" – and vice versa!

But in the past several months, apparently after the MLM fruit juice craze had peaked, the demand for expensive superfruit juices at health food stores dropped to near zero. The exceptions were old standard juices that had always been popular and inexpensive – such as Aloe Vera juice by George's, which helps to heal intestinal inflammations. A one-quart bottle sells for $8.19. The demand – up or down - has changed very little during the superfruit craze. As one health food owner put it, "The shelf life of the demand for MLM products coincides with the MLM "business opportunity" – and vice versa!"

For more excellent information on superfruit juices, read the article posted by Brian Denning, which includes a summary of a major study by the Australian Consumer Association (See Appendix 4B)

Interestingly, several years ago I wrote a satirical article and posted it online titled "*How to start a pyramid scheme that is very profitable for the founders – and get away with it." (See Appendix 2F)* My first suggestion was that the founder find a rare fruit drink derived from an exotic rain forest or other remote location – something that could be high priced because it would be unavailable elsewhere Then the founder was to find some scientists who would – for a fee – vouch for its effectiveness. This approach is precisely what some of the newer MLM companies have done.

Why MLM products are priced so high.

Thousands of middlemen (and women). If MLM were involved in standard retail markets, they would of course have to price products low enough to compete with the competition. And as will be discussed in Chapter 10, in order to avoid operating as an illegal pyramid scheme, they need to sell most of their products to customers who are not involved in the network of participants. To do this, one would think that MLM products would be priced competitively. But typically they are not. So why not?

The obvious reason is that they must pay multiple levels of participants – far more than is the case in a standard retail market. So again, the claim by MLM promoters that they cut out the middleman is patently false. MLMs can create thousands of middlemen in the form of downline participants.

Skimming by founders. Another reason is not so obvious, but as one who has observed the life styles of many MLM founders, as well as TOPPs (top-of-the-pyramid promoters), I am keenly aware of how these people profit handsomely from the purchases of downline recruits. Even those who simply founded the business and do no recruiting often engage in a practice I call "skimming," in which they siphon off a significant percentage of every sale before covering product costs and before anything is shared with management, the infrastructure, or with participants.

As I am located in Utah, I have observed founders of several MLMs living lavish life styles by skimming a substantial portion of company revenues – even while 99% of participants are losing money. I was informed from an inside source that one MLM founder has luxury homes in several states and a couple of foreign countries, ranch properties, and her own private jet. Another had a home built that had so many rooms that the building contractor said that he many never enter some of the rooms. He wanted to know if he really wanted that many. "Go ahead and build it as planned," was the response.

In the recently settled California case[10] against Quixtar (recent U.S. version of Amway), an organization of IBO distributors has complained about the company's high prices numerous times and every time was told that "the multilevel marketing business plan requires higher margins and that the company will not reduce its margins."

A consultant who analyzed the Quixtar's prices concluded that "Quixtar has few actual customers and that few IBOs ('independent business owners') are selling their products." When it was explained that "the Quixtar pricing formula is to take a product and multiply the manufacturing cost

[10] Notice of Errata re exhibits E,F, and G to affidavit of Billy Florence submitted with complaint, U.S. District Court for the Central District of California, Case No. CV 07-05194 GAF (JTLx), §45

by three ['the Jay factor'] just to determine the IBO cost, which is supposed to be the wholesale cost," one of the affiants commented, "With such a pricing formula, it is clear why 'Quixtar IBOs cannot retail products."

MLM a brilliant business model for the founders. In the complaint filed against Quixtar[11], This statement is germane to the issue of high prices:

> *The MLM's Quixtar business model is brilliant if you are a member of the DeVos or Van Andel families [founders]. Elevate the price of all products to gain an alarmingly high profit margin for the company. Market the company as a business opportunity, promising retail salability, to get unsuspecting distributors to purchase products at exorbitant prices while investing their time and energies promoting the business opportunity. Offer monetary rewards to incentivize distributors to recruit new distributors who also buy the company's products. Teach all distributors to consume the products that cannot be sold, which is all of the products. . .*
>
> *Quixtar has created an army of IBOs who are effectively trapped in Quixtar's system, forced to buy and consume outrageously priced products, and recruit new victims as the only means of avoiding financial loss, [because leaving Quixtar is rendered impossible by the noncompetition and non-solicitation rules.]*

Again, the Quixtar case is offered only as an example of a problem that is widespread in the MLM industry. This top-down pricing which enriches founders and TOPPs by selling overpriced products primarily to a revolving door of hopeful new recruits is one of the features that make MLMs so unfair and deceptive as a "business opportunity."

[11] Complaint and demand for Jury Trial, U.S. District Court for the Central District of California, Case No. CV 07-05194 GAF (JTLx), § 117

The hard sell of "superior products" at MLM opportunity meetings

I speak from experience, having attended over several MLM "opportunity meetings" where participants drag in their friends, relatives, and other potential recruits they've been able to round up for slick presentations by upline presenters and product "experts." The objective seems to be to create an atmosphere of excitement and group mentality characteristic of political rallies or sports gatherings – or even of popular cults in other settings.

For years I made my living in legitimate direct selling, including selling my way through college. One of the techniques I learned early was to "anticipate the objection." This entailed answering and overcoming key objections before the prospect had a chance to raise it. The sale went much more smoothly if we didn't have to counter it after it was raised.

