The Case (for and) against Multi-level Marketing

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Chapter 2: MLM DEFINITIONS AND LEGITIMACY – what MLM is – and is not

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Chapter summary

One of the biggest problems with multi-level marketing (a.k.a., "network marketing", or "MLM" for short) is the wide variety of definitions of what is – and what is not – multi-level marketing. We will consider a sampling of definitions and then discuss a much more objective definition based on comparative research on structural characteristics and analyses of over 350 MLMs (MLM programs).

This research has yielded four (and in most cases five) causative and defining characteristics ("red flags") that can be recognized in the compensation plan – which motivates the behavior of participants. This definitional model makes possible a clear distinction between (1) legitimate direct selling or home-based businesses, (2) classic pyramid schemes, and (3) recruitment-driven MLMs – or what I call "product-based pyramid schemes" (since they are likewise structured as endless chain recruitment schemes).

As I shall explain, there are inherent flaws in any MLM, assuming an endless chain of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves. I have looked for exceptions to this generalization in the 350 MLMs I have analyzed, but have found none.

MLM operates on the same principle as a chain letter, in which a person receives a letter with a list of names on it, mails a dollar to everyone on the list, adds his/her name to the bottom, and then forwards it to friends and relatives to do the same - in an endless chain of such letters. In such schemes, it is mathematically certain that the vast majority will lose money. Chain letters are illegal.

Just like the chain letter, MLM assumes both infinite markets and virgin markets, neither of which exists in the real world. Thus, MLM with its endless chain of recruitment, is inherently flawed, unfair, and deceptive. And fifteen years of worldwide feedback tells me that MLMs are also extremely viral and predatory. This is advantageous for the founders, TOPPs (top-of-the-pyramid promoters), and the MLM company itself, but works to the detriment of new recruits.

When discussing issues about the legitimacy of MLM in this book, I am using the word "legitimate" in the broadest sense; i.e., "conforming to recognized principles or accepted rules or standards,"[1] as opposed to narrow legal definitions, which may or may not conform to accepted standards in business practices.

This chapter concludes with likely the only accurate real-world, research-based, and consumer friendly, definition of the business model which is termed "multi-level marketing:"

Multi-level marketing (MLM) is a purported income opportunity, in which persons recruited into a pyramid of participants make ongoing purchases of products and services, and recruit others to do the same, and they still others, etc. – in an endless chain of recruitment and personal consumption, in order to qualify for commissions and bonuses and to advance upward in the hierarchy of levels in the pyramid. Product purchases become the means of disguising or laundering investments in what is in fact a product-based pyramid scheme.

Based on my research that will be explained in later chapters, I would add the following:

Typically, prospects are lured into the scheme with exaggerated product and income claims. And because the pay plan is heavily stacked in favor of those at the highest levels in the pyramid, the vast majority of participants spend more than they receive and eventually drop out, only to be replaced by a stream of similarly misled recruits, approximately 99% of whom are likewise destined to experience loss and disappointment.

A problem of definitions. Much confusions exists on the subject of what is – and is not – multi-level marketing (MLM) and how it can be distinguished from illegal pyramid schemes. We will begin by looking at how others define it and then bring together what light can be shed on the subject from legal and regulatory sources and from recent research.

We will first look at the definitions of multi-level marketing offered by others

1The New Merriam Webster Dictionary, Springfield, MA, 2008

Examples of Definitions of MLM by others – with commentary

From Wikipedia (March 2010)**:**

Multi-level marketing (MLM), (also called network marketing, direct selling, referral marketing, and pyramid selling) is a term that describes a marketing structure used by some companies as part of their overall marketing strategy. *The structure is designed to create a marketing and sales force by compensating promoters of company products not only for sales they personally generate, but also for the sales of other promoters they introduce to the company, creating a downline of distributors and a hierarchy of multiple levels of compensation in the form of a pyramid.*

The products and company are usually marketed directly to consumers and potential business partners by means of relationship referrals and word of mouth marketing.

"Independent, unsalaried salespeople of multi-level marketing, referred to as distributors (or associates, independent business owners, dealers, franchise owners, sales consultants, consultants, independent agents, etc.), represent the company that produces the products or provides the services they sell. They are awarded a commission based upon the volume of product sold through their own sales efforts as well as that of their downline organization.

Independent distributors develop their organizations by either building an active customer base, who buy direct from the company, or by recruiting a *downline* of independent distributors who also build a customer base, thereby expanding the overall organization. Additionally, distributors can also earn a profit by retailing products they purchased from the company at wholesale price.

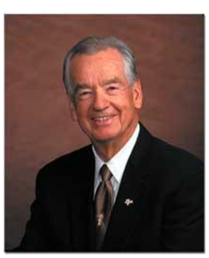
MLM spokesmen clearly crafted this definition, which Wikopedia uncritically accepted in lieu of definitions of consumer advocates that would highlight the inherent flaws in MLM. For example, no mention is made of the endless chain of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves. These critical features will be explained later in this chapter.

From author Richard Poe:

> Network marketing is not defined in any standard dictionary of business terms. Nor do network marketers themselves agree on what it means. For lack of any clear standard, I suggest the following definition: "Any method of marketing that allows independent sales representatives to recruit other sales representatives and to draw commissions from the sales of those recruits."[2]

This overbroad definition would take in many sales organizations that are not considered MLM, such as some insurance and real estate agencies. And as with the Wikopedia definition, no mention is made of the inherent flaws in any MLM system - the endless chain of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves.

Zig Ziglar (with Dr. John Hayes) offers his "technical definition" of what he claims network marketing (MLM) is – and is not. Below is an interesting definition put forth by Dr. John Hayes, in cooperation with prominent salesmanship author Zig Ziglar,[3] *who incidentally makes no mention of MLM or network marketing in his books directed to professional salesmen:*


Salesmanship author Zig Ziglar

> Would you like a technical definition? *Network marketing is a system for distributing goods and services through networks of thousands of independent salespeople, or distributors. The distributors earn money by selling goods and services and also by recruiting and sponsoring other salespeople who become part of their downline, or sales organization. Distributors earn monthly commissions or bonuses on the sales revenues generated by their downline.*
>
> Here's what network marketing is and is *not*:
>
> - Network marketing, or multi-level marketing (MLM), isn't illegal, fraudulent, or unethical.
> - Network marketing isn't an opportunity to get rich quick off the payments of others who join the organization. That's a pyramid scheme.
> - Network marketing isn't a pyramid scheme, which *is* illegal and unethical.
> - Network marketing isn't an opportunity to get rich quick. Period.
> - Network marketing isn't built on simple mathematics where many losers pay a few winners. That's also a pyramid scheme.
> - Network marketing isn't just for salespeople.
> - Network marketing isn't expensive. Unlike most other business opportunities, the start-up costs are low, almost always less than $500 and often under $100.
> - Network marketing isn't a way for companies to sell huge amounts of inventory to distributors. Network marketing isn't a way for distributors to sell stuff that nobody wants or uses.
> - Network marketing isn't a license to sell products and services at inflated prices.
> - Network marketing isn't for people who aren't willing to work hard.
> - Network marketing isn't for anyone who can't or won't follow a proven system that leads to business success.

While the first paragraph is quite descriptive and somewhat accurate, as is the Wikopedia definition, no mention is made of the inherent flaws in MLM - the endless chain of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases

2 *Wave 3: The New Era in Network Marketing*, by Richard Poe (Prima Publishing: New York, 1995), p. 7-8

3 *Network Marketing for Dummies,* by Zig Ziglar with John P. Hayes, Ph.D. (Hungry Minds, Inc.: New York, NY, 2001), p. 2

of the participants themselves. These critical features will be explained later.

Also, most of the items on the list of what network marketing is not would be vigorously challenged by knowledgeable experts advocating for consumers, based on extensive research as reported on the web site – www.mlm-thetruth.com.

Other authors on multi-level marketing offer weak definitions – or don't even attempt to define MLM. Another prominent MLM author, Dr. Charles King, professor of marketing at the University of Illinois at Chicago (with James Robinson), offers an even weaker definition that would be almost useless in making such distinctions:

Dr. Charles King

> Network marketing is the low-cost, and now high-tech, industry that invites you to build your own business and earn a potentially high income while working from home on your own schedule. You earn immediate income and serious long-term residual income by selling products and services directly to consumers and convincing others to do the same. [4]

Again, as with the Wikopedia definition, no mention is made of the inherent flaws in any MLM system – an endless chain of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves.

As an example of other authors who have made weak attempts to define multi-level marketing, David Roller suggests a definition that is rosy and descriptive, but not very helpful in making clear distinctions between MLM and other home-based businesses:

> Multi-level marketing or network marketing is a system by which a parent company distributes its services or products through a network of independent business people, not only in the United States but throughout the world. These independent business people or entrepreneurs then sponsor other people to help them distribute the product or service. This people-helping-people process may be continued through one or more levels of earnings.[5]

A search through the business section of a local Barnes and Noble store reveals that other authors have written on how to be successful at network marketing[6], but without offering any substantive definition of what they are talking about at all, apparently assuming readers all know precisely what they are talking about. This may be somewhat true of veteran MLM participants, but feedback I have received worldwide tells me this assumption may not always be correct, especially for those being recruited for the first time.

The FTC chooses a definition of multi-level marketing that only creates confusion. In its 2008 announcement by the FTC of its Revised Proposed Business Opportunity Rule (RPBOR), exempting MLM from having to comply with the Rule, the FTC quoted an article in which the following definition was advanced:

> Multi-level marketing is one form of direct selling, and refers to a business model in which a company distributes products through a network of distributors who earn income from their own retail sales of the product and from retail sales made by the distributors' direct and indirect recruits. Because they earn a commission from the sales their recruits make, each member in the MLM network has an incentive to continue recruiting additional sales representatives into their "down lines." - Peter J. Vander Nat and William W. Keep, *"Marketing Fraud: An Approach to Differentiating Multilevel Marketing from Pyramid Schemes,"* [7]

[4] King, Charles W. and Robinson, James W., *The New Professionals: The Rise of Network Marketing as the Next Major Profession,* Three Rivers Press, 2000

5 Roller, David, *How to Make Big Money in Multi-level Marketing,* Prentice Hall, 1989

6 One example is *The Ultimate Guide to Network Marketing: 37 Top Network Marketing Income Earners Share their Most Preciously Guarded Secrets to Building Extreme Wealth,* edited by Joe Rubino. John Wiley & Sons, Inc., 2006. Another book is by MLM promoters Yarnell, Mark, and Reid, Rene, *Your First Year in Network Marketing: Overcome Your Fears, Experience Success, and Achieve Your Dreams!"* Three Rivers Press, 1998.

[7] *21 Journal of Public Policy & Marketing* (Spring 2002), ("Vander Nat and Keep"), p. 140. (Cited in Footnote 34 at bottom of page 15 of RPBOR)

At a workshop hearing on the form for the final Rule, I pointed out that almost any direct selling company could circumvent the Rule by paying commissions to two or more levels of sales persons, who would have in some way been involved in recruiting new sales persons. In fact, many sales organizations do this, but do not consider themselves “multi-level marketing.”

With this definition, together with the MLM exemption, the proposed Rule would be almost totally ineffective in curbing abuse. It would be a tacit admission by the FTC that it is giving up on its mission to protect consumers against “unfair and deceptive practices” in this very important arena. As will be seen from further analysis, it would be difficult to conceive of a more unfair and deceptive practice than MLM, to say nothing of its extremely viral and predatory nature.

Again, in this FTC definition, as with the Wikopedia definition, no mention is made of the inherent flaws in any MLM system – an endless chain of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves.

The DSA attempts to define MLM as “direct selling.” The DSA (Direct Selling Association) was once an organization dedicated to advancing the interests of what were then legitimate direct selling companies like Fuller Brush and World Book Encyclopedia. But what has happened in recent decades could be illustrated by a farmer who has pigs and horses for sale. He gets more money for horses, so he attaches horse hairs on the buttocks of the pigs and marches them into the horse corral and proclaims, "See there, they are no longer pigs, but horses - because they are in the horse corral."

© Sorrel

Pigs are not horses!

Similarly, since “multi-level marketing” sounded too much like a pyramid scheme, MLM promoters coined the term "network marketing." Then, since it would sound even less pyramid-like, they sought to be called "direct selling" companies. So one by one, MLMs joined the Direct Selling Association and now boldly declare that they are “direct selling companies,” since they are members of the DSA.[8] The DSA now divides its membership into “single level” and “multi-level” pay plans.

The Direct Selling Association, has in recent years lobbied aggressively for the MLM industry to stop or water down proposed or existing legislation that protects consumers against what I call “product-based pyramid schemes”; i.e., MLMs. They also work to defeat efforts of consumer advocates to warn against product-based pyramid schemes, and to convince the public and the media of the legitimacy of MLM and of their stated intent to protect the public from unethical practices.

In 2006, the FTC proposed a Business Opportunity Rule, which would require sellers of business opportunities to disclose certain information to protect consumers. The excerpt below is taken from comments the DSA submitted, objecting to including MLMs in the Rule. The DSA’s efforts to equate MLM with legitimate direct selling and to justify its exclusion from the Rule are spelled out, as is their definition of MLM:

> DSA defines direct selling as: The sale of a consumer product or service, in a face-to-face manner, away from a fixed retail location. . .
>
> Multilevel marketing, also known as network marketing, is a compensation structure, not a sales strategy. In a multilevel compensation plan, independent consultants are compensated based not only on one’s own product sales, but on the product sales of one’s downline (those individuals the direct sales-person has recruited, or recruits of recruits.)
>
> In contrast, in a single level compensation plan, independent consul-tants are compensated based solely on

[8] See the section “The DSA/MLM cartel” in Chapter 10

> one's own product sales. Companies using a multilevel compensation structure may use either a person-to-person or party plan sales strategy. Eighty-four percent of direct selling firms use some form of multilevel compensation, and virtually all new companies entering direct selling are using some form of multilevel compensation. [9]

Another statement in the DSA comments is remarkable: "Recruiting is the lifeblood of the industry." This is a startling admission of the focus on recruitment, which is true of all product-based pyramid schemes. My analysis of the compensation plans of over 350 MLMs, including DSA firms, confirms this. Comparatively slight rewards for retailing, together with overpriced products, makes recruiting the focus of anyone seeking to profit from MLM.

The suggestion that "the vast majority of salespeople work[ing] only a few hours per week, with modest financial goals in mind" will be found in subsequent chapters to be totally misleading because one cannot build and maintain a large downline working part-time, seasonally, or with modest financial goals. Virtually all who do MLM part-time lose money, after subtracting expenses, including purchase of products necessary to qualify for commissions.

And again, as with the Wikopedia definition, no mention is made of the inherent flaws in any MLM system – an endless chain of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves. These critical features will be explained later in this chapter.

Needed: A more accurate, research-based definition of MLM that addresses structural flaws in the model – and harm to participants

This report uses the terms "Recruitment-driven MLM" (implying an emphasis of recruitment over selling) and "Product-based Pyramid Scheme"[10] as inter-changeable terms. These programs have also been called "Multi-level Marketing," "Network Marketing," etc. – even "direct selling" (though little selling to the public takes place). "MLM" is a generic acronym for any type of multi-level or endless chain selling program, and we will use it for brevity.

More negative sounding titles include "chain selling," "pyramid selling," entrepreneurial chains," etc. In this report, a "recruitment-based MLM" employs a compensation plan that rewards recruiting so much more than direct selling that there is comparatively little incentive to sell products.

No-product pyramid schemes are fairly easy to identify, and they seldom last long without law enforcement shutting them down. But when products are offered, and when consumers are presented with an income "opportunity" with multiple levels of "distributors," it is not easy for some to decide whether or not it is in fact an exploitive product-based pyramid scheme. Unfortunately, some of the most damaging programs manage to escape legal action.

After processing extensive data and analytical reports and posting them on a web site, I found myself interacting with the top experts in the field. I began offering research and training through the non-profit Consumer Awareness Institute that I had formed years earlier for other projects – all financed out of my own pocket.

CAI CONSUMER AWARENESS INSTITUTE
NON-PROFIT CORPORATION

[9] #178 FTC Matter No.: R11953 16 CFT Part 437 Notice of Proposed Rulemaking: Business Opportunity Rule, Comments #522418-12055, -58, -61, -66, -70, -74, -79, -83,-87, -92, and -96

[10] For a brief history of classic, no-product pyramid schemes, and MLM, or product-based pyramid schemes, see Chapter 10.

FTC rationale for considering pyramid schemes unlawful. The Federal Trade Commission Act states that "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful."[11] While the FTC does not specifically address pyramid schemes, such schemes have been deemed unlawful under the above clause in the Federal Trade Commission Act.[12]

". . . unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful." While the FTC does not specifically address pyramid schemes, such schemes have been deemed unlawful under the above clause in the Federal Trade Commission Act (Section 5).

MLMs are typically recruitment-driven. I refer to MLMs which recruit aggressively as "recruitment-driven MLMs," as opposed to hypothetical "retail-focused MLMs," which would allow a person to earn a significant income from retailing products to end users. Understanding the difference is the key to identifying the features in MLM that cause harm to participants – which will be explained in later chapters. Actually, harmless MLMs would be extremely rare. In fact, I found no retail-focused MLMs out of hundreds of MLMs I have reviewed.

Party plans do some retailing. The closest to a retail-focused MLM would be an "in-home demonstration" program, or "party plan," which features sales at parties sponsored by demonstrators. But determining whether or not the party plan is still recruitment-driven and financed primarily through purchases by participants would require analysis of their compensation plans and average earnings data, which such companies have not as yet been willing to provide. So they remain a grey area in my research.

In-home demonstration programs ("party plans")

Confusing comparisons. MLM is often compared to legitimate alternative business models, such as franchising, direct sales, insurance, and product distributorships. This adds confusion in the minds of consumers and law enforcement officials. However, my research suggests that clear differences can be seen.

As explained above, one common strategy for MLM companies seeking to build credibility is to go to great lengths to be identified as "direct sales" organizations. However, after rigorous comparisons of legitimate business models with characteristics of compensation plans of "recruitment-driven MLMs", when the four characteristics described below are taken together, clear distinctions between legitimate and illegitimate (using the FTC standard of "unfair and deceptive practices").

