

Keynote Remarks of FTC Chairwoman Ramirez
DSA Business & Policy Conference
Washington, DC
October 25, 2016

Direct selling, a \$36 billion industry, plays a robust role in the marketplace and has the capacity to provide consumers with valuable goods and services and an opportunity to try an entrepreneurial experience. The Federal Trade Commission, as you know, has been active in this area for decades.

We hear often from members of the direct selling industry, and one of the frequent themes is the negative public perception about how the industry operates. Multi-level marketers have a tremendous opportunity to address these concerns by enhancing transparency and fostering credibility across the industry. There are three important facets to this that I would like to address this morning: self-regulatory initiatives to improve compliance and level the playing field; realistic and candid communication about the limited nature of the earnings potential; and practices showing that MLM companies are making real sales to real customers.

I. Self-Regulatory Initiatives

The Direct Selling Association works persistently as the voice of self-regulation in this market. And, as DSA president Joe Mariano has emphasized, the DSA Code of Ethics can play an important role in modeling behavior for its members. I want to commend the DSA for the willingness it has shown to continue to work on and improve the Code. Changes were made most recently in 2015 and 2016. Among other things, the DSA established a mechanism to handle complaints about the practices of member companies – and for the DSA to publish reports about those complaints – and included lifestyle representations in the definition of earnings claims.

And, as Mr. Mariano noted, the DSA plans to take further steps next year to bring greater transparency to the industry. It is encouraging to see both the steps that have been taken so far and the recognition that this work is far from finished. This activity also reflects that the DSA has heard, and is open to hearing, concerns from the FTC.

I would like to use the majority of my time to address two areas where multi-level marketers need to take effective action to halt the practices that understandably damage the credibility of the whole industry. One is misleading income representations; the other concerns business structures that are unfair or deceptive because they are not focused on real sales to real customers.

II. Legitimate MLMs Must Accurately Represent Business Opportunities

I will start with misleading income representations. Earnings claims, regardless of whether they are express or implied, are highly relevant to consumers in making their investment decisions. In fact, we find that earnings claims are often the single most decisive factor in those choices. So it should be no surprise that the FTC takes earnings misrepresentations very seriously.

False and unsubstantiated earnings claims are deceptive and unlawful under Section 5 of the FTC Act. Unfortunately, however, our law enforcement experience shows that many MLMs continue to misrepresent the amount of money participants are likely to earn. In fact, in all of our cases against multi-level marketers, the FTC has alleged that the defendants made false earnings representations. These misrepresentations cause real harm to consumers, and they need to stop.

A legitimate multi-level marketer must accurately represent its business opportunity and what a participant is likely to earn. These representations must be truthful, non-misleading, and

substantiated. Practically speaking, this means that multi-level marketers should stop presenting business opportunities as a way for individuals to quit their jobs, earn thousands of dollars a month, make career-level income, or get rich because in reality, very few participants are likely to do that. Although it may be true that a very small percentage of participants do have success of this type, testimonials from these rare individuals are likely to be misleading because participants generally do not realize similar incomes.

The fact that most MLM participants do not earn substantial incomes is not new. The low incomes received by most MLM participants is something that the DSA itself acknowledged more than a decade ago. In 2006, when commenting on the FTC's Business Opportunity Rule, the DSA cited a 2002 National Salesforce Survey showing that the majority of direct sellers made less than \$10,000 per year from direct selling, with a median annual gross income of about \$2,400 or only \$200 per month.¹

Just last month, Mr. Mariano noted that the majority of multi-level marketing participants do not earn more than very modest incomes. I commend him for emphasizing that MLMs "must increase [their] efforts to ensure prospective distributors are fully aware...that for most, direct selling can [only] provide supplemental income. Most distributors will not realize replacement income, let alone a lavish lifestyle."²

It is time that MLM income representations matched the income reality of the majority of multi-level marketing participants. This means both explicit statements about how much a participant is likely to earn, as well as implied claims and lifestyle claims.

¹ Direct Selling Ass'n, Comments on the Notice of Proposed Rulemaking for the Business Opportunity Rule at 15 (July 17, 2006), available at https://www.ftc.gov/system/files/documents/public_comments/2006/07/522418-12055.pdf.