Speakers at MLM opportunity meetings invariably begin by hyping magical properties of the products they will be selling, which only amplifies the value of the "business opportunity." And no wonder. They must convince those attending that their products are far superior to those available in retail outlets in order to answer any objections to the high prices they would be expected to pay – hopefully taking a supply home that very evening.

Other MLM products

Not all MLM companies sell vitamins or fruit juices. Many other products and services have been used as a product base for their programs. These include telephone and internet services, insurance and investments, fuel additives, pre-paid legal services, online photos, weight loss programs, seminars on secrets of building wealth, water filtration devices, and even tax avoidance advice. (The latter – "Rennaissance – The Tax People" was shut down by federal and state authorities.)

What's next? As long as it's unique and consumable, almost anything can be sold through MLM. Just identify something that people get excited about, and you have the basis for an MLM kickoff. How about online education? Memory enhancers? Exercise programs? And of course – aphrodisiacs to enhance one's sex life!

"No requirement to buy" to join

"Pay to Play." Another line typically used in MLM recruitment is that anyone can join without any requirement to buy products or to stock inventory. But analyses of the compensation plans of over 350 MLMs confirms what I and others have long believed – that MLMs incentivize purchases of participants to generate the bulk of their income. In other words, participants must "pay to play" the game.

There is usually a nominal signup fee – often under $50 – to join an MLM. This enables them to avoid exceeding any threshold requirements for initial investment that would require that they register as a "business opportunity" in some states. This may be $500, so they manage to be exempt.

However, the signup fee is merely a ruse. In order to get to any of the payout levels where significant commissions are paid, one must meet minimum purchase quotas, either from one's own purchases ("personal consumption") or from those in one's immediate group that he/she has recruited.

The sellers are the buyers, and the buyers are the sellers – to them-selves and their families.

Some participants are in reality sympathy buyers, counterfeit customers, and dummy distributors. As new recruits struggle to maintain "pay to play" purchases in order to qualify for commissions and to advance up the various levels in the scheme, they soon become desperate for buyers. They may pressure family members to buy - or give them away even if they are not interested. In my research, I found many buyers of MLM products made purchases to "help out" these new recruits. I call these "sympathy buyers." Other participants would buy products that they could not use in the name of someone they knew but who had no interest in the products just to satisfy any retail requirement the company may have. They may even give products away to these people as gifts or samples, but claim credit to satisfy "pay to play" minimums. These I call "counterfeit customers."

MLM participants make minimum "pay to play" purchases (Though redundant, this graphic from Chapter 2 is repeated here, as it so well illustrates this practice.)

Some MLMs have not only volume requirements to qualify for escalating commissions and bonuses as participants moved up the pay scale, but also head count requirements, such as in binary and breakaway systems. So in Nu Skin and other such programs, I observed the phenomenon of "dummy distributors" who were persons who agreed to sign up and allow their name to be used to satisfy the head count, even though they were not interested in becoming a distributor. The distributor would then buy products in their name to satisfy head count requirements.

Stockpiling. These kinds of purchases often lead to what MLM has a bad name for – stockpiling, which is personal consumption beyond the need of the participant – and if it becomes a widespread practice encouraged by an MLM, the company may be technically operating an illegal pyramid scheme. MLM companies claim to have rules to protect against stockpiling, but in practice the compensation plans reward and even encourage stockpiling. But this is a difficult thing to prove.

Stockpiling by MLM participants is common.

Getting MLM products cheap on ebay

If a person really wanted some specific MLM products, but didn't want to pay exorbitant prices, there is another option some people are discovering – ebay. *Ex-participants often seek to unload these overpriced "potions & lotions" – or other MLM products at a tiny fraction of the wholesale price!* Just go to the ebay website, click on the "Buy" tab, select the product category (such as "health & beauty"), enter the name of the company, click "search," and see what comes up.

Here are some examples of what I found:

- For Usana, I found (among a variety of Usana products) Healthpak 100 going for about $34 (US) plus shipping.
- For Pharmanex (Nu Skin), I found LifePak for $0.99 (US) plus shipping.
- Melaleuca's Vitality Mineral Complex was going for $2.01 (US) plus shipping.
- A case (4 bottles) of Xango's Mangosteen juice for $0.99

Conclusions

As a qualified independent investigator who has studied hundreds of MLM compensation plans and marketing strategies, it is clear that the products promoted by MLM companies (MLMs) are merely a disguise for investing in a supposed "business opportunity," or - more accurately – a product-based pyramid scheme. People are primarily buying the "opportunity," not the products.

Products are unique to prevent price comparisons with much lower priced products from other sources. To pump up the perceived value of the products, speakers at MLM opportunity meetings tout the unusual or magical properties of the products and services offered "exclusively" by the MLM. But the perceived value of the products is seldom translated into sales to non-participants at the suggested retail price. The sellers are the buyers, and the buyers are the sellers – to themselves and their family.

MLM products are also consumable to encourage repeat purchases. Minimum purchases are rewarded with the opportunity to reap commissions from sales through recruitment of new recruits and/or to advance to higher levels in the scheme's pay structure. In fact, quotas must be met to realize any significant benefit from the recruitment-driven system of rewards. . Stockpiling, though discouraged in company policies, is common and driven by purchases incentivized within the compensation plan.