Interestingly, the four characteristics, which when taken together differentiate these programs from legitimate businesses, are the same features that cause an extremely high loss rate and other problems for participants. I call them "causal and defining characteristics of product-based pyramid schemes" because they both *cause* the harm and also serve to *define* MLMs as product-based pyramid selling schemes, or recruitment-driven MLMs. Properly applied, they can also be highly effective in identifying programs that violate federal and state laws against pyramid schemes.

[11] Section 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. 45(a)(1)
[12] In re Koscot Interplanetary, Inc., 86 F.T.C. 1106 (1975)

Inadequate legal definitions. Most of the laws and statutes were crafted before the structure, dynamics, and effects of product-based pyramid schemes were fully understood, so the definitions within anti-pyramid statutes do not accurately reflect the root causes of the problems. They tend to focus on behavior of participants, rather than on objective underlying structural features.

However, there is enough validity in the present legal definitions of pyramid schemes in most jurisdictions that enforcement against such schemes can be effective if the principles in this paper are understood and applied. This is true regardless of the complexity of the compensation plan of any given MLM.

FTC guidelines and most state statutes include a *key element in defining pyramid schemes* – the payment of money by the company in return for the right to recruit other participants into the scheme. If the *primary emphasis is compensation from recruiting,* rather than from the sale of products to end users, it is considered a pyramid scheme. How such primary emphasis is to be determined has until now been a formidable challenge for investigators.

Why understanding the compensation plan is so important. Decades ago, psychologists experimenting with both animals and people learned 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.

Similarly, since an MLM compensation plan specifies how participants are rewarded, it reveals whether the primary income emphasis is on recruiting or on retailing – and therefore, whether or not a given MLM is a disguised pyramid scheme.

MLM spokesmen maneuver to divert authorities from examining how participants are rewarded. They speak of the validity of a company's products, the integrity of its leaders, and the company's solid financial condition. *It seems that the one thing MLM leaders do not want regulators to understand – the compensation plan – is the one thing investigators must grasp in order to answer the question of where the emphasis is* – on company payout resulting primarily from recruiting (or product sales to recruits), or primarily from retailing to consumers outside of the MLM's network of participants.

The problem of evaluating MLM programs is further complicated by a wide array of complex MLM payout formulas, or compensation plans. The problem of identifying emphasis on recruiting vs. retailing in a compensation plan, as well as consumer harm, can be greatly simplified by understanding the four characteristics discussed below – all of which are generic to all MLMs, or product-based pyramid schemes. (There is also a fifth characteristic that appears in almost all MLMs which amplifies the fourth characteristic.)

MLM compensation plans can get quite complex. Appendix A illustrates just two examples out of hundreds of MLM compensation plans, showing the complexity of only a portion of a typical MLM compensation plan. Many of the plans are far more extensive and complex than these. This makes it difficult to compare plans from different MLMs. *These widely varying plans also illustrate the need for an understanding of the commonalities and distinguishing features that separate MLM from all other forms of business activity.*

These widely varying pay plans illustrate the need to understand the commonalities and distinguishing features that separate MLM from all other forms of business activity.

What is the difference between recruitment-driven MLMs and (hypothetical) retail-focused MLMs? Companies with all four of the following characteristics of a product-based pyramid scheme can be classified as *recruitment-driven MLMs,* as differentiated from *hypothetical retail-focused MLMs,* which would primarily reward those who sell products. In reality, MLMs (with the exception of some party plans) are essentially closed systems, which sell products at retail primarily to program participants and cooperating family members – seldom to the general public.

These product purchases could be considered disguised or laundered investments in a product-based pyramid scheme. TOPPs (top-of-the-pyramid promoters), founders, and company executives are rewarded at the expense of a revolving door of unwitting recruits.

How these defining characteristics were derived. Fifteen years of research and feedback confirm this analysis, including a one-year experiential test, direct observations of numerous MLM opportunity meetings, communications with thousands of participants (and ex-participants) and executives from a variety of MLMs – and with consumers as MLM prospects, consultations with top MLM experts and attorneys, collection/ processing of available data (including official company reports), analysis of over 350 MLMs with all types of compensation plans, and surveys of tax professionals.

In the early stages of my research, after months of comparative analysis, I was able to identify a list of characteristics that are common to all MLMs, including the 350 MLMs I have since analyzed. These were compared to characteristics of no-product pyramid schemes – as well as to legitimate business models to which MLM is often compared, such as direct sales, franchises, distributorships, insurance agencies, etc. (See Appendix 2F for details of this analysis, which can be downloaded as a separate pdf file.)

From this comparative analysis, a trained eye can see that when one focuses on the causes of the problems with highly leveraged MLMs, which are compensation plans with perverse reward features (enriching a few at the top at the expense of a huge downline who lose money), certain characteristics, or "red flags," become apparent. Amazingly, four key *characteristics* are both *causative* (causing high loss rates) and *defining* (clearly distinguishing pyramid schemes from legitimate businesses). I'll refer to these causative and defining characteristics as "CDCs." (For terms used in describing MLM compensation plans, see Appendix 2B. See Appendix 2C for additional terms related to MLM.)

The four characteristics (CDCs) of recruitment-driven MLMs, are causal, defining, and legally significant. The set of four characteristics below were found to be exclusive to recruitment-driven MLMs (which included all MLMs in my sample of 350 programs). Based on careful analysis of available data, *MLM programs with all of these characteristics have a shocking loss rate – approximately 99.6%*[13] *of ALL participants lose money (after subtracting ALL expenses)! – not a legitimate business by any reasonable measure.*

In the light of these odds, typical promises made by MLM promoters of lucrative incomes are misleading, except for a few at the top of the pyramid who got in early.

Again, it is important to recognize that —

- These four characteristics are *causal* because they identify the cause of the harm or consumer losses.
- They are *defining* because they clearly separate what I call "recruitment-driven MLMs" or

[13] See Chapter 7: "MLMs Abysmal Numbers"

product-based pyramid schemes from all other forms of commercial activity.

- And they are *legally significant* because they answer the question that law enforcement has not consistently answered in cases before; i.e., how the *primary emphasis on income from recruiting* (as opposed to selling direct to consumers at retail prices) can be determined from the reward system (compensation plan) – rather than from complaints, which simply are too cumbersome and unreliable in this arena.

It is the synergistic effects of these four CDC's working together in an MLM that cause the extraordinary loss rates characteristic of these schemes. Interestingly, *most of the laws that might implicate MLMs as pyramid schemes are based on one or more <u>effects</u> of the scheme (such as whether or not sales are made to end users, not just participants) and not the essential <u>causes</u> of the problems; i.e., the underlying structure of the scheme or compensation plan, since rewards are what drives behavior.*

No wonder law enforcement has been so confused and inconsistent in this arena. Even so, using this analysis, law enforcement agencies can work within existing laws. Attempting to change the laws is risky, since the MLM lobby (Direct Selling Association) could then influence legislators to pass deceptive "anti-pyramid" laws that are actually favorable to MLM, as they have already done in several states.

"The Commission has previously condemned so-called "entrepreneurial chains" as possessing an *intolerable capacity to mislead."*

The four CDCs of recruitment-driven MLMs, or product-based pyramid schemes, that cause the harm and that clearly distinguish between MLM and legitimate direct selling opportunities

1. Each person recruited is empowered and given incentives to recruit other participants, who are empowered and motivated to recruit still other participants, etc. – in an endless chain of empowered and motivated recruiters recruiting recruiters – without regard to market saturation.

When analyzing a program, prospects could ask: Is unlimited recruiting allowed, and are those who are recruited empowered and spurred on by incentives (such as overrides from downline purchases, advancement, etc.) to recruit additional participants, etc. – so that the effect is unlimited recruiting of empowered and motivated recruiters in an endless chain?

The endless chain of recruiters recruiting recruiters – works on the same principle as a "pay to play" chain letter.

This endless chain of recruitment is the great underlying flaw in MLM. In fact, all pyramid schemes, chain letters, and MLMs have this endless chain recruitment characteristic in common. MLMs assume both infinite and virgin markets – neither of which exist. Since MLM as a business model depends on an endless chain of recruitment, or infinite expansion in finite markets, MLM is inherently flawed, unfair, and deceptive. It is also extremely viral and predatory. These should have been sufficient grounds for the FTC to consider MLMs as unfair and deceptive practices, and therefore illegal. However, that opportunity was missed in 1979, and FTC officials have not had the will to revisit the issue.

It is interesting that in the Koscot case[14], the court noted, "*The Commission has previously condemned so-called "entrepreneurial chains" as possessing an intolerable capacity to mislead*."[15] 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 Amway decision. (The numerous deceptions typically used in MLM recruitment campaigns will be discussed in a later chapter.) 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. (See Chapter 8 for lists of over 100 typical mis-representations used in MLM recruitment.)

MLM promoters often argue that all organizations are organized as pyramids, with a few at the top and many at the bottom and with those at the top being paid the most. If this were the only distinguishing characteristic of a pyramid scheme, they would be right. But the endless chain of recruitment of participants as primary customers – with money to those at the top coming from purchases of those at the bottom - is far more accurate and discriminating.

The stacking of participants in a pyramid for the purposes of payout is secondary to the chaining aspects. However, it should be noted that in corporations and government organizations, even those at the very bottom at least earn a minimum wage – as opposed to all those on the bottom of a pyramid scheme actually losing money. A more apt analogy for MLM as an income opportunity would be that of an iceberg, instead of a pyramid. Those few who profit from MLM stick out like an iceberg, with the vast majority under water, or in a losing position, after subtracting expenses.

Had all forms of endless chain marketing schemes been declared illegal (as happened in Wisconsin in 1970 – but unfortunately was not enforced[16]), this confusion over definitions would be minimal. Based on DSA data on worldwide sales by MLMs (which represent losses to 99% of participants) I estimate that *since 1979, aggregate losses totaling hundreds of billions of dollars by hundreds of millions of unwitting victims would have been prevented.* MLM in its present form would not have existed, and you would not be reading this.

The ill-fated Amway decision – and the "retail rules." In 1979, FTC attorneys were outfoxed and outgunned by Amway attorneys. The FTC's administrative judge (later FTC Chairman) Robert Pitofsky ruled that Amway was not a pyramid scheme, subject to "retail rules" that Amway claimed it would voluntarily enforce. These rules can be summarized as follows: (1) distributors were to sell or consume 70% of the products they purchased each month (later refined to mean sales to non-partici-pants[17]), (2) they

14 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)

15 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).

16 *Tax Returns of the Top Amway Direct Distributors in Wisconsin,* Bruce Craig, op cit

17 Webster v. Omnitrition, IIB, filed in the Appeals court for the U.S. District Court for the Northern District of California, March 4, 1996. Also statements by FTC officials James Kohm and Debra Valentine – referred to later in this report.

must be able to prove a sale to each of ten customers each month, and (3) reasonable buy-back provisions be permitted.[18] These retail rules have been used as a benchmark in other MLM cases.

The rules were merely given lip service. In practice, the first two of these rules are unenforceable and are generally ignored by MLMs. The Amway decision opened the floodgates for some of the most unfair, deceptive, viral, and predatory schemes ever devised. Consumers recruited into MLMs worldwide will continue to pay heavy prices for that decision – unless regulatory agencies more rigorously apply existing laws.

Just like the chain letter, MLM assumes both infinite markets and virgin markets, neither of which exists. Thus, MLM with its endless chain of recruitment, is inherently flawed, unfair, and deceptive. MLM is also extremely viral and predatory.

In spite of the confusion over definitions of what constitutes a pyramid scheme, much can still be accomplished within the present legal framework. This chapter focuses on clarifying those definitions and on identifying the combination of features in the compensation plan that cause the greatest harm.

Avoiding market collapse. When pyramid promoters introduced product purchases as the means for financing the scheme, then labeled MLM, some found ways to avoid ultimate collapse. First, in recruitment cam-paigns, MLMs used a hard-sell approach to focus attention on the quality and unique nature of the products, and away from the endless chain of recruitment of participants as primary (or only) customers.

As a second strategy, major MLMs introduce new product lines or divisions, enter new demographic markets or countries, or change the name of the company and introduce the package as a whole new company with a "different" product or service emphasis – as Amway did when it morphed into "Quixtar" in the United States, while keeping the "Amway" name and brand in overseas markets. Nu Skin shifted it's recruiting to Asia to the point that about 85% of its revenues came from Asia. Later, Nu Skin "re-pyramided" by developing new product divisions, such as Interior Design Nutritionals (IDN), Big Planet (internet services), Pharmanex, and PhotoMax – through which it could cycle whole new rounds of recruitment.

Third, MLMs engage in recruitment campaigns and use the DSA to influence public opinion to accept and define their schemes as legitimate direct selling opportunities.

And fourth, there is a revolving door of recruits, particularly near the bottom, where newly recruited participants replace those who quit. Thus, in MLM there is a continuous collapse of the base of the pyramid, involving the churning of exiting and newly recruited participants, allowing those near the top to keep their places and their high income levels.

It is through actions like this, indicative of continuous collapse, that MLMs, or product-based pyramid schemes, can survive longer without total collapse than no-product pyramid schemes. Further, because of the prolonged collapse, many more participants are adversely affected in product-based schemes than in no-product schemes.

Strategies used by MLMs to compensate for market saturation and to avoid market collapse will be discussed further in chapter 3.

Are participants buyers or sellers? Unlimited recruiting in MLMs also changes the marketing nature of the system from one of a network of "distributors" to a network of buyers. Any clear distinction between buyers and sellers is blurred – even evaporating. The sellers are the buyers, and the buyers are the sellers – to themselves and their families. Also, we see the fallacy of the claim of MLM promoters that they are removing the "middle man" in their marketing system. Actually, in an MLM, middlemen may number in the thousands in multiplying downlines.

[18] See 93 F.T.C. 618, 716-17 (1979).

New MLM recruits buy products mainly to qualify for profits from recruiting others, rather than from any real need for the products or from any expectation of profit from retailing. And as people tire of being solicited, the perceived opportunity to find willing buyers eventually diminishes to a trickle. Since the retail market is a phantom one, in order to increase the base of recruiting prospects who will pay retail to "play the game," we see promoters introducing new product divisions or opening up new markets to recruit in other areas.

Recruitment-driven MLMs can become Ponzi schemes. When MLM promoters expand into other areas to make it possible for earlier investing participants to be paid off from newer investors, the MLM can be said to have evolved from a pyramid scheme into a type of Ponzi scheme – which is illegal in almost all jurisdictions. Ponzi schemes are programs in which new investors are repaid, not from the sales of products or fulfillment of services, but from the investments of new investors.[19] Ultimate collapse is inevitable as new markets become less accessible, or when perceived or market saturation makes future prospects resistant to participation.

MLM proponents argue that replacement of continual dropouts by ongoing recruitment is like other direct sales businesses. But this is a fallacy. Later recruits never have the same opportunity as earlier entrants due to market saturation. (See Chapter 3.)

The more resourceful MLMs prevent market collapse by opening new markets in other states or countries and/or by starting new product divisions and repeating the cycle all over again. As mentioned above, 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.

[19] *Ponzi Schemes, Invaders from Mars, & More Extraordinary Popular Delusions and the Madness of Crowds,* by Joseph Bulgatz, (New York: Harmony Books, 192), pages 11-45

Why is recruiting emphasized over retailing? Unlimited recruiting of recruiters, combined with the other factors explained here, creates enormous leverage. Rewards for recruiting a large downline are so much greater than for retailing products that participants see no point in spending time and effort retailing, except for token sales (often fake sales to cooperating relatives) to satisfy "retail rules." Again, "you get the behavior you reward." The "primary emphasis on income from recruiting" test of a pyramid scheme is thus satisfied.

The following items summarize the evidence that recruitment-driven MLMs do not engender any significant retail market:

1. The compensation plan rewards the recruitment of a downline so well that there is little incentive to sell directly to consumers at retail prices.

2. An analyst can subtract all incentivized purchases by new distributors and their families from total revenues from that area on the company's financial report. If the volume left over is minimal, direct selling is not the major thrust of the company, in spite of what its promoters claim.

3. Surveys of ex-distributors reveal that few continue buying the products after leaving the MLM. They recall that little if any direct selling occurred outside of the network of distributors and their immediate families. (Surveys of ex-distributors are more valid than those of current distributors, who may have contracted to sell at retail to keep their distributor license.)

4. We know from surveys conducted in areas where intense MLM activity is occurring that few sales are made directly to consumers who are not connected to the recruitment scheme.

5. Little if any direct selling continues in an area two or three years after an MLM finishes its recruitment blitz through the area.

6. To counter dwindling sales due to a drop-off in recruiting, the MLM recruits in other areas or shifts to new product divisions in the company. Promoters can then sell to new recruits.

6. Signs of reporting inconsistencies can reveal a lack of direct sales – in

contradiction to what MLM officials are telling law enforcement investigators. In the case of Nu Skin, sharp discrepancies appeared between U.S. revenues reported to the SEC and those reported to the FTC and to recruits in the amount of sales that were occurring at retail prices. This was blatant evidence of misrepresentation.[20]

7. Direct observation can be revealing. In my test of Nu Skin's program, I saw over 400 Nu Skin distributors over a one-year period, but I can recall only one who made a serious effort to sell Nu Skin's expensive supplements directly to non-distributors. She sold to rich neighbors who were sympathetic to her struggle to succeed.

2. Advancement in a hierarchy of multiple levels of "distributors" is achieved by recruitment and/or by purchase amounts, rather than by appointment.

Ask: Does a participating "distributor" advance one's position (and potential income) in a hierarchy of multiple levels of participants by recruiting other "distributors" under him/her, who in turn advance by recruiting distributors under them, etc.? Or by buying products to qualify at certain levels in the compensation plan?

In MLM, the position in the hierarchy is determined not by appointment, but by time of entrance into the program and by recruiting success. When persons are recruited into such a program and then given incentives to buy products, they are being "leveraged" for the profit of those above them. They may think they are advancing, when in fact they are often being manipulated into buying more products and recruiting more people to benefit those above them.

MLM is all about getting in early - or climbing to the top of the pyramid - where the big money is made.

