Chapter 10: LEGAL AND REGULATORY ISSUES –

When is an MLM (multi-level marketing program) a fraudulent business opportunity? Or an illegal pyramid scheme? Are all MLMs technically illegal? What are the most significant legal precedents for MLM cases? Where are the regulators in all this?

PREFACE

Let me begin by admitting I am not an attorney and make no pretense about this being an exhaustive legal treatise on this thorny issue. I am a qualified business analyst, teacher, and entrepreneur-turned consumer advocate. This career change came after witnessing what I believe to be the most unfair, deceptive, viral, and predatory business practice ever foisted on unsuspecting home-based business opportunity seekers (and many victims who were not seeking anything) – most of whom had no idea how damaging to their personal and financial well-being it can be to commit to an MLM program.

When I have consulted with attorneys and/or acted as expert witness in MLM cases, I have found it necessary to focus on legal precedents for much of my analyses. And of course, attorneys must constantly focus on the law and its interpretation, regardless of what logic and research may suggest.

However, as a consumer advocate and educator, I try to be guided by solid logic and by research and feedback that I have received from victims and their families worldwide. It is frustrating to those of us working for consumer protection to find laws and regulatory actions and rules to be so inadequate to meet the needs of vulnerable consumers. But we do the best we can. In this chapter, I hope to strike a balance between the legal issues and the economic and social issues.

The chapters leading up to this one serve a dual purpose: First, I have attempted to thoroughly analyze and expose the inherent flaws in multi-level marketing as a business model and as manifested in hundreds of MLM programs currently operating, and – by extension – in thousands of defunct and future MLMs. Substantial evidence for these flaws has been summarized. New evidence is also presented in this book for the first time.

Secondly, this book demonstrates that the degree of unfairness and deceit of MLM as an industry, as well as harm to participants, strongly suggests that MLM is as bad as or worse than any classic, no-product pyramid scheme. At least, if MLMs were classified as pyramid schemes, they would be illegal per se, according to FTC guidelines.[1]

Though it is not my primary objective in this book to prove that any given MLM is an illegal pyramid scheme,[2] it is relevant to know whether or not an MLM displays the characteristics of a recruitment-driven MLM, or what I would label a "product-based pyramid scheme" because such a model leads to horrendous loss rates among participants.[3] Where data has become available, 99.6-99.9% of MLM participants lose money,[4] assuming at least somewhat realistic estimates of attrition, incentivized purchases, and minimum operating expenses are factored into the analysis.[5]

[1] Letter from Robert Frisby of the FTC, citing section 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. 45 (a)(1). See also Koscot Interplanetary, Inc., 86 F.T.C. 1106 (1975)

[2] Again, I am a business analyst and consumer advocate, not an attorney

[3] A more complete discussion of re-pyramiding and how major MLMs manage to avoid market collapse and endure for decades is found in Chapter 3.

[4] See Chapter 7. Similar results were also reported in "*The Myth of 'Income Opportunity' in Multi-level Marketing,"* by Robert FitzPatrick, Pyramid Scheme Alert, 2008.

[5] See Chapter 7.

I will in this chapter attempt to summarize some of the more significant statutes, court decisions, and agency rules and communications that have been and could be used in arguing and deciding the merits of one side or the other. I will also share observations that I and other consumer advocates firmly believe deserve diligent attention by federal and state regulators. It is my hope that this chapter, along with those preceding it, will also provide information that will be useful for business scholars, media investigative reporters, consumer awareness groups, and consumers themselves.

Chapter contents

INTRODUCTION: A brief history of pyramid schemes and of MLM

I will not attempt to provide here a thorough history of MLM (multi-level marketing) or analysis of all the problems with MLM (or what I like to call product-based pyramid schemes) but merely my observations as a qualified consumer advocate and business analyst. The history of pyramid schemes in this country is interesting, as you will see from the brief sketch below:

Ponzi schemes. When Charles Ponzi organized the Securities Exchange Company in Boston in 1919 and issued promissory notes payable in 90 days with 50 percent interest, he kicked off a storm of investment frenzy which duped just about everyone, including politicians, law enforcement officers, and reporters. He tricked speculators by using the money of new investors to pay old investors huge 'profits.'

Ponzi took in over $15 million from this and other schemes before his house of cards collapsed, causing losses for thousands and leading to jail time and his eventual deportation to Italy in 1934. Incidentally, there were similar schemes prior to Ponzi (for example, John Law's "Mississippi Bubble" scheme in France in 1719 and William Franklin Miller's Franklin Syndicate in 1899—a.k.a. "520 percent Miller"), but the Ponzi name stuck for this type of phenomena.

Some consider Ponzi schemes as separate and distinct from pyramid schemes, but as one writer observed,

> Ponzi and pyramid schemes do have similarities. Both are fraudulent arrangements for the receipt and redistribution of money with early participants winning and those who enter later losing. In each case it is essential to continue the game with new infusions of money, for if the play ends and there is an accounting, there must be a deficit and cries of pain. But where Ponzi promised a definite return on one's investment—albeit a huge one—the possibilities in a pyramid were almost limitless as new subscribers feed those who joined before.
>
> Furthermore, the machinery of the pyramid is always explained and is, in fact, one of its alluring features, whereas Ponzi plans invariably refer obscurely to exotic investments that are really irrelevant and usually nonexistent. In some cases the pyramid seems almost acceptable socially, as in the cases of chain letters or distributorship plans, but there has never been any question about the vice of Ponzi schemes."[6]

"Pay-to-play" chain letters. Later came chain letters, beginning with the "send-a-dime" letter widely appearing in Denver in 1935, which bore the heading "Prosperity Club" and the slogan "In God We Trust" This led to the $1 chain letter in Omaha, chain letter agencies or "factories, and the "Circle of Gold" which spread from California throughout the country in the late 1970's – all of which used the postal system. Participants would send a dollar to the person at the top of a list of names that was mailed to you, add their name to the bottom of the list, and then mail copies of the letter to persons they know with instructions to do the same.

Many of these chain letters went underground because of aggressive enforcement of federal mail fraud statutes. Still other variations, such as chart and airplane games, emerged later.

Another variation appeared about the time the Internet was launched. What I call "report chains" encouraged you to buy reports listed on a list of names with addresses and then mail a report on anything of interest and add your name to the bottom before mailing it to your list of contacts. The reports were typically useless rehashes of readily available information – often money-making ideas.

"Chain selling" or "chain distribution" systems, or what eventually came to be called multi-level marketing, were an

[6] Joseph Bulgatz , *Ponzi Schemes, Invaders from Mars, and More Extraordinary Popular Delusions and the Madness of Crowds* (New York: Harmony Books, 1992), p. 36.

eventual offshoot from chain letters and report chains. With chain selling, the selling of products was made through multiple levels of distributors, each of whom received some type of compensation for the sales of those recruited at lower levels, or one's "downline."

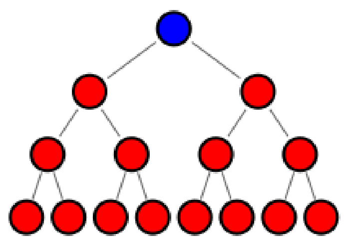
Early direct selling programs. Parallel to these developments were direct selling programs which focused on door-to-door selling or in-home demonstration plans, or "party plans." Some of the direct selling programs that were popular in the 50s and 60s included Stanley Home Products, Mary Kay Cosmetics, Fuller Brush, Shaklee, Nutralite, and of course Amway. Even Amway at this time was primarily focused on selling of unique cleaning products to friends and family, rather than primarily to downline participants.

In Chapters 2 and 7, I explained why it is essential to examine carefully the compensation or pay plans of direct selling programs in evaluating them. This, of course, would apply to any packaged home business opportunity.

To help pay my way through college, I sold World Book Encyclopedia. When I made a sale, the largest commissions (from 20% to 30%, as I recall) from the company went to me as the person who produced the sale. My division manager got a smaller percentage, and his manager a still smaller percentage – but of course they were drawing commissions from many salesmen. I found a similar pay structure when I sold insurance many years later. The person who made the sale got the lion's share of the commission.

In sharp contrast, in MLM, the commissions paid by the company to the front line person making the sale is only a small percentage of the total commissions paid by the company for that particular sale. In fact, an upline person several levels up often receives as much as or even several times as much per sale as the person making the sale. This greatly increases the "top weighted" emphasis that drives participants not to sell products, except as part of the recruitment of huge downlines – because that is where the money is. It also is what technically makes an MLM an illegal pyramid scheme.

No-product pyramid schemes. I use this designation to separate these schemes from product-based pyramid schemes, or recruitment-driven MLMs. It is difficult to determine when the first no-product pyramid schemes were promoted, but by the 1980s several were operating. One example was "The Airplane Game," in which participants were recruited into four layers, or "tiers" – one captain, two "co-pilots," four "crew" members, and eight "passengers." Typically, one would pay up to USD$1500 to enter at the level of passenger, in the hopes of receiving a USD$10,000-plus payout when one 'piloted out' at the top of the scheme. The pyramidal structure is shown below:



The Airplane Game: The "eight-ball" model contains a total of fifteen members. Note that unlike in the picture, the triangular setup in the cue game of *eight-ball* corresponds to an arithmetic progression 1 + 2 + 3 + 4 + 5 = 15. The pyramid scheme in the picture in contrast is a geometric progression 1 + 2 + 4 + 8 = 15.

The "captain" at the top walks away with the money and then either drops out – and the others each move up a level – or he/she either starts a new pyramid and repeats the process all over or enters at the bottom and recruits his/her way up to the top in order to cash in again. The problem is that at some point the game reaches a point of saturation in which no one wants to enter the pyramid and it collapses – or is shut down by authorizes. Then all those at the bottom levels lose money, which approximates 90% of participants. (For a breakdown of the loss rates, go to Chapter 7, "Appendix 7C: Winners & losers in no-product pyramid schemes ")

It doesn't matter how many times the pyramid has been recycled into other pyramids, the scheme will eventually collapse, leaving approximately 90% will be in a loss position. These schemes are widely considered to be unfair and deceptive practices. And though the FTC does not specifically address pyramid schemes, such schemes have been deemed unlawful under the above clause in the Federal Trade Commission Act.[7]

Another recent genre of no-product pyramid schemes were the "gifting schemes," such as "Women Empowering Women," in which participants donated or "gifted" money to the operators of the scheme, who claimed it was legal since the money was paid as gifts, rather than investments. But authorities did not accept this distinction, and the gifting schemes were shut down.

"Affinity groups" were also promoted, in which close-knit groups were targeted to promote "Dinner Parties" with guests investing in a pyramid of participants similar in structure to the Airplane Game. These too were shut down by authorities. Periodically, others follow suit. However, most pyramid promoters today see little need to initiate no-product schemes which are easily recognized as pyramid schemes. The trend today is to introduce products to give them an air of legitimacy – and to deceive regulators, the media, and the public into accepting them as legitimate.

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[7] 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."[7] In re Koscot Interplanetary, Inc., 86 F.T.C. 1106 (1975)

Multi-level marketing – or product-based pyramid schemes – evolved from no-product pyramid schemes. In about 1934, a company called Nutralite was founded and by 1945 developed multi-level marketing, a means of turning consumers into distributors. They learned they could sell far more products by selling to distributors than they could by selling direct to consumers. After all, it is easier to buy than to sell, and if a person can be convinced that he/she will make money by buying products to qualify for commissions from sales by those he or she recruited, the sale is an easy one.

The nutritional products were promoted as effective in treating a variety of ailments, including even cancer, heart disease, and depression. Sales exploded, but the FDA took notice and battled such spurious claims for four years. This led to other battles with regulatory agencies later.

In 1960, Rich DeVos and Jan Van Andel developed an MLM they named Amway – short for American Way. Their product was a unique biodegradable soap called Frisk that would avoid FDA scrutiny. They created a compensation plan that essentially rewarded those at the top of a pyramid of distributors at the expense of a continuing stream of recruits at the bottom, who bought the hype of promised riches if they followed their system – which included buying products on a monthly basis to qualify for commissions and advancement in the scheme.

Sales exploded from approximately $½ million in 1960 to $25 million in 1964. Amway also acquired Nutralite in 1972. The "recruiting machine" that Amway developed quickly attracted the interest of vulnerable prospects and of regulators as well – setting the stage for a later battle with the Federal Trade Commission. Thus Amway, and the contest between those advocating for consumers, and an industry promoting a flawed business model that featured an endless chain of recruitment, was born.

KEY LEGAL & REGULATORY ISSUES

As an endless chain recruitment model, MLM is fundamentally flawed.

In Chapter 2, I carefully defined and distinguished MLM from all legitimate forms of direct selling or business opportunities. I also explained the inherent flaw in all MLMs.

In a nutshell, MLMs are driven by an endless chain of recruitment by TOPPs (top-of-the-pyramid promoters). All of the hundreds of MLM compensation plans I have analyzed assume infinite expansion in both finite markets and virgin markets, neither of which exist. MLMs are therefore inherently flawed, uneconomic, and deceptive. A continuing stream of new participants must be recruited to replace those continually dropping out – all to enrich the founders and a few TOPPs. The vast majority of participants become victims, having been promised substantial ongoing income but experiencing a net loss; i.e., having spent more than they received.[8] They also lose time and often important relationships from incessant recruiting.

Saturation underestimated by FTC. When the issue of saturation was raised in the 1979 FTC vs. Amway case, the Amway defense was that the total market for its distributors was nowhere near saturation. What was overlooked (or not understood) at the time was that total saturation is not a relevant issue. Why would a city of 100,000 people need 100,000 distributors? Ten or twenty may be plenty to serve the city as a market. It is *market saturation* that is relevant, not *total saturation.* Realistic *market saturation and collapse* is explained further in Chapter 3.

Judging MLM by behavior vs. structure and rewards. I dedicated considerable space in Chapter 2 to explaining that rewards drive behavior. Therefore, I believe that to approach MLM as strictly a behavioral problem is counter-productive. Yet it is the behavior of participants and leaders that many of the laws and rulings address, resulting in much of the confusion in efforts (or lack thereof) to regulate MLM.

An example is the tendency of lawmakers and regulators to look at such things as the percentage of personal consumption of participants compared with sales to non-participants – or worse, products consumed vs. products stockpiled. Proving such spending patterns requires much research and discovery efforts, which can be very expensive and time-consuming. It is also easily circumvented by evasive company "policies" and pretended enforcement actions.

Another behavioral "policy" is refunds or buybacks. While this can appear to provide consumer protection, those who deal with MLM refunds know that the fine print of how they are to be executed can assure that only a small percentage of purchases (usually less than 5%) ever result in refunds.

A far more cost-effective strategy would be to consider all endless chains to be illegal per se because of the flaws in their fundamental operational structures and reward systems. But with the reality of the 1979 Amway decision, which the FTC seems unwilling to revisit even with evidence strongly suggesting reversal, at the very least the following consumer protections should be provided by the FTC, state attorneys general, and other agencies charged with protecting against unfair and deceptive practices:

1. The fundamental flaws of endless chain systems should be recognized and pointed out to consumers, so they can be given valid guidance to avoid such programs
2. Consumers should be provided adequate disclosure of essential information to make an informed decision. For example, if a prospect knew that less than one in 100 earns a gross profit (receives more from the company than paid to the

[8] See Chapter 7

company and upline for products and services), and that less than one in 25,000 receives the huge incomes reported for TOPPs, they may decide not to participate.

Unfortunately, neither of these protections is being provided, and only a handful of states make an effort to challenge the MLM industry and the DSA (Direct Selling Association). The DSA is the MLM lobbying organization that functions as a cartel to promote the dialogue of deception that shields MLMs from legislation or rulings that could hurt the MLM industry, regardless of how helpful they may be in protecting consumers from abuse.

MLMs vs. pyramid schemes – a distinction without a difference

A rationale for the legitimacy of MLM was promoted quite successfully by the MLM industry in the 80s and later by the "DSA/MLM cartel" (my term). This was the argument that when products were sold by MLM participants, an endless chain recruitment scheme then somehow became a legitimate business. The chain of recruitment and stacking of participants into levels of rank in a pyramid was acceptable because this was just another way of moving products to the ultimate consumer.

To say that the addition of products somehow mitigates the damage done by a pyramid scheme is an uninformed view.

The problem with this line of thinking is that products can then become merely a means of disguising or laundering investments in the pyramid scheme. However, the dynamics of the chain promotional system are essentially the same. In fact, money from sales must go through a company infrastructure with only a portion (typically less than half) of payout rebated to participants – after company costs, including skimming of a significant portion of revenues by founders and company executives. And instead of 14 downline participants in an 8-ball no-product pyramid scheme[9] paying 100% of investments to TOPPs (top-of-the-pyramid promoters), most of what is left over after expenses for company payout to MLM participants goes to TOPPs, and the rest is spread amongst (usually) tens of thousands of participants – at least 99.6% of whom lose money[10].

The net result of all this is that provable statistics show that participants in classic, no-product pyramid schemes are ten to 100 times more likely to profit from the scheme as are participants in product-based pyramid schemes, or MLMs. So participants in MLMs suffer far greater harm than those in no-product pyramid schemes by any measure – loss rate, aggregate losses, and number of victims. In my opinion, to say that the addition of products somehow mitigates the damage done by a pyramid scheme is an uninformed view.

A "good MLM" may be an oxymoron. So from a systemic or structural standpoint, the difference between "legitimate MLMs" and illegal pyramid schemes is a distinction without a difference,"[11] except that MLMs offer products and are more damaging to the vast majority of participants. I would go so far as to say that a "good MLM" may be an oxymoron.

I have frequently been asked how one would create a fair and honest MLM program. In response, I have given suggestions as outlined in Chapter 2, but no one has followed my advice – which would take away the huge payout to founders and TOPPs and give the bulk of the commissions to those actually making sales to non-participants. Other features would include paying no commissions on sales to downline participants.

9 For more on comparisons between no-product and product-based pyramid schemes, see Chapters 2 and 7.
10 Chapter 7
11 This is an argument made by Bruce Craig who was involved in the Koscot Interplanetary case.

No one would suddenly get rich in such a program, and to make a profit the founders and TOPPs would have to work as hard as they would in any legitimate business. In fact, they would have to work harder because direct selling has been replaced by handy and competitively priced discount stores and Internet shopping.

Causative and defining character-istics of recruitment-driven MLMs, or product-based pyramid schemes

In chapter 2 I described in detail typical characteristics of MLM programs that are recruitment-driven, which includes all of the over 350 MLMs whose compensation plans I analyzed. Below is a summary of the characteristics that both distinguish between product-based pyramid schemes and legitimate direct selling programs. These same characteristics are what cause the horrendous loss rates of these MLMs.

Endless chain of recruitment of participants as primary customers. The F.T.C.'s position on pyramid schemes was originally set forth in the *In re Koscot Interplanetary, Inc.* case. On page 1181, the *Koscot* court noted:

> The Commission has previously condemned so-called "entrepreneurial chains" as possessing an intolerable capacity to mislead. *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). 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.* In general such recruitment is facilitated by promising all participants the same "lucrative" rights to recruit.

This "intolerable capacity to mislead" is demonstrated by over 100 typical misrepresentations used by MLM defenders and in MLM recruitment campaigns, as discussed in Chapter 8.

MLM programs are recruitment-driven. Having analyzed the compensation plans of over 350 MLMs, I can say with confidence that all rewarded recruitment far more than selling of products to non-participants. One advances to the top ranks of the pay plan not by appointment, but by recruiting a downline. This feature was alluded to in the *Webster v. Omnitrition* case, from which I quote the following:

> "The key to any anti-pyramiding rule in a program like Omnitrition's, where the basic structure serves to reward recruitment more than retailing, is that the rule must serve to tie recruitment bonuses to actual retail sales in some way."[12]

The "basic structure" likely refers to the potential for growth of an expanding downline, or pyramid, of participants in exponential fashion so that – even though the commissions from purchases by each downline participant is small, the aggregate commissions can grow to rapidly increasing amounts with each additional level of participants. This makes retailing of products to non-participants in the scheme a comparative waste of time for those seeking to maximize their gain – which it is human nature to do.

"Pay to play" purchases are used to finance pyramid schemes. On the FTC web site[13] is an article entitled "The Bottom Line about Multi-level Marketing Plans." 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.

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[12] *Webster v. Omnitrition, IIB, filed in the Appeals court for the U.S. District Court for the Northern District of California, March 4, 1996*

[13] www.ftc.gov

Most MLMs, in fact, require purchases in order to participate in the financial rewards outlined in the compensation plan. This is one of the earmarks of a pyramid scheme, as opposed to a legitimate direct selling program. – re FTC v. Amway (1979 – 142-145), Webster v. Omnitrition (Discussion on "Pyramid"), and FTC v. Skybiz (29)

For comparison, when I sold World Book Encyclopedia to help pay my college expenses, I was never expected to buy my own set. But I was able to get my own set for a discount – my own commission.

While the cost of the actual enrollment fee, which includes a sales kit, may be small and likely not a for-profit item, the cost to qualify for commissions and bonuses can be substantial. In fact, participants are encouraged to satisfy their minimum "pay to play" requirement by purchasing enough products to satisfy their monthly minimum quota to qualify for commissions. This "pay to play" feature of an MLM compensation plan assures that, given the low amounts of commissions and bonuses received for 99% of distributors, it would be extremely rare for any distributors to realize a profit – after minimal operating expenses are subtracted along, with their purchases from company.[14]

MLM programs are top-weighted. In every one of the hundreds of MLM compensation plans I analyzed, the rewards escalated almost exponentially as viewed commissions and bonuses paid to participants at the highest levels. Those at the lower levels paid out more to the company than they received back, and their purchases from the company served only to impoverish those at the bottom to the benefit of those at the top. This was most noticeable for those with a large number of "pin levels" or ranks in the pay plan. This inequity in distribution of income across the various ranks in the pay plan was confirmed by actual payout statistics in companies that release average earnings data.[15]

[14] See Chapter 7.
[15] See Chapter 7.

Possible exception: Party plans may be retail-focused. The only possible exception I have found to the futility of recruitment-driven MLM programs are in-home demonstration programs, or "party plans." While their products are typically priced several times those in supermarkets, they may focus on actual sales to non-participants. At least one expert suggested[16] that emphasis on sales of products to non-participants could be a mitigating factor in the otherwise despoiling effects of a product-based pyramid scheme. Whether or not they are recruitment-driven and top weighted would depend on the compensation plan of those at the higher levels, or TOPPs.