The Case (for and) against Multi-level Marketing

By Jon M. Taylor, MBA, Ph.D., Consumer Awareness Institute

Chapter 5: RECRUITING A DOWNLINE – why the emphasis on selling in company communications, but on recruitment in practice – and what it costs to recruit a downline

Chapter contents

Rewards stacked in favor of recruiting

Incentives drive decisions. Since it so vital to understanding MLM incentives, I will quote from Chapter 2: **"**Psychologists experimenting with both animals and people learned decades ago that *you get the behavior you reward*. For example, if you place a dog in a room with two bowls, the first containing a pound of beef, and the second an ounce of dry dog food, invariably the dog will choose to eat from the first bowl. "

You get the behavior you reward.

While working on my doctorate at the University of Utah, I had a small office on the 9th floor of the Social and Behavioral Science Building, which is where what we called the "rat psychologists" did their research. It was amazing how even rats could be motivated to learn fairly complicated tasks by manipulating their rewards. Over and over again the principle was demon-stated that *you get the behavior you reward.*

We find a similar principle at work in economics: *Incentives drive decisions.* People will decide to invest or to put forth rigorous effort when the right incentives are in place. This is the reason for stock options, performance bonuses, etc. It is also a major factor that drives entrepreneurs to take extraordinary risks in hopes of a potentially handsome eventual payoff.

Similarly, since an MLM compensation plan specifies how participants are rewarded, it reveals whether the primary emphasis of income is on recruiting a downline of participants or on retailing products to the (non-participating) general public. In Chapter 2, I explained how such emphasis can best be determined.

Psychologists know that you get the behavior you reward. And economists teach that incentives drive behavior. So it is imperative to understand the compensation plan to determine the emphasis – on selling products or on recruiting people.

"**Retail rules" inconsequential**. If the MLM's compensation plan rewards recruiting over retailing, it matters very little whether or not "retail rules" are included in the policy and procedures manual - or how often company officials urge participants to meet minimum retail sales requirements. Following basic principles of psychology and economics, participants will focus their efforts where they perceive the greatest payoff to be.

MLMs weighted towards building a downline. The DSA claims that "recruiting is not a requirement for success in "direct selling."[12] However, in every one of the compensation plans of over 350 MLM programs I analyzed, the rewards were clearly weighted towards building a downline-building which requires constant and aggressive recruitment. I certainly found this to be true during my one-year test of the Nu Skin program. My recruitment efforts were successful, having risen to the top 1% of participants by the end of a year (though not high enough to profit), assuming all who signed up were counted.

The phony argument of joining to buy wholesale. MLM defenders, including the Direct Selling Association (DSA), attempt to dismiss those who did not succeed in building a dowline or who dropped out as having joined "just to get the products wholesale." But as demonstrated in Chapter 4, prices were not competitive even at wholesale, especially after adding taxes and shipping. Eventually, those who attempt to sell MLM products at suggested retail price soon give up when they cannot overcome stiff price objections.

An extreme differential. The differential between rewards for retailing and recruiting are so extreme that almost no one seriously attempts to retail products except to a few "sympathy purchasers" – usually close family members. When those who succeed at recruiting a large downline are held up as examples for all to follow, new recruits soon sense the extreme gulf in payout between the two activities.

Who would retail (especially products that are way overpriced) for $100 to $200 a month in profits, when they could conceivably be earning the $100,000 to $200,000 a month held out as bait for downline-building – a ratio of 1 to 1,000? (These numbers are just for illustration, as the actual returns vary all over the place. But the extreme differentials apply to all MLMs I've studied.

[12] "Ten Myths & Facts about Direct Selling." Direct Selling 411 web site, registered by DSA communicator Amy Robinson.

In actuality, as will be proven in later chapters, the ratio is not 1 to 1,000 because at least 99% actually lose money after subtracting "pay to play" purchases and minimum operating expenses – which can be substantial. So the comparison is between a loss of hundreds of dollars for direct selling – and the potential gain of hundreds of thousands of dollars for aggressive, long-term recruitment efforts. At least that is my perception looking back, and I have noticed the same perception on incentives from the worldwide feedback I have received from literally hundreds of MLM programs.

However, even the latter perception is incorrect because (as will be shown), it is extremely rare for anyone to be earning such huge incomes, except for the first downline builders (who MLM promoters like to call "business builders") to join the program. As a general rule, the more one invests in time and money, the more he/she loses – with the exception of the founders and the first ones in.

TOPPs get the lion's share of the company payout to distributors.

In addition to the founders, those who I call TOPPs (top-of-the-pyramid promoters) are the chief beneficiaries of all MLM programs. In every one of the hundreds of MLMs I've analyzed, this stands out as a key characteristic.

For example, when I tested the Nu Skin program, one of my top upline Blue Diamonds boasted he had over 100,000 downliners from whom he was collecting commissions. Later, careful analysis of Nu Skin's "Distributor Compensation Summary" report revealed that approximately 61% of company payout to the distributor force (in commissions and bonuses) went to the Blue Diamonds (Nu Skin's TOPPs). That means the other 39% was shared by over 100,000 hapless downliners, almost none of whom received enough to exceed expenses.