Are MLM "distributors" really distributors? When the pay plan rewards recruits far more for recruiting others than for retailing products or services, and when purchases are "incentivized," or tied more to advancement in the scheme than to the sale of products and services to non-participants, it is a misnomer to refer to them as "distributors." (Some MLMs use other terms for participants, such as "representatives," "associates," etc.) This is why I often place the term "distributors" in quotation marks. It is more correct to refer to them as "investing participants."

Correctly viewed, an accumulation of such incentivized purchases over a period of time constitutes a substantial investment in a pyramid scheme. (See #3 below) Unfortunately, MLM participants are led to believe that purchases of goods and services are not part of the cost of doing business, so they don't subtract these purchases when figuring supposed "income."

Participants are typically not sophisticated business analysts, so the customary subtraction of all costs from revenues to figure profits is often ignored. Such purchases would be made from less expensive sources if any comparison shopping were done.

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20 *REPORT OF VIOLATIONS of the FTC Order for Nu Skin to Stop Misrepresenting Earnings of Distributors*, by Jon M. Taylor, filed with the FTC November 20, 2002 – based on the 1998 report of "Actual Average Incomes" of U.S. distributors for Nu Skin Enterprises." Since that time, NuSkin has not reported retail sales that they could not prove had occurred. See latest updates at – www.mlm-thetruth.com.

Close examination reveals that *both advancement and income are dependent primarily on downline recruiting and on "internal consumption"* (sales to participants in the scheme). If participants must recruit and buy products to be successful, and if the pay plan's primary rewards are for building a downline, it should be considered an illegal pyramid scheme.

3. "Pay to play" requirements are met by ongoing "incentivized purchases," with participants the primary buyers.

Ask: Are "distributors" who are recruited presented with significant "pay to play" options; i.e., are they encouraged to make initial or ongoing investments in "incentivized purchases" in order to take advantage of the "business opportunity," and to continue qualifying for advancement in – or overrides and bonuses from – the MLM company?

MLM participants subscribe to minimum product purchases in order to "play the game" – to qualify for commissions or advancement in the scheme

What are "incentivized purchases?" - or "pay-to play[21] purchases"? I coined the term "incentivized purchases" to refer to the practice of tying purchases of products from an MLM company with requirements to enter the "business opportunity" option and to advance in the hierarchy of "distributors" – who are in effect merely participants making pyramid scheme investments disguised (or laundered) as purchases. They are also called "pay to play" purchases. (See Appendix 2C for definitions)

Percentage of revenues accounted for by internal consumption – a key legal issue. In pyramid scheme cases, the percentage of purchases accounted for by participants' personal consumption – as opposed to sales to non-participants – has become a litmus test for determining if an MLM is an illegal pyramid scheme. MLM executives may attempt to excuse lack of evidence of retail sales by pointing to company rules that require sales to non-participants as proof of such sales. However, the existence of rules aimed at encouraging retail sales and discouraging inventory loading will not protect a company from being an illegal pyramid scheme if not effective or adequately enforced.[22]

How much is actually invested in the scheme? MLMs typically charge a nominal fee to be licensed as a distributor. This is usually less than $100 to avoid raising the eyebrows of enforcement officials – and to escape subjecting the MLM program to more strict guidelines as a security or "business opportunity."

However, in the typical scenario, initial registration or license fees are merely the beginning of the total investment for MLM participation. One must add incentivized

[21] For this insight, I thank Kristine Lanning, former assistant to the Attorney General for North Carolina.
[22] *In re Koscot Interplanetary, Inc*., 86 F.T.C. 1106, 1181 (1975), aff'd., *Turner v. F.T.C.,* 580 F.2d 701 (D.C. Cir. 1978); *In the Matter of Amway Corp.,* 93 F.T.C. 618 (1979); *Webster v. Omnitrition*,79 F.3d 776, 781 (9th Cir. 1996); *United States v. Gold Unlimited, Inc.,* 177 F.3d 472, 480-81 (6th Cir. 1999); *F.T.C. v. Equinox, Int'l. Corp*., 1999 U.S. Dist. LEXIS 19866, *15 (D. Nev. Sept. 14, 1999); *People v. Cooper*, 166 Mich. App. 638, 651-52; 421 N.W.2d 177 (1987); *Koscot Interplanetary, Inc. v. Draney*, 90 Nev. 450, 530 P.2d 108 (1974); Section 5 of the FTC Act; M.C.L. 750.372; N.R.S. 598.100, et, seq.

ongoing purchases, which may total thousands of dollars a year.[23] They constitute a substantial portion of the cost of participating in the "business opportunity." Whether they are used, sold, given away, or stored, is irrelevant.

Escalating incentives to continue purchasing products to qualify for higher commissions rates and/or ever-higher levels in the hierarchy of participants often leads "distributors" to hyper-consume products or to give away a lot of samples. Many fill their garages with products they don't need. The argument that they would have purchased the products anyway, and that these purchases should not be considered an expense of doing business, does not hold water. Upon quitting, most cancel product subscriptions.

We know from surveys that few sales are made directly to consumers who are not connected to the recruitment scheme. Only motivated participants can be induced into paying for overpriced "pills, potions, and lotions" typically sold by MLMs.

So when participants are expected to make product investments to get into an MLM – and then to continue purchasing products (by subscription), training, etc., in order to progress in the organization, *they are paying pyramid investment fees to "play the game," one of the earmarks of a product-based pyramid scheme.*[24]

If participants must recruit and buy products to be successful, or if the pay plan's primary rewards are for building a downline, it should be considered a recruitment-driven MLM, and hence an illegal pyramid scheme.

If participants subtracted purchases and the operating costs of recruiting from commissions, they would find a high breakeven bar rarely exceeded by revenues. In other words, almost all participants below the TOPPs lose money.

Why are incentivized MLM product purchases not recognized as pyramid investments? Most MLMs offer lucrative incentives for recruiting an increasing number of "distributors" and for revenues from product sales. So many participants recruit <u>"dummy distributors</u>" from friends and relatives and buy products in their names – or simply buy products for them as "<u>counterfeit customers</u>." They believe this will qualify them for "the really big bucks." Few realize that they have in effect paid a very large fee for participation in a pyramid scheme. Through a variety of misrepresentations about the "opportunity," large sums of money may thus be extorted from them.

Such an amount paid at the start into a no-product pyramid scheme would immediately arouse suspicions of its' being an illegal pyramid scheme. But since the money paid into an MLM is paid for legitimate products and over a period of time, most participants and investigators fail to see it as an investment in a pyramid scheme. In reality, this means of investing in the form of incentivized and ongoing product purchases could be considered a device for disguising or laundering pyramid scheme investments.

MLMs typically sell overpriced potions and lotions touted to prevent or cure a wide range of maladies. This could be compared to a bushel of apples selling for $20 a bushel. The seller paints blue stripes on them and sells them for $60 – $40 more because of the "magical properties" attributed to the blue stripes – the old "snake oil" pitch.

Many MLM products are sold at a premium so that commissions can be paid

[23] The minimum 100 PV (personal volume) for Quixtar (Amway) participants was "roughly equal to $260/mo." ($3,120 per year) . . . and "because Quixtar's overpriced products are not sellable to anyone except distributors who are buying to qualify for bonuses, Quixtar distributors' earnings are a direct function of how much product they and their downline consume. The more internal consumption and the larger the downline, the higher the bonus." (Complaint and demand for jury trial, US Dist. Ct., Central District of Calif., Western Div., Case No. CV 07-05194), § 97)

[24] In FTC v. Amway (1979 – 142-145), Webster v. Omnitrition (Discussion on "Pyramid"), and FTC v. Skybiz (29)

to many levels of distributors. If an MLM product were sold for $20 more than a comparable one sold through other outlets, this $20 premium could be considered the pyramid investment portion of the price, which would flow to the top of the hierarchy of participants in typical pyramid fashion.

Do MLM participants sell products at listed retail prices to non-participants? MLM promoters have convinced many regulators that MLM distributors sell a significant amount of products to persons not participating in the scheme. In most MLMs, this is patently false. We know from surveys conducted in areas where intense MLM activity is occurring that few sales are made directly to consumers who are not connected to the recruitment scheme. Only motivated participants can be induced into paying for overpriced "pills, potions, and lotions" typically sold by MLMs.

Investing in the form of incentivized and ongoing product purchases could be considered a device for disguising or laundering pyramid scheme investments.

In a randomized survey of households in Utah County, Utah, where many MLMs are located, we found _four_ MLM distributors for every _one_ non-participating customer.

A startling admission. We usually see a "wink-wink, nod-nod" attitude of MLM promoters on how they get participants to purchase most of the products from the company. "Pay-to-play" or incentivized purchases play a bigger role than most are willing to admit. But occasionally the truth leaks out. Consider this quote from Advocare's "Policy and Procedures" manual regarding its compen-sation plan:

> You may choose any method you like to achieve Advisor status. These examples point out the practical reasons you always want to track your volume if you think you're close to qualifying Advisor status – and if necessary, cover the $500 Personal Volume with your own purchases.[25]

". . . if necessary, cover the $500 Personal Volume with your own purchases,"

MLM not recognized as legitimate selling. Additional evidence that little actual direct selling takes place in MLM can be found on the business shelves of any bookstore. I searched the contents of books on salesmanship of major bookstores and found no mention of MLM or multi-level or network marketing as an arena for professional sales-persons. The only exceptions were when networking (not MLM) was discussed, and when a professional sales person mentioned a bad experience with MLM on his way to becoming a real salesperson[26]. And even in the books that Zig Ziglar (who has written on MLM[27]) has written on salesmanship, he is careful not to include MLM as a form of selling. Apparently, MLM is only respectable to those doing it.

When as a young man I sold encyclopedias to help pay my way through college, it was not a requirement that I buy a set for myself or to meet a certain quota in order to qualify for commissions. And later, as an insurance agent, I was not required to buy the insurance I was selling. This would not be true in an MLM, which depends for much of its revenues on minimum purchases by participants who buy to qualify for commissions and/or advancement.

For a list of criteria to clearly distinguish between MLM and direct selling, refer to Appendix 2D: *"Does Multi-level Marketing* Qualify as a Form of Direct Selling? – a 7-Point Checklist."*

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[25] (Advocare) "*Policies, Procedure, and the Compensation Plan" (Rev. 10/21/08), "Section II: The Compensation Plan," Chapter 4:"Advancing to Advisor*," p. 20.

[26] *The Sales Bible: The Ultimate Sales Resource*, by Jefferey Gitomer (John Wiley & Sons, Inc., N.J., 2003)

[27] Ziglar, op cit

How recruitment-driven MLMs kill their own retail market*.* In many MLMs, purchases at inflated retail prices are primarily made by new recruits as a form of entry fee – after which they pay wholesale for products. Recruiters at MLM opportunity meetings often kill their own retail market. Why would anyone pay full retail price when there are plenty of "distributors" who would gladly sell at wholesale prices to meet their "pay to play" quota of purchases?

Most ex-distributors of MLMs I have interviewed have said they cancelled automatic bank draft payments for monthly product shipments or sharply reduced purchases from the company following their quitting an MLM. This supports the conclusion that the retail market for the products is more contrived than real. "Pay to play" purchases usually cease upon termination.

What about the refund policy of MLMs? Many MLMs have a 30-day or one-year return policy, allowing for a refund for unused and unopened merchandise, minus a small re-stocking fee. While this sounds acceptable to recruits and regulators, hundreds of interviews with ex-distributors lead to the conclusion that this offers little actual protection to participant/victims of the schemes. It is extremely rare for MLM victims to recognize the fraud in an MLM program without intensive de-programming by a knowledgeable consumer advocate. They have been told by their upline that anyone can succeed and are conditioned to blame themselves – not the MLM program – for their "failure." And many have opened their product packages to sample or share the contents, so they don't "qualify" for a refund.

A 99% loss rate wouldn't be so serious, except that in opportunity meetings, the MLM is touted as the path to financial freedom, and the earnings of top distributors are displayed – but without the abysmal odds of getting there.

"Tools for success" – or just more money down the drain." The top distributors in some MLMs sell "tools" (books, audio programs, etc.) to aid new recruits in "building their business." Their message to floundering participants is that if they are not succeeding in selling products or recruiting a downline, it is because they are not doing it right – not because the program itself is deficient. If they want to be successful, they need the proper "tools."

The sellers of these tools may make more money on the sales helps than on the sale of products to or through their downline. While not required "pay to play" items, some upline promoters will not give the training and other support to downline participants who do not buy the tools. So these tools become in fact a necessary cost to "play the game" – further reducing the likelihood that these hapless recruits will realize a profit.

Incentivized purchases are typical of a pyramid scheme. On the FTC web site is an article entitled "*The Bottom Line about Multi-level Marketing Plans."*[28] Under the heading "Evaluating a Plan," the following advice is given: "*Beware of plans that ask new distributors to purchase expensive products and marketing materials. These plans may be pyramids in disguise."*

MLMs typically require significant purchases in order to participate in the financial rewards outlined in the compensation plan. While the actual enrollment fee may be small, the cost to qualify for commissions and bonuses can be substantial. This is one of the earmarks of a pyramid scheme, as opposed to a legitimate direct selling program.[29]

The FTC ruling that Amway was not a pyramid scheme was conditioned on the assumption that its "retail rules" would be enforced. Yet it was disclosed in a recent California case involving Quixtar's (Amway's) "top guns" that *only 3.4% of sales were to non-participants!* [30]

[28] www.ftc.gov

[29] In FTC v. Amway (1979 – 142-145), Webster v. Omnitrition (Discussion on "Pyramid"), and FTC v. Skybiz (29)

[30] Notice of Errata re exhibits E, F and G to Affidavit of Billy Florence submitted with complaint, US Dist. Ct., Central District of Calif., Western Div., Case No. CV 07-05194), § 97) p. 13

4. Company payout (in commissions & bonuses) per sale for the total of all upline participants equals or exceeds that for the person selling the product – resulting in inadequate incentive to retail and excessive incentive to recruit. This is what is meant by a "top-weighted" pay plan.

Ask: Would a "distributor" purchasing products for resale receive less in total payout (in commissions, bonuses, etc.) from the company as would the total of all upline participants?

MLM's typically top-weighted compensation plans disproportionately reward founders and TOPPs – at the expense of those at the bottom levels

While the previous four features are fairly easy to identify, this one requires understanding of alternative distribution models and complex incentives in the MLM pay plan. Group bonuses and other incentives must be factored in to determine actual payout per sale. Sometimes the bonuses come in the form of larger discounts or higher commissions per sale at higher levels.

Why does this "top-weighted" feature of recruitment-driven MLMs discourage retailing of products to end-users? MLMs offer small rewards to front line "distributors" for selling products, which are usually overpriced to support the large network of participants. So to achieve significant income one must recruit a large downline from which to draw commissions from their combined purchases.

This "top weighted" characteristic, more than any other, determines whether a program is biased towards recruitment or towards retailing (direct selling to end users). It is also an important red flag signaling an illegal pyramid scheme in most jurisdictions because it shows a primary emphasis on compensation from recruitment rather than from sales to end users who are not participating in the scheme.

Why is this top-weighted feature one of the main problems with recruitment-driven MLMs? Compensation plans of recruitment-driven MLMs lead to extreme inequality in payout (money paid by the company) to participants. There are a few "winners" who profit at the expense of a multitude of "losers." When plotted on an income distribution chart, the graph resembles a candlestick, with a handful on the left receiving huge earnings, and a large multitude of participants to the right of them losing money.

For example, Nu Skin has published average income figures of its distributors, having been ordered by the FTC to cease its misrepresent-tations of distributor earnings. Based on its own report entitled "2008 Distributor Compensation Summary," on discussions with top executives and high level ex-distributors, and on my one-year experiential test of their system, I concluded the following:

At best, one out of 1,961 distributors profited; i.e., received more in commissions than they spent on products and minimum operating expenses. But of those few who profited, only a few netted anywhere near the average incomes that promoters at opportunity meetings stated were earned by "Blue Diamond" distributors. It is likely *that less than one in 13,000 new recruits received the potential Blue Diamond incomes held out to them!* All others just "didn't try hard enough."

This "top-weighted" characteristic is an important red flag signaling an illegal pyramid scheme in most jurisdictions because it shows a primary emphasis on compensation from recruitment rather than from sales to end users who are not participating in the scheme.

Often these "losers" will invest considerable amounts of time and money and then quit, blaming themselves. But their "failure" is due not so much to their lack of effort, as to an exploitive system, which dooms approx-imately 99.6% of ALL participants[31] (including dropouts) to losses - after subtracting "pay to play" purchases and minimal operating expenses. A 99% loss rate would not be so serious, except that in MLM opportunity meetings, the program is typically touted as the path to financial freedom, or time freedom, and the earnings of top distributors is posted – but without the abysmal odds of getting there.

In other sales settings, it is not unusual for a successful commissioned sales persons to receive more income than their sales managers. This is because the person doing the selling usually makes more in commissions per sale (often 20-40%) than managers two or three management levels above him or her. But in recruitment-driven MLM programs, upline distributors several layers removed from the actual sale may receive as much or more in commissions and bonuses per sale from the company as the person who actually sold the product. The latter may only get a sales commission of 5-15% from the company – not enough to make selling profitable, even if the products were priced competitively.

Since the total payout per sale is limited, when upline participants receive substantial income in overrides from downline purchases, this tightens any resale margin and limits the percentage of commissions to any participants selling products to actual customers. So the income of front line "distributors" is extremely limited, forcing him or her to recruit a large downline to realize a significant income from commissions on downline purchases. Powerful incentives are then at work to recruit a downline of hundreds, even thousands, of participants.

Can't low commissions to front-line distributors be offset by retailing products at marked up retail prices? MLM promoters claim "distributors" who buy products at wholesale prices from the company can then sell them at a higher retail price, such as happens in conventional retail outlets, which allow for a substantial retail profit margin. MLM companies then go to great lengths to assure recruits and regulators that they are legitimate direct sales operations and that participants can make money buying wholesale and selling products at retail prices. They also tout the miraculous and/or unique qualities of their products to justify the high prices they must charge to pay commissions on huge pyramids of participants.