MLM as simple fraud – or MLM as systemic fraud

When I spoke at a seminar for state and national law enforcement officials on product-based pyramid schemes[17], I carefully laid out MLM's flaws and examples of loss rates of at least 99%, though its promoters were claiming MLM was the answer to their financial problems. Those who attended were shocked at the statistics. I asked the group if any believed MLM qualified as a legitimate business opportunity. No one thought it qualified.

Then I asked if it qualified as a lottery or a form of gambling because a lucky few made it to a place at or near the top of the pyramid of participants where the money was made. Again I got a "no" answer because not everyone had an equal chance. Those who entered at the beginning of the chain of recruitment had a huge advantage over those who came in later – almost all of whom lost money.

Finally, I asked, "If MLM is not a legitimate business opportunity, and if it does not qualify as a fair game of chance, what should we call it?"

[16] Letter from Bruce Craig to Peter J. Vander Nat, then chief economist of the FTC, April 24, 2001.
[17] "Product-based Pyramid Schemes," sponsored by Pyramid Scheme Alert. Washington, D.C., June 1, 2001.

Almost in unison, they answered, "Fraud."

While it may be appropriate – considering the great amount of deception used in MLM recruitment campaigns – to classify MLMs as simple common law fraud, the term "fraud" poses a problem. Most definitions of fraud include an element of intent, such as the following in my dictionary:

> Fraud – intentional perversion of truth in order to seduce another to part with something of value or to surrender a legal right.[18]

As I explained in Chapter 9, it is my observation that few MLM participants deliberately seek in their recruiting to defraud prospects into joining. They are merely doing what they have been instructed to do to "build their business." They are taught that they can both sell products and build a "team," or downline. And I have found denial of deliberate intent to defraud at the highest levels, where a great deal of self-deception occurs, even though they should have the information to recognize the deceptions and unfairness of the system. In MLMs, self-deception is characteristic of both management and participants at all levels.

In fact, MLM may be the perfect con game, because many of the very people who are doing the deceptive recruiting are themselves victims, having to recruit large downlines to have any hope of recovering their investments, which include monthly quotas to participate fully in the compensation plan.

Participants keep buying and recruiting until they run out of money and drop off the vine. What they don't know is that they have been conned into participating in a deceptive marketing program with a compensation plan that mathematically guarantees that nearly everyone will spend more than they get back. What money is paid to participants is funneled up primarily to TOPPs. It is the SYSTEM that is deceptive, not the participants who are duped into carrying it out.

I know there is no legal term for *systemic fraud,* except that regulatory agencies such as the FTC consider some activities per se illegal, simply because they are inherently unfair and deceptive. These include "pay to play" chain letters, Ponzi schemes, and no-product pyramid schemes.[19]

As Bruce Craig, former assistant Wisconsin Attorney General observed:[20]

> In the case of pyramids the unfairness was the inherent failure in their marketing systems, as Mr. Ponzi demonstrated long ago. The FTC actually recognized this in their Amway decision, and then frittered it away with its exculpatory [retail] 'rules.'
>
> This makes discussion of 'fraud', as you point out, a little more difficult. Fraud is often thought of as misrepresentation and, in the case of pyramids, the details of the plan are fully spelled out and they are, usually, implemented as stated. Most plan operators say the plan works just as they say it does. While earning misrepresentations may also be present, they aren't central to the plan – often earning experiences do not even exist when the plan is first offered. The problem, as I have stated, is in the inherent nature of the pyramid, product based or not. *Legally, this can still be considered 'misrepresentation' because the marketing plan is held forth as a viable business concept when it is not. It is usually not required that the perpetrator knows he is misrepresenting, just that the offering is in fact deceptive.*

My position – and that of other informed consumer advocates – is that product-based pyramid schemes, or MLMs, should be treated in the same fashion, since it is inherently unfair and deceptive.[21] The addition of products as disguised or laundered investments in the scheme does nothing to lessen the harm, but in fact increases it – by any measure – loss rate, aggregate losses, or number of victims.

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[18] Merriam Webster's Collegiate Dictionary

[19] Letter from FTC official Robert Frisby to directors of Pyramid Scheme Alert, citing section 5(a)(1) of the Federal Trade Commission Act, 15

[20] Letter from Bruce Craig to me dated May 4, 2004

[21] As demonstrated in Chapters 2-9

However, since a 1979 FTC ruling that Amway was not a pyramid scheme, consumers are left exposed to an MLM industry that constitutes an exceedingly unfair and deceptive marketing practice – perhaps the most unfair and deceptive of all existing business practices. At the very least, rules need to be in place to provide consumers some protection against deceptive MLM recruitment.

Complaint-based regulation does not control MLM abuse.

As explained in Chapters 2 and 9, MLMs are protected against action by authorities because victims rarely file complaints with law enforcement. And in law enforcement, the squeaky wheel gets the grease.

Not only are MLM victims led to believe that MLM is legitimate and that failure is their fault, but in endless chains every major victim of necessity becomes a perpetrator – recruiting friends and family and anyone who will listen. If they file a complaint, they fear self-incrimination and/or consequences from or to those they recruited, or who recruited them – who are often close friends or relatives. Also, they often blame themselves for their "failure," having been led to believe that those who fail did not try hard enough to "work the system."

According to my research and the feedback I've received, I doubt that more than one in 500 victims (including those who have lost tens of thousands of dollars) ever files a complaint with either a federal or state regulatory agency. No complaints – no action by authorities. And no action by authorities facilitates MLM abuse. This is another reason for considering all endless chains illegal per se – as is the case for "pay to play" chain letters, Ponzi schemes, and no-product pyramid schemes.

Victims also rarely report their losses to the Better Business Bureau for the same reasons. We have observed "A" ratings for some of the most damaging product-based pyramid schemes, having had few or even no complaints registered with the BBB.

Lack of complaints shield MLMs from public scrutiny. Lack of complaints also affects the media, which can be easily manipulated by powerful MLM companies with large public relations staff. Whenever media representatives are considering reporting on the downside of MLM, they want victims they can interview. It is hard getting enough victims to be willing to be vocal about their losses, so reporters often go with glowing but untrue releases from an MLM's PR staff.

Academia is also virtually silent on this issue. This may be due not only to lack of public outcry at MLM abuses, but also to donations made to universities by MLM PR slush funds in areas where major MLMs are headquartered.

MLMs are protected against action by authorities because victims rarely file complaints with law enforcement. And in law enforcement, the squeaky wheel gets the grease.

Carefully placed donations and campaign contributions – together with lack of complaints – provide MLMs protection against regulatory scrutiny. Legislators who may be tempted to propose legislation controlling MLM abuse are also affected by campaign contributions by the DSA/MLM cartel. This was forcefully demonstrated to me at hearings before committee hearings of the 2006 Utah State Legislature considering a bill (apparently initiated by the DSA) that would exempt MLMs from prosecution as pyramid schemes. SB182 would exempt "direct selling" companies from the definition of a pyramid scheme as long as consumable products were sold. Utah's Attorney General Mark Shurtleff testified that the bill was designed to protect against the worst schemes – those that don't sell any products. The bill passed.

I checked Shurtleff's campaign contributions. He had recently received $50,000 from one MLM and has received a total of over a quarter of a million over the past several years from MLMs – his top contributors. Those of us advocating for consumers appealed to Utah's Governor Jon Huntsman to veto the bill, but he too had received substantial political contributions from MLMs and could not be persuaded by leading consumer advocates on the issue to veto the bill.

I am convinced that if Utah's citizens, the media, the legislators, and the governor had a clear understanding of the massive damages caused by Utah-based MLMs; if so much money and political influence had not come from the DSA/MLM cartel; and if enough victims had filed complaints to create public resistance to the bill, SB182 never would have passed.

Consumer awareness vs. consumer protective legislation and/or rules

After 15 years of consumer advocacy on this issue, I and others I have worked with have become somewhat cynical about the prospect of getting the FTC or other law enforcement agencies to undertake responsible steps to control MLM abuse. It may be that some of this is due to the background of those who work in these regulatory agencies. Many are lawyers or officials who have worked in a resource or administrative capacity in conjunction with the agency's legal teams.

This is not a harangue against attorneys. Some of my best friends are attorneys – we laugh at the same lawyer jokes, like these:

Question: "What's the thin-nest book ever published?"
Answer: "The Lawyers' Book of Ethics."

Question: "How can you tell when a lawyer is lying?"
Answer: "They breathe."

Those who are making critical decisions affecting literally hundreds of millions of consumer worldwide are looking backwards, not forward. A good example is the FTC's determination – under pressure from the DSA/MLM cartel – to exempt MLMs from inclusion in the proposed new Business Opportunity Rule.

As a consumer advocate with wide business experience, I have to agree with the former president of American Motors and candidate for U.S. president, George Romney, who said that a key difference between businessmen and attorneys is that successful business leaders look forward and attorneys look backwards. Attorneys of necessity must be thoroughly grounded in legal precedents, and when they try a case they look for evidence of what has happened, not what could happen.

A business executive is often calculating the effects of current decisions and actions on the bottom line for the next year or quarter – or beyond. What's past is prologue. To be successful, they must of necessity be proactive, not just reactive.

Unfortunately, those who have been and are making critical decisions affecting literally hundreds of millions of consumer worldwide are looking backwards, not forward. A good example is the FTC's determination – under pressure from the DSA/MLM cartel – to exempt MLMs from inclusion in the proposed new Business Opportunity Rule. The FTC has stated they will rely on Section 5 instead. But this is almost totally reactive, not proactive. By the time an MLM is prosecuted, thousands or even millions of consumers may have been defrauded of their resources, and any action coming from the FTC will recover but a tiny fraction of their losses, if anything.

It should also be emphasized that Section 5 does nothing to warn consumers of what they can do to avoid participation in the first place. It certainly does not provide disclosure of information that is crucial for making an informed decision. How can MLM prospects make an informed decision when MLM promoters are allowed to blatantly misrepresent their "opportunity" and their products?[22]

[22] Over 100 misrepresentations used by MLM companies and defenders are listed in Chapter 8.

The DSA/MLM Cartel

I have referred to the DSA/MLM lobby as a cartel that seeks to control the dialogue of deception upon which MLM depends. It also seeks to strengthen and legitimize member MLMs by weakening laws and misleading legislators, regulators, consumers, and the media into accepting the deceptive arguments of MLM promoters. Let's take a closer look at the DSA, or Direct Selling Association.

Legitimate direct selling has virtually disappeared. The DSA represented legitimate direct selling companies, such as Fuller Brush, Tupperware, World Book Encyclopedia, etc., in an earlier time period when information about products and efficient transportation to get them to consumers was lacking. However, as advertising and transport developed, and supermarkets and other retail outlets flourished, price competition led to the demise of most legitimate direct selling, and on the almost total elimination of door-to-door selling. Then – following the 1979 Amway decision, a plethora of new MLMs literally exploded in the marketplace, like a fast-growing cancer.

MLM rescued the DSA, and the DSA enhanced the image of MLM. MLM leaders soon saw an advantage to joining the DSA to give them an air of legitimacy as a form of "direct selling". "Multi-level marketing" sounded too much like a pyramid scheme, and "network marketing" wasn't much better. The situation was like a farmer who gets more money selling horses than pigs. So he fastens horse hairs on the buttocks of the pigs and marches them into the horse corral and announces, "See there, they are no longer pigs, but horses because they are in the horse corral."

This move to join the DSA helped the MLMs by their laying claim to be legitimate direct sellers. It also helped the DSA because it gave new life to a decaying membership. The majority of DSA members now are MLMs, who provide most of its support. And not surprisingly, the DSA promotes the interests of its MLM members, not the interests of consumers.

Below is a chronological breakdown of the gradual takeover of the DSA by MLMs[23]:

- In 1970, less than 5% of U.S. DSA members were multilevel (as opposed to traditional single-level)
- In 1990, 25% of U.S. DSA members were multilevel;
- By 1996, over 70% of U.S. DSA members were multilevel;
- By 1999, 77.3% of U.S. DSA members were multilevel;
- By 2000, 78% of U.S. DSA members were multilevel;
- And by 2009, <u>over 90%</u> of U.S. DSA members classified themselves as multilevel.

DSA: "Direct Selling Association" – or "Deceptive Selling Alliance" The DSA has endeared itself to the MLM industry by becoming chief articulator of the litany of misrepresentations that sustain the whole industry – over 100 of which were listed in Chapter 8. DSA could just as appropriately stand for "Deceptive (MLM) Selling Alliance."

This is not to excuse their actions, but DSA officials face a tough challenge. They must work hard to defend MLM, a system that is so inherently flawed and dependent on deception to survive.

DSA's deceptive lobbying efforts. As discussed above, I witnessed DSA representatives at committee hearings at the Utah State Legislature for both the 2005 and 2006 sessions testify for proposed bills obviously crafted by the DSA to exempt MLMs from prosecution as pyramid schemes. Their arguments were full of deceptions, including the statement in 2005 by Neal Offen, president of the DSA, that the DSA represented 90,000 direct sellers in the state of Utah (translation: 90,000 votes). What he didn't say was that they were

[23] Per article "All you need to Know about MLM" – available for download from web site – http://www.armydiller.com/financial-scam/mlm.htm

90,000 victims of product-based pyramids, over 99% of whom lose money.[24]

Then in 2006, DSA representative Misty Fallock quoted FTC attorney James Kohm out of context to suggest that internal consumption by participants in an MLM satisfies the retail requirement to exempt it from the definition of a pyramid scheme. The DSA had managed to get eight state senators as co-sponsors and even saw that Utah's Attorney General received large contributions from DSA members to assure his support.

I was shocked at the utter corruptness of the whole proceeding. The DSA had no small part in assuring passage of the bill, in spite of eleven emails I sent to each of the senators and representatives in hopes of truth prevailing. I and other consumer advocates appealed to the Governor for veto of the bill, to no avail. The DSA/MLM cartel had gotten to him with significant campaign contributions to assure his support.

Using similar deceptive tactics DSA-initiated bills were passed in several other states, including Texas**,** Montana**,** Louisiana**,** Oklahoma**,** New Mexico. Kentucky, Idaho**,** South Dakota**,** Georgia**,** North Dakota**,** Maryland**,** and Illinois. In those states, consumers were deprived of what little consumer protection they had against product-based pyramid schemes.

By now other states may have passed such laws as well while critics weren't looking — or were conveniently ignored.

The DSA even attempted to get a bill[25] passed in the U.S. Congress that would officially legalize the non-retailing, endless chain recruitment model of MLM. Fortunately, that effort failed.

[24] See the "Survey of Utah Tax Preparers" – posted under "MLM research" on the web site: mlm-thetruth.com

[25] HR1220 was proposed in 2004.

Are MLM participants employees or independent contractors?

Should direct salespersons be classified as employees or as independent contractors? An issue that has threatened the whole field of direct selling (including MLM) was the possibility of being classified as employees, since control was exercised by the company and training was provided. In my research, I found an extremely enlightening article titled "*All you need to know about MLM: Is MLM a scam?"*[26] The comments at the beginning are quoted below. For more information, read the full article.

> In 1982 under President Ronald Reagan ([R] 1981-1989), the IRS added Internal Revenue Code Section 3508, which conveniently gave a statutory exemption to two groups of workers: real estate agents and direct sellers.
>
> IRC Section 3508(b)(2)(*) defines the term "direct seller" to mean any person if – such person
>
> - is engaged in the trade or business of selling (or soliciting the sale of) consumer products to any buyer on a buy-sell or deposit-commission basis for resale by the buyer or any other person in the home or in some other place that does not constitute a permanent retail establishment, or
> - is engaged in the trade or business of selling (or soliciting the sale of) consumer products in the home or in some other place that does not constitute a permanent retail establishment;
> - substantially all the remuneration (whether or not paid in cash) for the performance of the services described above is directly related

[26] The applicable section titled "*1982's IRC §3508: Lobbyists push bad legislation to reclassify specific employees as independent contractors to those contractors' detriment"* is quoted from the full article, which can be downloaded from the website – www.armydillar.com. While the person who did this research report prefers to remain anonymous (a handicapped woman who fears retaliation), I have found the research to be credible and well worth reading for serious students of the subject.

to sales or other output (including the performance of services) rather than to the number of hours worked; and

Such person performs the services pursuant to a written contract between such person and the service-recipient and *the contract provides that such person will not be treated as an employee with respect to such services for federal tax purposes*.

§3508 in effect only muddled the difference between independent contractors and employees, and I have no doubt lobbying by the MLM and real estate industries had everything to do with it. This was certainly the case in 1996 when the newspaper lobby got Senator Bob Dole [R-KS], who happened to be running for president, to slip a rider into the minimum wage bill that exempted newspaper carriers from all of the labor laws, making them permanent independent contractors like direct sellers regardless of how they were treated. President Bill Clinton signed it into law that same year.

The biggest problem with §3508's exemptions is that they directly conflict with the IRS's own criteria for being an independent contractor. Legitimate independent contractors come to their clients pre-hatched — they:

- already present themselves as pro-fessionals in their fields (have all business and professional licenses, are incorpora-ted, and do NOT require training);
- assume responsibility for taxes, workers' comp, insurance (E&O, health, dental, vision, etc.), expenses (advertising, overhead), and legal liability (bonded);
- are hired on a per-project basis and are paid upon completion of the project;
- can realize a profit or suffer a loss in their business;
- may perform services *for as many clients as they wish* with no restrictions;
- come with all tools necessary to complete jobs; and
- *do not perform work for clients which can impact the success or continuation of the clients' businesses.*

That last point is crucial. Businesses who utilize the MLM model depend on the services these workers provide; remove these workers, and the business must grind to a halt! And it works in reverse too — take away the company, and these workers' "businesses" vanish. The last point is also significant in that MLM law directly conflicts with it, actually requiring the MLM to rely on the generation of sales and enrollments exclusively by distributors and not by company "employees". (This is to satisfy the "Howey Test" of 1946, mentioned in the "Koscot" section in this chapter, which determined that a regulatable security existed when "a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party".) That alone should tell you there is something very wrong with the MLM model to begin with!

So why do MLMs and other like employers misclassify workers as independent contractors when those workers should quite clearly be classified as employees of the company? Because it's cheap and lessens legal liabilities. Companies that hire independent contractors generally avoid employer obligations under many state and federal laws.

MLM’s terrible problem – legal identity

(This duplicates what I wrote in Chapter 2, as it also applies here. For more clarification on MLM definitions, read all of Chapter 2.)

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 for promoters it often must - change colors to suit the situation. For example:

- *Are MLM participants <u>independent con-tractors</u> – or <u>employees of the company</u>?* 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. 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 DSA 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 <u>not</u> – an endless chain of recruitment of participants as primary customers.
- *Are MLMs* *__buyers' clubs__? MLM promoters often present their programs as ways to buy from your own business rather than from others – like 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 a type of* *__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 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 the DSA and 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. If 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.

Political considerations

There is no question that the big push for deregulation by conservative politicians has wreaked havoc on those seeking to provide consumer protection from some of the most damaging schemes in history. The mortgage meltdown, severe Wall Street setbacks – including the Bernie Madoff scandal[27], and depth of the recession in the period from 2007 to 2010, were in no small part direct consequences of such deregulation. And of course the weakening of the FTC and its enforcement powers against MLM fraud were a part of that, as MLM promoters capitalize on peoples' misfortunes.

While I would love to pontificate further about political corruption in high places, even at the FTC, I would refer the reader to the excellent annotated references cited at the end of this chapter titled "Notes regarding other resources."

KEY STATUTES, RULINGS, AND COMMUNICATIONS

Efforts of states to confront pyramid schemes and MLM abuse

A hodgepodge of state statutes and terminology. Those who expect to find uniform definitions and sanctions against pyramid schemes across the 50 states would be severely disappointed. As explained in Chapter 2, 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. This is not surprising, as many attorneys, legislators, academicians, and so-called experts are not clear on these issues. Even the terms suggesting pyramid schemes vary, as the following list of terms used in state statutes demonstrates:

- Pyramid sales structure – Alabama
- Chain distributor scheme – Alaska, Nebraska, New Hampshire New York, Vermont, Wisconsin,
- Pyramid promotional scheme – Arizona, Colorado, Georgia, Idaho, Indiana, Kansas, Louisiana, Maryland, Montana, Nevada, New Mexico, North Dakota, Oklahoma, South Dakota, Texas, Virginia, West Virginia
- Pyramiding device – Arkansas
- Endless chain – California, Wyoming
- Endless chain scheme – Hawaii
- Pyramiding – Connecticut
- Pyramid or chain distribution scheme – Delaware
- Pyramid sales scheme – Florida, Illinois, Mississippi, Missouri,
- Pyramid distribution plan – Kentucky, North Carolina
- Pyramid club – Maine, Oregon, South Carolina
- Pyramid or chain promotion – Michigan
- Chain referrals, pyramid sales, or multi-level sales distributorships – Minnesota
- Pyramid sales plan or program – Ohio
- Chain letter plan or pyramid club – Pennsylvania
- Pyramid distributorship
- Pyramid scheme – Utah, Washington

Definitions and terms designating pyramid schemes used in state statutes are compiled in Appendix 2E (chapter 2), and in Appendix 10A following this chapter you will find a checklist of prohibitions and restrictions related to pyramid schemes used by federal agencies and included in statutes in the 50 states. Reviewing and comparing these wide variations in nomenclature, definitions, and statutes should convince anyone that there is far

[27] Markopolos, Harry, *No One Would Listen: A True Financial Thriller.* (Hoboken, N.J.: John Wiley & Sons, 2010), p. 159

from unanimity across the country on determining what is and what is not an illegal pyramid scheme.

Some of the more useful – and problematic statutory provisions. Eleven of the state statutes imply the endless chain terminology that implies the fundamental flaw of all no-product pyramid schemes and product-based pyramid schemes (MLMs). A few suggest or specifically state that a program that does not emphasize income primarily from sales to non-participants is a pyramid scheme. In my opinion, the most consumer-friendly of these is Maine's statute[28].

Unfortunately, most of the states fail to mention the inherent flaws of the endless chain of recruitment. And many definitions allow sales to participants to qualify as legitimate sales to end use consumers. The latter have in many if not most cases been influenced by clever lobbying by the DSA/MLM cartel, which works ceaselessly to weaken anti-pyramid legislation to its advantage – but to the detriment of consumers who need protection from such schemes.