² Joseph Mariano, *Learning and Building on Collective Experience*, DSA News (Sept. 1, 2016), available at http://directsellingnews.com/index.php/view/learning_and_building_on_collective_experience.

We all know examples of the obvious types of lifestyle claims that can be misleading: representations that participants can be “set for life” or “make more money than [they] ever thought possible” and images of expensive houses, luxury cars, and exotic vacations. But there are also problematic claims that are a bit more subtle, like claims that you can quit your job, “fire your boss,” become a stay-at-home parent, travel the world, or have the time and money to enjoy the “finer things in life.” These lifestyle claims – whether made through statements or images – are deceptive when made to a general audience because participants are unlikely to achieve them.

Now, some of you may be thinking that what I am saying does not apply to you because you do not make income misrepresentations and you prohibit your distributors from making income misrepresentations. However, simply prohibiting your distributors from making income misrepresentations is not enough. MLMs must take reasonable steps to monitor and ensure that participants are not misleading others about the business opportunity. In addition, MLMs should provide sufficient information and training to participants to ensure that they will adequately understand the business and will not be misled by others.

This message is consistent with the DSA’s Code of Ethics, which states that member companies must comply with and ensure that their independent salespeople adhere to the Code’s guidance on earnings representations. As you know, the Code prohibits false, deceptive, misleading and unsubstantiated earnings representations. And, as the Code acknowledges, FTC case law provides ample guidance on the subject. I urge you to review FTC precedent and ensure that any income claims you and your distributors make accurately and truthfully reflect distributors’ likely earnings.

III. Legitimate MLMs Must Be Driven by Real Sales to Real Customers

Let me now turn to the second main problem we see in the MLM industry, namely, that many MLMs have structures that are unfair or deceptive because they are not focused on real sales to real customers.

A legitimate multi-level marketer must be focused on, and must pay compensation that is based on, real sales to real customers, not wholesale purchases by its sales force. This is a familiar concept, but I want to spend a few minutes breaking it down and showing how it animates FTC enforcement efforts. You can find the concept embodied in Commission decisions reaching back more than forty years, like the 1974 *Holiday Magic* opinion, which stressed the importance of basing multi-level compensation on actual product sales rather than on purchases by recruits.³ And, as the Ninth Circuit's decisions in *Omnitrition*⁴ and *BurnLounge*⁵ made clear, MLMs that pay compensation for product purchases by recruits, rather than for actual sales to customers, are facially unlawful.

As a practical matter, what does it mean for a multi-level marketer to base compensation on real sales to real customers? There are four aspects of this core principle that I want to emphasize:

- First, a legitimate MLM must be focused on real customers;
- Second, a legitimate MLM opportunity must be based on sales that are both profitable and verifiable;

³ *In re Holiday Magic, Inc.*, 84 F.T.C. 748, 1042-43 (1974).

⁴ *Webster v. Omnitrition Int'l, Inc.*, 79 F.3d 776, 782 (9th Cir. 1996) (explaining that an MLM operation is facially unlawful if a participant earns compensation based “on product orders made by [his] recruits” rather than “on actual sales to customers”).

⁵ *FTC v. BurnLounge, Inc.*, 753 F.3d 878, 885–86 (9th Cir. 1996) (citing with approval the issuance of a preliminary injunction against an MLM in which “rewards are received by purchasing product and by recruiting others to do the same”).

- Third, a legitimate MLM should not use targets or thresholds that are met by mere product purchases; and
- Fourth, the compensation paid by a legitimate MLM must be tied to retail sales.

I will start by explaining what we mean by “real customers.” Simply put, products sold by a legitimate MLM should be principally sold to consumers who are not pursuing a business opportunity. For good reason, the law has always taken a skeptical view of paying compensation to someone based on the presumed “internal consumption” or “personal consumption” of recruits who are pursuing a business opportunity.⁶ When a product is tied to a business opportunity, experience teaches that the people buying it may well be motivated by reasons other than actual product demand.