The problem is that suggested retail prices for MLM products are generally too high to be competitive with other outlets. So MLM "distributors" purchase large quantities for themselves and their families and/or sell products at wholesale prices to downline participants and others in order to meet volume requirements for bonuses or discounts at different levels. Again, the payment of full retail listed price generally occurs with new recruits who are "buying into" the system. This is how they "pay to play" (the game).

[31] To see how this was calculated, see Chapter 7.

How does this feature distinguish recruitment MLMs from (hypothetical) retail-focused MLMs? *This "top weighted" characteristic is primarily what would separate recruitment-driven MLMs from "retail-focused MLMs," if such were to exist.* Retail-focused MLMs would make it possible for participants to make money from the sale of products with only a small downline of participants, or with none at all – by assigning the majority of commission payments to front-line distributors for actual sales.

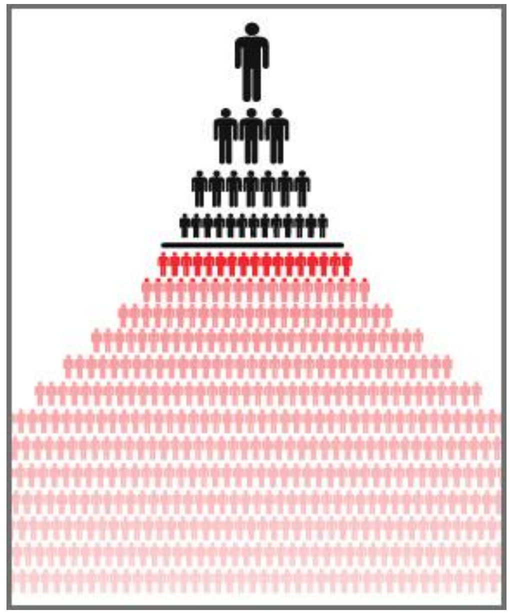
However, out of over 350 MLM programs I have analyzed, I did not find any that could clearly be classified as retail-focused MLMs. Possible exceptions are the party plans that emphasize income from the sale of products at in-home parties, though they may allow for recruitment of a downline. But even then, one must look at the compensation plan to see if the program is so top-weighted as to encourage recruitment and self-consumption over selling to the general public.

In summary, this "top-weighting" of MLM compensation plans is what drives TOPPs to feverishly build their downlines – to recruit a revolving door of new recruits who buy products in order to participate in the "opportunity."

5. In addition to the four CDCs above, nearly all MLMs also have a fifth CDC, making it even more top-weighted. The MLM company pays commissions and bonuses on more "distributor" levels than are functionally justified; i.e., five or more levels, which only further enriches those at the top of the pyramid.

Ask: Does the company pay overrides (commissions and bonuses) to distributors in a hierarchy of more levels than are functionally justified; i.e., five or more levels?"[32]

For even the largest of conventional *distributor arrangements, the entire U.S.* can be covered by four supervisory levels in the distributor hierarchy; e.g., branch managers, district managers, regional managers, and national sales manager. More than that is superfluous and bloated, driving up prices and making sales at a competitive retail markup unprofitable (except for TOPPs) and unrealistic.



More than four levels in the compensation plan exponentially enriches those at the top with the addition of each additional level. The primary customers are those in the downline, making the MLM merely a money transfer or pyramid scheme.

Why does five or more levels signal a recruitment-driven MLM? There is seldom any functional justification for five or more levels in an MLM hierarchy of "distributors," other than to encourage recruiting and the illusion of very large potential incomes to more participants than is mathematically possible – a hallmark of pyramid schemes.

Combined with other factors, this feature hugely enriches those participants at the top of the pyramid at the expense of those beneath them, 99% of whom lose money. Such exorbitant incomes result from the reaping of huge overrides from the combined product investments of as many as thousands of downline participants, which increase exponentially with each added level. (See below.) This should be considered "unjust enrichment" – certainly an unfair and deceptive trade practice.

[32] For this insight, I am indebted to Douglas M. Brooks, a Boston attorney, who has for many years worked on cases related to franchises and MLMs.

It should be noted that in the afore-mentioned 1979 FTC v. Amway ruling, the prosecution had argued that ***as the number of levels in an MLM compensation plan increased, so did the opportunity for fraud.*** *It is interesting that in 1979, Amway had ten payout levels. By 2008, the number of levels had increased to an astonishing 22 levels!*[33] *But no one at the FTC noticed this worsening of Amway's highly leveraged compensation plan.*

Generally, but not always, this character-istic of excessive payout levels is a key feature (other than products for sale) separating recruitment-driven MLMs from classic, no-product pyramid schemes. The latter typically pay on only four or five levels before the person atop the pyramid collects and moves on to start a new pyramid. It also helps explain why the loss rate for recruitment-driven MLMs is much higher than for classic, no-product pyramid schemes.

The FTC prosecution argued that as the number of levels in an MLM compensation plan increased, so did the opportunity for fraud (FTC v. Amway). But no one at the FTC noticed that the number of levels has since that time more than doubled at Amway.

How does extreme leverage result from excessive payout levels? MLM promoters refer to such residuals as "leverage" – large company payouts, disproportionate to effort expended, to top-level participants. The effects of leverage can be illustrated in a downline of six levels of participants. For example, assume that a "distributor" recruits five "active distributors," each of whom recruits five more, and so on through six levels of distributors.

[33] *Quixtar Business Reference Guide*, 2007, and *Amway Business Reference Guide* (or counterpart), 1979,

The pyramid grows exponentially as shown below:

Level 1: 5 distributors
x $5 in commissions & bonuses =
$25/month

Level 2: (5x5=) 25 + 5 = 30 total distributors
x $5 " " " " = $150/month

Level 3: (25x5=) 125 + 30 = 155 total
distributors x $5 " " " " = $775/month

Level 4: (125x5=) 625 + 155 = 780 total
distributors x$5 " " " " = $3,900/month

Level 5: (625x5=) 3,125 + 780 = 3,905 total
distributors x $5 " " " " = $19,525/month

Level 6: (3,905x5=) 15,625 + 3,905 =
19,530 total distributors x 5 " " " " =
$97,650/month!

If each "distributor" were to buy enough products each month to yield an override of $5 in commissions and bonuses to the original upline distributor, then with a five-level downline, the upline distributor gets $19,525 per month, while with a six-level downline the same distributor can get $97,650 per month – five times as much as for five levels. The incentive to recruit to get to the sixth level becomes enormous. Of course, it seldom works out that way, but these are the type of figures that are often presented to illustrate why recruiting is emphasized, as opposed to selling products to persons outside the pyramid. An income of $97,650 is much more appealing to a Level 1 participant than $100 that might be earned by selling the products at the full retail price (assuming $20 markup on products sold to each of five customers).

Compared to recruiting, selling products at full retail price becomes a waste of time in such a system. The incentive to recruit to move up a level becomes very great. Again, one can see that the legal requirement of "primary emphasis" on income from recruiting fees (in the form of downline purchases) is satisfied.

Exploitive breakaway compensation plans – legal or not? One category of compensation plans, the "breakaway" deserves mention, as it is so highly leveraged that the losses of participants are staggering.

In a breakaway system, the levels in the hierarchy are made up, not of individual participants, but of "breakaway organizations" (or pyramids) – groups of participants who have met requirements to "break away," allowing a small commission override from all participants in the breakaway unit. So in a breakaway system, a hierarchy of six levels is actually six levels of *groups* of participants, which makes it a constellation of pyramids within a giant mega-pyramid – with most of the payout going to TOPPs.

The extreme loss rate results from each profitable top-level "distributor" being supported by a downline of many groups of participants (often totaling thousands), almost all of them victims who lose money – after subtracting purchases and other expenses. In my opinion, MLMs with breakaway compensation plans are the most extreme and exploitive type of pyramid scheme and therefore should be illegal.

Other MLM compensation plans have their own unique problems, primarily obfuscating the fact that the programs are designed to enrich TOPPs at the expense of a multitude of downline participants.

"Australian two-up," and other schemes that limit the number of levels for payout, make up for it in other ways*.* The fact that an MLM compensation plan limits the number of levels upon which any distributor can be paid overrides from the company does not necessarily negate the "endless chain" feature of the scheme. For example, in "Australian two-up" plans, new recruits must forfeit commissions for the first two sales to an upline sponsor before qualifying for commissions. The mathematical impossibility of later recruits enjoying the same financial benefit as earlier participants is apparent. It should also be noted that 2-up recruits that fail to recruit two others become in effect the downline of someone above them. This could continue for several levels.

In summary, a recruitment-driven MLM, or product-based pyramid scheme, is characterized by an endless chain of recruitment of participants incentivized by a multi-level pay plan and whose investments (in the pyramid scheme) are typically laundered through ongoing purchases of overpriced products, rather than through upfront recruitment fees.

Harm of recruitment-driven MLMs

MLM compensation plans with all of the aforementioned characteristics inevitably lead to the following negative effects:

1. Loss rates are extremely high. To those who understand the numbers, this is the harm that is most objection-able. Because of the extreme leverage in the compensation plan, the founders, early entrants into the program, and a few top distribu-tors get huge gains – who are held up as examples for all prospects to see. However, for the vast majority of MLM participants, actual profits are rare.

For nearly all MLM participants, money paid out exceeds money coming in.

When discussing average income of MLM participants, it should be noted that *there are three statistical measures used to indicate "average" – the mean, median, and mode*. The most talked about is the *arithmetic mean,* or the aggregate income of all divided by the number of participants – *which is negative if all recruits are counted and minimal expenses (including incentivized purchases) are subtracted.*

The median, or middle measure, for all MLMs I have studied is zero. And the mode, or most common measure, is also zero. By any measure, MLM is a losing proposition. This explains why the DSA and MLM spokespersons and statisticians do everything they can to skew the numbers in their favor. A more detailed analysis of the abysmal statistics on average earnings will be presented in Chapter 7.

2. Since the compensation and marketing system is weighted towards recruitment, instead of retailing of products, recruitment-driven MLMs are technically illegal in many jurisdictions. This one effect is the basis of most statutes against pyramid schemes. Recruiting MLM promoters go to great lengths to make it appear that their revenues come from direct selling of products, which is simply not the case.

3. Misrepresentations abound. Deception is essential for the MLM company to survive and grow. If the truth were told about the odds of success, few would join an MLM.

Some MLM promoters also make exaggerated product claims to draw in new recruits. I have concluded that success in a recruiting MLM requires one first to be deceived, then to maintain a high level of self-deception, and finally to go about deceiving others.

Chapter 8 lists typical misrepresent-tations used in recruiting MLMs. With this many falsehoods used in MLM recruitment campaigns, it would not be exaggerating to consider the income thus generated as "theft by deception," and certainly ill gotten gain.

4. Recruiting MLMs evolve into Ponzi schemes, with promoters moving from one location to another, as each area is increasingly perceived by the public to be saturated. What happens is that the MLM grows rapidly until it reaches market saturation in a given area. All later entrants are severely disadvantaged in their recruiting efforts and are usually found in a losing position. MLM companies sometimes try to get around this by starting new divisions, introducing new products, or entering new geographic regions to start new pyramids, a process I call *"re-pyramiding."*

So investing participants recover their investments by recruiting in other areas – in Ponzi fashion – to get new participants to invest. If they don't do this, they can lose their income stream and the position they gained. Company officials cooperate – or the company may collapse, along with their jobs.

5. The distinction between seller and buyer becomes confused and blurred. The seller becomes the buyer, and the buyer becomes the seller – to themselves and their families.

In typical MLMs, the more you invest, the more you lose. Of all those approached, the most fortunate are those who refuse to join at all.

6. Stockpiling of products is common, a fact seldom admitted by MLM participants. Many wind up making excessive purchases in their own name or in the name of downline "distributors" in order to advance up the hierarchy of participants, so they can reap large residual incomes off the efforts of others – which seldom happens. Most participants are left with unsold products, broken promises, and unrealized dreams. Return privileges for refunds are not used as much as one would expect for the reasons mentioned above.

Stockpiling is common

7. The regulatory process – essential in a democracy to protect consumers – is compro-mised when pyramid fraud is allowed by regulatory agencies.

Victims of all types of pyramid or chain selling schemes rarely file complaints, fearing consequences from or to those they recruited (often close relatives or friends) – and having been taught that any failure is "their fault."

Lacking such complaints, law enforcement seldom acts against these scams*. This complacency on the part of those responsible for consumer protection creates, in effect, a "license to steal."*

8. MLM observers have noticed cultish and even compulsive behavior from MLM participation. Some MLM programs adopt cultist patterns in recruitment and retention of members, becoming a rather closed society. Also, the evolution of "MLM junkies" has been observed, with traits of addiction similar to those for other addictions.

9. A perverse risk-reward relationship develops with recruiting MLMs. In legitimate businesses, the more time and money one invests (risks) in the business, the more likely it is that success will be achieved. But with recruiting MLMs, with the exception of the first ones in and those at the top of the pyramid, the more one invests, the more one loses.

The luckiest of MLM participants are those who invest the least time and money. Of all those approached, the most fortunate are usually those who refuse to join at all.

10. Extreme leverage results, meaning the majority of company payout goes to participants at the top of the hierarchy or pyramid. Cases of huge gains of some distributors are rare, but are held up as examples for all prospective recruits to see. However, for the vast majority of MLM participants, actual profits are rare.

11. The program becomes a closed market system, in which products are sold primarily through a downline of participants (and sympathetic family members) and seldom to legitimate customers at retail prices. This alone should qualify it as an illegal pyramid scheme. See Table 1 for some of the effects stemming from the CDCs of recruitment-based MLMs, both individually and in combination.

12. Personal losses can be substantial, including psychological, social, and spiritual harm[34] *– far outside of the norm for legitimate businesses.* Some MLM participants lose far more than money for their participation. We often hear of marriages and families broken up, credit cards maxed out,, bankruptcies, long-term friendships ruined, religious and other groups stressed or broken up, even suicides – all from single minded dedication to a recruiting MLM. In fact, the more committed a person is to an MLM, the greater the likelihood that he/she will suffer at least some of these consequences.

Also, disturbing tendencies to move away from ethical and charitable attitudes to more materialistic and greedy motivations often becomes apparent from MLM participation. These consequences help explain why some see MLM as an unethical business model. [35]

Considering all the harmful effects of MLM, it is easy to see why MLMs are far more harmful than classic, no-product pyramid schemes. They have a higher loss rate, cause far greater losses in the aggregate, and affect far more victims. They also have a much lower payout ratio for distributors, since most of the proceeds go to products and infrastructure, to say nothing of the founders. Conversely, in no-product pyramid schemes, all the money goes to the top.

The unsavory reputation of MLM among the general public in the U.S. Fifteen years of feedback from all over the world confirms what most consumer advocates have observed – that MLM generally has an unfavorable reputation among the general public. This certainly has been true in surveys of consumers that I and others have done. I also found it interesting to do an advanced Google search of the (exact) term “fraud,” with (one or more of these words) “multi-level marketing,” “network marketing,” or “MLM.” There were over 1 million results!

The typical answer by promoters of specific MLMs to the unsavory reputation of MLM is that the reputation is deserved by <u>most</u> MLMs, but not <u>their</u> MLM. Theirs is somehow different. This is another reason why defining and under-standing the underlying MLM model is important.

No one today questions the underlying flaws in chain letters of the past, where you pay a dollar to everyone on a list, add your name at the bottom, and forward it to all your friends – and they to their friends, ad infinitum. By now, most consumers see the flaws in this concept, so that it requires little explaining. But *when MLMs (requiring an endless chain of recruitment) came along and introduced unique and exotic products with complicated pay plans, charismatic leaders, palatial home offices, and donations to influential political candidates and charitable causes; promoters were able to dupe regulators, legislators, and many in the media into believing that they were legitimate.*

[34] For examples, go to feedback in Appendix of Chapter 9.

[35] Jon M. Taylor, *The Network Marketing Game: Gospel Perspectives in Network* Marketing. op cit. See also *False Profits*, by Robert Fitzpatrick. (Herald Press: Charlotte, N.C., 1997).

Table 1: Characteristics and effects of product-based pyramid schemes

CHARACTERISTICS	EFFECTS
1. Each person recruited is empowered & given incentives to recruit other participants, who are empowered and motivated to recruit still other participants, etc. – in an endless chain of empowered and motivated recruiters recruiting recruiters – without regard to market saturation.	Demonstrates primary income is from recruiting, especially with the features of unlimited recruitment and such powerful incentives to recruit – vs. meager profits from retailing over-priced products. Hyper growth inevitably leads to perceived saturation, which often is followed by a Ponzi move to other markets to repay early investors.
2. Advancement in a hierarchy of multiple levels of "distributors" is achieved by recruitment, rather than by appointment.	Demonstrates primary income is from recruiting, since that is the only way to advance in the scheme and to realize major profits. In recruiting MLMs, most recruits are doomed to failure.
3. "Pay to play" requirements are met by "incentivized purchases".	Raises breakeven bar, assuring losses for most participants. May place MLM in category of a security or business opportunity – or a de facto investment in a pyramid scheme. Encourages hyper-consumption of products by participants – who are the primary buyers.
4. Company payout per sale for upline participant equals or exceeds that for the person selling the product	Removes incentive to do direct selling, since recruiting is potentially many times more profitable.
5. (optional) The company pays commissions and bonuses on more "distributor" levels than are functionally justified.	Demonstrates primary income is from recruiting, not retailing. Enhances leverage for top participants who profit hugely, while assuring high loss rate for lower levels. Virtually eliminates retail option, due to high wholesale prices that make direct sales with retail markup difficult. Primary retail target is new recruits – which are making de facto pyramid investments.
1-5: Combining all five characteristics	Results in high loss rates (close to 99.9%) – much higher than for no-product pyramid schemes (87.5% to 93.3%). Strong emphasis on recruiting as the primary source of income, satisfying most statutory definitions of a pyramid scheme. Demonstrates extreme leverage, necessitating fraud and misrepresentation in order to survive and grow.

What is the difference between Ponzi schemes and (no-product or product-based) pyramid schemes?