As one who has taught business, performed extensive research on literally thousands of self-employment options and hundreds of MLMs, I can say with utmost confidence that it would be impossible to find a business practice that is more unfair and deceptive, and more viral and predatory, than MLM. In fact, it would be difficult to conceive of one.

State statutes regarding "unfair and deceptive practices." A problem closely related to MLM and pyramid schemes that is addressed by many state statutes is that of "unfair and deceptive practices" – which an informed person would expect would have to include MLM.[29] But unanimity in defining and regulating this category of abuse at the state level is not much better than in defining and regulating pyramid schemes and multi-level marketing at the state level. The wide diversity of statutes of what constitutes unfair and deceptive trade practices is illustrated in a state-by-state summary in Appendix 10B.

State agencies are typically too weak to control MLM abuse. Attorneys general and consumer protection agencies in only a few states have made significant efforts to control MLMs, or what I have labeled "product-based pyramid schemes".[30] This may be due in part to lack of information, resources, and the prosecutorial will to go after promoters of these schemes, which are often very well-financed and politically powerful.

Also, MLM executives can afford the best attorneys. Kristine Lanning, former assistant to the Attorney General in North Carolina, told me that it would take twenty times the resources to prosecute an established MLM as what is needed to prosecute the typical cases brought before them.

For some important lessons regarding the David vs. Goliath struggle of states attempting to enforce laws against MLM/pyramid schemes, read Robert Fitzpatrick's article on Montana vs. ACN:[31]

The FTC's protection of consumers from MLM as an "unfair and deceptive practice" is crucial –but not happening.

Why FTC is the most appropriate agency for dealing with MLM abuse. While the Federal Trade Commission has

[28] See Appendix 10A and Appendix 2E

[29] Or if there is any question whether or not MLM is an unfair and deceptive practice, read prior chapters

[30] Douglas M. Brooks of Martland & Brooks, LLP, who has acted as lead plaintiff attorney for victims of major MLMs, wrote me that the term "product-based pyramid schemes" to correctly label MLM is "spot on."

[31] *"Analysis: Montana/ACN Settlement Displays the MLM Loophole, Once Again."* Go to – http://pyramidschemealert.org/ analysis-montanaacn-settlement-displays-the-mlm-loophole-once-again/

demon-strated little commitment to protecting consumers from the thousands of product-based pyramid schemes that have cropped up since the 1979 Amway decision, it is the appropriate agency for such action. There are two reasons for this:

The existence of products in an MLM does not make it any less a pyramid scheme, and in fact results in greater harm than no-product schemes by any measure – loss rates, aggregate losses, and number of victims. This is clearly explained in prior chapters

First, all MLMs have compensation plans based on an endless chain of recruitment and are therefore extremely viral – quickly spreading like a fast-growing cancer across state borders. Even beginning distributors often find themselves having to recruit persons they know in other states because their city or state is so heavily saturated with MLM recruiters. So in effect, they are engaging in interstate commerce.

Second, a primary mission of the FTC is to protect consumers against "unfair and deceptive practices." As one who has taught business, performed extensive research on literally thousands of self-employment options and hundreds of MLMs, I can say with utmost confidence that it would be impossible to find a business practice that is more unfair and deceptive, and more viral and predatory, than MLM. A careful reading of prior chapters, especially Chapters 2, 7, and 8, should convince anyone with an open mind that this is true.

The great FTC blunder. For these reasons, I refer to the 1979 Amway decision that Amway is "not a pyramid scheme" (assuming compliance with its "retail rules") as "*the great FTC blunder.*" Prosecutors simply did not have the research to guide them that we have now, and under pressure by conservative politicians, the political climate at the time was moving towards deregulation. *It is time for the FTC to take corrective action to alleviate at least some of the devastating effects of the 1979 Amway decision.*

Important FTC communications

Justification for considering pyramid schemes illegal. To be perfectly clear on why I and other informed consumer advocates are convinced the legality of MLM should be ques-tioned, consider this communication from Robert M. Frisby, an FTC staff attorney, in response to my request for the rationale for laws against pyramid schemes:

> Thank you for your recent inquiry. Section 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. 45(a)(1), 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." While the Federal Trade Commission Act does not specifically address pyramid schemes, such schemes have been deemed unlawful under the Federal Trade Commission Act.[32]

If you have read the prior chapters, you can see that the same justification for exists for action against all MLMs, or product-based pyramid schemes, as for no-product pyramid schemes. The existence of products in an MLM does not make it any less a pyramid scheme, and in fact results in greater harm than no-product schemes by any measure – loss rates, aggregate losses, and number of victims. This is clearly explained in prior chapters.

Classic speech by the FTC's Debra Valentine. In her opening remarks in a speech on pyramid schemes, Debra A. Valentine, General Counsel for the FTC, stated the following:

[32] Email communication dated May 22, 2001 (in re Koscot Interplanetary, Inc., 86 F.T.C. 1106 (1975

> Pyramid schemes now come in so many forms that they may be difficult to recognize immediately. However, they all share one overriding characteristic. They promise consumers or investors large profits based primarily on recruiting others to join their program, not based on profits from any real investment or real sale of goods to the public. *Some schemes may purport to sell a product, but they often simply use the product to hide their pyramid structure.* There are two tell-tale signs that a product is simply being used to disguise a pyramid scheme: inventory loading and a lack of retail sales. Inventory loading occurs when a company's incentive program forces recruits to buy more products than they could ever sell, often at inflated prices. If this occurs throughout the company's distribution system, the people at the top of the pyramid reap substantial profits, even though little or no product moves to market. The people at the bottom make excessive payments for inventory that simply accumulates in their basements. *A lack of retail sales is also a red flag that a pyramid exists. Many pyramid schemes will claim that their product is selling like hot cakes. However, on closer examination, the sales occur only between people* ***inside*** *the pyramid structure or to new recruits joining the structure, not to consumers out in the general public.*[33]

A lack of retail sales is also a red flag that a pyramid exists. Many pyramid schemes will claim that their product is selling like hot cakes. However, on closer examination, the sales occur only between people inside the pyramid structure or to new recruits joining the structure, not to consumers out in the general public.

While this state-ment clearly describes virtually all MLMs as typically structured and practiced today, Ms. Valentine goes on to make distinctions between "legitimate multi-level marketing" and pyramid schemes.

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[33] Section of speech titled: "What is a Pyramid Scheme and What is Legitimate Marketing?" from a **p**repared statement of Debra A. Valentine, General Counsel for the U.S. Federal Trade Commission on "Pyramid Schemes," presented at the International Monetary Fund's Seminar on Current Legal Issues Affecting Central Banks, Washington, D.C., May 13, 1998

> Some people confuse pyramid and Ponzi schemes with legitimate multilevel marketing. Multilevel marketing programs are known as MLM's,(4) and unlike pyramid or Ponzi schemes, MLM's have a real product to sell. More importantly, MLM's actually sell their product to members of the general public, without requiring these consumers to pay anything extra or to join the MLM system. MLM's may pay commissions to a long string of distributors, but these commission are paid for real retail sales, not for new recruits

Is it any wonder that consumers, attor-neys, academia, and the media are confused as to which MLMs should be classified as illegal pyramid schemes? FTC officials condemn pyramid schemes, but seem determined to let product-based pyramid schemes, or MLMs, off the hook – or to selectively label some MLMs as legitimate and some as illegal. The underlying assumption seems to be that there are "good MLMs" and "bad MLMs" – which are all, in fact, disguised pyramid schemes.[34]

Of course, I have to admit that at one time I believed MLMs were somehow different from pyramid schemes. For several years I searched diligently for what I called "retail MLMs"; i.e., retail-focused MLMs. But analysis of hundreds of MLMs did not turn up any, though promoters often made efforts to make their MLM appear to be legitimate, or retail focused. Ultimately, careful study of their compensation plans reveals that all MLMs are recruitment-driven and top-weighted, and financed primarily by "pay to play" purchases of participants – making them essentially pyramid schemes.

So I find Ms. Valentine's arguments justifying the Amway decision and the viability of other MLMs – though well

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[34] See Chapter 2.

meaning – unpersuasive and even uninformed about actual practices across the broad spectrum of the MLM industry. The full text of her remarks are included in Appendix 10C.

Staff Advisory Opinion of FTC staff attorney James Kohm. Without going into detail here, if the MLM is characterized by rewards paid primarily for recruitment of a downline and by purchases primarily by participants rather than by non-participants, it can be considered a pyramid scheme. At the very least it is a transfer scheme, transferring money from those at the bottom of the pyramid to those at the top; i.e., from losers to winners. Rewards can be in the form of commissions from purchases on a monthly basis to meet requirements to qualify for commissions and bonuses. James Kohm, Acting Director of Marketing Practices, wrote the following in a Staff Advisory Opinion to the DSA[35]:

> Much has been made of the personal, or internal, consumption issue in recent years. In fact, *the amount of internal consumption in any multi-level compensation business does not determine whether or not the FTC will consider the plan a pyramid scheme.* . .

.The DSA and its many minions have quoted out of context the highlighted statement above to justify including sales to MLM participants ("internal consumption") as qualified retail sales. This was a key part of the aforementioned testimony of Misty Fallock before a committee hearing at the 2006 Utah Legislature in hearings about SB182, which exempted MLMs from prosecution as pyramid schemes. However, when one reads the rest of Mr. Kohm's statement, one gets an entirely different perspective:

> . . . The critical question for the FTC is whether the revenues that primarily support the commissions paid to all participants are generated from purchases of goods and services that are not simply incidental to the purchase of the right to participate in a money-making venture.
>
> A multi-level compensation system funded primarily by such non-incidental revenues does not depend on continual recruitment of new participants, and therefore, does not guarantee financial failure for the majority of participants. In contrast, a multi-level compensation system funded primarily by payments made for the right to participate in the venture is an illegal pyramid scheme.
>
> In a pyramid scheme, participants hope to reap financial rewards well in excess of their investment based primarily on the fees paid by members of their "downlines." Downline members pay these fees to join the scheme and meet certain prerequisites for obtaining the monetary and other rewards offered by the program. A participant, therefore, can only reap rewards by obtaining a portion of the fees paid by those who join the scheme later. The people who join later, in turn, pay their fees in the hope of profiting from payments of those who enter the scheme after they do. In this way, *a pyramid scheme simply transfers monies from losers to winners. For each person who substantially profits from the scheme, there must be many more losing all, or a portion, of their investment to fund those winnings. Absent sufficient sales of goods and services, the profits in such a system hinge on nothing more than recruitment of new participants (i.e., fee payers) into the system.*
>
> *The Commission's recent cases, however, demonstrate that the sale of goods and service; [sic] alone does not necessarily render a system legitimate. Modern pyramid schemes generally do not blatantly base commissions on the outright payment of fees, but instead try to disguise these payments to appear as if they are based on the sale of goods or services. The most common means employed to achieve this goal is to require a certain level of monthly purchases to qualify for commissions. While the sale of goods and services nominally generates all commissions in a system primarily funded by such purchases, in fact, those commissions are funded by purchases made to obtain the right to participate in the scheme. Each individual who profits, therefore, does so primarily from the payments of others who are themselves making payments in order to obtain their*

[35] Letter from James Kohm, Acting Director of Marketing Practices, expressing a Staff Advisory Opinion to Neil Offen, President of the Direct Selling Association, January 14, 2004

own profit. As discussed above, such a plan is little more than a transfer scheme, dooming the vast majority of participants to financial failure. . .

The purchase of goods and services is not merely incidental to the right to participate in a money-making venture, but rather the very reason participants join the program. Therefore, the plan does not simply transfer money from winners to losers, having the majority of participants with financial losses."[36]

I have a list of over 350 MLMs that finance their operations in precisely the manner described in the last two paragraphs! And since that's 100% of those I have analyzed, it seems safe to assume that all MLMs are financed in essentially the same way – through "pay to play" purchases of participants.

Are MLMs expensive buyers' clubs? Mr. Kohm then distinguishes between a pyramid scheme and a legitimate buyers' club.

> **Modern pyramid schemes generally do not blatantly base commissions on the outright payment of fees, but instead try to disguise these payments to appear as if they are based on the sale of goods or services. The most common means employed to achieve this goal is to require a certain level of monthly purchases to qualify for commissions.** *- James Kohm, FTC's Acting Director of Marketing Practices*

1 A participant's downline usually consists of the people the participant recruits to join the program as well as the people her recruits recruit, and so on through a predetermined number of levels.

2 It is important to distinguish an illegal pyramid scheme from a legitimate buyers club. A buyers club confers the right to purchase goods and services at a discount. If a buyers club is organized as a multi-level reward system, the purchase of goods and services by one's downline could defray the cost of one's own purchases (i.e., the greater the downline purchases, the greater the volume discounts that the club receives from its suppliers, the greater the discount that can be apportioned to participants through the multi-level system). The purchase of goods and services within such a system can, therefore, be distinguished from a pyramid scheme on two grounds.

First, purchases by the club's members can actually reduce costs for everyone (the goal of the club in the first place). Second, the purchase of goods and services is not merely incidental to the right to participate in a money-making venture, but rather the very reason participants join the program. Therefore, the plan does not simply transfer money from winners to losers, having the majority of participants with financia11osses.[37]

Mr. Kohm apparently had not analyzed the compensation plans of MLMs, and how prices are influenced by the depth of the downline. In stan-dard retail settings, the prices must cover shares going to the retailer (who may get anywhere from 10-20% for discount stores to as high as 60-70% for luxury items in exclusive shops) and the whole-saler, who may get only 10-15% - but who has many retailers to cover his costs.

With MLM, the pay structure is reversed, with the upline getting most of the commissions, and with several levels in the pay plan, the commissions are funneled even more to the top. The MLM cannot compete with discount stores or even standard retail outlets because they have to pay commissions on so many levels.

As I have said before, I would have no objection to an MLM promoter selling participation in an MLM, *<u>not</u> as an income opportunity (since 99% lose money),* but as a buyers' club[38] which allows participants to *pay <u>more</u>* (not less) for some good, and some highly questionable, products. The DSA should love that suggestion.

[36] Ibid

[37] Ibid

[38] This is said in jest, of course, since MLM would not even qualify as a buyers' club. Buyers' clubs have to meet certain criteria that would make it a whole different ball game.

LESSONS FROM LANDMARK CASES

The Koscot precedent.

In 1967 Glenn W. Turner began an incredible distribution scheme in Orlando, Florida.

His line purported to be cosmetics, featuring mink oil as a special ingredient, but in reality he sold distributorships. A participant paid a fee and became a distributor, entitling him to sell the cosmetic products, but more important, entitling him to sell other distributorships. Little selling of the cosmetics actually took place, for the real money was to be made in the sale of distributorships. Those transactions were essentially the same as in the chain letter, or the airplane or chart games, in that the new participant paid one fee to the party who brought him in, another to the party at the top, and then assumed a position at the bottom of the pyramid.

Nothing better describes MLM than "*entrepreneurial chains.*" And its effects are well articulated in the *warning that such schemes possess an <u>intolerable capacity to mislead</u>.*

Over five years, Turner "parlayed $10,000 . . . into a conglomerate that generated a cash flow of $200 million, and in which as many as 100,000 people may have invested. . . .Two main business organizations were developed to carry out his activities: Koscot ('Kosmetics Company of Tomorrow') Interplanetary, Inc., the sales arm, and Dare to Be Great, Inc., the training body."[39]

I cannot leave the Turner case without quoting the following, which sounds like many typical MLM opportunity meetings today:

> Would-be [Dare to Be Great] participants were brought to staged gatherings in places like hotel ballrooms where clean-cut young men, each with a rhinestone pin of a flag . . . attached to his lapel, subjected them to the rigors of high-pressure salesmanship. . ." These gatherings, called "Adventure Meetings" or "Golden Opportunity Meetings," were described by one judge as being like an old-time revival meeting but directed toward the joys of making easy money rather than salvation. Their purpose is to convince prospective purchasers, or 'prospects,' that Dare is a sure route to great riches.
>
> At the meetings are employees, officers, and speakers from Dare, as well as purchasers (now 'salesmen') and their prospects. The Dare people, not the purchaser-'salesmen,' run the meetings and do the selling. They exude great enthusiasm, cheering and chanting; there is exuberant handshaking . . . The Dare people dress in expensive, modern clothes. . . . they drive new and expensive automobiles, which are conspicuously parked in large numbers outside the meeting place. Dare speakers describe, usually in a frenzied manner, the wealth that awaits the prospects if they will purchase one of the plans. Films are shown usually involving the 'rags-to-riches' story of Dare founder Glenn W. Turner. The goal of all of this is to persuade the prospect to purchase a plan . . . and thus grow wealthy as part of the Dare organization.[40]

In this case, the Koscot court noted something that has become increasingly significant:

> *The Commission has previously condemned so-called <u>"entrepreneurial chains"</u> as possessing an <u>intolerable capacity to mislead</u>.*[41] 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

[39] I Joseph Bullgatz , *Ponzi Schemes, Invaders from Mars, and More Extraordinary Popular Delusions* (New York: Harmony Books, 1992), p. 42-3

[40] **Ibid, p. 42-3**

[41] 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), page 1181.

the program rewards which are unrelated to sale of the product to ultimate users. In general such recruitment is facilitated by promising all participants the same "lucrative" rights to recruit.

The language used here is incredibly insightful and prophetic. Anyone who has read Chapter 8 with an open mind would have to agree that this is exactly what has happened since that time. MLMs have demonstrated an *intolerable capacity to mislead.*

The end result is an 800-pound gorilla in the Commission chambers. Thousands of MLMs have sprung up since the 1979 Amway decision, resulting in losses of literally hundreds of billions of dollars suffered by hundreds of millions of participants worldwide.

FTC v. Amway, the 1979 decision that facilitated the proliferation of product-based pyramid schemes

Amway led the way in an MLM industry that has caused massive consumer losses. While the practice of multi-level marketing had been evolving for decades, the industry was given a huge boost by a key decision of an FTC administrative judge in 1979. This decision opened a Pandora's Box of MLM look-alikes that since that time have numbered in the thousands.

Is Amway a pyramid scheme? According to an FTC release on May 23, 1979, Amway - one of the earliest MLM companies – was ordered by the FTC "to stop fixing retail and wholesale prices and misrepresenting the profitability of Amway distributorships." Since that time Amway Corporation (as a company) has been more careful about making inflated promises to prospects.

However, on a far more important issue, Amway and – by extension - an emerging industry triumphed. The complaint that Amway's sales plan was an illegal pyramid scheme was dismissed by the Commission – a major coup for Amway and for all MLM companies that followed – and a huge setback for consumer protection.

Amway's "retail rules." As part of the agreement with the FTC, Amway agreed to abide by "retail rules,"[42] such as the "ten-customer rule" (10 customers outside the network of distributors), the "70% rule (70% of products purchased are sold at retail), and a buyback policy. Amway assured the FTC it had procedures in place to assure compliance with these rules. However, the retail rules have never been consistently enforced. Except for the buyback policy, Amway and other MLMs have essentially ignored the retail rules accepted by the FTC. Both company officials and participants employ a "wink-wink, nod-nod" attitude towards compliance. In fact, the image of Amway as distributors of patented soap products has yielded to the reality of a pseudo-business of opportunity or entrepreneurial chains.

The FTC's 1979 Amway ruling[43] gave credence to MLM and led to enormous growth in an industry that in the past three decades (if you understand the math in Chapter 7) has cost consumers worldwide hundreds of billions of dollars and left hundreds of millions of participants holding the bag of broken promises – and in many cases – broken lives. This has been accomplished through a whole litany of misrepresentations – over a hundred of them listed in Chapter 8. Taken together, MLM constitutes one of the most massive and successful con games in history.

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[42] In the Matter of Amway Corp., 93 F.T. C. 618 (1979)

[43] For more information on this legislative history, read the treatise by Robert Fitzpatrick, President of Pyramid Scheme Alert, titled "*Pyramid Nation – The Growth, Acceptance, and Legalization of Pyramid Schemes in America.*"

Amway's "retail rules" focused on behavior, not the underlying structural flaws. As discussed in earlier chapters, MLMs typically incentivize an endless chain of recruitment of participants as primary customers. Their compensation plans assume an endless chain or infinite recruitment in finite markets and in virgin markets, neither of which exists. MLMs are therefore inherently flawed, uneconomic, and deceptive.

In focusing on the (sales) behavior of participants, the FTC's Amway decision failed to address these inherent structural flaws that many believe should have led to a decision that MLM is per se an unfair and deceptive trade practice, and therefore illegal. The end result is an 800-pound gorilla in the Commission chambers. Thousands of MLMs have sprung up since 1979, resulting in losses of literally hundreds of billions of dollars suffered by hundreds of millions of participants worldwide.[44]

Perspective of a former SEC official – and of a former Assistant AG for Wisconsin. Gary Langan Goodenow, Sr., a former senior trial attorney in the SEC enforcement division, wrote:[45]

> The FTC, not the SEC, first went to court to combat the "serious potential hazards of entrepreneurial chains" and urged the "summary exclusion of their inherently deceptive elements, without the time-consuming necessity to show occurrence of the very injury which justice should prevent." FTC In Koscot Interplanetary case, the FTC enjoined a promoter from "offering, operating, or participating in, any marketing or sales plan or program wherein a participant is given or promised compensation for inducing other persons to become participants in the plan or program". This FTC opinion had nothing to do with the federal securities laws. The holding was based on common law fraud concepts on the theory that such programs will inexorably fail because eventually there are not enough people on earth to support it.

*[**Note by Jon Taylor**: This reasoning resonates in decisions today, since it has legal precedence, even though the reasoning is based on a weak understanding of how markets work. In Chapter 3, I explained the difference between total saturation and market saturation. In a town of 100,000 people, the notion of total saturation of 100,000 distributors would be absurd. But the market could be said to be saturated with 10 or 20 distributors, after which adding more distributors would mean less and less opportunities for them to thrive in the market because the market is too saturated. So market saturation could be said to exist, and market saturation can happen very quickly in a population, especially so in MLM, since hundreds of MLMs are now saturating the market for such schemes.]*

The premise of "multilevel vs. pyramid" may well represent a distinction without a difference. -Bruce Craig, formerly assistant Attorney General in Wisconsin

The FTC test for determining what constitutes an illegal pyramid scheme holds that they "are characterized by the payment by participants of money to the company in return for which they receive the right to sell a product and the right to receive in return for recruitment, rewards which are unrelated to sale of the product to ultimate users." The key concept is the "unrelated" idea—that the program is so divorced from economic reality or mercantile endeavor, as to be merely a chain letter passing around money.