One of the more vivid examples of this comes from the *BurnLounge* case. The activities of the BurnLounge defendants included selling packages of music-related merchandise. Before the FTC brought its enforcement action, anyone who wanted to participate in the business opportunity was also required to buy a package. BurnLounge had monthly revenues of over \$475,000 from package sales, but those revenues did not reflect consumer demand for BurnLounge’s merchandise.⁷

After the FTC filed suit, charging that BurnLounge made deceptive income representations and paid compensation that was tied to recruitment rather than the sale of merchandise, the court entered a preliminary injunction that radically changed BurnLounge’s operations. Under the preliminary injunction, distributors could still buy BurnLounge products if they liked the merchandise, but they could no longer advance in the business opportunity. What

⁶ *Id.* at 886–88 (rejecting claim that business opportunity participants bought product packages for their own use and finding “[t]he merchandise in the packages was simply incidental”); *Omnitrition*, 79 F.3d at 783 (rejecting argument that a business opportunity participant’s use of products represents a sale to an ultimate user).

⁷ See *BurnLounge*, 753 F.3d at 885.

happened to sales? In only two months, they plummeted from over \$475,000 to less than \$11,000.⁸ As it turned out, at most, only a small minority of sales had been motivated by actual product demand, whether internal or external.

So, what does an MLM organized around real customers look like? You can see one approach laid out in the recent consent order we obtained in the *Herbalife* case.⁹ The order identifies two classes of people who are not pursuing the business opportunity: “retail customers” who simply buy product from Herbalife distributors and do not have any direct connection to the company; and “preferred customers,” who have registered with Herbalife as customers and do not participate in the Herbalife business opportunity.¹⁰ Under the order, there are a number of requirements that are intended to ensure that preferred customers represent a genuine class of discount buyers and are not simply business opportunity participants under another name. Preferred customers, for instance, are not permitted to resell product, recruit, or receive multi-level compensation.¹¹

The *Herbalife* order also reflects the law’s justified skepticism of compensation based on the presumed “internal” or “personal” consumption of recruits who are pursuing a business opportunity. To address this issue, the order incorporates a number of provisions that impose reasonable limits on the compensation paid for the consumption of products by business opportunity recruits. I will highlight one in particular: at least two-thirds of the compensation paid by Herbalife must be based on sales to retail customers or preferred customers, not on consumption by business opportunity participants.¹²

⁸ *Id.*

⁹ See *FTC v. Herbalife Int’l of Am., Inc.*, No. 16-5217 (C.D. Cal. July 25, 2016) (Stipulated Order for Permanent Injunction and Monetary Judgment) [hereinafter *Order*].

¹⁰ *Id.* at Def. I, N.

¹¹ *Id.* at Def. I, § I.B.

¹² *Id.* at §§ I.A.1.d, I.A.4.

The second issue I want to highlight concerns the meaning of “real sales.” “Real sales” are sales that are both profitable and verifiable.

To a certain extent, this is just simple logic. An MLM that pays compensation based on claimed sales that do not generate a net profit for the individual making the sale, or that cannot be verified as sales, cannot reasonably be characterized as based on “retail sales.” And, of course, decisions like *Omnitrition* and *Holiday Magic* have long recognized that compensation should be based on “actually consummated sales” to consumers.¹³

The *Herbalife* order also shows how these principles can play out in the operations of an MLM. It requires that retail sales that generate multi-level compensation for a participant, or that advance a participant in the business plan, must be both profitable and verifiable. Herbalife is required to collect verification information for every claimed retail sale and take all reasonable steps to verify that these sales both occurred as reported and represent genuine purchases by a true customer.¹⁴

Third, a legitimate MLM should not use targets or thresholds to satisfy eligibility for compensation or rewards that are met by mere product purchases. Because the focus of a legitimate MLM, and the basis for the compensation it pays, must be real sales to real customers, business opportunity participants should buy product only in response to actual consumer demand. For this reason, any requirements or incentives that participants purchase product for reasons other than satisfying genuine consumer demand – such as to join the business opportunity, maintain or advance their status, or qualify for compensation payments – are problematic. As you will recall from the *BurnLounge* example, these incentives can be powerful. There the defendants were selling nearly a half-million dollars of merchandise every

¹³ *Holiday Magic*, 84 F.T.C. at 1043 (compensation must be “based on actually consummated sales of such recruits to consumers”); *see also Omnitrition*, 79 F.3d at 782 (compensation must be based on “actual sales to consumers”).