This extreme differential in payout was often misrepresented in company reports and at opportunity meetings. It was likely one reason that in 1994 the FTC issued an

Order for Nu Skin to cease its misrepresentations of distributor earnings.

However, Nu Skin was not unique in this regard. In virtually all of the compensation plans I have analyzed, I found that payout to participants increased exponentially as they were positioned at higher and higher levels in the pay plan.

The life of a recruiter

When a new recruit catches the vision of the enormous rewards supposedly awaiting him for recruiting a large downline, he/she must make some dramatic lifestyle changes.

Forget the drudgery of an 8-hour workday. Now it's an 18-hour workday! Every waking moment must be spent thinking up ways to recruit friends, relatives, and anyone within one's circle of influence who is breathing. We used to call this the 3-foot rule" – anyone within three feet is a prospect.

Cartoon by Cal Grondahl. From the book THE NETWORK MARKETING GAME. © 1997 by Jon M. Taylor.

I tested the Nu Skin program in 1994-95 because no one with my background had done a thorough analysis of the costs and success rates of MLM (then called "network marketing"). Many of my friends had been recruited into an MLM program, and several persons I respected had repeatedly tried to recruit me.

When a friend who was a Nu Skin distributor recruited me, his upline sponsor told me that with my background and contacts, within two years I could be making the "750,000 per year." This was the average reported income for Blue Diamonds at that time.

Though I told them "no" four times, I finally relented and decided to give it a try. I told myself, "$750,000 a year. If that's true, I could live on that. If not, I'll tell the world about it." So I decided to give it my all for a year.

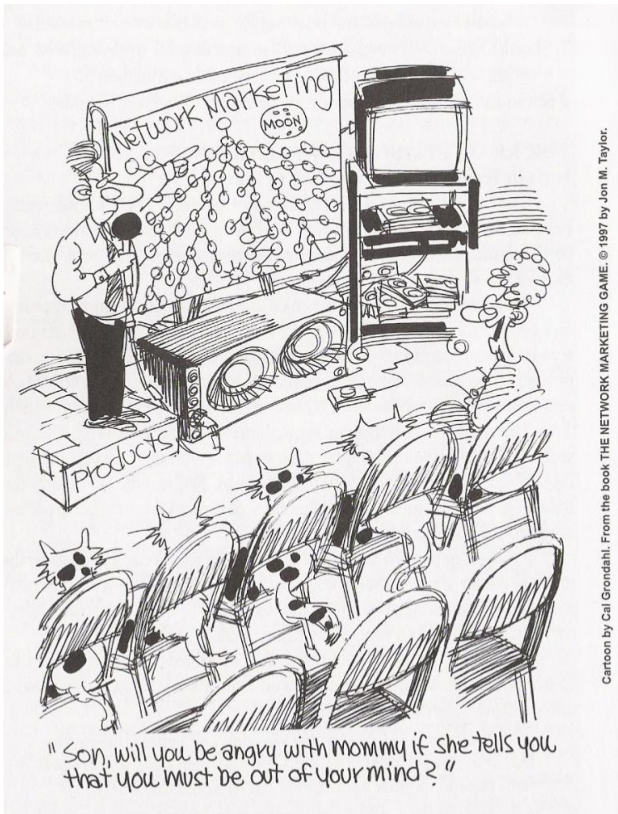
$750,000 a year –
If true, I could live on that!

I bought the more expensive $1,500 package, including "Executive starter packs" of products and sales materials, so that I could sign up five people and have on hand what I would have to sell them to get started. Five "active" distributors were required to become an "Executive." No one really got anywhere unless they achieved that level. (Levels in the pay plan were determined by the number of people recruited and the volume of purchases.)

I soon found that I needed to be on the phone constantly and was setting up appointments for 3-way calls with my upline sponsor so that he could help convince my prospects that they should come to the next opportunity meeting. The meetings were held locally weekly and regionally at least monthly.

Then there were training meetings we were expected to attend (for a fee), in addition to the annual conference. Exciting presentations were offered by Blue Diamonds and by "experts" on the various products and the occasional celebrity from athletic or nutritional fields who were using the products and allowing their names to be associated with them (I assume for handsome speaking fees).

We were to begin by recruiting our "warm market" of close friends and relatives. I soon found myself having gone through all my close relationships and having to advertise outside my warm market – placing small ads in newspapers and magazines, posting notices or signs any place that allowed them, leaving cards on windshields in parking lots, etc. And I began setting up my own opportunity meetings in nearby cities and towns – and even at some distance when anyone responded to my advertising. Even if I had only one or two persons attend, I went ahead with my presentation.



Cartoon by Cal Grondahl. From the book THE NETWORK MARKETING GAME. © 1997 by Jon M. Taylor.

A reality check. After a year of aggressive recruitment, I had a reality check. My wife threatened to leave me. My focus on recruiting was affecting all our relationships. People we had known and loved for years were now avoiding us. I was burning through our social capital as though it was of no consequence. “It’s Nu Skin or me, take your pick,” JoAnn challenged. This was my wake-up call, though I honestly felt that with another year or two of concentrated effort I could become a Blue Diamond.

I love my wife and had no desire to lose her – no matter how much it cost. So I did a careful re-examination of what I was doing and of the results so far from my efforts. I had been too busy to tally my expenses as I had done in previous business ventures. This was truly a reality check for me.