[44] These figures are based on DSA figures of direct sales worldwide. What the DSA calls "sales revenues" may be sales revenues for the companies, but since 99% of participants lose money, they represent losses for the participants, nearly all of whom are victims.

[45] Mr. Goodenow, a former senior trial attorney in the SEC enforcement division, is licensed to practice in the Florida and the District of Columbia. This quotation is posted on Dr. Stephen Barrett's MLM Watch web site at – www.mlmwatch.org/11Legal/sec.html

The FTC later recognized the distinction of "saturation" between legitimate pyramid structured programs and illegal pyramid schemes. In 1979, the FTC determined that the MLM program operated by Amway was neither fraudulent nor illegal. The FTC found that Amway Corporation was essentially structured as a pyramid, not a Ponzi scheme, with an ever increasing downline privity of recruits. Nonetheless, the FTC determined that the plan did not constitute an illegal pyramid because certain Amway rules ensured a focus on retailing merchandise over pyramiding of members.

" . . .plaintiffs have produced evidence that the [Amway] 70% rule can be satisfied by a distributor's *personal use* of the products. If Koscot is to have any teeth, such a sale cannot satisfy the requirement that sales be to 'ultimate users' of a product."

This effort at retailing, the FTC found, meant that the program would never be 'saturated' with members sending' money to each other until there were no further people to join. These "anti-saturation" rules saved Amway from the ambit of the anti-Ponzi and pyramid scheme rules, not the specific structure of the enterprise. So, an Amway-like program that happened to pay participants a small fixed fee for bringing in recruits could constitute a "pyramid" but not a scheme to defraud because saturation will not occur.

Bruce A Craig, an assistant attorney general for the State of Wisconsin Department of Justice has questioned the logic of not considering Amway an illegal pyramid scheme. His comments deserve serious consideration because, during 30 years of service he has prosecuted a significant number of pyramid scheme including the Koscot case. In a letter to Robert Pitofsky, the FTC Chairman who drafted the original Amway opinion, Craig noted that since the Amway decision, "investments in pyramid type offerings have resulted in billions of dollars over the years." He highlights that "the FTC Amway decision has created a good deal of uncertainty in respect to private and public legal efforts to deal with abuses of pyramid plans" that "will only increase with the onset of marketing over the Internet."

I certainly agree. Every time I prosecuted a pyramid or Ponzi for the SEC, the first words out of the founder's mouth were: "I set this up just like Amway." Craig has urged the FTC to reexamine the aspects of Amway that make it legal because *"the premise of 'multilevel vs. pyramid' may well represent a distinction without a difference."* I believe *Craig is correct when he asks "whether these exculpatory factors can be effectively evaluated in time to prevent losses to the consuming public." In my experience, the fraudsters know that; and that is why, unfortunately, when the SEC Enforcement Division comes in with an asset freeze, the money is long gone.*

Webster v. Omnitrition challenges "personal use"

The 1979 Amway decision did not specify that the Amway requirement that 70% of retail sales must be to non-participants, which left the door open to sales by "internal consumption" or "personal use" of participants only. Fortunately, this was clarified in later federal decision, beginning with the Webster v. Omnitrition decision, in which the U.S. Ninth Circuit Court of Appeals in 1996 reversed some of the findings of a U.S. District court in Northern California.

Quoting from the 9th Circuit Court of Appeals in 1996:

> "The key to any anti-pyramiding rule in a program like Omnitrition's, where *the basic structure serves to reward recruitment more than retailing*, is that *the rule must serve to tie recruitment bonuses to actual retail sales in some way*."[46]

The "basic structure" likely refers to the potential (in a compensation plan) for growth of an expanding downline, or pyramid, of participants in exponential

[46] Webster v. Omnitrition, IIB, filed in the Appeals court for the 9th U.S. District Court for the Northern District of California, March 4, 1996. (79 F. 3d 776)

fashion so that – even though the commissions from each downline participant is small, the aggregate commissions can grow to rapidly increasing amounts with each additional level of participants. This makes retailing of products to non-participants in the scheme a comparative waste of time for those seeking to maximize their gain.

Quoting further from the Judge's Opinion:

> Whether Omnitrition's program runs afoul of California's laws against false advertising, unfair business practices and fraud is determined under California's statutory definition of "Endless Chain" marketing schemes. California Penal Code § 327 makes it a public offense for any person to operate 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. .[47]
>
> This definition is equivalent, if not identical, to the *Koscot* test. Because there is sufficient evidence for a jury to conclude the Omnitrition program fails the *Koscot* test, there also is a genuine issue of material fact as to whether it is an "Endless Chain" scheme under § 327.
>
> *Indeed, at least one of the Omnitrition's Amway protections is less salient under the California statute. Omnitrition's "70% Rule" allows supervisors to count products sold at wholesale to their own downlines toward their 70 percent sales requirement. This allows supervisors to be compensated on the basis of sales other than "sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme." Id. This is expressly prohibited by the California statute, while it is only implicit in the Amway "retail sales" defense.*

And now *Omnitrition's in dicta* language which referenced Koscot:

> *"[...] plaintiffs have produced evidence that the [Amway] 70% rule can be satisfied by a distributor's personal use of the products. If Koscot is to have any teeth, such a sale cannot satisfy the requirement that sales be to 'ultimate users' of a product."* [48]

Fortuna Alliance, Jewelway, and World Class Network in 1997: FTC formulating criteria for Business Opportunity Rule review

Fortuna Alliance made fabulous earnings claims. Using fabulous earnings claims, promoters induced tens of thousands of consumers in over 60 countries around the world to pay between $250 and $1750 to join their pyramid scheme, claiming that members would receive over $5,000 per month in 'profits' as others were induced to 'enroll.' In addition, Fortuna and its officers provided advice and promotional materials for members to recruit others to join the pyramid, both through direct contact and by setting up their own web sites.

Jewelway ordered to disclose information needed for making an informed decision. In 1997 the FTC went after MLM Jewelway, alleging it was an illegal pyramid scheme that emphasized recruiting over retailing. Jewelway, its assets frozen under temporary restraining order, agreed under duress to exactly the language that had been so dangerous in Omnitrition: Jewelway's sales revenue must come "primarily from retail sales" to *nonparticipants*. In addition, Jewelway agreed to some very onerous restrictions in order to enforce compliance so Jewelway could continue its business. Among other things, the settlement required Jewelway to:

[47] California Penal Code § 327 (West 1995).

[48] In re Webster v. Omnitrition International. Fed. Sec. L. Rep. P 99,071,96 Cal. Daily Op. S erv. 1419,96 Daily Journal D.A.R. 2427

- *disclose the percentage of all representatives in the program who have received a particular reward* (e.g., a specific income level, car or home allowance, vacation package) at the time a claim is made regarding income potential or likelihood of earning other types of rewards;
- implement a *90 day "cooling off" period*, under which the purchaser of JewelWay's jewelry cannot join the company as a representative for 90 days**;**
- review all representatives' advertisements before allowing the ads to run;
- obtain from each new representative a signed *verification form***,** which the defendants must review before depositing any of the representative's money, *to ensure that none of the prohibited claims were made* (if the defendants do not receive a completed verification form from a consumer, the purchase price must be refunded).[49]

Later that year, in a case involving World Class Network, the FTC made similar stipulations. The above rules were later to become a foundation for the FTC's 2006 Proposed Business Opportunity Rule. Unfortunately, by the 2008 and 2010 revised versions of the Rule, the FTC had completely backed away from requiring transparency through requiring such disclosures to protect consumers. It would instead rely on Section 5, which would ensure massive losses by tens of millions of participants before the FTC could possibly prosecute even a tiny fraction of the hundreds of MLMs which my research and the observations of other consumer advocates suggest are blatantly violating Section 5.

[49] Quoted from the "Army Dillar" article "All You Need to Know about MLM": Is MLM a Scam?," cited in "Notes regarding other resources" at the end of this chapter.

In 2000, Equinox Int'l settled with FTC and eight states, for nearly $40 million in restitution for victims

Rather than comment on this famous case, I quote from the insightful article titled ""10 Lessons for Consumers from the Equinox Case," by Robert FitzPatrick:[50]

> In April, 2000, the FTC and eight states successfully prosecuted Equinox International, one of the nation's largest multi-level marketing companies. In the suit filed jointly with the states on August 3, 1999, the FTC alleged that the defendants operated an illegal pyramid scheme, made deceptive earnings claims, and provided distributors with the means and instrumentalities to violate federal law. State law enforcers alleged violations of state securities laws, deceptive trade practices laws, false advertising laws, pyramid laws, and licensing requirements laws. The settlement resulted in shutting down the company which was founded in 1991, restitution of about $40 million to victims, and the banning of the company founder, Bill Gouldd, from the MLM business forever.
>
> What are consumers to learn from this prosecution and settlement? Here are 10 points and lessons to consider:
>
> 1. **Some of the largest and most successful MLMs may be pyramid schemes.** Equinox was one of the largest in the MLM industry. Sales topped $200 million with hundreds of thousands of distributors. Yet, it is now shut down and disgraced as a pyramid scheme
>   ***Lesson****: An MLM company's "success" is not a reliable indicator of its legitimacy.*
>
> 2. **DSA membership is no assurance of an MLM's legality.** Equinox was a dues paying member of the Direct Selling Association (DSA), the official

[50] "10 Lessons for Consumers from the Equinox Case," by Robert FitzPatrick, President of Pyramid Scheme Alert – posted on his False Profits web site at – http://www.falseprofits.com/equinoxlessons.html

association of the MLM industry. One of the witnesses who testified on behalf of Equinox was formerly a member of the Board of the Direct Selling Association Education Foundation. ***Lesson****: That Equinox, one of DSA's larger members, was successfully prosecuted as an illegal pyramid scheme ought to be a red flag that others may also be operating as pyramid schemes. It also indicates that the DSA cannot be relied upon to "self-police" the MLM industry.*

3. **Rapid growth, profitability and "momentum," key factors that MLMs use to lure distributors, may be signs of pyramid schemes, not legitimate enterprises.** Pyramid schemes are notorious for their meteoric rise in sales and numbers of followers. In fact, they must show growth or they quickly die. Between 1990 and 1995, Equinox revenue grew from $545,000 to $195 million and its number of employees rose from just 10 to 218. Equinox posted a 10% profit margin.

4. **Exposure and bad publicity are not enough to inform or protect consumers from MLM scams.** Equinox was previously fined by several states for deception and it was raked over the coals in a 1996 segment of 20-20 that was seen by millions of TV viewers across the country. The company continued to attract hundreds of thousands of victims for four more years.

5. **The nation's most authoritative business magazines do not understand MLM, and their reporting of it is often misleading and inaccurate.**
INC Magazine listed Equinox #1 in its 1996 "Inc 500" list of the fastest growing privately held companies. The edition that listed Equinox as #1 winner, also featured pyramid scheme perpetrator, Bill Gouldd, on the cover and included a glowing interview with him. It included a long article touting the power and value of the MLM sales system. One of the other companies it referenced as an example of MLM's marketing success was Jewelway. Jewelway has also been prosecuted by the FTC as an illegal pyramid scheme.

6. ***Lesson****: Don't believe all the positive hype about MLM in business magazines. Few of them ever focus on the plight of the average distributor whose financial investments and losses are the real sources of the financial "success" of pyramid scheme perpetrators and the MLM corporate profits.*

7. **The people very close to the top of MLMs really might not know what's going on and are therefore not necessarily useful guides - even when they quit the organization.** One of Equinox's top trainers and upliners, Robert Styler, left the company and wrote an exposé book about working under Bill Gouldd. But Styler did not accuse the company of being an illegal pyramid scheme. In fact, in reviewing his own book for Amazon.com, he stated, "I want to make it clear that I love network marketing and am still in the business full time -- just not with Equinox. As I reached the top of the Equinox system, like pulling the curtain back from the Wizard of Oz, I saw things I did not want to see. I do not feel Equinox is a 'bad' company. There are some wonderful people that are part of that organization. There are also some aspects to the company that I do not agree with and could no longer support."
Lesson*: Distributors at the bottom of the downline (who make up 90% of all MLMs) need to think for themselves.*

8. **The Federal Government may not have enough money to prosecute the larger MLMs.** Equinox was one of the largest MLMs prosecuted by the FTC in the last 25 years. The Federal regulators and the State Attorneys General who prosecuted Equinox were seeking a court ruling that would strengthen future cases against MLM pyramid schemes. The case was very strong and did result in getting the company shut down, the owner banned from the industry and millions paid back to victims.
But, in the end, the FTC and the states "settled," rather get a formal court ruling.

One key factor that led to the decision to abandon getting a ruling was the extreme cost of prosecution. MLM owners and top ranking upliners can pour millions into legal defense. The FTC faced years of appeals and extraordinary costs to pursue Equinox to the end. To get a quicker and more affordable settlement, they had to lose the opportunity to gain a stronger, definitive court ruling.

9. **The claim that "We are operating just like Amway" is not a valid defense for MLMs.**
Equinox pleaded that it operated just like Amway and Amway was legal, so it should be legal too. This is the main defense used by most MLMs. The judge ruled that the Amway defense was not necessarily relevant to Equinox and the Amway decision of 1979 was not a court decision, but an FTC action. ***Lesson****: If companies who turn out to be pyramid schemes claim they are "just like Amway" shouldn't the FTC be looking at Amway?*

10. **MLMs that don't gain most of their sales revenues from retail sales to non-distributors are probably pyramid schemes.**
The FTC and the states that prosecuted Equinox used this definition of a pyramid scheme:
"'Pyramid scheme' means a sales scheme, Ponzie scheme, chain marketing scheme, or other marketing plan or program in which participants pay money or valuable consideration to the company in return for which they receive: (1) the right to sell a product or service; and (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of products or services to ultimate users. For the purposes of this definition, "sale of products or services to ultimate users" does not include sales to other participants or recruits in the multi-level marketing program or to participants' own accounts."
The FTC experts showed that Equinox's rebate payments to upliners, which amounted to 48% of all wholesale sales to distributors, were really just "payments for recruiting." Only a small percentage of Equinox sales were ever retailed to people who were not also recruited as distributors. ***Lesson****: If you are in a MLM that does not emphasize retailing over recruiting, you are very likely a party to an illegal scam.*

11. **Starting and running an MLM that is prosecuted as an illegal pyramid scheme by the FTC can be a very profitable business, even if you get shut down.**
Equinox founder, Bill Gouldd, got to keep two luxury houses in Boca Raton, Florida, plus furnishings, a Rolex watch valued at $11,000, a luxury car, and up to $8 million.
Lesson: *The FTC needs a specific ruling on MLMs so that scams can't be started and run for years before being closed down. With the current lack of regulation, pyramid perpetrators can make millions even if the government finally catches up with them and eventually shuts down their frauds. The lack of a clear ruling on MLM results in much higher costs to prosecute MLM frauds. The higher costs may lead to less protection for the public.* (see #7 and #8 above.)

Bigsmart pyramid promoters settle FTC charges

In FTC release dated March 27, 2001, the following was stated regarding the settlement, which included $5 million in redress for victims:

> The FTC charged that the claims that consumers who invested in Bigsmart would make substantial income were false; that promotional materials that made the false and misleading claims provided the means and instrumentalities for others to deceive consumers; and that Bigsmart was actually a pyramid scheme. All three were violations of the FTC Act.

Hold on here. Have not these three violations become boilerplate for hundreds of MLMs operating with the same business model?

The FTC finds 96% of Skybiz participants lose money.

96%? One digit was missing – try 99.6%. In May 2001 the FTC charged that Skybiz was a classic pyramid scheme in which promoters misrepresented the income opportunity and products. Evidence showed at least 96% of participants lost money in the scheme. My research on all the MLMs for which I could obtain valid data, suggests this loss rate excludes all participants who dropped out and fails to factor in minimum operating expenses. Based on my research, I would strongly suggest *the loss rate is closer to 99.6%.* Be that it may, it was a misrepresentation to even refer to Skybiz as a profitable business opportunity.

The 2002 settlement provided for *$20 million* in redress to consumers and barred the promoters from participating in or encouraging others to start another MLM for varying periods, ranging from seven to 22 years.. This was likely Democratic FTC Chairman Pitofsky's last significant case against pyramid schemes. But while in office, he assured that some significant actions were taken against some MLMs – possibly to partially redeem himself from the horrible consequences of his decision as the administrative judge in the 1979 Amway decision.

George W. Bush rewards his Amway supporters with very little action against MLMs from 2001 to 2008.

After coming into office in 2001, President George W. Bush quickly replaced Chairman Pitofsky in June 2001 with Timothy Muris, an MLM sympathizer who had worked for Amway's legal firm[51]. And you guessed it, MLMs found in him a safe haven for the duration of his tenure, with only about three cases (NexGen 3000, Trek Alliance, Burnlounge) pursued out of hundreds of MLMs that could – and should – have been prosecuted.

In fact, one of the very few officials who were actually making headway in deciphering the fraud in MLMs was soon replaced. Dr. Peter J. VanderNat, FTC's Senior Economist, had developed a formula or test that could be used to determine the legitimacy of an MLM by measuring how much retail sales to non-affiliating consumers would have to occur for an MLM to pay legitimate commissions rather than rewards for illegal pyramid recruiting.[52] One of Muris's first actions was to move Dr. VanderNat out of the arena of MLM fraud investigation and analysis to another department of the FTC where he could do no harm to MLMs. He was replaced by David Scheffman, who had argued that Equinox was not a pyramid scheme, largely based on the assertion that Equinox operated *just like Amway*. [53]

Blame it all on Amway.

Here's a bizarre insight that may jar you a little. We can blame some of our biggest economic problems today on Amway. That's right. Let's look at what happened in the year 2000.

Remember how close the election was that year? Al Gore actually received more popular votes than George W. Bush. The outcome for the electoral vote came down to a close vote in Florida and finally to a Supreme Court decision to stop the recount.

Bush's top supporters that year were first, Reynolds Tobacco, and second – you guessed it – Amway and its founding families. Had it not been for their support in

[51] Muris worked at the law firm of Collier, Shannon, Rill & Scott from 1992-2000, was an anti-trust lawyer whose largest client was the multi-level marketing company, Amway.

[52] Robert FitzPatrick, quoted by Marc Sylvestre in the article "*Probable cover-up, protection of Ponzi, pyramid schemes by FTC,"* Subworld News, Charlotte, Carolina, Sunday Dec. 5, 2010

[53] Robert Fitzpatrick, *The Main Street Bubble, a Whistleblower's Guide to Business Opportunity Fraud: How the FTC Ignored and Now Protects It – Memoran-dum to President Barack Obama and Members of Congress overseeing the FTC. ©2009*

such a close race, Al Gore would likely have been president. Gore would surely not have twisted intelligence to justify invading Iraq, and we would instead have concentrated on Afghanistan, perhaps with a better – and less expensive – outcome.

Had Gore been elected, the demand for deregulation and unhindered free markets by conservative politicians would not have received so much support by the administration, and the weakening of regulation of the mortgage and financial markets may not have been so extreme. We may have had some setbacks on Wall Street and in real estate, but had the SEC and other regulators been more vigilant and had whistleblowers at the FDIC and Wall Street-savvy institutions[54] not been ignored, the damage would not have been nearly so severe.

We might possibly be trillions of dollars less in debt from the huge expenses of war, bailouts, and stimulus packages to prevent a depression and near total collapse of our financial system. That is another devastating effect of the "patriotic" money-making machine called Amway (a.k.a. Altacore, Quixtar, etc.). Yep – If you're looking for a scapegoat for our current economic problems, blame it all on U.S. flag-waving Amway, the promoters and defenders of the American Way!

Other significant regulatory actions

Nu Skin ordered to cease misrepresenting earnings of its distributors. In 1994, the FTC went after Nu Skin, alleging unsubstantiated claims for the income opportunity and products. The company and its distributors were ordered to cease its misrepresentations of distributors' earnings. Later, in 2003, I presented evidence to the FTC in a "*Report of Violations*"[55] that Nu Skin's misrepresentations continued. some modifications were made in Nu Skin's "Report of Average Incomes" of its distributors, but major deceptions remained in their reporting, as I have found to be true for all MLMs that publish average income data.

In 1997, Nu Skin paid a $1.5 million civil penalty to settle its case but came under scrutiny for continuing to disobey the 1994 FTC Order against it — with the FTC failing to enforce the Order and assess further consequential penalties.[56]

Pitofsky tries to redeem himself for his Amway decision. In 1995 Clinton appointed FTC Chairman Robert Pitofsky [D], who had noted the meteoric rise in "business opportunity" frauds about which consumer complaints surged in the 1980s and early 1990s, and in April 1995 Pitofsky began soliciting public comments about the possible inadequacy of the Franchise and Business Opportunity Rule (the "Franchise Rule" or "The Biz Op Rule"). He described the biz op problem in a February 1996 warning to consumers thusly: *"Lured by deceptive promises of independence and easy income, many would-be entrepreneurs are jumping into the arms of con artists who claim: 'we are not just selling you a business, we put you in business'"*, further calling the problem "epidemic."

Still, MLM misrepresentations continued unabated. But it would be disingenuous to be critical of Pitofsky as being too soft, as he proved quite the pitbull for the remainder of his six-year term (likely to atone for his disastrous decision as the

[54] including Harry Markopolos who warned of Bernie Madoff's Ponzi scheme. See Markopolos, Harry, *No One Would Listen: A True Financial Thriller.* (Hoboken, N.J.: John Wiley & Sons, 2010)

[55] The full name of the report was descriptive: **"**Report of Violations of the FTC Order for Nu Skin to stop misrepresenting earnings of distributors – and the need for FTC action to redress damages and to prevent further worldwide consumer losses – including evidence (Appendix) of recent misrepresentations and failure to implement meaningful disclosure to correct them"

[56] "Examples of Business Opportunity Scams," posted on FTC web site at – http://www.ftc.gov/bcp/franchise/tsweep02.shtm

administrative judge in the 1979 Amway case) until Republican President George Bush replaced him with Timothy Muris in 2001 – after which new MLM prosecutions came to a virtual halt.