¹⁴ *See, e.g., Order Def. M*, §§ I.C, I.D, I.F.2.

month and almost all of those purchases were driven by the desire to get ahead in the compensation plan rather than by genuine product demand.

Under the *Herbalife* order, the company is prohibited from imposing any requirement that a business opportunity participant purchase a minimum quantity of products. It also prohibits business opportunity participants from joining an automatic-shipment or similar program involving standing orders of product. And, targets or thresholds are permitted only if they are met exclusively through sales to retail customers or preferred customers.¹⁵ These provisions underscore that an MLM should always be focused on making sales to real customers who are not pursuing a business opportunity. MLMs should not contrive ways to get their business opportunity participants to make purchases for reasons other than actual retail demand.

The fourth point I want to highlight is that compensation paid by a legitimate MLM must be tied to real sales to real customers. If an MLM's participants buy product that does not result in real sales to real customers, this revenue should not be used to fund compensation.

It goes without saying that a legitimate MLM should not pay compensation solely for enrolling or recruiting a new participant. This means there should be no headhunter fees, recruitment bounties, or anything else of the sort.

For example, in *Herbalife*, we are requiring the company to track the percentage of wholesale revenues earned from product that is (i) sold to a retail or preferred customer, or (ii) within the limits established for compensating reasonable personal consumption by business opportunity participants. If at least 80% of Herbalife's wholesale revenue is not accounted for within these categories, the order imposes a cap limiting the total amount of compensation Herbalife can pay to its participants.¹⁶

¹⁵ *Id.* at §§ I.F.1.- I.F.3.

¹⁶ *Id.* at § I.A.4.

What does this mean in practice? If, hypothetically, half of the product that Herbalife sells wholesale results in verifiable retail sales as defined by the order and half does not, the total rewards that the company can pay are limited to the 50% that consists of verifiable sales to customers. On the other hand, if the vast majority of product purchases are genuine retail sales, total compensation can be higher. And if they are not, then the total compensation will be much lower.

All of the points I have highlighted are intended to operate in combination to provide reasonable assurance that product purchases will be driven by real product demand. Providing this assurance is both appropriate and necessary; it is not enough for an MLM to simply assume the existence of real sales to real customers.

Finally, I want to note that, although this is less common today, in the past some MLMs have sought to rely on policies similar to those referenced in the Commission's 1979 *Amway* decision – specifically, the so-called “buy-back,” “70 percent,” and “10 customer” rules – as a sufficient basis for assuming that their product is purchased by real customers to satisfy genuine demand. This reliance is misplaced. The Commission found those policies were effective given the specific facts in *Amway*,¹⁷ but neither the Commission nor the courts have ever endorsed those policies for the MLM industry at large.¹⁸ Indeed, the existence of a refund policy and a low refund rate do not necessarily mean that consumers are satisfied with their business opportunity, and both the “10 customer” and “70 percent” rules offer, at best, weak and attenuated evidence of a business focused on real sales to real customers.¹⁹

¹⁷ *In re Amway Corp.*, 93 F.T.C. 618 (1979).

¹⁸ *See, e.g., Omnitrition*, 79 F.3d at 784 (observing that holding in *Amway* was no broader than specific factual findings of that case).

¹⁹ *See FTC v. Pantron I Corp.*, 33 F.3d 1088, 1098 (9th Cir. 1994); *Omnitrition*, 79 F.3d at 783.

IV. Conclusion

Let me conclude by thanking you for allowing me to share some of my thoughts about reforms that the MLM industry should undertake in order to operate lawfully and prevent consumer harm. The industry's self-regulatory efforts to date are steps in the right direction, but more needs to be done. For our part, the FTC will be issuing further guidance for MLMs, but I believe the principles that I have outlined today should provide an important foundation for structuring business practices in the MLM industry in a way that provides consumers with truthful information and helps prevent consumer harm.

Thank you.