“It’s Nu Skin or me, take your pick,” she challenged.

The costs of a successful recruitment campaign

To my surprise, though I was in the top 1% in the distributor hierarchy (counting ALL who had joined), I was only bringing in about $250 a month – while spending over $1,500 a month, thus losing $1,250 a month! I would have to rise several more levels to realize profits after all the expenses.

As I mentioned earlier, after exhausting my “warm list” of friends, relatives, and acquaintances I found it necessary to turn to advertising and other resources to obtain additional prospects. *The argument that this is a no-cost or low cost business was found to be totally misleading,* at least for those seeking “success” advancing in the pay plan through an aggressive recruitment campaign.

I could have spent a lot more, but I am quite conservative and spent only what was needed to succeed in my recruitment. However, even though I was only receiving commission checks of about $250/month, I believed that with enough effort and expense, I could become a Blue Diamond and profit handsomely within a couple of years.

But now I had a moral dilemma. It became apparent that to be successful in recruiting a large enough downline to become a Blue Diamond, I would have to deceive hundreds – even thousands – of people, as I had been deceived. Being a deeply religious person with strong moral convictions, I decided to terminate my distributorship with Nu Skin. So I would no longer have to make “pay to play” purchases. I got my vitamins cheaper elsewhere.

Table 1 below provides a breakdown of my recruiting expenses for my one-year test of the Nu Skin program. I could not have conducted a successful recruitment campaign for less, unless it were in a virgin market – which does not exist in this country.

Table 1: One year of recruiting expenses

Money paid to Nu Skin	
Nu Skin products (including samples and "pay to play" purchases to qualify for commissions & advancement)	$5,416.75
"VIP" services (by Nu Skin)	102.21
Nu Skin training & conferences	755.00
Nu Skin Publications & tapes ("tools for success")	459.98
Total amount paid to Nu Skin	$6,733.94
Operating expenses (not paid to NS)	
Advertising	$1,457.81
Supplies	586.30
Printing & duplication	418.99
Telephone & computer costs	3,496.15
Postage & shipping	329.85
Travel & mileage	5,277.12
Miscellaneous	216.76
Total operating expenses	$11,782.98
Total expenses	$18,516.92

New sales and recruitment "tools" – and travel costs. Now of course, much of that has changed. New recruits use the internet for much of their recruiting. And they have access to lead generation systems that are competing for their dollars – each of them claiming to have the best system that will guarantee results. But if anything, the costs for a successful recruitment campaign are even higher today than they were then, especially since the market has become increasingly saturated with hundreds of MLMs engaged in recruiting simultaneously.

The argument that this is a no-cost or low cost business was found to be totally misleading, **at least for those seeking "success" advancing in the pay plan through an aggressive recruitment campaign.**

This means that new recruits who are ambitious enough to seek advancement to the higher levels in the pay plan (where the money is made) will likely have to do a lot of travel to less saturated areas, even overseas, to get in on the ground floor of a more new market for the MLM program they are promoting. I believe it would be much more expensive to mount a successful recruitment campaign today than it was then.

Minimum breakeven amounts. To be conservative, I will say that the total costs for a combination of minimum "pay to play" purchases, selling tools and training, and operating expenses would be as listed in Table 2 below for each year from 1995 to 2008, allowing for inflation using a standard CPI (Consumer Price Index) adjustment. I will start with a bare minimum of $18,000 for the year 1995, the year I was last involved. Based on careful analysis of my records and of the reports of others, I believe this to be a realistic estimate.

Table 2: Minimum operating expenses for conducting a successful MLM recruitment campaign, adjusted by Consumer Price Index

Year	CPI	Min. costs of participation and recruitment for the year
1995	0.656	$18,000
1996	0.638	18,507
1997	0.623	18,953
1998	0.765	19,263
1999	0.600	19,680
2000	0.581	20,324
2001	0.565	20,899
2002	0.556	21,237
2003	0.543	21,745
2004	0.529	22,321
2005	0.512	23,062
2006	0.496	23,806
2007	0.482	24,498
2008	0.464	25,448 (2008 is the latest year for which I have the CPI figures)

These figures will come in handy later when we look at the profitability for MLM participants of carrying out a successful recruitment campaign. Since recruiting a downline is where any profits are made from MLM participation, this information is highly relevant as breakeven points in doing any analysis of profitability.

MLM defenders will likely argue that the costs presented here are atypical, as Nu Skin is such a highly leveraged program. Though there is some truth to that, analysis of hundreds of MLM compensation plans and worldwide feedback convinces me that all MLMs are recruitment-driven (with the possible exception of some party plans) and would all require expenditures of at least as much as I had to make in order to have any hope of reaching a high enough level to realize any significant profits – or even to be lifted out of the loss column.

In addition, I have observed that costs for higher level distributors, especially for TOPPs (top-of-the-pyramid prmoters), can be several times the amounts I spent. I have observed TOPPs from a wide variety of MLMs who are continually travelling to pump up their downlines and to sell the prospects of downline recruiters on signing up for this "opportunity of a lifetime."