The MLM industry did note the pattern under Pitofsky: MLMs were ambushed, with the FTC often gaining injunctions that froze assets as it fined the targeted MLM for FTC violations, often to the point of bankruptcy, and without the MLM ever admitting guilt. Pitofsky successfully applied the FTC Act and Franchise and Business Opportunity rule to end many MLMs and like businesses, including promoters selling "franchises" of vending machines, pay telephones, medical billing biz ops, and envelope-stuffing schemes.

FutureNet illustrates the need for sales to non-participants and for honest disclosure. In an FTC release dated April 8, 1998, the headline reads: FutureNet Defendants settle Charges; $1 Million in Consumer Redress for "Distributors." Some of the more interesting passages follow:

> On March 3, 1998, the Court modified the order substituting a monitor for the receiver and allowing the defendants to resume the sale of goods and services, *but only to persons not participating in defendants' marketing program -- in effect maintaining the injunction against pyramiding included in the initial restraining order.* . .

There you have it again. *Sales must be to non-participants in order for it not to be a pyramid scheme.*

> . . . according to the FTC, a major portion of the income the defendants promised was not based on sales of the devices, which are easily available at other retail distributors, including Sears and Circuit City, at comparable or lower prices. Instead, *the promised income came from fees paid by newly recruited distributors who would then bring on more recruits to provide a nonstop "downstream"of paying members.* FutureNet claimed that their recruits -- so called "Internet Consultants" -- would receive $200 - $400 when they personally recruited another consultant, and $25 - $50 when a person in their downline recruited a new member. The agency charged that income from the FutureNet multilevel marketing plan did not depend on sales of the Internet devices they were purportedly selling, but rather on the recruitment of new distributors -- the typical profile of an illegal pyramid. *Since almost 90 percent of investors in any pyramid program actually lose money, the defendants' earnings claims were false, and violated federal law, the FTC alleged.*

Again, the 90% loss rate is for no-product pyramid schemes. As explained in Chapter 7, for product-based schemes, or MLMs, the loss rate is approximately 99.6%.

Also, the final settlement would, among other things,

- prohibit misrepresentations about earnings or sales and *require that if the defendants make specific earnings claims, they must disclose the number and percentage of distributors who achieved those earnings or the stated level of sales figures;*
- *require the defendants to obtain a completed written verification form from investors before they collect payment, to assure that no one in the marketing structure made any of the prohibited claims;*

This supports the importance the FTC at one time placed on honest disclosure of information necessary to make an informed decision about participation in an MLM.

Trek Alliance was ordered to disclose material information. Quoting an FTC release[57]:

> In December of 2002, the Federal Trade Commission sued the California-based operation Trek Alliance *for using deceptive earnings claims to lure recruits into investing hundreds or thousands of dollars in their illegal scheme. The FTC alleged that Trek told recruits that they could earn money by selling products or recruiting, but emphasized* that more money could be made through recruiting.

[57] FTC.gov – release dated August 4, 2003

> While the company promised monthly incomes ranging from $2,000 to $20,000, *the FTC complaint alleged that the vast majority of consumers made less money than they had paid for front-end expenses, and that many made little or nothing. The complaint also alleged that compensation was not sufficiently linked to retail sales, and that Trek did not adequately enforce policies and requirements that were ostensibly designed to assure such a link.*
>
> *The FTC charged that Trek's earnings claims, as well as its claims implying that employment opportunities were available, were false. The FTC also charged that the defendants deceptively failed to disclose that most investors would not make substantial income. Finally, the FTC alleged that the program is a pyramid scheme and most participants lose money. The practices violate federal law, the complaint says.*

To one who has observed the effects and behavior stemming from recruitment-driven compensation plans in hundreds of MLM recruitment campaigns, I have to say that *the language in the complaint above accurately describes what happened in MLM recruitment across the industry. False earnings claims have become the standard for the industry, and actual loss rates are horrendous.*

In his order, Federal District Court judge Spencer Letts barred the defendants from making misrepresentations about the financial gains, or benefits of multi-level marketing program, business investment opportunity, or pyramid marketing scheme. Among other items, *the Order also prohibited the defendants from failing to disclose all information material to a consumer's decision to participate in such programs.*

The FTC was on the right track in this case. "Failing to disclose all information material to a consumer's decision to participate in such programs" is a major factor in losses of tens of billions of dollars by tens of millions of MLM victims every year. This again begs the question: So why would the FTC back away from such disclosure in its proposed Business Opportunity Rule? Methinks something's fishy in Denmark (or at least at the Commission's offices in Washington, D.C.

BurnLounge – singled out among hundreds of MLMs that do the same thing. In June of 2007, the FTC filed a complaint for the Federal District Court of California against BurnLounge, Inc. Quoting from the FTC release in June of 2007:

> The complaint charges that BurnLounge sold opportunities to operate on-line digital music stores that was, in fact, an illegal pyramid scheme.
>
> According to the FTC, BurnLounge recruited consumers through the Internet, telephone calls, and in-person meetings. *The sales pitch represented that participants in BurnLounge were likely to make substantial income. BurnLounge recruited participants by selling them so-called "product packages," ranging from $29.95 to $429.95 per year. More expensive packages purportedly provided participants with an increased ability to earn rewards through the BurnLounge compensation program.*
>
> *The BurnLounge compensation program primarily provided payments to participants for recruiting of new participants, not on the retail sale of products or services, which the FTC alleges would result in a substantial percentage of participants losing money.*
>
> *The FTC specifically alleges that the defendants operate an illegal pyramid scheme, make deceptive earnings claims, and fail to disclose that most consumers who invest in pyramid schemes don't receive substantial income, but lose money, instead. These practices violate the FTC Act, the agency alleges.*

Again, what is striking about this language is that it describes exactly what goes on every day in hundreds of MLMs in this country and abroad (in vulnerable markets where many MLMs are finding easy pickings). So why single out one or two companies instead of at least the 350 I know of who are similarly recruitment-driven and top-weighted?

The release goes on to state proudly:

> Over the last 10 years, the Commission has halted 17 pyramid schemes and has collected almost $90 million in consumer redress and tens of millions of additional dollars in suspended judgments.

17 out of what – about 1700 who are or were doing essentially the same things during that 10-year period. That means *the FTC is acting on at best one out of 100 MLMs that are violating Section 5*, based on my research and their own admission. Can you as the reader not see that going after MLMs that violate Section 5 one by one is totally impractical – and even irresponsible? Not only can they not possibly pursue all the violators without increasing their staff 50 to 100 times, but in the meantime, millions of consumers would be victimized while the actions are pending.

The release goes on to proclaim:

> . . . The FTC works for the consumer to prevent fraudulent, deceptive, and unfair business practices in the marketplace and to provide information to help consumers spot, stop, and avoid them.

Oh really! Is addressing merely 17 cases out of at least 1700 MLMs that are or were following the same flawed business model accomplishing the mission they just articulated. I think not.

Is anyone missing the point here? *A strict disclosure rule such as ordered in the Trek Alliance case would be at least 100 times as cost-effective and whole lot more responsible than relying on Section 5.*

A strict disclosure rule such as ordered in the Trek Alliance case would be at least 100 times as cost-effective and whole lot more responsible than relying on Section 5.

Another lesson we learn from these MLM cases. The following is another lesson worth remembering, which someone expressed to me recently: *Any "business" in which the total of commissions exceeds the* <u>*finite*</u> *marketable retail markup of the product has only one purpose: funneling money up a chain.* Most recruits will join because of the "business opportunity" and because they are led to believe the products are not only in high demand but are unique ("always!"), exclusive ("absolutely!"), elite, upscale, innovative, super-concentrated, miraculous, healthier, more environmentally friendly, etc. They are also conveniently consumable, so that participants can be incentivized to subscribe to monthly autoship.

When the business opportunity fails, they either accept the theft-by-deception because they've had it drilled into their heads that only losers quit and settle on believing that they're buying these products at some tremendous discount because they're in a "buying club", or quit and feel so guilty they fail to understand they've been robbed.

Now imagine an entire legion of MLMers paying for millions of these overpriced, uncompetitive products just so they can participate in a compensation plan they believe is leveraged to help them earn a reasonable part-time supplemental income – if not a vast fortune – *and you've got MLM's gravity-defying money funnel, which is more aptly compared to a vacuum cleaner sucking the income stream from the bottom up.*

States act while the FTC sleeps. In 2008, **California Attorney General Edmund G "Jerry"** Brown alleged YTB (YourTravelBiz.com) operated a "gigantic pyramid scheme that is immensely profitable to a few individuals on top and a complete rip-off for most everyone else." (So what else is new?) and won $1 million for California consumers in May 2009. Also in May 2009, Illinois Attorney General Lisa Madigan filed a similar suit against YTB in her state. These cases beg the question: 'where has the FTC been?'

For more information on these cases. Announcements about the outcomes of these cases are included in Appendix 10D, in which I have highlighted significant wording supporting the following conclusions:

- Misrepresenting or exaggerating potential income of participants, especially in a program guaranteed to cause losses for 99% of participants, is unfair and deceptive

– and illegal. But since such misrepresentations have become standard practice in the MLM industry, a good disclosure rule is essential if the FTC is to accomplish its mission to protect consumers from unfair and deceptive practices.

- While not specified in the FTC v. Amway decision, it was made clear in these cases that retail sales, or sales to end users, means sales to non-participants in the scheme.

Pyramid schemes easily camouflaged as MLMs. Several years ago, I posted an article on my web site that has amused many readers. It is called "How to Start a Pyramid Scheme that Is Very Profitable for the Founders – and Get Away with It." (See Appendix 10E.) It illustrates how easily officials, the media, and the public is deceived by MLM promoters.

Private or class actions. Numerous class actions have been filed against MLM companies. However, to undertake such a case is so expensive that few legal firms have the resources to proceed with plaintiffs. This challenge is daunting because the MLMs often can afford powerful legal teams that will use every trick in the book to delay and frustrate their opposition. The case that the Boston plaintiff firm Gilman and Pastor litigated against Nu Skin on behalf of 50,000 distributors in Canada dragged on for eight years before a settlement was finally reached.

And for attorneys willing to initiate a class action against an MLM, it is often exceedingly difficult to find victims who have the patience and determination to stand up as lead plaintiffs. Even when victims have lost tens of thousands of dollars, they fear consequences from or to those they have recruited, as well as the emotional toll and demands on their time that they may have to endure for years. They are often so drained from futile efforts and investments in their MLM that they have little time or energy left, except to try to recover through other work.

A notable success story: Amway/Quixtar settles for $150 million. I quote from Robert FitzPatrick of Pyramid Scheme Alert in his article titled "*Amway Accused of Fraud; Pays $150 Million; Where's the FTC and DOJ?*"[58]

> Amway is the largest, oldest and best known representative of "multi-level marketing" (MLM). It is the most prominent member of the Direct Selling Association.
>
> This icon of "direct selling" just announced that it has agreed to pay restitution to consumers and reform costs estimated at over $150 million. The payments are in response to consumer accusations that Amway/Quitar is operating an illegal pyramid scheme. The settlement is the largest in MLM history.
>
> Three Directors and Advisory Board members of Pyramid Scheme Alert served individually as experts or consultants in this historic class action case against Amway. The suit was filed by the law firm of Boies, Schiller & Flexner.
>
> The size of the settlement astonished some observers and the news is spreading fast. It was reported on the front page of the *USATodayAmway11.05.10*. About $55 million of the total is in actual cash and products as restitution for victims and legal fees. Other elements of the settlement include substantial price reductions to make retail sales feasible, and major changes in the infamous "tools" business that will require Amway to take greater responsibility. These schemes are run by some of Amway's top recruiters and have been allowed to function as arm's length, rogue operations, though highly beneficial to Amway.
>
> The huge settlement throws open to question the validity of Direct Selling Association's "Code of Ethics" and the legitimacy of all other multi-level marketing companies as viable "business opportunities.," based on the Amway model.
>
> Among the accusations made in the Amway class action suit that resulted in Amway's agreement to pay $150 million (the suit was technically brought against Quixtar, the now defunct name used by Amway for its North American operations):

[58] Posted November 11, 2010 on the web site – pyramidschemealert.org

* Amway is an illegal pyramid scheme.
* Amway's Kingpin companies that sell "motivation and training" products to recruits are also an illegal pyramid scheme.
* Amway criminally violates federal racketeering law.
* Amway violates California's "endless chain" law.
* Amway masks "criminal behavior" with claims that it is in compliance with a federal Amway ruling of more than 25 years ago. In fact, Amway is not in compliance with the ruling.
* Amway induces salespeople to buy thousands of dollars of overpriced products and useless "success tools" and then to recruit others to do the same in an endless chain scheme that dooms, by design, nearly all to losses.
* Amway deliberately deceives consumers to enroll in the pyramid scheme in which they inevitably suffer financial loss.
* Amway's arbitration rule which is intended to prevent victim lawsuits against it is unfair and "unconscionable". [Arbitration can be extremely expensive to contest.]
* Amway commits wire fraud and mail fraud.

Careful review of the evidence in prior chapters could easily lead an impartial analyst to conclude that virtually all of the hundreds of operating MLMs are breaking at least some federal and/or state laws. This is because MLM is *inherently* flawed, uneconomic, and deceptive. In fact, it is the epitome of an unfair and deceptive practice.

The 99% Factor. A key aspect of the suit is the charge that Amway misleads consumers with false income claims and promises for its "business opportunity." Pyramid Scheme Alert's analysis of Amway payouts to distributors shows that more than 99% of all who sign up never earn a profit. When actual costs are factored, including the related "tools" business, some estimates put the loss rates at 99.9%. This 99% loss figure correlates with tax data gathered as early as the 1980s when the state of Wisconsin prosecuted Amway. It was also verified by data gained by federal regulators in England who sued to shut down Amway in that country just several years ago.

Under terms of the settlement, Amway will be restating its "income disclosure" to reflect that the figure offered to consumers is a "gross income" not net, meaning that it is not profit and does not reflect costs that consumers incur when they pursue the scheme. (It should be noted that Amway's advertised "average income" is also a "mean", not a median, average, so it factors the high incomes of the few at the peak of the pyramid, skewing the "average" upward. Such a skewed "average" can also mislead consumers to think that the "average" participant actually earns a profit, masking the reality that the vast majority earn no commissions at all or no net profit.)

Muzzled Regulators. Amway has concealed or obscured these devastating losses to consumers, totaling in the billions over time, with elaborate diversions and rationalizations. But, its most effective weapon of mass deception has been its ability to influence politicians who in turn muzzle regulators.

The lack of government prosecutions, along with sophisticated PR spin and misleading income data have given MLM schemes an aura of legitimacy, heightening their ability to fool consumers and the media as well. Gradually, though, the truth about how MLMs have escaped regulation is coming to light. The answer is plain and simple: MLMs bought influence in Washington and in some state legislatures with campaign contributions and high pressure lobbying.

Amway is ranked as #68 in the 75 top corporate sponsors of Washington politicians, according to the investigative news magazine, *Mother Jones.* It ranks ahead of food giant Archer Daniels Midland, pharmaceutical behemoth Bristol Myers Squibb and just behind in ranking of Wal-mart, General Motors and oil magnate, Koch Industries.

For a full report on how Amway and the multi-level marketing industry have so far escaped law enforcement, send for the free report, the *Main Street Bubble*. Just put the words, "Main Street Bubble" in your email's subject area.

Admission of Guilt? Even though the settlement states that Amway admits no wrongdoing, the fact that Amway agreed to pay accusers and incur other remedial costs up to $150 million and chose not to allow the case to go to trial

will be read by many people as compelling evidence of guilt. A settlement of this size can hardly be written off as cheaper than legal defense. In fact, Amway incurred huge legal costs and held up the settlement for three years by arguing not that the accusations were untrue but that the victims had no legal right to bring a suit. When the right to sue was established in court, Amway paid up.

Obvious questions are raised by the suit and the settlement

* Will the Dept. of Justice now investigate the consumers' charges that Amway engages in criminal behavior?
* Will the Federal Trade Commission, finally, investigate the consumers' charge of Amway is operating a pyramid scheme in violation of the Amway ruling of 1979?
* Will the California Attorney General begin to investigate the charges that Amway violates its state anti-pyramid scheme law?

The huge settlement and payments to victims follows other actions againt Amway. Government regulators in England several years ago sought to close down Amway for defrauding consumers in that country. Criminal charges have also been brought in one state in India against Amway. And Amway is also being sued for deception and fraud in Canada by Canadian consumers.

It is an open question as to how many actions by other governments, consumer lawsuits and evidence of harm are required before the FTC and Dept. of Justice act.

The recently published book, *No One Would Listen*, by whistle blower, Harry Markopolos, dramatically describes how SEC regulators ignored his alerts and allowed the Bernard Madoff Ponzi scheme to grow to enormous proportions. Their failure to act caused harm to thousands more people, despite his written and detailed warnings, which he brought to the agency five separate times over an eight-year period of investigating the scam. Additionally, the news media such as the *Wall Street Journa*l and *Forbes magazine* also failed to respond to his evidence which he offered them. Madoff was apparetnly treated as "too big to expose."

Beyond possible new regulatory investigations of Amway, the lawsuit settlement raises another even larger question about other MLM companies:

How many other MLM companies are operating exactly as Amway does, which led to this huge payment to victims? This question is especially relevant to regulators and other law firms since the standard defense of most multi-level marketing companies is that they are legal because they operate just like Amway!

CURRENT DEVELOPMENTS

Compliance by MLMs with federal and state laws are questionable at best.

A wide range of laws are likely being violated by MLMs. A careful review of state statutes affecting pyramid schemes, chain referral schemes, multi-level marketing, etc. leads one to conclude that law enforcement and consumer protection officials, attorneys, and consumers are justified in being confused as to what is and what is not legal and in what states specific prohibitions or restrictions apply. See Appendix A for a quick overview of the confusion that can result from a state-by-state comparison of applicable statutes.

Careful review of the evidence in prior chapters could easily lead an impartial analyst to conclude that virtually all of the hundreds of operating MLMs are breaking at least some federal and/or state laws. Examples of possible violations by MLM founders, promoters, and/or recruiters (including participants) include but are not limited to the following:

1. Establishing, promoting and engaging in unfair and deceptive practices (See Chapters 2, 7, and 8)
2. Promoting an MLM as an "income opportunity" or "business opportunity" when almost all participants (except for a tiny few at or near the top) lose money.
3. Establishing and promoting illegal pyramid schemes, chain referral schemes, endless chain selling schemes, etc. – depending on the definition (See Chapter 2)
4. Failure to file as investment securities when MLM promoters present their programs as "passive income," "residual income," etc.
5. Presenting an MLM as "like a franchise" while refusing to file with the FTC as a franchise with franchise disclosure documentation, etc.
6. Promoting a lottery in the form of a pyramid scheme, chain referral scheme, etc., where success is dependent on chance elements not under the control of the participant, but of an unpredictable "downline" that could make them rich.
7. Violating employment laws in applying excessive control over distributors they want to classify as independent contractors.
8. Establishing and promoting a scheme in which earnings are contingent on procurement of customers or occurrence of some event after purchase or transaction
9. Establishing and promoting a scheme in which participants are not contributing to sales efforts to qualify for commissions, bonuses, etc., from sales of others (downline)
10. Unreasonable purchase quotas
11. No repurchase or buyback provision – or misrepresentation of the same
12. Conducting what appears to be a buyers' club but calling it something else.

The FTC fails to protect against MLM as an unfair and deceptive practice.

MLMs are best regulated on a national level – by the FTC. As discussed in Chapter 2, endless chain recruitment programs quickly spread beyond state boundaries and become national in scope – even international when successful. It therefore becomes a formidable challenge for states to adequately control their activities or to protect consumers from abuses. MLM is best regulated on a national basis. And since a primary mission of the FTC is to protect against unfair and deceptive practices, MLM – as what could easily be considered the most unfair and deceptive of all business practices functioning today – comes under the ambit of the FTC's responsibility.

The FTC ill-equipped to cope with MLM on a case-by-case basis. What was noted in an American Bar Association Commission study of the FTC clear back in 1972, is just as true today:

> The recurrent flaws of FTC enforcement-failures of detection, undercommitment of resources to important projects, timidity in instituting formal proceedings and failure to engage in an effective compliance program-tend to outweigh its occasional successes.

On November 7, 2002, Robert FitzPatrick and I gave presentations at a seminar in Washington, D.C. (sponsored by Pyramid Scheme Alert) on Product-based Pyramid Schemes to federal and state regulators. We then went to the FTC offices to meet with FTC attorney James Kohm, Acting Director of Marketing Practices, and his staff. After I got through explaining that my research had enabled me to identify the causative and defining characteristics of product-based pyramid schemes, Mr. Kohm called us aside to talk with us privately. I quote from my journal for that day:

I presented the tight summary of my research on MLM's to Jim Kohm and his staff at the FTC legal offices in DC. The reception was mixed, since obviously there were some differences within the group on the issues we raised.

Afterwards, Jim lectured Bob and I for over 40 minutes as to why they were doing the best they could, were putting in long hours, and did not need to be instructed on how to improve.

I was struck with his tacit admission that they were simply not up to the task of confronting this massive challenge of enforcing the law against powerful MLMs. It should be obvious to all concerned that case-by-case prosecution of hundreds of MLMs violating Section 5 is simply not possible, given the resources available to the FTC. A blanket rule would be far, far more cost-effective. It may be the only way the FTC could cope with MLM abuse, given its limited resources.

Since a primary mission of the FTC is to protect against unfair and deceptive practices, then MLM – which could easily be considered the most unfair and deceptive of all business practices functioning today – comes under the ambit of the FTC's responsibility.

The FTC exempts MLM from its Business Opportunity Rule – another setback for consumer protection. As I've said repeatedly, the Federal Trade Commission is the nation's agency charged with the responsibility to protect consumers from unfair and deceptive trade practices. But as has been discussed, the FTC has essentially reneged on its responsibility in the MLM arena, even proposing a Business Opportunity Rule that would exempt MLMs from having to comply. It justifies this action by instead enforcing Section 5 of the FTC code when violations occur.

The problem with this decision is that virtually all of the hundreds of operating MLMs are violating Code 5, in that they are all engaging in unfair and deceptive practices. Dependent on an endless chain of recruitment, they all assume infinite expansion in finite markets. MLMs are therefore inherently flawed, uneconomic, and deceptive.

Worldwide feedback leads those of us advocating for consumers to conclude that they are also extremely viral and predatory, preying on the most vulnerable among us – especially in times of economic uncertainty. They can cause great harm (financial and personal losses) to those who invest heavily in them.