Both pyramid schemes (whether or not product-based) and Ponzi schemes[36] are money transfer schemes, meaning that they involve a transfer of money between participants, rather than offering either legitimate investments or the production or sale of actual goods or services to those outside of the participants themselves. In the case of Ponzi schemes, new investors are recruited to provide revenues, but no real investment occurs. Instead, earlier investors are paid dividends or "profits" from the investments of new investors. Of course, since the supply of new investors is limited, eventually the scheme collapses when new investors cannot be found, or the demand for refunds of original investment principal by earlier investors exceeds available funds. This is what happened to cause the collapse of the Bernie Madoff scheme in 2008 when the financial markets imploded.

As discussed previously, classic, no-product pyramid schemes offer no product, merely the transfer of investors' money from those at the bottom to those at the top. MLMs, or product-based pyramid schemes, deceive participants into thinking that they are legitimate businesses by offering consumable products. But few are sold outside the network of participants, so they wind up also being transfer schemes, at least indirectly – transferring money from product purchases of a continuing stream of new recruits to the company to pay for products, infrastructure costs, and distributors. Usually less than half the money from purchases of recruits is rebated back to the network of distributors, with a disproportionate amount going to founders and TOPPs (top-of-the-pyramid promoters).

Since MLMs are dependent on the recruitment of an endless chain of recruitment, recruiters soon

[36] The history of pyramid and Ponzi schemes will be discussed in Chapter 10.

find their local market saturated and must recruit elsewhere. As will be discussed in Chapter 3, this saturation of markets happens rather quickly, so MLMs are extremely viral in spreading like a fast-growing cancer from state to state and eventually to vulnerable foreign markets to keep the chain of recruitment going.

However, unlike Ponzi schemes and no-product pyramid schemes, some of the more successful MLMs are able to continue almost indefinitely not only by expanding overseas, but by introducing new "product divisions" or name brands and starting the whole recruitment process all over again. And of course, after enough years have gone by, a new generation of prospects can be targeted under a new name or focus, as Amway has done with Quixtar and Nu Skin has done with several divisions. *This is a process I call "re-pyramiding."*

MLM's problem with legal identity

MLM promoters and defenders have a recurring problem whenever they have to present MLM as a class of business activity. This is because MLM is like a chameleon; it can – and often must - change colors to suit the situation. For example:

- *Are MLM participants employees of the company?* As discussed above, MLM executive would like to exercise the control of an employer, but don't want to be classified as such because of the costs and legal liabilities. Yet, their contracts have been challenged as exercising too much control for participants to be considered independent contractors.[37] For example, they are not allowed to sell competitors products along with those of the particular MLM they signed with.
- *Are MLM promoters selling investment securities?* They talk to prospects about the "residual income," "passive income," or "absentee income" potential of signing up in their MLM – as though it were an investment that was not dependent so much on their own efforts as on the efforts of persons in their downline. But they do not register as securities with the state or federal securities agencies.
- *Are MLMs franchises?* Though many promoters refer to their MLMs as "like a franchise" or as an "unfranchise" – or even as a "personal franchise," the last thing MLM executives want is to have to comply with franchise disclosure requirements, including a franchise disclosure document that could be hundreds of pages long with financial data, background of founders, etc.
- *Are MLMs a form of gambling or a lottery?* Some promoters present MLM as an opportunity for the chance of unlimited income. For example: "You never know how much money you will make if you sign up now," or "You may have some people in your downline who are 'business builders' who will make you a lot of money," etc.
- *Are MLMs a form of direct selling*? Of course, the Direct Selling Assn (which I prefer to call the "DSA/MLM cartel") says it satisfies the criteria of person-to-person selling away from a fixed location, etc. The problem is that the DSA does not specify what legitimate direct selling is not – an endless chain of recruitment of participants as primary customers. See Appendix 2D for a 7-point checklist for determining if MLM as a form of legitimate direct selling.
- *Are MLMs buyers' clubs? Some MLM promoters present their programs as ways to buy from your own business rather than from others – like a buyers' club. The problem is that products from MLMs are almost always far more expensive as from alternative outlets, so they can't qualify as discount buyer's clubs. Also, if personal consumption by participants is the main source of revenues, that strongly suggests a pyramid scheme.*
- *Are MLMs business opportunities?* If so, they must register as such with the applicable state agencies, which may require disclosure of information they don't want to disclose and other requirements with which they would not

[37] For a thorough discussion of bad legislation (IRC § 3582) pushed by lobbyists in 1982 to reclassify employees as independent contractors to those contractors' detriment, go to the following web site ("All you need to know about MLM) – http://www.armydiller.com/financial-scam/mlm.htm#dsalegislation

want to comply. So while MLM promoters often refer to their particular program as a "business opportunity" to prospects, they are careful to refer to it as "direct selling" or an "income opportunity" to law enforcement officials – including the FTC in comments filed by MLMs regarding its proposed Business Opportunity Rule.

- *Are MLMs income opportunities?* If they were, they should provide a good likelihood a person could earn a significant income from them. However, the opposite is true. As carefully demonstrated in Chapter 7, almost all participants in MLMs – at least 99.6% of them (where data is available), lose money. It is more honest to call MLMs money traps that lead to almost certain loss, except for those at or near the top of the pyramid of participants.
- *And finally, are MLMs cleverly disguised pyramid schemes?* If you are not already convinced, read the other chapters in this book with an open mine and decide for yourself. But I can attest that *after analyzing the compensation plans of over 350 MLM schemes, I feel more comfortable than ever labeling them recruitment-driven MLMs, or product-based pyramid schemes.*

Are all MLMs pyramid schemes?

As the following chapters will demonstrate, MLMs are merely product-based pyramid schemes disguised as "direct selling companies." But even when confronted with overwhelming evidence of this, MLM defenders - especially the Direct Selling Association - will likely protest: "Wait a minute. You're not suggesting that *all* MLMs are (illegal) pyramid schemes, are you?"

As if all of the foregoing were not sufficient to answer that question, an appropriate response would be –

If it looks like a duck,
walks like a duck,
swims like a duck,
and quacks like a duck,
then it's probably a duck!

In fact, as will be shown in later chapters, MLM is the most harmful of the two classes of pyramid schemes (no-product and product-based), by any measure – loss rates, aggregate losses, low payout percentage, degree of leverage enjoyed by TOPPs (at the expense of new recruits), and total number of victims.

Terms for pyramid schemes vary among the states. Those who expect to find uniform definitions of pyramid schemes across Statutory definitions of what is and what is not a pyramid scheme vary, and many show lack of recognition of the fundamental flaws in all endless chain recruitment programs, including MLMs. This is not surprising, as many attorneys, legislators, academicians, and so-called experts are not clear on these issues.

As will be explained in chapter 10, the structural difference between pyramid schemes and MLMs – aside from the existence of products for sale – may represent a distinction without a difference. Definitions and terms designating pyramid schemes used in state statutes are compiled in Appendix 2E. One can see from reviewing these that it is no wonder there is so much confusion on terminology.

What would a "good MLM" look like?

Many have asked if it is possible to have a fair and equitable "retail-focused MLM" program. In other words, what would a "good MLM" look like? Considering the inherent flaws in MLM as a business model, the established precedents, and the motivations that drive the industry, I seriously doubt that such an MLM is possible. A "good MLM" may be an oxymoron.

However, for anyone willing to try, here are some consumer protections that should minimize the harm done by a business using an MLM model. Assuming honest execution, they could help to assure an MLM would be both legal and ethical.

1. An MLM could reward selling of products more than recruiting by paying at least half of the total company payout to "front line distributors" actually selling products to end use consumers; i.e., persons not in the network of participants. So if a company's total payout to participants was 50% of total revenues, commissions (not retail markup) paid by the company to frontline distributors would be at

least 25%. The other 25% would be split among the upline. This could make retailing profitable.

2. "Pay to play," or incentivized purchase requirements would be minimal or non-existent. Participants would be eligible for commissions and/or bonuses without having to satisfy a minimum of over $100 a year. This could minimize losses.

3. Commissions or bonuses would be paid only for sales to non-participants - not for "internal consumption" (sales to participants). This would minimize losses from buying what is not needed and would put the emphasis squarely on selling, as opposed to recruiting a downline.

4. The number of levels in the payout structure would be no more than are functionally justified. Any sales program can cover the country with four levels of sales management – branch, division, regional, and national sales managers. Thus, if MLM is a legitimate direct sales program, it should be capped at a maximum of four levels of individual participants. (More than that serves only to enrich founders and TOPPs at the expense of their downlines).

5. In a hypothetical "retail MLM" that's both legal and ethical, products would be sold at competitive prices; and distributors could succeed from retailing the products, not just from recruiting and selling to their downlines at inflated prices. Not having to pay on so many levels would make competitive pricing possible, although MLM may never compete with discount outlets. If the pay plan were limited to three levels, retail sales prices could be even lower.

6. Ideally, no commission payments would be paid in perpetuity, except for sales by those on the first level ("front line") in one's downline of participants. For example, downline commissions might be paid for one or two years to give time for the upline to profit from training recruits until they are competent. This minimizes the mathematical absurdity of a program that expands endlessly not only in space (area-by area market saturation), but also in time and limits the motivation to build a downline for "residual income," or the dream of sitting back and profiting forever from the efforts of others.

7. Breakaway compensation plans – essentially pyramids within mega-pyramids – would be banned, and other complex plans (matrix, binary, etc.), would be replaced with simpler unilevel plans. This would help to limit the obfuscation that hides misrepresentations and makes comparisons difficult. The irony of this is that such an MLM compensation plan would be fashioned after classic "8-ball" no-product pyramid schemes – which are illegal.

8. The MLM would disclose average NET payout to ALL participants at all levels in the pay plan, meaning money paid by the company to participants, less money paid in to the company by these same participants, including purchases, training, and selling tools.

9. In reports of average income of participants, ALL participants who joined would be included in these averages, not just those who are "active." Attrition rates and total refunds ("buybacks") as a percentage of total revenues would also be disclosed. Such transparency would discourage many typical MLM misrepresentations.

10. Prospects would have to be told that market saturation would inevitably occur, leading to a diminishing opportunity for new recruits. Such protections would remove the underlying "easy money" motivation ("residual income," "time freedom," etc.) and the complex maze of deceptions, upon which MLM is dependent.

11. Any major legal actions against the company would be disclosed, whether or not resolved successfully.

12. And finally, a list of at least five names drawn randomly from the total population of participants in a given region who had been with the company for at least a year would be provided with telephone numbers as references, whether or not they are still active.

I have tried in vain to visualize an MLM program with such consumer protections succeeding. The driving force of huge incomes for TOPPs would be absent, and founders may find it more difficult to skim from revenues. In fact, I have run these suggestions by several persons who were interested in starting a "good MLM," but they each decided on a more standard MLM compensation plan – probably because they would not make obscene profits with a program that included such strict protections against abuse. So again, a "good MLM" may be an oxymoron.

Based on 15 years' research and evaluation of hundreds of MLMs, I would have to conclude that a "good MLM" may be an oxymoron.

Conclusions

An accurate, research-based, and consumer-friendly definition of MLM (multi-level or network marketing). Based on 15 years' consumer advocacy and research on over 350 MLMs, I can now articulate what I believe to be an accurate definition. It incorporates the four causal and defining factors of a recruitment-driven MLM discussed above. I am confident this definition is the most useful for analytical purposes, as it holds true for all 350 MLMs I analyzed.

Unlike other definitions cited earlier, *this definition recognizes the inherent flaws of any MLM, or product-based pyramid scheme; viz., an endless chain of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants.* Also, it clearly separates MLM from all other income activities, which definitions articulated by others have not accomplished.

So in summary, here is perhaps the only real-world, consumer friendly, research-based definition of the business model which is termed multi-level marketing, or MLM. It is much closer to the truth than those cited earlier.

Multi-level marketing (MLM) is a purported income opportunity, in which persons recruited into a pyramid of participants make ongoing purchases of products and services, and recruit others to do the same, and they still others, etc. – in an endless chain of recruitment and personal consumption, in order to qualify for commissions and bonuses and to advance upward in the hierarchy of levels in the pyramid. Product purchases become the means of disguising or laundering investments in what could be considered a product-based pyramid scheme.

Based on my research that will be explained in later chapters, I would add the following:

Typically, prospects are lured into the scheme with exaggerated product and income claims. And because the pay plan is heavily stacked in favor of those at the highest levels in the pyramid, the vast majority of participants spend more than they receive and eventually drop out, only to be replaced by a stream of similarly misled recruits, approximately 99% of whom are likewise destined to experience loss and disappointment.

A testable hypothesis for the legitimacy of MLM. If the legitimacy of MLM were approached scientifically, the scientific method of proposing a testable hypothesis could be applied, at least in the examination of effects of MLM on the company and on its participants.

Some regulators made decisions on the theory (and may have been convinced by MLM promoters) that if MLMs were pyramid schemes, they would be destined for ultimate collapse. However, as discussed above, Amway defenders were able to refute this argument on the grounds that Amway had already been operating for some many years without reaching saturation and collapsing. If is obvious the prosecutors did not understand the difference between total saturation and market saturation, which will be explained in Chapter 3.

MLM promoters have found ways to overcome market saturation and to transfer losses to a revolving door of new recruits, so that the company can continue to thrive. This also will be explained in Chapter 3.

Because MLM is presented as an income opportunity, and income claims are what is most often challenged by critics, the bogus income claims issue is a better place to start. Given available data, the most relevant strategy for testing MLM as a business model would be to take a broad sample of MLM companies and analyze their compensation plans and resulting average income figures for participants. So a testable hypotheses might be framed like this:

Assuming MLM's endless chain of recruitment, average income data for participants in a broad sample of MLMs will show that participation in MLM is profitable primarily for those at the top of the pyramid of participants, which are generally those who enrolled at or near the beginning of the chain of recruitment in any specific market. And given the costs of participation, it would be rare for new participants to realize profits above expenses – meaning the vast majority lose money. And accordingly, attrition for MLM participation would be high.

This hypothesis will be tested in upcoming chapters. In fact, in Chapter 7 I will show that MLMs are the most harmful of the two classes of pyramid schemes (product and no-product), by any measure – loss rates, aggregate losses, payout ratios, and number of victims. So read on.

Appendix 2A: Examples of complex MLM compensation plans

Example #1

sibu
The Seabuckthorn Company™

Fast Start

Fast Start will be paid weekly

Fast Start			
Minimum monthly production requirement [1]	60 PV Auto	120 PV Auto	Business Builder 240 PV Auto
Personally Sponsored	20%	30%	33%
Business Builder Rollup [2]	20%	10%	7%

Unilevel - Dynamic Compression

Unilevel bonus will be paid monthly

Level	Base Camp		Everest 1 (E1)	Everest 5 (E5)	Everest 20 (E20)	Everest 50 (E50)	Everest 100 (E100)
Group Volume	Preferred Customer	Distributor	1,000	5,000	20,000	50,000	100,000+
Minimum monthly production requirement [1]	Autoship	60 PV	120 PV Auto	120 PV Auto	240 PV Auto	240 PV Auto	240 PV Auto
Minimum monthly leg requirement			3 legs	3 legs 1,000 GV each	3 legs 4,000 GV each	3 legs 10,000 GV each	3 legs 20,000 GV each
1		5%	5%	5%	5%	5%	5%
2		5%	5%	5%	5%	5%	5%
3		5%	5%	5%	5%	5%	5%
4			5%	5%	5%	5%	5%
5				5%	5%	5%	5%
6					5%	5%	5%
7						5%	5%
8							5%
Tashi Shares				1	2	5	10

ABOVE THE CLOUDS BONUS - 10%

Tashi Bonus - paid monthly 6%

- Share of global bonus pool is calculated as a 'share' with qualification depending upon attaining level requirements.
- Shares of all qualifiers will be added and global bonus will be paid according to an individual's total number of shares.
- Bonus will be paid monthly along with 'unilevel bonus.'

Everest Summit Bonus - paid quarterly 2%

Volume	Bonus [3]	Monthly Average Requirements
150,000 (E150)	.5%	3 legs minimum 30,000 GV each plus an additional leg minimum 20,000 GV
300,000 (E300)	.5%	3 legs minimum 60,000 GV each plus an additional 2 legs minimum 20,000 GV each
600,000 (E600)	.5%	3 legs minimum 120,000 GV each plus an additional 3 legs minimum 20,000 GV each
1,000,000 (E1M)	.5%	3 legs minimum 200,000 GV each plus an additional 4 legs minimum 20,000 GV each

Sibu Discovery Bonus 2%

Exciting trips, prizes and other incentives to reward the hard work and efforts of Sibu Distributors

[1] PV requirements can be satisfied through personal or retail customer/autoship purchases.
[2] Business Builder Rollup pays out to the personal sponsor's first qualifying Business Builder upline.
[3] Prorated based on position volume.

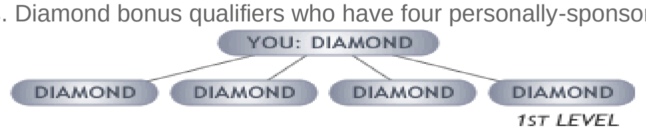
All commissions paid via EFT will be free. Commissions paid by check will be subject to a 2 USD administration fee and will be limited to 10 USD minimum.
Sibu reserves the right to make changes to the Compensation Plan.

Example #2:

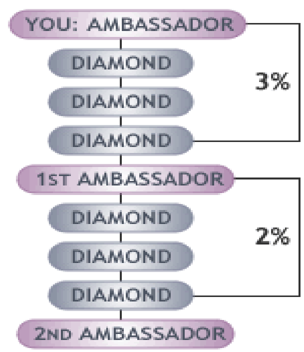
Becoming an Ambassador Affiliate

QUALIFICATION

The fourth stage of compensation: Diamond bonus qualifiers will earn the Ambassador Bonus on is the Ambassador bonus. Diamond bonus qualifiers who have four personally-sponsored s.



BONUSES

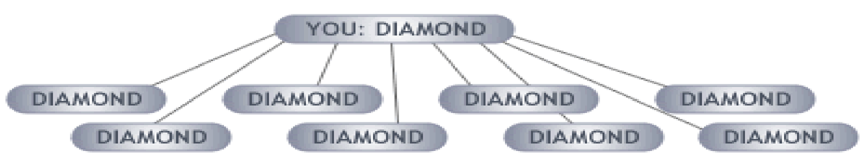


The Ambassador bonus pays an additional 3% bonus on your organization's bonus points down to the first Ambassador bonus qualifier, and then a 2% bonus down to the second Ambassador bonus qualifier.