It should also be noted that most MLM participants don't spend nearly as much as I spent, but these are not serious recruiters and - based on analysis of MLM company reports and surveys of tax professionals – never reach profitability. The usual pattern is to buy a few products, or enough to meet "pay to play" requirements. After attempts at selling and recruiting, they eventually drop out, only to be replaced by others in a revolving door of thousands of hopeful but hapless new recruits – who are the primary source of income for the MLM. Based on tax studies and my analyses of average earnings of MLM participants where such data is available, those who reaped the promised rewards always did it by recruiting large downlines.

Like other MLMs, the cost of "building the business" limits any profits for Amway IBOs. The high cost of recruitment was emphasized in the UK action against Amway. One of the points of objectionability was expressed as follows:

. . . because of the requirement that an IBO pay a joining and renewal fee and the likelihood that an IBO would purchase BSM there was a certainty that the Amway business would cause a loss to a large number of people (to the extent that out of an IBO population which exceeded 33,000 only about 90 IBOs earned sufficient bonus to cover the costs of actively building the business).[13]

This means that at best one out of 367 IBOs (Independent Business Operators) are in a position to even show a profit, especially since very few products are sold at suggested retail. After subtracting incentivized purchases and operating expenses, the number who earned a significant income (more than a minimum wage) would likely be far less than one out of a thousand.

The lucky few who actually earned the substantial ongoing income (profits above expenses) suggested in opportunity meetings could be said to be virtually nil. In fact, another statement in the same judgment suggests that "instances of those who did have some success . . . are the equivalent of one out of many thousands."[14] Labeling such an activity as a business or income opportunity is a major misrepresentation. This lack of profitability will be examined in detail in Chapter 10.

It is both very demanding and very expensive to achieve success at recruiting a downline, which is essential if one is to realize significant ongoing profits from MLM.

Recruiters in UK called "gang masters." In the UK case, the importance of recruiting as the life blood of the business was strongly emphasized in these words:

The existing IBOs effectively act as gang masters, the gang master being rewarded under a system which rewards him or her more highly for the assembly of a gang (the "downline" with the aggregation of the group volume to produce ever higher commission rates) than for the direct selling of product.[15]

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[13] Approved Judgment: The Secretary of State for Business Enterprise and Regulatory Reform v. Amway (UK) Limited May 14, 2008. § 7(c),

[14] Ibid., § 54 (c)

[15] Ibid., § 46

Conclusions

It should be clear to any qualified independent analyst who looks at the available data, MLM compensation plans, and the arguments for and against MLM, that the MLM business model is predicated on recruitment of an endless chain of participants as primary customers. My analysis of hundreds of MLM programs supports the conclusion that MLMs are recruitment-driven with very little incentive to sell products to non-participants. Products are priced too high to be competitive, and compensation plans provide rewards to participants that escalate exponentially as they climb the hierarchy (pyramid) of participants.

It is both very demanding and very expensive to achieve success at recruiting a downline, which is essential if one is to realize significant ongoing profits from MLM. Those who lock in a position as the first ones in the chain of recruitment have a huge advantage over those who come in later, but this is seldom disclosed to new recruits.

The Case (for and) against Multi-level Marketing

By Jon M. Taylor, MBA, Ph.D., Consumer Awareness Institute

Chapter 6: ATTRITION RATES OF MLM PARTICIPANTS – why few recruits stay, and why it matters

Chapter contents

Why attrition rate is a key issue in MLM

High attrition - an Achilles heel for MLM defenders. MLM promoters are often touting to prospects the "residual income" that MLM provides for those who participate. They make it sound like an author's royalties or an annuity – a steady stream of income from the commissions that will flow to them from their downline, even while they sleep or travel in luxury with all that money they're going to make.

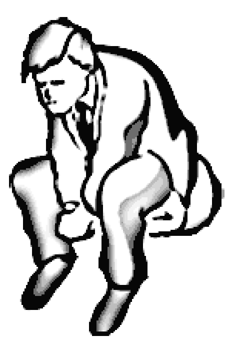
While the endless chain of recruitment assumes in infinite market, the promised residual income from MLM assumes perpetual residuals from a permanent cast of downline buyers. As we shall see, careful investigation suggests that nothing is further from the truth.

We will find that attrition rates in MLM are extremely high, which will have a huge impact on profit and loss rates. This may explain why MLM companies are loathe to disclose information on "turnover" or "retention" or "attrition" rates. It requires considerable sleuthing to get this information, but enough is available to make some realistic estimates of actual rates.

Incidentally, replacement of dropouts is accomplished by continual recruitment of a revolving door of new recruits, which is one reason "TOPPs" (top-of-the-pyramid promoters), or "kingpins," garner a disproportionate share of the revenues. TOPPs are the driving force of MLMs.

Evidence of high attrition rates

What turns up in a Google search. When one does an "Advanced Search" in Google for "MLM" - associated with the words "attrition," "retention," or "turnover" - thousands of interesting search results come up. Nearly all of them acknowledge horrible turnover of new recruits into the MLM business, and sponsors of most of the web sites each have their own solution to the "problem." It may be a special lead system, a revolutionary training program, or an unusual compensation plan, etc. However, few acknowledge the stark truth of the cause of such high attrition – the flawed system of an endless chain of recruitment that has led to increasingly saturated markets and high loss rates. Participants may be quitting for some very good reasons, whether they fully understand them or not.



Except for TOPPs (top-of-the-pyramid promoters), almost all MLM participants wind up losing money – and eventually drop out of the program, many of them discouraged and blaming themselves – rather than a flawed program.