This is not a company-specific complaint, but a return to the original arguments put forth by FTC prosecutors prior to the 1979 FTC v. Amway decision. The prosecutors working on the case did not have the experience or research behind them that we have now, and the judge's final decision reflects this, as well as a climate of deregulation that placed protection against unfair and deceptive practices in a low priority position. This remains true to this day where MLM is concerned.

The FTC still flounders with its proposed Business Opportunity Rule. In its latest release about the Rule, an FTC Business Center blog titled "FTC Staff Recommends Changes to Business Opportunity Rule." It appears the FTC is tripping all over itself in its continued efforts to exempt MLM from having to disclose information that could help to protect consumers from MLM abuse. The FTC has caved to demands from the DSA/MLM cartel and comments filed by 17,000 MLM participants (out of millions who were urged via the Internet to file comments) to exempt MLM ("direct selling") from its proposed Business Opportunity Rule.

Some 80 U.S. Congress-men also commented that the Rule should not apply to MLMs. I know that in Utah where I live, Congressmen parroting the DSA line are given a lot of political support from MLMs in the state, and I assume the same is the case elsewhere. Even if they don't donate money to their campaigns, the DSA is fond of touting their large constituency – the millions of minions whose votes they influence.

It should be obvious that a good rule requiring adequate disclosure of crucial information to prospects would be far more cost effective than falling back on Section 5.

What cartel promoters fail to tell these lawmakers is that almost all of these "direct sellers" are victims of endless chain recruitment schemes – hoping to someday cash in on their investments in the MLMs to which they have subscribed. Read my comments submitted at my appearance at the FTC's RPBOR Workshop June 1, 2009, in Appendix 10F.

Comments from former high level FTC officials who "flipped" and moved from consumer protection to fraud protection. Other persons of interest who submitted letters supporting the DSA position include Joan **"**Jodie" Bernstein, former *Director of Consumer Protection with the FTC*, who wrote on behalf of Amway/Alticor/Quixtar, and none other than Timothy Muris, the former FTC Chairman with Amway ties, who wrote on behalf of Primerica Financial Services. *The Primerica letter Mr Muris contributed to actually had the nerve to include the words: "There Is No Evidence of Widespread Fraud in the Direct Selling Industry." The comment by Mr. Muris was essentially parroted in the October 2010 staff report on the Business Opportunity Rule, which states on page 30:*[59]

As explained in supra Section I.B., two key problems emerged with the IPBOR's breadth of coverage. First, the IPBOR would have unintentionally swept in numerous commercial arrange-ments *where there is little or no evidence that fraud is occurring.*

Those of us advocating for consumers – plus millions of MLM victims – would beg to differ. And now with the evidence presented in this book, *the evidence for business opportunity fraud by MLMs is overwhelming.*

Another contributor to that same support letter for Primerica is J. Howard Beales III, whom Muris appointed as the FTC's *Director of the Bureau of Consumer Protection* (who resigned from his post in 2004). We expect Congress-men to be manipu-lated by special interests, but FTC members *who are appointed to protect consumers* should know better!

We expect Congressmen to be manipulated by special interests, but FTC members who are appointed to protect consumers should know better!

Why the FTC's reliance on enforcement of Section 5 with MLMs is shortsighted and totally impractical. Challenged by myself and several other consumer advocates, the FTC's response was to fall back on enforcement in individual cases of MLM violations of Section 5 of the FTC Code. But this is totally avoiding the issue of consumer protection. The FTC admits to prosecuting only about 17 cases in ten years. Yet my research (and that of others) demonstrates that all of the over 350 MLMs I have analyzed are blatantly violating Section 5 [60], and that is only a sampling of the hundreds of MLMs that are constantly coming and going – no doubt virtually all of them, likewise violating Section 5. This is not because founders

[59] Disclosure Requirements and Prohibitions Concerning Business Opportunities Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 437)

[60] See prior chapters for compelling evidence that all endless chain recruitment schemes are "Unfair and deceptive practices."

want to scam people, but because of the inherent flaws in all MLMs.

Let me put it another way. Reliance on Section 5 assumes there are some bad players it the MLM arena. The FTC blindly ignores (or fails to recognize) the reality that *it is a fraudulent system that is to blame for the defrauding of 99% of MLM recruits, upon which all MLMs are built.*

At the rate that the FTC has been enforcing Section 5 with MLMs, it would have to increase its staff by at least 50 times just to keep up with sorely needed prosecutions of current and newly hatched MLMs. Failure to do so would mean tens of millions of additional victims would be without any substantive consumer protection – and could easily fall victim to the deceptive recruitment of hundreds of MLMs. The impact worldwide could easily total hundreds of millions of additional victims, based on DSA "direct sales" figures. It should be obvious that a good rule requiring adequate disclosure of crucial information to prospects would be far more cost effective than falling back on Section 5.

Another reason that reliance on Section 5 would be far less effective in providing consumer protection than a disclosure rule is that case-by-case- law enforcement is dependent on complaints and evidence gathering. As explained in Chapter 9, this simply does not work with endless chain recruitment schemes. Victims of endless chains almost never file complaints because every major victim is almost of necessity a perpetrator – having recruited friends and family in hopes of recovering (and eventually profiting) ongoing investments, including "pay to play" purchases from the company. To they fear self-incrimination and conse-quences from or to those they recruited or those who recruited them. They also have been taught to blame themselves for their "failure."

FTC corruption to the detriment of consumers becoming more evident. Watch to see if the FTC chooses on the side of consumers – or of the DSA/MLM cartel, with whom FTC officials seem altogether too cozy. This collusion between the cartel and the Commission is demonstrated by the revolving door of former high level FTC officials hired by MLM companies and writing comments to the FTC on behalf of the cartel. This includes former FTC Chairman Timothy Muris and J. Howard Beales III, former Director of the Division of Consumer Protection, who commented on behalf of Primerica; and Jodie Bernstein, another former Director of Consumer Protection, who commented for Quixtar (Amway).

This symbiotic relationship between the FTC and the DSA/MLM cartel is also demonstrated by blatant ex parte communi-cations between FTC rule-making officials and with DSA officials during the rule-making process, as explained in Appendix 10F.[61]

An interesting phenomenon is happening here as happened at the Securities and Exchange Commission. Harry Margopolis, the whistle-blower who exposed the incompetence and impotence of the SEC in the Bernie Madoff scandal, reported Madoff as saying:

> "These guys, they work for five years at the Commission, then they become a compliance manager at a hedge fund." And he said he knew that was true because every time an SEC investigator came up to his office he or she would ask for an employment application.[62]

Watch for this pattern to be repeated in the future at the FTC. Pay particular attention to the officials responsible for the Business Opportunity Rule. When they leave the FTC, will they flip and lobby on behalf of the DSA/MLM cartel – and against the interests of consumers they were once pledged to protect? History suggests they will do as other high level officials at the FTC have done.

Pre-launch kickoff of new MLMs. It has become customary for new MLM startups to announce a pre-launch kickoff, stressing the importance of getting in early to get one's place established before others. The

[61] Exhibit 10E is a copy of my comments posted on the FTC web site (FTC.gov).following the June 1979 workshop on the final r
ule, in which I participated.

[62] Markopolos, Harry, *op. cit., p.* 159

implications are that those who get in early have a huge advantage over those who come in later. Of course, they are right. In any endless chain recruitment program, whether it be a chain letter, naked pyramid scheme, or MLM (a.k.a. product-based pyramid scheme), the pay plans favor early entrants.

In my view, it would be difficult for anyone to read the information in this book with an open mind without concluding that MLM is the epitome of an unfair and deceptive marketing practice.

For those who understand the inherent flaws in such a system, such an announcement is tantamount to a blatant admission that they are conducting a pyramid scheme. MLMs – with their endless chain of recruitment – assume infinite expansion in a finite market. It not only assumes an infinite market, but also a virgin market – neither of which exist. MLMs are therefore inherently flawed, deceptive, and profitable only for founders and a few early entrants or those placed at or near the top of the pyramid in the compensation plan.

We can find instances of the first entrants in a new MLM becoming rich, but only at the expense of thousands who lose their entire investment in products and operating expenses, which can be substantial over time – to say nothing of a great amount of time and effort. As a general rule in MLM, the more one invests, the more one loses – except for those who got in at the start.

Worldwide expansion of an unfair and deceptive practice – MLM. Because of the viral nature of MLM and the need to feed off of less saturated markets, MLMs are expanding rapidly overseas. Worldwide feedback convinces me and others who are publishing our findings on the Internet that great harm is being done to vulnerable populations that can least afford to be impoverished by these fraudulent schemes.

Unfortunately, some of our U. S. trade representatives are promoting or supporting expansion of MLM overseas. This could eventually come back to haunt us, as more and more people become educated or victimized by MLMs and point the finger of blame at the U.S. for allowing such fraudulent exports to expand unchecked in such a viral fashion worldwide. Many foreigners believe that U.S. businesses operate on principles of honesty and fairness, and this can only tarnish that image.

CONCLUSIONS

In my view, it would be difficult for anyone to read the information in this book with an open mind without concluding that MLM is the epitome of an unfair and deceptive marketing practice. Based on the FTC's mission to protect against such practices in the marketplace, MLM should be illegal per se. MLMs would also technically be illegal under many state statutes if strictly enforced.

The bare minimum of consumer protection would be a rule requiring that MLMs disclose information essential to prospects' making an informed decision about participation. Warnings against the inherent flaws in all endless chain recruitment programs would also be appropriate.

RECOMMENDED READING AND ANNOTATED WEB SITES:

For serious students of the subject, I would strongly suggest reading the rather lengthy article titled *"All you need to Know about MLM."* In it you will find thorough reporting on legal issues related to MLM. Though very factual in her approach, the author has been sued for expressing her opinions and so prefers to remain anonymous. For interesting details, go to – http://www.armydiller.com/financial-scam/mlm.htm

For general background, the serious student will benefit from an older, but extremely relevant, article published in the William and Mary Law Review entitled:
"Regulation of Pyramid Sales Ventures," Go to – http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=2563&context=wmlr

For MLM laws in the 50 states, go to "The Advocate Group," sponsored by MLM attorney Kevin Thompson:
http://www.scribd.com/doc/21293376/MLM-and-Pyramid-Laws-in-50-States
Another MLM attorney, Jeffrey A. Babener has similar information posted at –
http://www.mlmlegal.com/kansas.html

Three other treatises are very insightful and helpful in gaining a thorough understanding of the subject. They are written by Robert FitzPatrick of Pyramid Scheme Alert:
- *The Main Street Bubble: How the Federal Trade Commission (FTC) has Ignored and now Protects Business Opportunity Fraud on Main Street*.[63]
- *PyramidNation: The Growth, Acceptance, and Legalization of Pyramid Schemes in America*[64]
- *The Case for Reopening the Amway Pyramid Scheme Case*[65]

I also heartily recommend the following:
- www.pyramidschemealert.org – the official web site for Pyramid Scheme Alert – and – \www.falseprofits.com – which has some insightful blogs worth reading.
- www.mlmwatch.org, one of several informative web sites by Dr. Stephen Barrett, focusing on questionable supplements and other health quackery, which seems to be a favorite product category for MLM promoters.
- http://www.sequenceinc.com – sponsored by forensic accountant Tracy Coenen. Check out her articles on pyramid schemes.

A scholarly article titled "*Marketing Fraud: An Approach to Differentiating Multilevel Marketing from Pyramid Schemes*"[66] was written by economists Peter VanderNat (with the FTC) and William Keep and has been referenced by the FTC in connection with the Business Opportunity Rule, as discussed in Chapter 2. However, the article assumes that MLM is a legitimate business model, an assumption that deserves re-examination based on what recent research has shown, as reported in this chapter.

Many other useful reports and blogs on this subject are available from the following web sites:
- www.mlm-thetruth.com – and check out numerous other recommended web sites, which are annotated for the reader's convenience. Go to –
http://mlm-thetruth.com/recommendedLinks.html

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[63] For description and instructions on how to order, go to – http://www.pyramidschemealert.org/PSAMain/resources/resources.html
[64] Available for free download from www.falseprofits.com.
[65] Available for free download from www.falseprofits.com.

66 See Peter J. Vander Nat and William W. Keep, *Marketing Fraud: An Approach to Differentiating Multilevel Marketing from Pyramid Schemes*, 21 J. of Pub. Pol'y & Marketing (Spring 2002), (''Vander Nat and Keep'') at 140.

Appendix 10A: Prohibitions and restrictions by federal agencies – and those in the statutes of the 50 states

Prohibitions or restrictions applicable to pyramid promotional schemes, chain distribution schemes, multi-level marketing, etc.	**FTC**	**SEC**	**USPS**	**Alabama**	**Alaska**	**Arizona**	**Arkansas**	**California**	**Colorado**	**Connecticut**	**Delaware**	**Florida**	**Georgia**[67]
Unfair and deceptive practices	X				X				X				
Misrepresentations or no documentation of earnings or marketability claims				X									X
Initial investment above threshold	X[68] $500			X $100					X $50			X $100	X $500
Unreasonable quota of purchases req'd to participate (inventory loading)													
Establishing or promoting pyramid scheme, chain distributor schemes or referral sales plans				X	X				X	X[69]	X	X	
Pyramid or chain referral scheme – primary income from recruitment rather than sales to non-partic's	X[70]			X	X	X	X	X	X				X
Establishing endless chain or referral sales													
Pyramid scheme as lottery, whereby income dependent on chance over skill or judgment of participant						X[71]		X					X
Earnings contingent on procurement of customers or occurrence of some event after purchase										X			
Participants not contributing to sales efforts to qualify for commissions, etc., from sales of others (downline)													X
Mail or wire fraud			X										
No repurchase (buyback) provision													
Repurchase (buyback) provision misrepresented													X
Misrepresentation of products in source, quality, certification, etc.,									X				
Implications of approval or endorse-ment by any agency of the state													X
Misrepresentations on financial reports or statements to investors		X[72]											
Purchase discounts, other incentives to refer others													
Failure to file disclosures to state													
Failure to provide disclosures to recruits													

[67] In Georgia, extensive disclosures (including signed statements), records retention, and $75,000 bond required if threshold exceeded

[68] If an MLM exceeds the threshold of $500 over months (laundering investment via "pay to play" purchase requirements, etc.), it could be subject to franchise regulations

[69] In Connecticut, contingent consideration is void; i.e., payments for rights, etc. contingent on procurement (recruitment) of other persons with similar rights, etc.

[70] Requirement for sales to non-participants clarified in recent rulings and staff communications

[71] In Arizona, participants can satisfy the law by selling.consumable products to anyone, including participants (language similar to that initiated by the DSA, as in the 2006 amendment to Utah's Pyramid Scheme Act)

[72] MLMs must avoid franchise classification, including threshold

Prohibitions or restrictions applicable to pyramid promotional schemes, chain distribution schemes, multi-level marketing, etc.	**Hawaii**	**Idaho**	**Illinois**	**Indiana**	**Iowa**	**Kansas**	**Kentucky**	**Louisiana**	**Maine**	**Maryland**	**Massachusetts**	**Michigan**	**Minnesotta**	**MIssissippi**	**Missouri**	**Montana**
Unfair and deceptive practices			X		X	X						X	X			
Misrepresentations or no documentation of earnings or marketability claims										X	X		X			
Initial investment above threshold				X $100										X $100		
Unreasonable quota of purchases req'd to participate (inventory loading)											X					X
Establishing or promoting pyramid scheme, chain distributor schemes or referral sales plans		X [73]	X [74]	X			X [75]	X [76]		X [77]		X		X	X	X [78]
Pyramid or chain referral scheme – primary income from recruitment rather than sales to non-partic's	X			X					X		X		X	X		
Establishing endless chain or referral sales																
Pyramid scheme as lottery, whereby income dependent on chance over skill or judgment of participant									X		X					
Earnings contingent on procurement of customers or occurrence of some event after purchase				X	X	X						X	X			
Participants not contributing to sales efforts to qualify for commissions, etc., from sales of others (downline)											X					
Mail or wire fraud																
No repurchase (buyback) provision		X						X		X			X			X
Repurchase (buyback) provision misrepresented											X					
Misrepresentation of products in source, quality, certification, etc.,																
Implications of approval or endorse-ment by any agency of the state																X
Misrepresentations on financial reports or statements to investors										X		X				
Purchase discounts, other incentives to refer others																X
Failure to file disclosures to state																

[73] In Idaho, sales to participants exempts an MLM from classification as a pyramid scheme – due to amendment initiated by DSA and/or its members

[74] In Illinois, MLM is not classified as a pyramid scheme if sale is to persons for purpose of resale. The statute does not specify that these sales must be to non-participants.

[75] In Kansas, sales to participants exempts an MLM from classification as a pyramid scheme

[76] In Louisiana, sales to participants exempts an MLM from classification as a pyramid scheme – due to amendment initiated by DSA and/or its members (same language as in Utah's statue, which was changed through DSA lobbying)

[77] Maryland's definition of pyramid promotional scheme excludes sales by participants or others introduced into the scheme

[78] In Montana, iIlegality of pyramid schemes is only implied, but programs with consumable products are exempt

Prohibitions or restrictions applicable to pyramid promotional schemes, chain distribution schemes, multi-level marketing, etc.	**Nebraska**	**Nevada**	**New Hampshire**	**New Jersey**	**New Mexico**	**New York**	**No. Carolina**	**No. Dakota**	**Ohio**	**Oklahoma**	**Oregon**	**Pennsylvania**	**Oklahoma**	**Oregon**
Unfair and deceptive practices				X								X		
Misrepresentations or no documentation of earnings or marketability claims														
Initial investment above threshold									X $25			X $25		
Unreasonable quota of purchases req'd to participate (inventory loading)	X													
Establishing or promoting pyramid scheme, chain distributor schemes or referral sales plans	X [79]	X	X		X [80]	X [81]		X [82]		X [83]	X [84]	X[85]	X [86]	X [87]
Pyramid or chain referral scheme – primary income from recruitment rather than sales to non-partic's		X					X		X					
Establishing endless chain or referral sales														
Pyramid scheme as lottery, whereby income dependent on chance over skill or judgment of participant							X							
Earnings contingent on procurement of customers or occurrence of some event after purchase								X			X	X		X
Participants not contributing to sales efforts to qualify for commissions, etc., from sales of others (downline)														
Mail or wire fraud														
No repurchase (buyback) provision	X									X			X	
Repurchase (buyback) provision misrepresented														
Misrepresentation of products in source, quality, certification, etc.,														
Implications of approval or endorse-ment by any agency of the state														
Misrepresentations on financial reports or statements to investors														
Purchase discounts, other incentives to refer others														
Failure to file disclosures to state														

Note: For definitions of pyramid schemes in the statutes of the various states, go to Appendix 2E of Chapter 2.

[79] Nebraska exempts sales to participants in definition of pyramid schemes
[80] New Mexico exempts sales to participants in definition of pyramid schemes
[81] In New York, chain distributor schemes constitute a security and are subject to law for such
[82] North Dakota exempts sales to participants in definition of pyramid schemes
[83] Oklahoma exempts sales to participants in definition of pyramid schemes
[84] Oregon uses the term "pyramid club."
[85] Pennsylvania uses the term "pyramid club."
[86] Oklahoma exempts sales to participants in definition of pyramid schemes
[87] Oregon uses the term "pyramid club."

Prohibitions or restrictions applicable to pyramid promotional schemes, chain distribution schemes, multi-level marketing, etc.	**Pennsylvania**	**Rhode Island**	**So. Carolina**	**So. Dakota**	**Tennessee**	**Texas**	**Utah**	**Vermont**	**Virginia**	**Washington**	**W. Virginia**	**Wisconsin**	**Wyoming**
Unfair and deceptive practices	X		X	X	X	X	X	X	X				
Misrepresentations or no documentation of earnings or marketability claims													
Initial investment above threshold	X $25												
Unreasonable quota of purchases req'd to participate (inventory loading)				X									
Establishing or promoting pyramid scheme, chain distributor schemes or referral sales plans	X[88]		X[89]	X[90]		X[91]	X[92]	X[93]	X[94]	X[95]	X	X	
Pyramid or chain referral scheme – primary income from recruitment rather than sales to non-partic's					X[96]								X
Establishing endless chain or referral sales													X
Pyramid scheme as lottery, whereby income dependent on chance over skill or judgment of participant													
Earnings contingent on procurement of customers or occurrence of some event after purchase	X			X	X	X							
Participants not contributing to sales efforts to qualify for commissions, etc., from sales of others (downline)													
Mail or wire fraud													
No repurchase (buyback) provision				X		X							X
Repurchase (buyback) provision misrepresented													
Misrepresentation of products in source, quality, certification, etc.,													
Implications of approval or endorse-ment by any agency of the state													
Misrepresentations on financial reports or statements to investors		X											
Purchase discounts, other incentives to refer others													
Failure to file disclosures to state		X											X

NOTE: For excerpts from actual statutes relating to MLM and pyramid schemes, see Appendix 2E at the end of Chapter 2**.**

88 Pennsylvania uses the term "pyramid club."
89 South Carolina uses the term "pyramid club," and prohibits chain process of advancement by recruitment
90 South Dakota exempts sales to participants in definition of pyramid schemes
91 Texas exempts sales to participants in definition of pyramid schemes
92 Utah's Pyramid Scheme Act was amended in 2006 with bill initiated by DSA members, using deceptive arguments (witnessed by the author) and reinforced by heavy donations to Utah's Attorney General, who spoke in favor of the bill –.
93 Vermont statute clearly describes uneconomic nature and harmful effects of "chain distributor schemes."
94 Virginia exempts sales to participants in definition of pyramid schemes
95 Washington exempts sales to participants in definition of pyramid schemes
96 Tennessee uses the terms "pyramid distributorship" and "chain referral sales plan.

APPENDIX 10B: Federal and State and Provisions Prohibiting Unfair and/or Deceptive Trade Practices

Federal legislation and statutes in every state prohibit employment of unfair or deceptive trade practices and unfair competition in business. The Federal Trade Commission regulates federal laws designed to prohibit a series of specific practices prohibited in interstate commerce. Several states have established consumer protection offices as part of the state attorney general offices.