Becoming a Presidential Affiliate

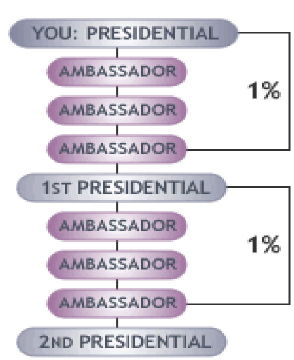
QUALIFICATION

Diamond bonus qualifiers who have eight personally-sponsored Diamond bonus qualifiers will earn the Presidential bonus



BONUSES

The Presidential bonus pays an additional 1% bonus on your organization's bonus points down to the first Presidential bonus qualifier and a 1% bonus down to the second Presidential bonus qualifier.



Appendix 2B

Explanations of compensation plans

MLM promoters frequently argue that while they know of problems in their industry, they have solved the problems with their new brand of MLM compensation plan, which is supposedly more fair, honest, generous, etc., than all the others.

Why are compensation plans so important to MLM promoters? Because they are at the heart of what MLM is about. As one promoter admitted in a meeting I attended, “Our compensation plan IS our product.”

Here are the basic MLM compensation plans:

Unilevel – There is no limit to the number of distributors that can be recruited on the first level (who “retail” products to end users). However, there is usually a limit on the number of levels deep that can qualify for commissions or overrides. It could be considered a “flat pyramid” and is probably the most fair of the compensation plans – though few would get rich.

Binary – Binary plans promote recruiting in a downline of two legs of distributors (left and right “profit centers”), with incentives to maintain matching sales volume between the two legs. Commissions are paid only on matching volume, and this can sharply limit company payout. Seldom are high volume producers matched in the same leg of the downline. Binary plans could be considered “split pyramids.”

Matrix – A limit is placed on the number of distributors in the first level and on the number of levels deep. Additional recruits “spill over” into the next level. Growth is limited (for example, 4x12=48 total downline). Can be played like a lottery – lazy participants can win. Matrix plans could be viewed as a “block pyramids.”

Stair step/breakaway – A “distributor” ascends a staircase of groups of participants with escalating incentives to recruit more people to profit from more and more “pay to play” purchases. Commissions from one’s personal group are replaced with overrides for volume of qualifying breakaway groups (“organizations”) of “distributors.” Extremely high leverage rewards hugely those at the top at the expense of a multitude of downline distributors who invest in “pay to play” purchases – their loss, but their upline’s gain.

Each breakaway is a separate organization tied to one person who draws overrides from the entire breakaway organization, which may be one of many. It is important to recognize that six levels in a breakaway is not six levels of distributors, but of whole breakaway organizations of people.

Though breakaway plans are found in some of the most popular MLMs, those who understand breakaway plans agree that they are the most exploitive and extreme of all the pyramid schemes ever devised – and therefore have the greatest leverage and the highest loss rates. The author characterizes breakaways as “mega-pyramids” comprised of many nested “poly-pyramids.”

Though these are the basic compensation plans that have been used by MLM companies in the past, it should be noted that new forms of compensation are being developed by a never-ending supply of MLM schemers. These include a trinary plan, modifications of matrix and binary plans, and creative combinations of the above. However, the five red flags discussed in this paper can be applied to all multi-level compensation plans.

Appendix 2C

Definitions of Other Relevant Terms

Compensation plan – the method of compensating participants in a program, which can be very elaborate in recruitment-driven MLMs. Often ignored by regulatory officials, it is the position of this author that analysis of compensation plans is essential in identifying the programs likely to cause the greatest consumer losses. See above for types of MLM compensation plans.

De facto saturation – an area where recruiting opportunities are perceived to have diminished to the point that recruiting becomes unprofitable. Promoters of an MLM program must then find other areas or create other product divisions in which to recruit. De facto saturation is reached far sooner than actual saturation, a point often overlooked when MLM apologists defend their programs by saying that saturation has never actually happened, and that replacement is an ongoing process like many other businesses.

Downline – all of the MLM distributors who are recruited under a given distributor and from whom are generated overrides on product sales

Incentivized (or "pay to play") purchases – the practice of tying purchases of products from an MLM company with requirements to enter the "business opportunity" option and to advance in the hierarchy of "distributors" – who are in effect merely participants making pyramid scheme investments disguised (or laundered) as purchases.

Leverage – a concept often used by MLM promoters to convey the idea that by drawing income from a large downline of distributors, a person can leverage his/her time and investment in the scheme. A related concept is "residual income," a form of passive income often received by authors, artists, insurance agents, and others who have made a contribution and thereafter get royalties from work performed earlier. The ideal presented is that a successful MLM recruiter can work hard for a period of time and never have to work again, thanks to his/her downline.

Multi-level marketing program (MLM), as defined by the Federal Trade Commission is "any marketing program in which participants pay money to the program promoter in return for which the participants obtain the right to –

1. recruit additional participants, or to have additional participants placed by the promoter or any other person into the program participant's downline, tree, cooperative, income center, or other similar program grouping;
2. sell goods or services; and
3. receive payment or other compensation;

provided that:

(a) the payments received by each program participant are derived <u>primarily</u> from retail sales of goods or services, and not from recruiting additional participants nor having additional participants placed into the program participant's downline, tree, cooperative, income center, or other similar program grouping, and

(b) the marketing program has instituted and enforces rules to ensure that it is not a plan in which participants earn profits primarily by the recruiting of additional participants rather than retail sales." [36]

As this report will make clear, this definition has some problems with it, most notably:

(1) Until this analysis, it has never been made clear how it was to be determined that payments to participants came primarily from the retail sales of goods or services and not from recruiting of additional participants. Hopefully, after reading this report, the question can be answered.

(2) the fact that the institution of "rules" [in (b) above], is insufficient to correct the problems with product-based pyramid schemes. The compensation plans must be addressed, along the lines of this analysis, if the problems with MLM are to be corrected.

.

Network marketing – a term devised by MLM companies to get around the implications of "multi-level marketing" – which sounds too much like a chain distribution or pyramid form of marketing.

No-product pyramid scheme – a blatant pyramid scheme that is easy to detect because no products are offered, merely a participation fee or "investment." Chain letters work on the same principle. A continuous chain of "participants" or "investors" is recruited, in which each pays a fee to participate and receives money by recruiting others into the program.

"**Pay to Play"** – a requirement common to all chain letters, no-product pyramid schemes, and product-based pyramid schemes, in which an investment – either in monies or in products purchased – is required in order to "play the game," i.e., participate in and/or advance in the scheme. This need not be a substantial up-front fee to enroll in the MLM, but can be in the form of volume purchase requirements for bonuses, advancement to "pin levels," etc. These could be viewed as disguised or laundered investments in a product-based pyramid scheme. See "incentivized purchases."

Ponzi scheme (in the final evolution of a recruitment-driven MLM) – named after Charles Ponzi, an Italian-born swindler who cheated over 30,000 investors of over $15 million in 1919-1920. Since that time, a Ponzi scheme refers to any investment swindle in which some early investors are paid off with money put up by later ones. Since recruitment-driven MLMs use compensation plans that pay much greater rewards for recruiting than for direct sales to end users, they cannot sustain themselves from direct sales only. So when recruiting leads to de facto saturation in a given market, they must recruit elsewhere. They thus eventually become Ponzi schemes, seeking new investing participants elsewhere (in the form of incentivized product purchases) to pay off earlier investors.

Pyramid scheme – According to the FTC, these are plans which "concentrate on the commissions you could earn just for recruiting new distributors" and which "generally ignore the marketing and selling of products and services."[38] The latter feature, of course, ignores the realities of product-based pyramid schemes, which this paper demonstrates do more aggregate damage to consumers than no-product schemes. The FTC has also described the essential features of an illegal pyramid scheme as follows:

Such schemes are characterized by the payment by participants of money to the company in return for which they receive (1) the right to sell a product and (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of the product to ultimate users. . . As is apparent, the presence of this second element, recruitment with rewards unrelated to product sales, is nothing more than an elaborate chain letter device in which individuals who pay a valuable consideration with the expectation of recouping it to some degree via recruitment are bound to be disappointed.[39]

Here is an example of the definition that existed in at least state statute:

"Pyramid scheme" means any sales device or plan under which a person gives consideration to another person in exchange for compensation or the right to receive compensation which is derived primarily from the introduction of other persons into the sales device or plan rather than from the sale of goods, services, or other property."[40]

While this definition is used extensively for legal purposes, it does not address the issue of harm to participants, which is the primary focus in this paper.

Product-based pyramid scheme – a pyramid scheme that in most respects resembles a no-product pyramid scheme, except that products are purchased by distributors, ostensibly for resale, but actually for qualification or advancement in the scheme. Such product purchases, often combined with other incentives, qualifies distributors for commissions in ascending levels in the distributor hierarchy.

Recruitment-driven MLM – an MLM with a compen-sation plan that rewards primarily distributors who recruit huge downlines, and is therefore a product-based pyramid scheme.

Retail-focused MLM – an MLM which uses a compensation plan in which company remuneration to distributors is generous for front-line distributors who actually sell the products to consumers, but which does not allow huge and disproportionate fortunes to be made by upline distributors.

[38] ***FTC Consumer Alert*, December 1996**

[39] In *re Koscot Interplanetary, Inc.,* 86 F.T.C. 1106, 1180 (1975), gaff's mem, sub nom. Turner v. FTC 580 F .2d 701 (D.C. Cir. 1978).

[40] *Pyramid Schemes,"* Div. of Consumer Protection, State of Utah – similar to definitions used in other states. Unfortunately, in 2006 the DSA initiated legislation in the Utah legislature exempting companies that sold products that could be sold to anyone, including participants. Testifying on behalf of the bill (SB182) was Attorney General Mark Shurtleff, who failed to disclose that he had received $50,000 from PrePaid Legal. All told, he has received over $¼ million from grateful MLM companies.

Saturation – the occurrence of reduced interest in an MLM as more and more people are recruited into the scheme. Note that although total saturation of a market may never be reached, saturation is perceived as a problem by new prospects as the percentage of prospects dwindles due to the perception of diminished opportunity. De facto saturation is the result.

Scheme - "a plan or program of action, especially a crafty or secret one; . . . a systematic or organized . . . design."[41]

Time freedom – another term bandied about by MLM promoters to appeal to those who want to be relieved from the requirement of having to spend their precious time to earn a living. They can live off the labor of others.

Upline – the direct line of distributors who are above a given distributor in the MLM distributor hierarchy or pyramid scheme and who receive overrides from sales or purchases. In a recruitment-driven MLM, top upline participants receive most of the payout in commissions and bonuses from the company and are the only ones to profit significantly.

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

[41] Merriam Webster's Collegiate Dictionary, Tenth Edition, 1993

Appendix 2D: Does MLM (multi-level or network marketing) qualify as a legitimate form of direct selling? — a 7-point checklist

Much confusion exists on whether or not MLM can qualify as direct selling. Since the MLM industry has much to gain by being classed as direct selling, MLM promoters and the industry's lobbying arm, the Direct Selling Association, work hard to convince legislators, regulators, and the public that they are direct selling companies. Since few officials have much experience in direct sales, they are often misled on this key point.

Based on several years of experience, observation and research related to both direct sales and MLM, I can safely conclude that **the typical MLM business model constitutes what I call a "product-based pyramid scheme" and NOT a form of legitimate direct selling.** They should be considered "recruitment-driven MLMs"; i.e., MLMs that require aggressive recruiting of a large downline to earn a significant income. However, it is true that selling – mostly in the form of recruiting – is involved in building an MLM downline.

Based on this analysis, below is a comparison of two marketing models – direct sales, as represented by traditional Fuller Brush sales persons (or any non-MLM direct sales company, including life insurance) – with prominent MLM programs, such as Amway and Nu Skin.

CONCLUSION: **The typical MLM company is no more a direct sales company than a pig is a horse.** For MLM companies with highly leveraged compensation systems (rewarding top distributors at the expense of a large downline of recruits who invest in products to "play the game" – almost all of whom lose money), its participants are primarily recruiting to build downlines, not to sell products directly to end users.

When was the last time you were approached by an Amway or Nu Skin "distributor" to buy products without some mention of the "business opportunity"? With millions of "distributors" recruited over the last twenty years, if they were primarily selling direct to customers, you would expect by now to have been inundated with requests to buy products from them – without being asked to join up. No, the sellers are the buyers, and the buyers are the sellers – generally to themselves and their immediate families.

CHARACTERISTICS OF LEGITIMATE DIRECT SALES COMPANIES	**LEGITIMATE DIRECT SALES** (incl. life & health insurance sales)	**RECRUITMENT-DRIVEN MLMs** (that reward participants for recruiting large downlines Amway, Nu Skin, Nikken, etc.)
1. The number of agents/sales persons recruited for a given area is somewhat limited to prevent market saturation and resulting dissatisfaction of existing sales persons or agents.	*YES*	NO – MLMs use an endless chain of recruiters recruiting still more recruiters, ad infinitum. And each participant must recruit others to make his/her investment profitable.
2. Advancement to various levels of sales management is by appointment.	YES	NO – Advancement in the sales hierarchy is achieved by recruiting a downline.
3. Little or no purchases are required to begin and to continue selling the program profitably. The company, rather than the sales person, assumes the burden of financing and stocking inventory. When I sold encyclopedias as a young man, it was not a requirement that I buy a set for myself or meet a certain quota in order to qualify for commissions. And as an insurance agent, I was not required to buy the insurance I was selling	YES	NO – Sizable initial and ongoing purchases are tied to qualification to get commissions and/or to advance through higher distributor payout levels. Thus, many participants stock up on idle inventory. The burden of inventory cost is thereby transferred from the company to the distributor – who finds that the easiest way to sell the products is to sell the "opportunity." Most actual buyers are recruits.
4. A maximum of four levels of sales managers is sufficient– for example: branch manager, district manager, regional manager, & national sales mgr.	YES	NO – An MLM downline may include 6, 8, 10, or even an infinite number of levels of distributors.
5. Commissions per sale paid by the company to the person selling products and services to end users are typically greater than the total override commissions for ALL those above him/her in sales management.	YES	NO – A distributor several levels above the person selling the product may get as much commission per sale from the company as the person doing the selling – or the person who recruited him/her. And reselling at a profit products bought at high wholesale prices is unrealistic.
6. The primary focus in compensation systems, at sales meetings, and in actual effort by sales persons is on selling products and services to legitimate customers, or "end users."	YES	NO – The primary focus is on recruiting more MLM participants, so persons are seldom approached to buy the products without considering the "business opportunity." Top-level recruiters are often held up as examples for their huge pay checks.
7. Sales persons can make a reasonable income (in commissions and bonuses) from selling the products or services – without recruiting a downline.	YES	NO – Commissions paid by the company for direct sales pale in comparison with potential rewards for recruiting a downline. In recruitment-driven MLMs, it is rare for participants (except for those at the top of the pyramid), to report profits on their tax returns.

Appendix 2E: Definitions of or related to illegal pyramid schemes in state statutes

*[**Notes by JMT**: Most of the states fail to specify the endless chain of recruitment in pyramid schemes, which would help to separate them from legitimate recruiting businesses. Also, in several states where a chain selling or recruitment program is exempt from being classified as a pyramid scheme if sales are made to anyone (not just to non-participants), or where buyback provisions are offered, the Direct selling Association has likely influenced the legislation – especially if modifications were recent. Except where otherwise noted, the text for each state is a direct quote of that state's definition. For a compilation of MLM laws in the 50 states, go to the web site for The Advocate Group at – www.theadvocategroup.net .]*

Alabama

As used herein, "pyramid sales structure" includes any plan or operation for the sale or distribution of goods, services, or other property wherein a person for consideration acquires the opportunity to receive a pecuniary benefit, which is based primarily upon the inducement of additional persons by that person, and others, regardless of number, to participate in the same plan or operation, and is not primarily contingent on the volume or quantity of goods, services, or other property sold or distributed. [Ala. § Code 8-19-15 (19)]

Alaska

"Chain distributor scheme" means a sales device whereby a person, upon condition that the person make an investment is granted a license or right to solicit or recruit for profit one or more additional persons who are also granted a license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted a license or right upon the condition of investment. [Alaska Consumer Protection Act. AS § 45.50.561 (See definitions a.3)]

Arizona

"Pyramid promotional scheme" means any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from any person's introduction of other persons into participation in the plan or operation rather than from the sale of goods, services or intangible property by the participant or other persons introduced into the plan or operation. (Ariz. Rev. Stat. § 44-1731. Modified March 5, 2010)

Arkansas

A pyramiding device shall mean any scheme whereby a participant pays valuable consideration for the chance to receive compensation primarily from introducing one (1) or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant. (Ark. Code Ann. § 4-88-109)

California

An "endless chain" means any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant. *Compensation, as used in this section, does not mean or include payment based upon sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme. (*Cal. Penal § 327)

Colorado

"Pyramid promotional scheme" means any program utilizing a pyramid or chain process by which a participant in the program gives a valuable consideration in excess of fifty dollars for the opportunity or right to receive compensation or other things of value in return for inducing other persons to become participants for the purpose of gaining new participants in the program. (Colo. Rev. Stat. Ann. § 6-1-102)

Connecticut

The advertisement for sale, lease or rent, or the actual sale, lease or rental of any merchandise, service or rights or privileges at a price or with a rebate or payment or other consideration to the purchaser which is contingent upon the

procurement of prospective customers procured by the purchaser, or the procurement of sales, leases or rentals of merchandise, services, rights or privileges, to other persons procured by the purchaser, is declared to be an unlawful practice rendering any obligation incurred by the buyer in connection therewith, completely void and a nullity. The rights and obligations of any contract relating to such contingent price, rebate or payment shall be interdependent and inseverable from the rights and obligations relating to the sale, lease or rental. (Conn. Gen. Stat. Ann. 42-105)
Also – from State v. Bull Inv. Group, Inc. (1974) 351 A.2d 879, 32 Conn.Supp. 279:] Pyramid fraud law prohibits sale of rights or privileges where payment made or consideration given to purchaser is contingent on his procurement of prospective customers; since both vertical and horizontal pyramiding involve rebate or payment to purchaser which is contingent upon procurement of prospective customers procured by purchase, both forms of pyramiding are prohibited by this section.