Melaleuca's phony boast. There was one MLM that for some time boasted of having the highest retention rate in the industry. In fact, Melaleuca claimed to have an incredible 94.5% retention rate. However, when the issue was investigated in a Texas court case, it came out that the 94.5% was not per year or longer, but *per month*, which meant they were losing 5.5% per month – or about 66% per year. Nu Skin, Pre-Paid Legal, and other MLMs have admitted losing over 50% per year. Extended out over time, 95% or more would likely be gone in five to ten years.

Nu Skin's "permanent income." When I tested the Nu Skin program, several of the promoters touted the "permanent income" that one can attain through network marketing. Ten years after leaving the program, I was curious enough to attend a couple of their "opportunity meetings" to see if anything had changed.

The Nu Skin speakers were still talking of a "ground floor opportunity" and "permanent income." One thing had changed – the people. I looked around – all new faces, except for the TOPPs (top-of-the-pyramid promoters), the speakers themselves, who were essentially the same cast of characters with an audience of new prospects before them. I thought then, "How could they be enjoying permanent or residual income, if they have to recruit a whole new set of participants to replace the 98% or 99% who had dropped out?"

Another analyst, Robert FitzPatrick observed that "The pattern of 50-70% of all distributors quitting within one year holds true also for Nu Skin."[16]

After 10 years, the Nu Skin speakers were still talking of a "ground floor opportunity" and "permanent income." One thing had changed – the people. I looked around – all new faces, except for the speakers themselves, who were essentially the same cast of characters with an audience of new prospects before them.

Admission of Pre-Paid Legal. FitzPatrick also noted: In its annual report to the SEC, Pre-Paid Legal, another large MLM, revealed that 1/2 of all its customers and distributors quit each year and are replaced by another group of hopeful investors.[17]

Amway's "smoking gun." According to Eric Scheibeler[18], author of the book *Merchants of Deception*, out of 10,000 participating IBOs, only 414 remained in the business after the 5th renewal. That's a 95.9% dropout rate in only five years for the largest of all MLMs – truly a smoking gun![19]

Speaking of Amway (or Quixtar in the U.S. from 2000-2009), an active participant is called an "IBO" for "Independent Business Owner." As one of a group of consumer advocates who has studied the deceptions in Amway's program, I find this IBO designation amusing.

Amway's distributors are not *independent*, as anyone who has sought to work with any other MLM while with Amway can testify. It is not a *business*, unless one considers odds of success far below gambling a real business. And Amway's *IBO's don't own anything*, as anyone who tries to leave Amway and take their downline (that they spent years building) with them can testify. They don't even own the promised residual income because the high attrition rate assures them that they cannot count on those residuals – and because there are seldom any profits at all.

Out of 10,000 participating IBOs, only 414 remained in the business after the 5th renewal. That's a 95.9% dropout rate in only five years for the largest of all MLMs – truly a smoking gun!

[16] FitzPatrick, Robert, *"10 Big Myths of Multi-level Marketing". Report published in 2009. Available for free download from the web site pyramidschemealert.org*

[17] FitzPatrick, Robert, ibid.

[18] Scheibeler was citing a 2005 Quixtar (Amway) internal management report

[19] Term used by Bruce Craig, former Assistant Attorney General for Wisconsin

Estimates of minimum attrition rates – and a challenge to "prove me wrong."

Statistical distortion common in MLM. MLM companies that furnish data on average incomes are careful to include only "active distributors" (or "representatives," "associates," "agents," etc.) in their population of participants, comparing them with those who have achieved certain profitable levels in the pay plan – even if they have been with the MLM for ten or twenty years. This hugely distorts any resulting conclusions that would be drawn from the data. Statistical integrity would require that all participants be included for a given time period and none interjected into the data set from an earlier time period.

Reasonable attrition estimates – and a challenge to "prove me wrong." Based on my analysis of hundreds of MLMs, on investigations in court cases by myself and others, on comments by MLM spokesmen in the media, and on worldwide feedback on the Internet, I would estimate that that over a five-year period, at least 90% of participants would have quit their respective MLMs, and in ten years, 95% would be gone. This would mean retention of 5-10% at most. The only exception to that might be some party plans that can produce profits for legitimate sales to non-participants

I am open to making an exception to these figures if officials from any recruitment-driven MLM can produce their entire list of recruits over a five or ten year period and show retention higher than that.

Comparisons with failure rates for small businesses and franchises.

MLM defenders attempt to compare MLM to legitimate businesses. When confronted with evidence of high turnover, or attrition, MLM promoters are fond of comparing it to high failure rates in small businesses generally. But the latter do not even approach the high failure rates experienced by MLM participants.

In sharp contrast, one nationwide survey of small businesses[20] showed that over the lifetime of a business, 39% are profitable, 30% break even, and 30% lose money. Cumulatively, 64.2% of businesses failed in a 10-year period.