The Federal Trade Commission Act (FTCA), originally passed in 1914 and amended several times thereafter, was the original statute in the United States prohibiting "unfair or deceptive trade acts or practices." Development of the federal law was related to federal antitrust and trademark infringement legislation. Prior to the enactment in the 1960s of state statutes prohibiting deceptive trade practices, the main focus of state law in this area was "unfair competition," which refers to the tort action for practices employed by businesses to confuse consumers as to the source of a product. The tort action for a business "passing off" its goods as those of another was based largely on the common law tort action for trademark infringement.

Because the law governing deceptive trade practices was undefined and unclear, the National Conference of Commissioners on Uniform State Laws in 1964 drafted the Uniform Deceptive Trade Practices Act. The NCCUSL revised this uniform law in 1966. The law was originally "designed to bring state law up to date by removing undue restrictions on the common law action for deceptive trade practices." Only eleven states have adopted this act, but it has had a significant effect on other states. Most state deceptive or unfair trade practices statutes were originally enacted between the mid-1960s and mid-1970s.

PYRAMID SCHEMES AND SIMILAR PRACTICES

Several states prohibit certain illegal business schemes through deceptive trace practices statutes. One such scheme is a "pyramid scheme," where investors make money by recruiting others to join and invest in a company rather than selling a product as claimed by the company. Other schemes include deceptive employment opportunity claims and misleading or deceptive game or contest promotions. Some states do not specifically include these schemes in the statute, but courts in those states may have applied provisions of the relevant deceptive trade practices statute in cases involving these schemes.

STATE AND LOCAL PROVISIONS PROHIBITING DECEPTIVE TRADE PRACTICES

Although many state deceptive trade practices statutes include similar provisions, application of these statutes often differs from state to state. Consumers who have been victimized by a deceptive trade practice should be sure to consult their relevant state statutes to determine the appropriate procedures to follow, the appropriate office to contact, and special requirements that must be met to bring a suit in that state. Each state has adopted some version of a deceptive trade practices statute. The following are brief summaries of these statutes.

ALABAMA: The state statute prohibits 22 specific practices, plus any other deceptive or unconscionable acts or practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office or a district attorney's office may enforce the statute for violations by a business.

ALASKA: The state statute prohibits 41 specific practices, plus other unfair methods of competition and unfair or deceptive acts or practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

ARIZONA: The state statute prohibits deception or an omission of a material fact by one party to a transaction with the intent to deceive the other party. The transaction must involve the sale, offer for sale, or lease of goods, real property, services, or intangibles for the statute to apply. The attorney general's office or a county attorney's office may enforce the statute for violations by a business.

ARKANSAS: The state statute prohibits 10 specific practices, plus any other deceptive or unconscionable acts or practices. The transaction must involve the sale or advertisement of goods or services for the statute to apply.

CALIFORNIA: The state statute prohibits 23 specific practices, plus any other unfair methods of competition and unfair or deceptive practices. Parties must intend for the transaction to result in the sale or lease of goods or services to a consumer for the statute to apply.

COLORADO: The state legislature adopted the Uniform Deceptive Trade Practices Act which prohibits 43 specific practices. Transactions must be in the course of a person's business, vocation, or occupation, and involve the sale of goods, services, or real property for the statute to apply. The attorney general's office or a district attorney's office may enforce the statute for violations by a business.

CONNECTICUT: The state statute prohibits unfair methods of competition and unfair or deceptive acts or practices. The transaction must be conducted in trade or commerce for the statute to apply. The Commission of Consumer Protection or the attorney general's office may enforce the statute for violations by a business.

DELAWARE: The state legislature adopted the Uniform Deceptive Trade Practices Act which prohibits 12 specific practices, plus other conduct that creates the likelihood of a misunderstanding on the part of a consumer. The transaction must be conducted in the course of business, vocation, or occupation for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

DISTRICT OF COLUMBIA: The state statute prohibits 31 specific practices, plus other unfair, deceptive, or unlawful trade practices. The transaction must involve trade practices involving consumer goods or services. The Office of Consumer Protection may enforce the statute for violations by a business.

FLORIDA: The state statute prohibits unfair methods of competition, unconscionable acts or practices, and deceptive or unfair acts or practices. A finding of a violation may be based on rules promulgated by the Federal Trade Commission. The transaction must be conducted in trade or commerce for the statute to apply. The Department of Legal Affairs or the state attorney's office may enforce the statute for violations by a business.

GEORGIA: The state legislature adopted the Uniform Deceptive Trade Practices Act which prohibits deceptive or unfair acts or practices in a consumer transaction or an office supply transaction. A number of specific examples are included in the statute. The statute applies to consumer transactions in trade or commerce. Georgia Office of Consumer Affairs may enforce the statute for violations by a business.

HAWAII: The state legislature adopted the Uniform Deceptive Trade Practices Act which prohibits 12 specific practices, plus any other conduct that creates a misunderstanding on the part of a consumer. The transaction must be conducted in the course of a business, vocation, or occupation for the statute to apply.

IDAHO: The state statute prohibits 18 specific practices, plus any misleading consumer practices or un-conscionable practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

ILLINOIS: The state legislature adopted the Uniform Deceptive Trade Practices Act which prohibits 26 specific practices, plus other unfair methods of competition and unfair or deceptive acts or practices. Proscribed practices include concealment or omission by a business of any material fact with an intent to cause reliance by a consumer. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

INDIANA: The state statute prohibits a number of specific practices, including transactions involving contracts with unconscionable provisions. The transaction must be a consumer transaction as defined by the statute for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

IOWA: The state statute prohibits four specific practices, plus any other unfair or deceptive acts, or concealment or omission of a material fact by a business with the intent to cause reliance on the part of the consumer. The transaction must involve the sale, offer of sale, or advertisement of goods, real property, or several intangible items described in the statue for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

KANSAS: The state statute prohibits 11 specific practices, plus any unconscionable practices as defined by the statute. The transaction must involve the sale or lease of property or services intended for personal, family, household, business, or agricultural purposes. The attorney general's office or local prosecuting attorney's office may enforce the statute for violations by a business.

KENTUCKY: The state statute prohibits unfair or deceptive acts or practices, including unconscionable practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office or county attorney's office may enforce the statute for violations by a business.

LOUISIANA: The state statute prohibits unfair methods of competition and unfair or deceptive acts or practices. The transaction must be conducted in trade or commerce for the statute to apply. The Governor's Consumer Protection Division may enforce the statute for violations by a business.

MAINE: The state legislature adopted the Uniform Deceptive Trade Practices Act. The state statute prohibits 12 specific practices, plus conduct likely to create confusion or misunderstanding to a consumer, unfair methods of competition, and unfair or deceptive acts or practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

MARYLAND: The state statute prohibits unfair or deceptive trade practices, including a number of practices specified in the statute. The transaction must involve the sale, offer for sale, or lease of consumer goods, real property, or services. Consumer debt collection and extension of consumer credit are also within the scope of the statute. The Division of Consumer Protection of the Attorney General's office may enforce the statute for violations by a business.

MASSACHUSETTS: The state statute prohibits unfair methods of competition and unfair or deceptive acts or practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

MICHIGAN: The state statute prohibits 31 specific practices, plus any other deceptive, unfair, or unconscionable acts or practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office or a district attorney's office may enforce the statute for violations by a business.

MINNESOTA: The state legislature adopted the Uniform Deceptive Trade Practices Act which prohibits 13 specific practices, plus any other deceptive or un-conscionable acts or practices. The transaction must be conducted in the course of business, vocation, or occupation for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

MISSISSIPPI: The state statute prohibits 22 specific practices, plus any other deceptive or unconscionable acts or practices. The transaction must be conducted in trade or commerce for the statute to apply. The Attorney General's Office of Consumer Protection may enforce the statute for violations by a business.

MISSOURI: The state statute prohibits deceptive or unfair acts or concealment or omission of a material fact from a consumer. The transaction may involve the sale, offer for sale, or advertisement of any merchandise for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

MONTANA: The state statute prohibits unfair methods of competition and unfair or deceptive acts or practices. The transaction must involve the sale, offer for sale, or advertisement of any real or personal property, services, intangibles, or anything of value. The attorney general's office may enforce the statute for violations by a business.

NEBRASKA: The state legislature adopted the Uniform Deceptive Trade Practices Act which prohibits 14 specific practices, plus unfair methods of competition, other unfair or deceptive acts or practices, and all unconscionable acts by a supplier in a consumer transaction. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

NEVADA: The state statute prohibits a number of deceptive trade practices set forth in the statute. The transaction must be conducted in the course of a business or occupation. The Commissioner of Consumer Affairs, Director of the Department of Commerce, attorney general's office, or a district attorney's office may enforce the statute for violations by a business.

NEW HAMPSHIRE: The state statute prohibits 12 specific practices, plus any unfair methods of competition or any other unfair of deceptive act or practice. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

NEW JERSEY: The state statute prohibits unconscionable commercial practices, deception, fraud, or the knowing concealment or omission of a material fact with the intent to cause reliance on the part of a consumer. The statute includes numerous specific prohibitions. The transaction may be conducted in conjunction with the sale or advertisement of any merchandise or real property for the statute to apply. The attorney general's office or the director of a county or municipal office of consumer affairs may enforce the statute for violations by a business.

NEW MEXICO: The state legislature adopted the Uniform Deceptive Trade Practices Act which prohibits 17 specific deceptive practices, two specific unconscionable practices, and other unfair or deceptive trade practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

NEW YORK: The state statute prohibits deceptive acts or practices and false advertising. The transaction must be conducted in business, trade, or commerce, or in the furnishing of a service in the state, for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

NORTH CAROLINA: The state statute prohibits unfair methods of competition and unfair or deceptive acts or practices. The transaction must be conducted in or affect commerce, including all business activities. The attorney general's office may enforce the statute for violations by a business.

NORTH DAKOTA: The state statute prohibits deceptive acts or practices, fraud, or misrepresentation with the intent for consumer to rely on the representation. The transaction may involve a sale or advertisement of any merchandise for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

OHIO: The state legislature adopted the Uniform Deceptive Trade Practices Act. The state statute prohibits 11 specific practices, plus any other deceptive or unconscionable acts or practices. The transaction must be a consumer transaction for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

OKLAHOMA: The state legislature adopted the Uniform Deceptive Trade Practices Act which prohibits 11 specific deceptive trade practices. The transaction must be conducted in a course of a business, vocation, or occupation for the statute to apply. The attorney general's office or a district attorney's office may enforce the statute for violations by a business.

OREGON: The state statute prohibits 20 specific unfair or deceptive acts or practices, plus two unconscionable tactics. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office or a district attorney's office may enforce the statute for violations by a business.

PENNSYLVANIA: The state statute prohibits 21 practices, plus other unfair methods of competition, deceptive acts or practices, or any fraudulent or deceptive conduct that is likely to create confusion to a consumer. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

RHODE ISLAND: The state statute prohibits 19 specific unfair methods of competition or unfair or deceptive practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

SOUTH CAROLINA: The state statute prohibits unfair methods of competition and unfair or deceptive acts or practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

SOUTH DAKOTA: The state statute prohibits knowing and intentional deceptive practices, plus practices involving an omission of a material fact in connection with a sale of merchandise to a consumer. The transaction must be conducted in business for the statute to apply. The attorney general's office or the state's attorney with attorney general approval may enforce the statute for violations by a business.

TENNESSEE: The state statute prohibits 30 specific practices, plus any other deceptive or unfair acts or practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

TEXAS: The state statute prohibits 25 specific practices, plus additional actions for breach of warranty, insurance violations, or unconscionable acts or practices. The transaction must be conducted in trade or commerce for the statute to apply. The Consumer Protection Division of the attorney general's office or a district attorney's office may enforce the statute for violations by a business.

UTAH: The state statute prohibits 15 specific unconscionable practices by a supplier in a consumer transaction, plus other deceptive acts or practices. The transaction must be a consumer transaction for the statute to apply. The Division of Consumer Protection or other state officials or agencies with authority over suppliers may enforce the statute for violations by a business.

VERMONT: The state statute prohibits unfair methods of competition and unfair or deceptive acts or practices. The transaction must be conducted in commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

VIRGINIA: The state statute prohibits 32 specific practices, plus any other fraudulent acts or practices. A supplier must conduct a consumer transaction for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

WASHINGTON: The state statute prohibits unfair methods of competition and unfair or deceptive acts or practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

WEST VIRGINIA: The state statute prohibits 16 specific practices, plus other unfair methods of competition and unfair or deceptive practices. The transaction must be conducted in trade or commerce for the statute to apply. The attorney general's office may enforce the statute for violations by a business.

WISCONSIN: The state statute prohibits 14 specific practices, plus other untrue, deceptive, or misleading representations; unfair methods of competition; and unfair trade practices. The statute applies to virtually any transaction due to the broad scope of the statutory language. The Department of Agriculture, Trade, and Consumer Protection may enforce the statute for violations by a business.

WYOMING: The state statute prohibits several specific practices, plus other unfair or deceptive acts or practices. The transaction must be conducted in the scope of a business and in a consumer transaction for the statute to apply. The attorney general's office may enforce the statute for violations by a business.
Source: Encyclopedia of Everyday Law, posted on enotes.com

Additional Resources

Revised Uniform Deceptive Trade Practices Act. National Conference of Commissioners on Uniform State Laws, 1966. Available at http://www.law.upenn.edu/bll/ulc/fnact99/1920_69/rudtpa66.h... .*State Unfair Trade Practices Law: In One Volume.* Commerce Clearing House, Inc., 2000.
Unfair and Deceptive Acts and Practices, Fourth Edition. Sheldon, Jonathan, and Carolyn L. Carter, National Consumer Law Center, 1997.
Unfair Trade Practices Laws: Resource Book. Alliance of American Insurers, 1986.
U.S. Code, Title 15: Commerce and Trade, Chapter 2: Federal Trade Commission; Promotion of Export Trade and Prevention of Unfair Methods of Competition. U. S. House of Representatives, 1999. Available at – http://uscode.house.gov/title_15.htm

Appendix 10C: Statement on "Pyramid Schemes" by Debra A. Valentine, General Counsel for the U.S. Federal Trade Commission

Presented at the International Monetary Fund's Seminar on Current Legal Issues Affecting Central Banks, Washington, D.C., May 13, 1998

I would like to thank you for the opportunity to speak about the growing international problem of pyramid schemes. What is striking about these schemes is that while they are very old forms of fraud, modern technology has vastly multiplied their potential for harming our citizens. The Internet in particular offers pyramid builders a multi-lane highway to world-wide recruits in virtually no time.

Introduction

First, let me tell you about the Federal Trade Commission.(1) The Commission is an independent government agency that Congress established in 1914. We perform a core function of government -- ensuring that free markets work. This requires competition among producers and accurate information in the hands of consumers in order to generate the best products at the lowest prices, spur efficiency and innovation, and strengthen the economy.

For competition to thrive, consumers must be knowledgeable about available products and services. Our Consumer Protection Bureau ensures that consumer information in the marketplace is not deceptive or misleading. A free market also means that consumers have a choice among products and services at competitive prices. Our Competition Bureau ensures that the marketplace is free from anti-competitive mergers and other unfair business practices such as price-fixing or placing floors on retail prices.

With the exception of a few areas like air travel and insurance, the Commission has broad law enforcement authority over virtually every sector in our economy. Unfortunately, we now see pyramid schemes invading many of the sectors that we oversee.

What is a Pyramid Scheme and What is Legitimate Marketing?

Pyramid schemes now come in so many forms that they may be difficult to recognize immediately. However, they all share one overriding characteristic. They promise consumers or investors large profits based primarily on recruiting others to join their program, not based on profits from any real investment or real sale of goods to the public. Some schemes may purport to sell a product, but they often simply use the product to hide their pyramid structure. *There are two tell-tale signs that a product is simply being used to disguise a pyramid scheme: inventory loading and a lack of retail sales. Inventory loading occurs when a company's incentive program forces recruits to buy more products than they could ever sell, often at inflated prices. If this occurs throughout the company's distribution system, the people at the top of the pyramid reap substantial profits, even though little or no product moves to market. The people at the bottom make excessive payments for inventory that simply accumulates in their basements. A lack of retail sales is also a red flag that a pyramid exists. Many pyramid schemes will claim that their product is selling like hot cakes. However, on closer examination, the sales occur only between people* <u>*inside*</u> *the pyramid structure or to new recruits joining the structure, not to consumers out in the general public.*

A Ponzi scheme is closely related to a pyramid because it revolves around continuous recruiting, but in a Ponzi scheme the promoter generally has <u>no</u> product to sell and pays no commission to investors who recruit new "members." Instead, the promoter collects payments from a stream of people, promising them all the same high rate of return on a short-term investment. In the typical Ponzi scheme, there is no real investment opportunity, and the promoter just uses the money from new recruits to pay obligations owed to longer-standing members of the program.

In English, there is an expression that nicely summarizes this scheme: It's called "stealing from Peter to pay Paul." In fact some law enforcement officers call Ponzi schemes "Peter-Paul" scams. Many of you may be familiar with Ponzi schemes reported in the international financial news. For example, the MMM fund in Russia, which issued investors shares of stock and suddenly collapsed in 1994, was characterized as a Ponzi scheme.(2)

Both Ponzi schemes and pyramids are quite seductive because they may be able to deliver a high rate of return to a few early investors for a short period of time. Yet, both pyramid and Ponzi schemes are illegal because they inevitably must fall apart. No program can recruit new members forever. Every pyramid or Ponzi scheme collapses because it cannot expand beyond the size of the earth's population.(3) When the scheme collapses, most investors find themselves at the bottom, unable to recoup their losses.

Some people confuse pyramid and Ponzi schemes with legitimate multilevel marketing. Multilevel marketing programs are known as MLM's,(4) and unlike pyramid or Ponzi schemes, MLM's have a real product to sell. More importantly, MLM's actually sell their product to members of the general public, without requiring these consumers to pay anything extra or to join the MLM system. MLM's may pay commissions to a long string of distributors, but these commission are paid for real retail sales, not for new recruits.

How Pyramid Schemes Operate

Let's look at how a pyramid scheme operates from three points of view: the potential investor, the promoter or con artist, and the victim. Many pyramid schemes will present a payout formula or matrix much like this one:

Payment of $500

Level 1 # # #
$150 x 3 = $450

Level 2 # # # # # # # # #
$30 x 9 = $270

Level 3 # # # # # # # # # # #
$30 x 27 = $810 # # # # # # # # # # # # # # # #

Level 4 etc. # # # # # # # # #
$30 x 81 = $2430 # # # # # # # # # # # # # # # # # # #etc.

$3960

This example illustrates what is known as a three by four matrix. Each investor pays $500 to the promoter and is told to build a "downline" by recruiting three new members, who then each should recruit three more members. The investor is told that he will be paid $150 for each of the three members whom he enlists at the first level. The investor is also promised a $30 commission for each recruit at the next three levels. Thus, the investor should receive commissions for four levels of recruits below him, each of whom must recruit three more members, hence the name -- a three by four matrix.

To the potential investor/recruit this may look like a very appealing opportunity. The pyramid promoter is likely to persuade the investor that he is "getting in early" and that he should consider himself at the top of the matrix. From this perspective, it appears that he can earn $3,960 on an investment of $500, a whopping 792 percent return. You can do the math easily: $150 from the first level of 3 recruits is $450; $30 from the next 3 levels of recruits is $270 ($30 x 9), plus $810 ($30 x 27), plus $2,430 ($30 x 81). Not a bad deal.

Yet, consider the matrix from the promoter/con artist's point of view. He is the person at the top of the pyramid but in fact looks at the scheme from the bottom. He views each new investor as a predicable set of revenues and expenses, with the revenues flowing down to him. The con artist receives $500 for each new member, and at most he will have to pay $240 in commissions to earlier investors in the new recruit's "upline," i.e. those people responsible for bringing him into the system. So when an investor joins the system in the last level, the promoter will receive $500, but he will pay only $150 to the person who recruited the new investor, and $30 each to three longer-standing members in the new investor's "upline," for a total of $240. Thus, the con artist will keep over half of every $500 membership fee paid.

Let's assume that this scheme collapses after the fourth level of recruits is filled. The con artist will have made $500 from the first investor in the pyramid ($500 with no commissions paid out), $350 from the 3 at the next level ($500 minus commission of $150), $320 from the 9 at the next level ($500 minus commissions of $150 + $30), $290 from the 27 at the next level ($500 minus $150 + $30 + $30), and $260 from the 81 newest investors ($500 minus commissions of $150 + $30 + $30 + $30). The simple math -- $33,320 flowed down to the con artist -- and all he did was attract one investor!

Now consider the pyramid from the investor/victim's perspective -- after the entire scheme has collapsed around him. The victim, like the first investor, thought of himself at the top of the pyramid but suddenly realizes that he is actually at the bottom, unable to find people interested in the program to build out his downline. He is not alone because mathematics shows that MOST investors will find themselves at the bottom of the pyramid when it collapses. The very structure of this matrix dictates that whenever the collapse occurs, at least 70 percent will be in the bottom level with no means to make a profit. They all will be out $500. In our example, even those people one level above the bottom will not have recouped their investment. They each will have paid a membership fee of $500 and collected commissions of $150 for each of three recruits, leaving each investor in the second-from-the-bottom tier at least $50 shy of his break-even point. In short, when the pyramid collapses all the investors in the bottom two levels will be losers. *Adding together the number of victims from these bottom two levels shows that 89 percent of all the pyramid's participants (108 of 121 investors) are doomed to lose money.*

A Ponzi scheme could yield even worse results for investors, because it does not pay out any commissions at all. This can have disastrous consequences, as exemplified by Charles Ponzi's infamous fraud in the 1920's. Charles Ponzi, an engaging ex-convict, promised the Italian-American community of South Boston that he would give them a 50 percent return on their money in just 45 to 90 days.(5) Mr. Ponzi claimed that he could pay such a high rate of return because he could earn 400 percent by trading and redeeming postal reply coupons. These coupons had been established under the Universal Postal Convention to enable a person in one country to pre-pay the return postage on a package or letter sent back from another country.

For a short time after World War I, fluctuations in currency exchange rates did create a disparity between the cost and redemption value of postal reply coupons among various countries. However, Mr. Ponzi discovered that he could only make a few cents per coupon and that handling large volumes of coupons cost more than they were worth. He stopped redeeming any coupons but continued to collect investors' money. When he actually paid a 50 percent return to some early investors, his reputation soared and more money flowed in from around the country. Mr. Ponzi bought a stylish house in the best part of town and purchased a large minority interest in his local bank, the Hanover Trust Company.