Delaware
"Pyramid or chain distribution scheme" means a sales device whereby a person, upon a condition that the person part with money, property or any other thing of value, is granted a franchise license, distributorship or other right which person may further perpetuate the pyramid or chain of persons who are granted such franchise, license, distributorship or right upon such condition. (Del. Code Ann. § 2561)

Florida
A "pyramid sales scheme," which is any sales or marketing plan or operation whereby a person pays a consideration of any kind, or makes an investment of any kind, in excess of $100 and acquires the opportunity to receive a benefit or thing of value which is not primarily contingent on the volume or quantity of goods, services or other property sold in bona fide sales to consumers, and which is related to the inducement of additional persons, by himself or herself or others, regardless of number, to participate in the same sales or marketing plan or operation, is hereby declared to be a lottery, and whoever shall participate in any such lottery by becoming a member of or affiliating with, any such group or organization or who shall solicit any person for membership or affiliation in any such group or organization commits a misdemeanor of the first degree, punishable as provided in s. 775.082 or s. 775.083. For purposes of this subsection, the term "consideration" and the term "investment" do not include the purchase of goods or services furnished at cost for use in making sales, but not for resale, or time and effort spent in the pursuit of sales or recruiting activities. (Fla. Stat. Ann. § 849.091)

Georgia
"Pyramid promotional scheme" means any plan or operation in which a participant gives consideration for the right to receive compensation that is derived primarily from the recruitment of other persons as participants into the plan or operation rather than from the sale of goods, services, or intangible property to participants or by participants to others. (Georgia Code § 16-12-38 (8)

Hawaii
A person engages in an unfair method of competition and an unfair or deceptive act or practice within the meaning of section 480-2 when, in the conduct of any trade or commerce, the person contrives, prepares, sets up, proposes, or operates any endless chain scheme. As used in this section, an endless chain scheme means any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme, or for the chance to receive compensation when a person introduced by the participant introduces a new participant. Compensation, as used in this section, does not mean or include payments based upon sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme. [L 1970, c 28, §1; gen ch 1985] (Hawaii Rev. Stat. § 480-3.3)

Idaho
“Pyramid promotional scheme” means any plan or operation in which a participant gives consideration for the right to receive compensation that is derived primarily from the recruitment of other persons as participants in the plan or operation rather than from the sales of goods, services or intangible property to participants or by participants to others. (Idaho Code Ann. § 18-3101)

Illinois
The term “pyramid sales scheme” includes any plan or operation whereby a person in exchange for money or other thing of value acquires the opportunity to receive a benefit or thing of value, which is primarily based upon the inducement of additional persons, by himself or others,

regardless of number, to participate in the same plan or operation and is not primarily contingent on the volume or quantity of goods, services, or other property sold or distributed or to be sold or distributed to persons for purposes of resale to consumers. (815 Illinois Comp. Stat. 505/1)

Indiana
"Pyramid promotional scheme" means any program utilizing a pyramid or chain process by which a participant in the program gives a valuable consideration exceeding one hundred dollars ($100) for the opportunity or right to receive compensation or other things of value in return for inducing other persons to become participants for the purpose of gaining new participants in the program. (Ind. Code Ann. 24-5-0.5-2)

Iowa
The advertisement for sale, lease or rent, or the actual sale, lease or rental of any merchandise at a price or with a rebate or payment or other consideration to the purchaser which is contingent upon the procurement of prospective customers provided by the purchaser, or the procurement of sales, leases or rentals to persons suggested by the purchaser, is declared to be an unlawful practice rendering any obligation incurred by the buyer in onnection therewith, completely void and a nullity. The rights and obligations of any contract relating to such contingent price, rebate or payment shall be interdependent and inseverable from the rights and obligations relating to the sale, lease or rental. (Iowa Code Ann. 714.16)

Kansas
"Pyramid promotional scheme" means any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from any person's introduction of other persons into participation in the plan or operation rather than from the sale of goods, services or intangible property by the participant or other persons introduced into the plan or operation. (Kan. Stat. Ann. § 21-3762)

Kentucky
"Pyramid distribution plan" means any plan, program, device, scheme, or other process by which a participant gives consideration for the opportunity to receive compensation or things of value in return for inducing other persons to become participants in the program. Ky. Rev. Stat. Ann. § 361)

Louisiana
"Pyramid promotional scheme" means any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from the person's introduction of other persons into a plan or operation rather than from the sale of goods, services, or intangible property by the participant or other persons introduced into the plan or operation. (La. Rev. Stat. Ann. § 361)

Maine
The organization of any multi-level distributorship arrangement, pyramid club or other group, organized or brought together under any plan or device whereby fees or dues or anything of material value to be paid or given by members thereof are to be paid or given to any other member thereof who has been required to pay or give anything of material value for the right to receive such sums, with the exception of payments based exclusively on sales of goods or services to persons who are not participants in the plan and who are not purchasing in order to participate in the plan, which plan or device includes any provision for the increase in such membership through a chain process of new members securing other new members and thereby advancing themselves in the group to a position where such members in turn receive fees, dues or things of material value from other members, is declared to be a lottery, and whoever shall organize or participate in any such lottery by organizing or inducing membership in any such group or organization shall be guilty of a misdemeanor, and upon conviction thereof shall be punished by a fine of not more than $5,000 or by imprisonment for not more than 11 months, or by both. (Me. Rev. Stat. Ann. Title 17, § 2305)

Maryland
"Pyramid promotional scheme" means any plan or operation by which a participant gives consideration for the opportunity to receive compensation to be derived primarily from any person's introductions of other persons into participation in the plan or operation rather than from the sale of goods, services, or other intangible property by the participant or other persons introduced into the plan or operation. [Md. Title 8: 4: 8-404 § (a) (5)]

Massachusetts
[Note by JMT: While the applicable Massachusetts statute does not define pyramid schemes as such, it defines multi-level marketing and has some unique and very salient

restrictions regarding MLM, particularly Ch. 93:69 (a), (d), and (e)]

Section 69. (a) As used in this section the term "multi-level distribution company" shall mean any person, firm, corporation or other business entity which distributes for a valuable consideration, goods or services through independent agents, contractors or distributors, at different levels, wherein participants in the marketing program may recruit other participants, and wherein commissions, cross-commissions, bonuses, refunds, discounts, dividends or other considerations in the marketing program are or may be paid as a result of the sale of such goods and services or the recruitment, actions or performances of additional participants.

(d) No multi-level distribution company or participant in its marketing program shall: (1) operate or, directly or indirectly, participate in the operation of any multi-level marketing program wherein the financial gains to the participants are primarily dependent upon the continued, successive recruitment of other participants and where retail sales are not required as a condition precedent to realization of such financial gains; (2) offer to pay, pay or authorize the payment of any finder's fee, bonus, refund, override, commission, cross-commission, dividend or other consideration to any participants in a multi-level marketing program solely for the solicitation or recruitment of other participants therein; (3) offer to pay, pay or authorize the payment of any finder's fee, bonus, refund, override, commission, cross-commission, dividend or other consideration to any participants in a multi-level marketing program in connection with the sale of any product or service unless such participant performs a bona fide and essential supervisory, distributive, selling or soliciting function in the sale or delivery of such product or services to the ultimate consumer; or (4) offer to pay, pay or authorize the payment of any finder's fee, bonus, refund, override, commission, cross-commission, dividend or other consideration to any participant where payment thereof is or would be dependent on the element of chance dominating over the skill or judgment of such participant, or where no amount of judgment or skill exercised by the participant has any appreciable effect upon any finder's fee, bonus, refund, override, commission, cross-commission, dividend or other consideration which the participant may receive, or where the participant is without that degree of control over the operation of such plan as to enable him substantially to affect the amount of finder's fee, bonus, refund, override, commission, cross-commission, dividend or other consideration which he may receive or be entitled to receive.

(e) Multi-level distribution companies shall not represent, directly or indirectly, that participants in a multi-level marketing program will earn or receive any stated gross or net amount, or represent in any manner, the past earnings of participants; provided, however, that a written or verbal description of the manner in which the marketing plan operates shall not, standing alone, constitute a representation of earnings, past or future. Multi-level distribution companies shall not represent, directly or indirectly, that additional distributors or sales personnel are easy to secure or retain, or that all or substantially all participants will succeed. (Mass. § 93:69)

Michigan

A pyramid or chain promotion is any plan or scheme or device by which (a) a participant gives a valuable consideration for the opportunity to receive compensation or things of value in return for inducing other persons to become participants in the program or (b) a participant is to receive compensation when a person introduced by the participant introduces one or more additional persons into participation in the plan, each of whom receives the same or similar right, privilege, license, chance, or opportunity. (Mich. Comp. Laws Ann. § 445.1528)

Minnesota

It shall be illegal for any seller or lessor to operate or attempt to operate any plans or operations for the disposal or distribution of property or franchise or both whereby a participant gives or agrees to give a valuable consideration for the chance to receive something of value for inducing one or more additional persons to give a valuable consideration in order to participate in the plan or operation, or for the chance to receive something of value when a person induced by the participant induces a new participant to give such valuable consideration including such plans known as chain referrals, pyramid sales, or multilevel sales distributorships. (Minn. Stat. Ann. § 325F.69)

Mississippi

The term “pyramid sales scheme” includes any plan or operation for the sale or distribution of goods, services, or other property wherein a person for a consideration acquires the opportunity to receive a pecuniary benefit, which is not primarily contingent on the volume or quantity of goods, services, or other property sold or distributed to be sold or distributed to persons for purposes of resale to consumers, and is based upon the inducement of additional persons, by himself or others, regardless of number, to participate in the same plan or operation. (Miss. Code Ann. § 75-24-51)

Missouri

The term "pyramid sales scheme" includes any plan or operation for the sale or distribution of goods, services or other property wherein a person for a consideration acquires the opportunity to receive a pecuniary benefit, which is not primarily contingent on the volume or quantity of goods, services, or other property sold or distributed or to be sold or distributed to persons for purposes of resale to consumers, and is based upon the inducement of additional persons, by himself or herself or others, regardless of number, to participate in the same plan or operation. (Mo. Ann. Stat. § 407.400)

Montana

(a)"Pyramid promotional scheme" means a sales plan or operation in which a participant gives consideration for the opportunity to receive compensation derived primarily from obtaining the participation of other persons in the sales plan or operation rather than from the sale of goods or services by the participant or the other persons induced to participate in the sales plan or operation by the participant.

(b) A pyramid promotional scheme includes a Ponzi scheme, in which a person makes payments to investors from money obtained from later investors, rather than from any profits or other income of any underlying or purported underlying business venture.

(c) A pyramid promotional scheme does not include a sales plan or operation that:

(i) subject to the provisions of subsection (6)(b)(v)

(v) (A) provides for, upon the request of a participant deciding to terminate participation in the sales plan or operation, the repurchase, at not less than 90% of the amount paid by the participant, of any currently marketable goods or services sold to the participant within 12 months of the request that have not been resold or consumed by the participant; and

(B) if disclosed to the participant at the time of purchase, provides that goods or services are not considered currently marketable if the goods have been consumed or the services rendered or if the goods or services are seasonal, discontinued, or special promotional items. Sales plan or operation promotional materials, sales aids, and sales kits are subject to the provisions of this subsection (6)(b)(v) if they are a required purchase for the participant or if the participant has received or may receive a financial benefit from their purchase. (Mont. Code Ann. § 30-10-324)

Nebraska

Chain distributor scheme also known as pyramid sales shall mean a sales device whereby a person, upon a condition that he or she make an investment, is granted a license or right to recruit for profit one or more additional persons who also are granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. (Neb. Rev. Stat. § 87-301)

Nevada

A "pyramid promotional scheme" means any program or plan for the disposal or distribution of property and merchandise or property or merchandise by which a participant gives or pays a valuable consideration for the opportunity or chance to receive any compensation or thing of value in return for procuring or obtaining one or more additional persons to participate in the program, or for the opportunity to receive compensation of any kind when a person introduced to the program or plan by the participant procures or obtains a new participant in such a program. (Nev. Rev. Stat. Ann. § 598.100)

New Hampshire

"Chain distributor scheme" means a sales device whereby a person, upon condition that he make an investment, is granted a license or right to solicit or recruit for profit or economic gain one or more additional persons who are also granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. (N.H. Rev. Stat. Ann. § 358-B:1)

New Jersey

[Note by JMT: New Jersey was the only state for which I could not find anything resembling a statute defining or restricting pyramid or chain selling schemes, but I found this excerpt from an informative article by Eric Witiw in the Law Review of Seton Hall University School of Law:]

Who would not like to make a 700% return on an investment in a relatively short period of time? Although this offer is obviously too good to be true, over the last sixty years countless people have fallen victim to this allure. In fact, fraudulent pyramid investment schemes recur regularly. To address this problem, New Jersey's Legislature considered a bill which would have prohibited pyramid scams, but ultimately declined to enact any new legislation. Although the state may bring civil actions against a promoter under the Consumer Fraud Act and the Uniform Securities Law and criminally prosecute under the theft statute and the Uniform Securities Law, case law, including the appellate division decision State of New Jersey v. Frederica Bey and the New Jersey Supreme Court decision State v. DeLuzio, raises the question of whether New Jersey, like Delaware and Michigan, should adopt legislation prohibiting pyramid promotion scams.

The defendant, in Bey, was acquitted of theft by deception. On appeal, the New Jersey Superior Court, Appellate Division, overturned the defendant's conviction for promoting an illegal lottery after concluding that pyramid schemes do not fall within the statute which prohibits illegal lotteries. This decision, however, is more significant for the fact that it reveals a conflict in two lines of cases: one construing pyramid investments as merchandise under the Consumer Fraud Act and the other holding pyramid investments as securities under the Uniform Securities Law.

(Article on New Jersey Law: "Selling The Right to Sell the Same Right to Sell: Applying the Consumer Fraud Act, the Uniform Securities Law and the Criminal Code to Pyramid Schemes" 1996, 26 Seton Hall L. Rev. 1635)

New Mexico

"pyramid promotional scheme" means any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from any person's introduction of other persons into participation in the plan or operation rather than from the sale of goods, services or intangible property by the participant or other persons introduced into the plan or operation. (N. M. Stat. § 57-13-2)

New York

As used herein a "chain distributor scheme" is a sales device whereby a person, upon condition that he make an investment, is granted a license or right to solicit or recruit for profit or economic gain one or more additional persons who are also granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. . . It does not include sales demonstration equipment and materials furnished at cost for use in making sales and not for resale. (N. Y. Gen. Bus. Law § 359-fff)

North Carolina

"Pyramid distribution plan" means any program utilizing a pyramid or chain process by which a participant gives a valuable consideration for the opportunity to receive compensation or things of value in return for inducing other persons to become participants in the program; and "*Compensation" does not mean payment based on sales of goods or services to persons who are not participants in the scheme, and who are not purchasing in order to participate in the scheme.* [N. C. Gen. Stat. Ann. § 14-291.2 (b)]

North Dakota

"Pyramid promotional scheme" means any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from any person's introduction of other persons into participation in the plan or operation rather than from the sale of goods, services, or intangible property by the participant or other persons introduced into the plan or operation. (N.D. Cent. Code § 51-16.1-01)

Ohio

"Pyramid sales plan or program" means any scheme, whether or not for the disposal or distribution of property, whereby a person pays a consideration for the chance or opportunity to receive compensation, regardless of whether he also receives other tights or property, under either of the following circumstances: (1) For introducing one or more persons into participation in the plan or program; (2) When another participant has introduced a person into participation in the plan or program. (Ohio Rev. Code Ann. § 1333.91)

Oklahoma

"Pyramid promotional scheme" means any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from the person's introduction of other persons into the plan or operation rather than from the sale of goods, services or intangible property by the participant or other persons introduced into the plan or operation. (Okla. Rev. Stat. § 21-1071)

Oregon
"Pyramid club" means a sales device whereby a person, upon condition that the person make an investment, is granted a license or right to solicit or recruit for economic gain one or more additional persons who are also granted such license or right upon condition of making an investment and who may further perpetuate the chain of persons who are granted such license or right upon such condition. "Pyramid club" also includes any such sales device which does not involve the sale or distribution of any real estate, goods, or services, including but not limited to a chain letter scheme. (Or. Rev. Stat. Ann. § 646.609)

Pennsylvania
The terms "Chain-Letter Plan" or "Pyramid Club" mean any scheme for the disposal or distribution of property, services or anything of value whereby a participant pays valuable consideration, in whole or in part, for an opportunity to receive compensation for introducing or attempting to introduce one or more additional persons to participate in the scheme or for the opportunity to receive compensation when a person introduced by the participant introduces a new participant. (73 Pa. Stat. Ann. § 201-2)

South Carolina
Any contract or agreement between an individual and any pyramid club, or other group organized or brought together under any plan or device whereby fees or dues or anything of material value to be paid or given by members thereof are to be paid or given to any other member thereof, which plan or device includes any provision for the increase in such membership through a chain process of new members securing other new members and thereby advancing themselves in the group to a position where such members in turn receive fees, dues or things of material value from other members, is hereby declared to be an unfair trade practice pursuant to § 39-5-20 (a) of the South Carolina Unfair Trade Practices Act of 1971.