The following quote from an article in Journal of Small Business Management[21] is highly relevant here:

> *When aspiring business owners compare the options of franchise versus independent business ownership, an important consideration is the relative risk of business failure. To date, the primary referent for examining franchise failure rates has been surveys conducted by Andrew Kostecka (1988)(1) under the auspices of the U.S. Department of Commerce, which indicate that less than 4 percent of all franchises fail each year. This figure compares favorably with various estimates of independent small business failures (e.g., Dun and Bradstreet 1989).*

If only 64.2% of businesses failed in ten years, this totally refutes the argument of MLM defenders that - "MLM is just like any business. Those who work at it succeed. Most fail because they didn't really try." MLM is definitely not like a real, legitimate business.

If 99% of all MLM participants lose money[22] (compared to 30% of small businesses), and if in 5-10 years, 95% quit (compared to 36% of small businesses), there must be something wrong with the entire MLM industry; i. e., with the MLM business model itself. MLMs are not real, legitimate businesses – any more than classic no-product pyramid schemes are real businesses. MLMs are simply product-based pyramid schemes.[23]

High attrition is one of the most striking attributes of MLM. The "residual" or "permanent" Income touted by MLM promoters is a myth.

[20] William Dennis, Nat'l Federation of Independent Businesses, reported by Karen E. Klein in *Business Week*, September 30, 1999.

[21] Castrogiovanni, Gary J., Justis, Robert T., and Julian, Scott C. "Franchise failure rates: an assessment of magnitude and influencing factors." *Journal of Small Business Management* (April 1, 1993)

[22] See Chapter 7.

[23] See Chapter 2 and 7.

If 99% of all MLM participants lose money (compared to only 30% of small businesses), and if in five to ten years, 95% quit (compared to 36% of small businesses), there must be something wrong with the entire MLM industry; i. e., with the MLM business model itself. MLMs are not real, legitimate businesses – any more than classic no-product pyramid schemes are real businesses. MLMs are simply product-based pyramid schemes.

Comparisons of MLM participants with other types of sales persons

Comparisons of attrition rates for MLM participants to those for retail sales persons. In desperate attempts to explain away MLM attrition of 50%[24], the DSA makes comparisons with the high turnover among retail sales persons. But as Robert FitzPatrick of Pyramid Scheme Alert recently wrote:

For attrition rates, you may find DSA's latest statement of interest. They state that the average turnover rate in ["direct selling" is 56%], but then go on to compare that number with [53%] turnover rates in the traditional "retail" sales industry.

This, as we would expect, is spurious. Retail sales in stores is seasonal and, by design, part time. And, as you work, you actually get paid so there is no relation to the attrition rate in real retail sales and financial loss. And you are not required or even induced to buy the goods in the store as part of your pay plan. Finally, MLMs should not be compared to retail sales at all, since few MLMers ever retail anything anyway.

Since MLM is not sales work, but pyramid recruiting, it has no counterpart in the real world or work or employment.[25]

Temporary participation in "direct selling." In another attempt to explain away the high turnover in the MLM industry, the DSA often suggests that many persons participate in MLM (which they call "direct selling") only temporarily or seasonally to raise money for Christmas or college, etc. – not for regular income. So they claim these dropouts should not be counted as dropouts.

The problem with this argument is that none of the compensation plans of the hundreds of MLMs I have analyzed are set up to reward those who participate on a temporary basis. They are all recruitment-driven and top-weighted, meaning the rewards are weighted towards those who recruit huge downlines. This is not possible for seasonal participants.

Add to that the problem of MLM products that are not priced competitively for resale – and the cost of purchases required to participate fully in the pay plan – and seasonal participants are merely fattening the coffers of the MLM and its TOPPs.

While some may be fooled by this argument, it rings particularly hollow to me. Decades ago, when direct selling was viable, I sold encyclopedias and other products to help pay my way through college. My commissions were much larger than my sales managers, so that I could make a good income without recruiting a single person.

This was not self-delusion, as I had a reportable income from selling on my income taxes – which MLMs seldom do.[26] And I did not even have to buy a set of encyclopedias for myself.

The revolving door of MLM participation. This is so generic in MLM, that it's worth repeating what I said in Chapter 3 about how MLMs endure despite high attrition rates:

MLM recruitment is conducted as "body shops." Those who drop out on the bottom levels are constantly being replaced with new recruits who believe the promises of wealth and time freedom – or a little additional income for

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[24] **"**Top 10 Myths & Facts About Direct Selling," by DSA's Amy Robinson, posted at – www.directselling411.com.

[25] Letter to Jon Taylor dated October 21, 2010

[26] "Who profits from MLM? Preparers of Utah tax returns have the answer," by Jon M. Taylor. Posted on mlm-thetruth.com

persons who are struggling to make ends meet (which almost always places them further behind financially).[27]

A revolving door of recruits replaces dropouts.

Conclusions.

High attrition is one of the most striking attributes of MLM. This should be expected, since the business model is based on an endless chain of recruitment, which is inherently flawed, uneconomic, and deceptive. Mathematically, it cannot work in the long run in the real world. The vast majority are destined to failure and financial loss. This is the primary reason for such high attrition rates – not lack of effort, poor products, ineffective marketing, or bad management.

MLM officials are loathe to disclose attrition data and even hugely distort average earnings reports by including only "active" participants in their reporting. However, from available data and worldwide feedback, it appears that throughout the industry at least 90% of MLM recruits are gone in five years, and at least 95% in ten years. With the possible exception of TOPPs, the "residual" or "permanent" Income touted by MLM promoters is a myth.

[27] See Chapter 3