South Dakota
"Pyramid promotional scheme" defined. For the purposes of 37-33-1 to 37-33-11, inclusive, the term, pyramid promotional scheme, means any plan or operation by which a person gives consideration for the opportunity to receive compensation that is derived primarily from the introduction of other persons into the plan or operation rather than from the sale and consumption of goods, services, or intangible property by a participant or other persons introduced into the plan or operation. The term includes any plan or operation under which the number of persons who may participate is limited either expressly or by the application of conditions affecting the eligibility of a person to receive compensation under the plan or operation, or any plan or operation under which a person, on giving any consideration, obtains any goods, services, or intangible property in addition to the right to receive compensation. (S. D. Cod. Laws § 37-33-1)

Tennessee
A "pyramid distributorship" means any sales plan or operation for the sale or distribution of goods, services or other property wherein a person for a consideration acquires the opportunity to receive a pecuniary benefit, which is not primarily contingent on the volume or quantity of goods, services or other property sold or delivered to consumers, and is based upon the inducement of additional persons, by such person or others, regardless of number, to participate in the same plan or operation. (Tenn. Code Ann. § 47-18-104)

Texas
"Pyramid promotional scheme" means a plan or operation by which a person gives consideration for the opportunity to receive compensation that is derived primarily from a person's introduction of other persons to participate in the plan or operation rather than from the sale of a product by a person introduced into the plan or operation. (Texas Bus. & Com. Code Ann. § 17.461)

Utah
(b) "Compensation" does not include payment based on the sale of goods or services t*o anyone purchasing the goods or services for actual personal use or consumption. . . [Note by JMT: I personally testified against the SB182 amendment to the statute in 2006 which allowed for compensation for personal use. The DSA used deception and trickery to get it passed, with the support of Utah's Attorney General, whose main political donors were MLM companies. Similar tactics have been used by the DSA in other states.]*
(2) "Consideration" does not include payment for sales demonstration equipment and materials furnished at cost for use in making sales and not for resale, or time or effort spent in selling or recruiting activities.

(4) "Pyramid scheme" means any sales device or plan under which a person gives consideration to another person in exchange for compensation or the right to receive compensation which is derived primarily from the introduction of other persons into the sales device or plan rather than from the sale of goods, services, or other property. (Utah Code § 76-6a-2)

Vermont
"Chain distributor scheme" is a sales device whereby a person, upon a condition that he make an investment, is granted a license or right to solicit or recruit for profit or economic gain one or more additional persons who also are granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. ((06-031-002 Vt. Code R. §CF 101)

Virginia
"Pyramid promotional scheme" means any plan or operation by which a person gives consideration for the opportunity to receive compensation a majority of which is derived from the introduction of other persons into the plan or operation rather than from the sale or consumption of goods, services, or intangible property by a participant or other persons introduced into the plan or operation. (Va. Code Ann. § 18-2.239)

Washington
"Pyramid schemes" means any plan or operation in which a person gives consideration for the right or opportunity to receive compensation that is derived primarily from the recruitment of other persons as participants in the plan or operation, rather than from the bona fide sale of goods, services, or intangible property to a person or by persons to others. (Wash. Rev. Code Ann. § 19.275.020)

West Virginia
"Pyramid promotional scheme" shall mean the organization of any chain letter club, pyramid club, or other group organized or brought together under any plan or device whereby fees or dues or anything of material value to be paid or given by members thereof are to be paid or given to any other member thereof, which plan or device includes any provision for the increase in such membership through a chain process of any members securing other new members and thereby advancing themselves in the group to a position where such members in turn receive fees, dues or things of material value from other members. (W. Va. Code Ann. § 47-15.1)

Wisconsin
"Chain distributor scheme" is a sales device whereby a person, upon a condition that the person make an investment, is granted a license or right to recruit for profit one or more additional persons who also are granted such license or right upon condition of making an investment and may further perpetuate the chain of persons whoLare granted such license or right upon such condition. (586 Wis. Admn. Reg. 759 (October 2004), ATCP 122)

Wyoming
"Endless chain" means any scheme or plan for the disposal or distribution of property or services whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one (1) or more additional persons into participation in the scheme or plan or for the chance to receive compensation when the person introduced by the participant introduces a new participant. (Wyo. Stat. Ann. § 40-3-101)

Appendix 2F

Comparative Analysis of Direct Sales and other Legitimate Distribution Models with No-Product Pyramid Schemes (NPS) and Recruitment-driven MLMs*, or Product-based Pyramid Schemes (PPS)

Analysis performed by Jon M. Taylor, MBA, Ph.D., President, Consumer Awareness Institute,
and Advisor, Pyramid Scheme Alert

What this analysis reveals

The table which follows shows that clear distinctions can be made between classic (1-2-4-8, etc.) no-product pyramid schemes, product-based MLMs (multi-level marketing) programs*, and all forms of legitimate businesses to which the latter are often compared. MLM programs are often referred to as "network marketing" (also "consumer direct marketing," etc.) and can be separated into two categories:

1. Recruitment-driven MLMs use compensation systems that are so heavily weighted towards the top of the hierarchy of participants that it is necessary for participants to recruit aggressively to realize any significant profits. These are highly leveraged programs, enriching a few at the top of a pyramid of participants at the expense of the efforts and purchases of a multitude of downline distributors – whose contributions are "leveraged" for the benefit of those above them. In recruitment-driven MLMs, most of the payout in commissions and bonuses from the MLM go to top distributors and very little can be gained from efforts to sell products directly to consumers. Properly understood, such MLMs are illegal pyramid schemes. The vast majority of MLMs I have studied fall into this category.

2. Retail-focused MLMs pay the bulk of their commissions to the person selling the products or services to end use consumers. In a retail MLM, there is enough incentive to sell directly to customers that it is not necessary to recruit a large downline to realize significant profits. In over 350 MLMs to 2010, I could find no examples of retail-focused MLMs.

How these distinctions were derived

Fortunately, I was able to draw from an extremely broad background in home businesses to make these comparisons, having had direct experience or performed consultation services in almost all forms of business to which MLMs are often compared. In addition, I spent a full year in an intensive one-year test of a leading MLM as a full-fledged distributor, carefully noting everything that went on. I then conducted interviews with hundreds of present and former participants in a variety of MLMs before arriving at the conclusion that most MLMs are in fact cleverly disguised pyramid schemes.

I knew enough from my direct experience to know that the major problems with MLMs resulted from the compensation systems, or pay plans, of the various MLM companies. Decades ago, psychologists learned that "you get the behavior you reward." Nowhere is this more evident than in multi-level marketing.

Combining the research and experience of myself and others, I itemized what character-istics in MLM and in no-product pyramid schemes are unique to them and clearly differentiate them from other types of business activity. Then I broke these down into those which were implicit within the compensation plan – which seemed to cause most of the problems – and those that could be considered merely effects growing out of the reward system.

Other useful findings:

What I found was strikingly clear. Five characteristics*** clearly differentiated the recruitment-driven MLM's, or product-based pyramid schemes from the rest. These factors were both defining and causal – defining the differences, as well as identifying the causes of the problems. No-product pyramid schemes have always been more easily recognized, both by law enforcement and by consumers. What this analysis shows is that traits can be singled out both to clarify differences and to predict high loss rates.

These same five "red flags" could have legal significance in court cases. In most jurisdictions, a key element is considered in defining pyramid schemes – the payment of money by the company in return for the right to recruit other participants into the scheme. If the primary emphasis is compensation from recruiting, rather than from the sale of products to end users, it is considered a pyramid scheme. How such primary emphasis is to be determined has until now been a formidable challenge for investigators. Hopefully, this challenge will be met with this analysis and my more complete analysis entitled "*THE 5 RED FLAGS: Five Causal and Defining Characteristics of Product-Based Pyramid Schemes*" ***

In the spring of 1999, I mailed my conclusions to the presidents of 60 of the most prominent MLM companies and gave them a form to provide data to "prove me wrong." At least five of them attempted to do so, but none were able or willing to do so. So I was left with the necessity of validating my conclusions using other resources. With the help of associates, careful research into public documents, and a lot of communications with key informants, I was finally able to locate the average incomes and percentages of "distributors' at various payout levels at 26 "recruitment-driven MLM" companies. What I found was startling – far worse than expected. After eliminating typical deceptions in their reporting, the loss rate for the six recruitment-driven MLMs was approximately 99.8%. That means that at best, one in 100 participants earns a profit- and only a tiny percentage of those earn the huge "residual income" promised them. No-product pyramid schemes, which are illegal because of the guarantee that the majority left on the bottom layers will lose money, have far better odds than that! Recent data shows that product-based pyramid schemes are far worse than no-product schemes.

The chart that follows is color-coded to help discern the differences between characteristics of the various business models. Defining and causal characteristics of -

No-product pyramid schemes are marked in **blue**.

Recruitment-driven MLMs are **red**.

Retail-focused MLMs are **pink**.

Significant effects that are not causal are marked in **green**, the most important of which are listed first, as numbers 7 to 10.

* a.k.a. multi-level marketing, network marketing, consumer direct marketing, etc. Recruitment-driven MLMs can be distinguished from retail-focused MLMs, in which the company pays generously for retailing products without recruiting large downlines. For retail-focused MLMs, #5 (and preferably #4 as well) would be answered with a "NO."

** "Incentivized purchases" are purchases of goods and services from the MLM company that are tied to qualification to participate in commissions or to advance through ascending levels in the distributor hierarchy. If they constitute a required cost of participating in the "business opportunity," then whether they are used, sold, given away, or stored is irrelevant – they should be considered a cost of doing business.

*** **NOTE**: In 2003, I settled on the 5 CDCs (or "5 red flags") for analytical purposes. However, analysis of over 350 programs have led me to reduce the number to four, since #4 occasionally does not apply. But when the number of levels in the pay plan has been limited to four or less, this has been compensated for by extreme jumps in income at the top levels. All are top-weighted, though increasing the number of levels can enhance the effect.

DEFINING AND CAUSAL CHARACTERISTICS in the compensation system that identify harmful pyramid schemes. The features on this page both define a pyramid scheme and cause the harm (extreme loss rate).	Franchises	Distributor-ship sales	Insurance agency sales	Recruiting business	Direct selling	NPS (no-product schemes)	PPS- or recruitment-driven MLMs	Retail MLMs (hypothetical)	COMMENTS – and PROBLEMS resulting from these characteristics when applied to pyramid schemes (NPS and PPS)
1. RECRUITING OF PARTICIPANTS IS UNLIMITED IN AN ENDLESS CHAIN OF EMPOWERED AND MOTIVATED RE-CRUITERS RECRUITING RECRUITERS. Is unlimited recruiting allowed, and are those who are recruited empowered and spurred on by incentives (overrides, advancement, etc.) to recruit additional recruiters, who are also empowered and motivated to recruit still more recruiters, etc. – so that the effect is an endless chain of recruiters recruiting recruiters?	NO	NO	NO	NO	NO	YES	**YES**	YES	Income is dependent on downline recruiting, with the assumption of an unlimited market. Perceived or de facto saturation results in diminishing opportunity and guaranteed losses for participants at bottom levels.If all pyramid schemes were defined as illegal (and the laws were enforced) based on this one characteristic, we would not have the proliferation of schemes we see today.
2. ADVANCEMENT IN A HIERARCHY OF MULTIPLE LEVELS OF "DISTRIBUTORS" IS ACHIEVED BY RECRUITMENT, RATHER THAN BY APPOINTMENT. Does a participant advance in position (and potential income) in a hierarchy of multiple levels of "distributors," by recruiting other distributors under him/her, who in turn advance by recruiting other distributors under them, etc.?	NO	NO	NO	NO	NO	YES	**YES**	YES	If a participant must recruit to advance to more profitable payout levels in the scheme, and if a program's emphasis is on building a downline, it as a de facto pyramid scheme, whether or not it has been declared illegal by authorities. Also, for PPS's, quality of products often becomes questionable when advancement and monetary incentives are tied to recruitment.
3. "PAY TO PLAY" REQUIREMENTS ARE SATISFIED BY ONGOING "INCENTIVIZED PURCHASES."** Are new "distributors" given "pay to play" options? That is, are they encouraged to make sizable investments in "incentivized purchases" (purchases tied to qualification for commissions or advancement in the scheme**) in order to take advantage of the "business opportunity," and later to continue qualifying for advancement and payments from the company?	NO – only initial invest-ment	NO	NO	NO	NO	YES	**YES**	YES	Such cost of participation assures huge gains for top-level participants, but guarantees losses for those who fail to ascend to higher levels in the hierarchy of participants. The amount of initial investment for PPS's ma be small, but total purchases over time can be very significant for those seeking promised rewards, such as advancement to higher "pin levels" or bonus categories.
4. COMPANY PAYS COMMISSIONS AND/OR BONUSES TO MORE THAN FIVE LEVELS OF "DISTRIBUTORS." Does the company pay commissions and bonuses to distributors in a hierarchy of more levels than are functionally justified; i.e., more than five levels?" Even in major corporations, the entire world marketplace can be covered in five levels of sales management – branch, district, regional, national, and international sales managers.	NO	NO	NO	NO	NO	NO – not usually	**Usually –**If not, #5 is more extreme	4-level limit best	More than 4 levels in an MLM means huge payouts to top level participants, which come from overrides on purchases of a large downline. This more than compensates for the small payout per sale – vs. NPS's, where the top person gets it all. Paying bonuses on more than five levels in an MLM enriches those at the top at the expense of those at the bottom.
5. THE COMPANY PAYOUT PER SALE FOR EACH UPLINE PARTICIPANT EQUALS OR EXCEEDS THAT FOR THE PERSON SELLING THE PRODUCT, CREATING INADEQUATE INCENTIVE TO RETAIL AND EXCESSIVE INCENTIVE TO RECRUIT – AND AN EXTREME CONCENTRATION OF INCOME AT THE TOP. Would a "distributor" purchasing products "for resale" receive about the same total payout (in commissions, bonuses, etc.) from the MLM company as participants several levels above who had nothing to do with the sale? Those at the top of the hierarchy then profit hugely.	NO	NO	NO	NO	NO	YES	**YES**	NO	This results in extreme inequality in payout to distributors and a high loss rate (99.9% for MLMs with characteristics 1-5). Only a few participants at the top of the pyramid get enough in commissions from sales to a large downline to achieve a significant income. Conversely, those on lower levels seldom get enough payment from the MLM to cover their expenses, including purchases from the company. Thus the emphasis is on recruiting, not retailing or direct selling. If distributors on the front line get the bulk (over half) of an MLM company's payout, it would be a retail MLM – and could be legitimate.
6. ALL THE MONEY GOES TO THE TOP (applies to NPS only). Would participants who recruit other participants into the scheme receive little or nothing until advancing to the top level in the hierarchy?	NO	NO	NO	NO	NO	YES	NO	NO	With NPS's, only participants at the top of the pyramid get paid. Those at the bottom levels will always be waiting to advance to the highest level to get paid. Approximately 90% end up losers when the pyramid collapses or is shut down.

DEFINING AND CAUSAL CHARACTERISTICS in the compensation system that identify harmful pyramid schemes. The features on this page both define a pyramid scheme and cause the harm (extreme loss rate).	Franchises	Distributor-ship sales	Insurance agency sales	Recruiting business	Direct selling	NPS (no-product schemes)	PPS- or recruitment-driven MLMs	Retail MLMs (hypothetical)	COMMENTS – and PROBLEMS resulting from these characteristics when applied to pyramid schemes (NPS and PPS)
7. Emphasis is on payments for the rights to recruit as the primary source of income, rather than the sale of products and services	NO	NO	NO	NO	NO	YES	YES	NO	This EFFECT results from the system of rewards in the compensation system. **Though not a CAUSE of the harm done by pyramid schemes, it is a key criterion in federal and state laws against pyramid schemes**.
8. Loss rate is so dismal enough to disqualify them as legitimate businesses. It is rare for participants to report a net profit to the IRS.	NO	NO	NO	NO	NO	YES	YES	NO	Loss rates for recent NPS's have ranged from 87.5% to 93.3%. For PPS's or recruitment-driven MLMs the loss rates are about 99.9%. One can do better with a single roll of the dice in a game of craps in Las Vegas.
9. Misrepresentation and deceptive sales practices are commonplace, as they are essential for any pyramid scheme to survive and grow. If the truth were told about the abysmal odds of "success," few would join the program, and it would soon collapse.	NO	NO	NO	NO	NO	YES	YES	NO	Misrepresentation causes harm to consumers who invest on the basis of incorrect information. To be successful in a PPS or NPS, one must first be deceived, then maintain a high degree of self-deception, and finally go about deceiving others.
10. New pyramidal organizations are set up in other areas (or with new product divisions for PPS's) to maintain downline networks until the pyramid collapses or the scheme is stopped by legal action. By having to recruit new participants to repay earlier investors, NPS's and PPS's evolve into Ponzi schemes.	NO	NO	NO	NO	NO	YES	YES	NO	The more durable MLM companies avoid collapse by initiating new pyramids, which they label "growth oppor-tunities." **They then evolve into Ponzi schemes, moving to new areas or starting new divisions to get new recruits to buy products so that earlier investors can profit.**
11. The distinction between buyer and seller becomes blurred. With multi-level schemes, the seller, buyer, and recruiter (and his/her immediate family) may be the same entity.	NO	NO	NO	NO	NO	YES	YES	NO	This creates confusion and a low level of trust in the minds of consumers – and contaminates the marketplace for legitimate enterprises.
12. The program displays a pattern of rapid growth, then a leveling off in sales, followed by a precipitous decline in volume, unless aggressive re-pyramiding occurs.	NO	NO	NO	NO	NO	YES	YES	NO	This pattern is common to all pyramid schemes due to empowerment and incentives given to each recruit to recruit other recruiters, as in #1 (above)
13. Duplication of one's efforts and investment is encouraged in order to build one's downline.	NO	NO	NO	NO	NO	YES	YES	YES	Recruits are taught that this process can lead to great leverage for one's time and investment – but not that they are only fattening the checks of their upline.
14. Continuous replacement of "losers" is supplied by continual recruiting of new participants.	NO	NO	Some-times	NO	Some-times	YES	YES	NO	Replacement also helps to maintain a pyramid scheme by creating a "body shop" of new victims to replace an inordinate percentage of dropouts.
15. Demand for the products is distributor-driven, not market-driven.	NO	NO	NO	Some-times	Some-times	NO	NO	YES	The need for and quality of products becomes secondary to participation in the scheme. "Pay to play" purchases become disguised (or laundered) pyramid investments. Some MLMs are notorious for hyper-consumption of products, filling garages, etc.
16. Promises are made of quick return on investment, huge residual ("permanent") income, time freedom, and other easy money appeals.	NO	NO	NO	NO	NO	YES	YES	NO	Pyramidal income appeals induce distributor investments, which ultimately become losses for the vast majority of participants—especially for PPS's.
17. Pyramid addiction can be seen in many programs.	NO	NO	NO	NO	NO	YES	YES	NO	"MLM junkies" have been observed cycling through one MLM after another, losing money each time. It is likely that these same people would fall for NPS's.