Eventually his scheme began to unravel, bringing ruin to the bank and thousands of investors. When Mr. Ponzi began to overdraw his accounts at Hanover Trust, the Massachusetts Banking Commissioner ordered Hanover Trust to stop honoring Ponzi's checks. The bank refused and even issued back-dated certificates of deposit to cover Mr. Ponzi's overdrafts. A few days later, the Banking Commission took over Hanover Trust, and Mr. Ponzi was arrested for mail fraud. In the end, Charles Ponzi owed investors over $6 million, an enormous sum of money for that time. He was convicted of fraud in both state and federal court and served ten years in prison.(6)

Law Enforcement Partners

The legacy of Mr. Ponzi lives on as pyramid and Ponzi schemes continue to plague us and challenge the law enforcement community. Fortunately, in the U.S., the Federal Trade Commission is just one among many agencies that have the authority to file suit to stop this type of fraud. The Securities and Exchange Commission also pursues these schemes, obtaining injunctions against so-called "financial distribution networks" which in fact sell unregistered "securities."(7) The U.S. Department of Justice, in collaboration with investigative agencies like the FBI and the U.S. Postal Inspection Service, prosecutes pyramid schemes criminally for mail fraud, securities fraud, tax fraud, and money laundering.(8)

State officials independently file cases in state court, often under specific state laws that prohibit pyramids. California defines pyramids as "endless chains" and prohibits them under its laws against illegal lotteries.(9) In a slightly different vein, Illinois classifies pyramid schemes as criminal acts of deception directed against property.(10) Some states like Georgia prohibit pyramid schemes under a statutory framework that regulates business opportunities and multilevel marketing.(11)

At the Commission, we bring cases against pyramid schemes under the FTC Act, which broadly prohibits "unfair or deceptive acts or practices in or affecting commerce."(12) That Act allows the Commission to file suit in federal court and seek a variety of equitable remedies, including injunctive relief, a freeze over the defendants' assets, a receivership over the defendants' business, and redress or restitution for consumers.

FTC Precedent from the 1970's

The Commission took its first concerted action against pyramid schemes in the 1970's during a boom in home-based business and MLM or direct selling. One-on-one marketing became common for many consumer items -- from cosmetics to kitchenware, and Tupperware™ parties became an icon of the era. Unfortunately, the rise in legitimate multilevel marketing was accompanied by a surge in pyramid schemes. Those schemes played off the popularity of MLM or network sales but paid more attention to networking than to selling actual goods. Pyramid schemes became so notorious that then-Senator Walter Mondale sponsored a federal anti-pyramiding bill. It passed the United States Senate twice in the 1970's, but never became law.(13)

One of the Commission's first cases was In re Koscot Interplanetary, Inc.,(14) which involved a company that offered the opportunity to become a "Beauty Advisor" and sell cosmetics. The company's incentive structure really did not encourage retail sales. Instead, it encouraged people to pay $2000 for the title of "Supervisor" and purchase $5400 in Koscot cosmetics, and then to earn bonuses by recruiting others to make the same investments.(15) The Commission found that Koscot operated an illegal "entrepreneurial chain" and articulated a definition of illegal pyramiding that our agency and the federal courts continue to rely on.(16) The Commission found that pyramid schemes force participants to pay money in return for two things. First is "the right to sell a product", second is "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. (emphasis added)"(17) The Commission explained that paying bonuses for recruiting:

. . . will encourage both a company and its distributors to pursue that side of the business, to the neglect or exclusion of retail selling. The short-term result may be high recruiting profits for the company and select distributors, but the ultimate outcome will be neglect of market development, earnings misrepresentations, and insufficient sales for the insupportably large number of distributors whose recruitment the system encourages."(18)

In In re Amway Corp.,(19) another landmark decision from the 1970's, the FTC distinguished an illegal pyramid from a legitimate multilevel marketing program. At the time, Amway manufactured and sold cleaning supplies and other household products. Under the Amway Plan, each distributor purchased household products at wholesale from the person who recruited or "sponsored" her. The top distributors purchased from Amway itself. A distributor earned money from retail sales by pocketing the difference between the wholesale price at which she purchased the product, and the retail price at which she sold it. She also received a monthly bonus based on the total amount of Amway products that she purchased for resale to both consumers and to her sponsored distributors.(20)

Since distributors were compensated both for selling products to consumers and to newly-recruited distributors, there was some question as to whether this was a legitimate multilevel marketing program or an illegal pyramid scheme. The Commission held that, although Amway had made false and misleading earnings claims when recruiting new distributors,(21) the company's sales plan was not an illegal pyramid scheme.

Amway differed in several ways from pyramid schemes that the Commission had challenged. It did not charge an up-front "head hunting" or large investment fee from new recruits, nor did it promote "inventory loading" by requiring distributors to buy large volumes of nonreturnable inventory. Instead, Amway only required distributors to buy a relatively inexpensive sales kit. Moreover, Amway had three different policies to encourage distributors to actually sell the company's soaps, cleaners, and household products to real end users. First, Amway required distributors to buy back any unused and marketable products from their recruits upon request. Second, Amway required each distributor to sell at wholesale or retail at least 70 percent of its purchased inventory each month -- a policy known as the 70% rule. Finally, Amway required each sponsoring distributor to make at least one retail sale to each of 10 different customers each month, known as the 10 customer rule.(22)

The Commission found that these three policies prevented distributors from buying or forcing others to buy unneeded inventory just to earn bonuses. Thus, Amway did not fit the Koscot definition: Amway participants were not purchasing the right to earn profits unrelated to the sale of products to consumers "by recruiting other participants, who themselves are interested in recruitment fees rather than the sale of products."(23)

Pyramid Schemes in the 1990's

The 1990's first brought an important refinement in the law. As the Commission pursued new pyramid cases, many defendants proclaimed their innocence, stating that they had adopted the same safeguards -- the inventory buy-back policy, the 70% rule, and the 10 customer rule -- that were found acceptable in Amway. However, an appellate court decision called Webster v. Omnitrition Int'l, Inc.,(24)pointed out that the Amway safeguards do not immunize every marketing program. *The court noted that the "70% rule" and "10 customer rule" are meaningless if commissions are paid based on a distributor's wholesale sales (which are only sales to new recruits), and not based on actual retail sales*.(25) The court also noted that an inventory buy-back policy is an effective safeguard only if it is actually enforced.(26)

While new cases were refining the law in the 1990's, radical changes were underway in the marketplace. Pyramid schemes came back with a vengeance. Like most economic activity, fraud occurs in cycles, and new pyramid schemes exploited a new generation of consumers and entrepreneurs that had not witnessed the pyramid problems of the 1970's. Also, the globalization of the economy provided a new outlet for pyramiding. Pyramids schemes found fertile ground in newly emerging market economies where this type of fraud had previously been scarce or unknown.(27) In Albania, for example, investors poured an estimated $1 billion into various pyramid schemes -- a staggering 43% of the country's GDP.(28)

In the U.S., probably nothing has contributed to the growth of pyramid schemes as much as Internet marketing. The introduction of electronic commerce has allowed con artists to quickly and cost-effectively target victims around the globe. After buying a computer and a modem, scam artists can establish and maintain a site on the World Wide Web for $30 a month or less, and solicit anyone in the world with Internet access. Pyramid operators can target specific audiences by posting messages in specialized news groups (e.g., "alt.business.home" or "alt.make.money.fast"). In addition, through unsolicited e-mail messages -- known on the Internet as "spam" -- pyramid operators can engage in cheap one-on-one marketing. Whereas it might cost hundreds or thousands of dollars to rent a mailing list and send 10-cent post cards to potential recruits, it costs only a fraction of that to send out similar e-mail solicitations. On the Internet, you can acquire one million e-mail addresses for as little as $11 and spend nothing on postage.(29)

The Federal Trade Commission's current law enforcement efforts reflect this new wave in pyramiding. The Commission has brought eight cases against pyramid schemes in the last two years,(30) and six of those have involved Internet marketing.(31) One recent case,FTC v. FutureNet, Inc., is particularly instructive because it starkly reflects the potential for abuse in hi-tech and newly deregulated industries. FutureNet allegedly claimed that, for payment of $195 to $794, investors could earn between $5000 and $125,000 per month as distributors of Internet access devices like WebTV. *The FTC filed suit, charging that FutureNet's earnings claims were false because the company really operated an illegal pyramid scheme.* Near the time of filing, FTC investigators discovered that FutureNet had begun to sell electricity investments as well, riding a wave of speculation in advance of the deregulation of California's electricity market.

The Commission obtained a TRO and an asset freeze over the defendants' assets and eventually reached a $1 million settlement with the corporate defendants and two individual officers. The settlement requires the defendants to pay $1 million in consumer redress, bars them from further pyramiding activity of any kind, requires them to post a bond before engaging in any network marketing, and requires them to register with state utility officials before engaging in the sale of electricity. The Commission continues to litigate its case against three non-settling individual defendants.(32)

The Impact of Pyramids on Banking

Pyramid schemes not only injure consumers. In many cases, they affect the daily operations of banks and taint the banking industry's overall reputation for safety and soundness. Many pyramid promoters disparage the bank industry and promote their own program as a superior alternative to traditional banking and investment. Melvin Ford, a defendant in the SEC's recent case against International Loan Network, stated that his company's bonus program was "the most powerful financial system since banking."(33) At the height of his popularity, Charles Ponzi actually proclaimed that he would form a new banking system and divide profits equally between depositors and shareholders.(34)

In FTC v. Cano,(35) the Commission observed first-hand the impact of pyramid schemes on the banking system and individual banks. In that case, the Commission targeted an alleged Internet pyramid scheme that operated under the name Credit Development International ("CDI"). For an initial payment of $130 and subsequent monthly payments of $30, consumers could join CDI's "Platinum Infinity Reward Program" and become a participant in its "3x7 Forced Matrix" -- a structure that promised commissions going seven layers deep and that required each participant to recruit just three new members. CDI represented that participants could earn more than $18,000 per month in this program.

Besides the promise of high profits, the real attraction of CDI was its offer of an unsecured Visa or MasterCard, with a $5000 credit limit and a low 6.9% annual financing rate. This offer was especially attractive to consumers with poor credit histories, to whom CDI advertised saying "Guaranteed Approval, No Security Deposit! No Credit Check, No Income Verification and Bankruptcies No Problem!"(36)

CDI representatives claimed that they could offer such attractive terms because they had a special marketing relationship with a large overseas bank, the Banque Nationale de Paris (BNP). According to the transcript of a taped sales meeting, CDI hinted that a broad conspiracy prevented U.S. banks from offering such favorable terms. A CDI representative claimed, "normal banks do not want people to know that they could have a 6.9 [percent] credit card."(37) In the same meeting, CDI painted itself an alternative to a regular bank and said "our whole concept is to have the largest membership credit union in the world."(38) "We're the bank."(39)

In fact, according to the Commission's evidence, CDI had no business relationship with Visa, MasterCard, or BNP, and no relationship with any bank willing to issue credit cards to CDI members. Our evidence also showed that the defendants likely misled the one bank with which they did have a relationship. When investors paid by credit card to join CDI, the defendants apparently processed these payments, not through CDI but through a different "front" company with a VISA merchant account. Consequently, the defendants put their own merchant bank at risk for any charge backs that VISA might credit to angry investors.

In the end, CDI members never received their credit cards, and according to a Commission economist, at least 89 percent of them would never have made enough money to recoup their initial investment. Last autumn, the Commission obtained a temporary restraining order and a preliminary injunction against the CDI defendants, as well as a freeze over their assets. The Commission estimates that over the five-month life of CDI, more than 30,000 consumers from the U.S., Europe, Australia, and Southeast Asia lost $3 to $4 million dollars in this alleged scam. The matter is still in litigation; the Commission is now seeking to amend its complaint and name additional defendants.

In the largest pyramid case brought by the Commission in the 1990's, we witnessed how pyramid operators often try to use the international banking system to hide their assets. In FTC v. Fortuna Alliance,(40) the defendants allegedly promised consumers that, for a payment of $250, they would receive profits of over $5,000 per month. The program spawned numerous web sites on the Internet and victimized thousands of investors across 60 different countries. Although the defendants initially operated out of the United States, the Commission discovered they had secreted millions of dollars to offshore bank accounts in Antigua. But international cooperation saved the day. With the aid of the courts and banks in Antigua, the Commission obtained an order against the defendants, requiring them to repatriate over $2 million in offshore assets and pay approximately $7 million in redress to consumers from 60 countries.

Consumer Education

Law enforcement is the cornerstone of the Commission's fight against pyramid schemes; however, we also try to educate the public so that they can protect themselves. In our educational efforts, we have tried to take a page from the con artists' book and use new online technology to reach consumers and new entrepreneurs. For example, on the agency's web site at "www.ftc.gov", the Commission has posted several alerts regarding pyramid schemes and multilevel marketing problems. The Commission records over 2 million "hits" on its home page every month and receives several thousand visitors on its pyramid and multilevel marketing pages.

The staff of the Commission also has posted several "teaser" web sites, effectively extending a hand to consumers at their most vulnerable point -- when they are surfing areas of the Internet likely to be rife with fraud and deception. The "Looking for Success" site is one example. It advertises a fake pyramid scheme. The home page of "Looking for Success" promises easy money and talks in glowing terms about achieving "financial freedom." On the second page, the consumer finds a payout plan common to pyramid schemes, as well as typical buzz words like "forced matrix," "get in early," and "downline." Clicking through to the third and final page in the series, however, brings the consumer to a sobering warning: "If you responded to an ad like this one, you could get scammed." The warning page provides a hyper-text link back to FTC.GOV, where consumers can learn more about how to avoid pyramid schemes.

Business Education

In an effort to provide information to new entrepreneurs, especially those who may unwittingly violate the law, the Commission has conducted a number of "Surf Days" on the Internet. The first Surf Day, conducted in December 1996, focused on pyramid schemes. Commission attorneys and investigators enlisted the assistance of the SEC, the U.S. Postal Inspection Service, the Federal Communications Commission, and 70 state and local law enforcement officials from 24 states. This nationwide ad hoc task force surfed the Internet one morning, and in three hours, found over 500 web sites or newsgroup messages promoting apparent pyramid schemes. The Commission's staff e-mailed a warning message to the individuals or companies that had posted these solicitations, explaining that pyramid schemes violate federal and state law and providing a link back to FTC.GOV for more information.

In conjunction with the New York Attorney General's Office and the Interactive Service Association, the Commission announced the results of Internet Pyramid Surf Day at a televised press conference in New York City. A month later, the

Commission's investigative staff revisited web sites or newsgroups identified as likely pyramids during Surf Day and found that a substantial number had disappeared or improved their representations and claims made to consumers.

More recently in October 1997, the Commission helped coordinate the first "International Internet Surf Day." Agencies from 24 countries joined this effort and targeted "get-rich-quick" schemes on the Internet, including pyramid schemes.(41) Australia's Competition and Consumer Commission oversaw the world-wide effort while the FTC led the U.S. team consisting of the SEC, the Commodities Futures Trading Commission ("CFTC") and 23 state agencies.

In February of this year, the Commission announced yet another innovative use of the Surf Day concept, this time targeting deceptive e-mail solicitations. The Commission collects unsolicited commercial e-mail from annoyed consumers and other sources. A large percentage of these e-mails contain apparent chain letters or pyramid schemes. The Commission searched its e-mail database, topic by topic, and along with the Postal Inspection Service sent a warning letter to over 1000 individuals or companies identified as potentially responsible for promoting pyramids or other get-rich-quick schemes.

Looking Ahead

Unfortunately, pyramid schemes are likely to continue to proliferate both here and abroad in the near future. However, we can all help stem the tide by working together. Members in the the banking or financial sector can help law enforcement agencies in several ways. First, if your country does not have a law that makes pyramid schemes illegal, you should encourage your government to enact the necessary legislation and provide sufficient resources for enforcers to pursue pyramid schemes. Associations of reputable bankers or insurers, whose businesses can be jeopardized by the illicit schemes of unlicensed insurers or securities dealers, can be effective allies.

Recent history in Eastern Europe makes it only too clear that pyramid schemes exploit the absence of a fully-functioning market, adequate supervision, and/or an effective legal infrastructure. Second, you can report any suspect investment programs or potential pyramid schemes. Any information can help, and you may be able to provide valuable insight into who is operating a pyramid, how it works, and whom it victimizes. In the Cano case, it was the substantial assistance of financial fraud investigators at VISA that enabled the Commission to develop and bring its case. Third, help us and others foreign enforcers to identify and freeze defendants' assets located in your countries. Understandably, banks must observe their privacy laws, but to the extent it is legally possible for you to provide assistance in tracing and freezing the assets of pyramid operators, you will benefit all our citizens. This is often the only way to halt an illegal scheme and return money to victims. We hope that the Fortuna Alliance case signals the beginning of a trend in obtaining valuable help from foreign courts and banks.

Finally, you can encourage the relevant officials in your countries to combat pyramid schemes by educating consumers and businesses about how to recognize and avoid this type of fraud. This can be particularly important in emerging markets, where experience with investment opportunities may be scarce.

Here are some tips that consumers and business might find helpful.

1. Beware of any plan that makes exaggerated earnings claims, especially when there seems to be no real underlying product sales or investment profits. The plan could be a Ponzi scheme where money from later recruits pays off earlier ones. Eventually this program will collapse, causing substantial injury to most participants.

2. Beware of any plan that offers commissions for recruiting new distributors, particularly when there is no product involved or when there is a separate, up-front membership fee. At the same time, do not assume that the presence of a purported product or service removes all danger. The Commission has seen pyramids operating behind the apparent offer of investment opportunities, charity benefits, off-shore credit cards, jewelry, women's underwear, cosmetics, cleaning supplies, and even electricity.

3. If a plan purports to sell a product or service, check to see whether its price is inflated, whether new members must buy costly inventory, or whether members make most "sales" to other members rather than the general public. If any of these conditions exist, the purported "sale" of the product or service may just mask a pyramid scheme that promotes an endless chain of recruiting and inventory loading.

4. Beware of any program that claims to have a secret plan, overseas connection or special relationship that is difficult to verify. Charles Ponzi claimed that he had a secret method of trading and redeeming millions of postal reply coupons. The real secret was that he stopped redeeming them. Likewise, CDI allegedly represented that it had the backing of a special overseas bank when no such relationship existed.

5. Beware of any plan that delays meeting its commitments while asking members to "keep the faith." Many pyramid schemes advertise that they are in the "pre-launch" stage, yet they never can and never do launch. By definition pyramid schemes can never fulfill their obligations to a majority of their participants. To survive, pyramids need to keep and attract as many members as possible. Thus, promoters try to appeal to a sense of community or solidarity, while chastising outsiders or skeptics. Often the government is the target of the pyramid's collective wrath, particularly when the scheme is about to be dismantled. Commission attorneys now know to expect picketers and a packed courtroom when they file suit to halt a pyramid scheme. Half of the pyramid's recruits may see themselves as victims of a scam that we took too long to stop; the other half may view themselves as victims of government meddling that ruined their chance to make millions. Government officials in Albania have also experienced this reaction in the recent past.

6. Finally, beware of programs that attempt to capitalize on the public's interest in hi-tech or newly *deregulated markets. Every investor fantasizes about becoming wealthy overnight, but in fact, most hi-tech ventures are risky and yield substantial profits only after years of hard work. Similarly, deregulated markets can offer substantial benefits to investors and consumers, but deregulation seldom means that "everything goes," that no rules apply, and that pyramid or Ponzi schemes are suddenly legitimate.*

Conclusion

As we continue to pursue pyramid schemes, we would be delighted to coordinate our efforts with law enforcement in your countries. It is only too evident that the expansion of fraud across borders and on the World Wide Web means that no one agency or country can work effectively on its own. We must be collectively vigilant in order to protect the integrity of our marketplaces and the pocketbooks of our consumers.

References

1. The views I give, of course, are my own and do not reflect the official views of the Commission or any particular Commissioner.
2. Barbara Rudolph, Poof Go the Profits . . ., Time, Aug. 8, 1994 at 44.
3. Assume a pyramid scheme in which each person recruits 10 new people. There would be one person at the top, 10 beneath her, 100 beneath them, 1,000 beneath them and so forth. The pyramid would involve everyone on earth in just 10 layers of people with one con artist on top. The bottom layer would have more than 4.5 billion people. The Skeptic's Dictionary at "http://wheel.vcdavis.edu/nbtcarrol/skeptic/pyramid.html"
4. Some people also refer to multilevel marketing as direct selling or network selling.
5. See Mark C. Knutson, "The Ponzi Scheme," published online at "http://www.usinternet.com/users/mcknutson/pscheme.htm".
6. Id.
7. See e.g., SEC v. Int'l Load Network, Inc., 770 F. Supp. 678 (D.D.C 1991), aff'd, 968 F.2d 1304 (D.C. Cir. 1992)..
8. See e.g. U.S. v. Crowe, 4:95CR-13-C (W.D. Ky. 1995) (charging an alleged pyramid promoters with mail fraud under 18 U.S.C. § 1341; securities fraud under 15 U.S.C. § § 78j(b), 78ff, 17 C.F.R. § 240.10b-5, and 18 U.S.C. § 2; and money laundering under 18 U.S.C. § § 2, 1957.)
9. Cal. Penal Code § 327 (Deering 1996)
10. 720 Ill. Compiled Stat. Ann. 5/17-7 (Michie 1997) (formerly Ill. Rev. Stat., ch. 38, para. 17/7 (1993))
11. Ga. Code Ann. § 10-1-410 (1997)
12. 15 U.S.C. § 45 (1997)
13. See Thomas P. Rowan, Report, Confronting the Pyramid Hazard in the United States 15 (submitted to Prof. Robert Vaughn, Wash. College of Law, Am. U.) (1998) (citing Joseph N. Mariano & Mario Brossi, Multilevel Marketing: A Legal Primer 29 (2d ed. 1997)).
14. 86 F.T.C. 1106 (1975), aff'd sub. nom. Turner v. FTC, 580 F.2d 701 (D.C. Cir. 1978).
15. Id. at 1108-110 (complaint).
16. See e.g., Webster v. Omnitrition Int'l, Inc., 79 F.3d 776, 781-82 (9th Cir. 1996), cert. denied, 117 S. Ct. 174, __ U.S. __ (1996).
17. Koscot 86 F.T.C. at 1180.
18. Id. at 1181.
19. 93 F.T.C. 618 (1979)
20. Id. at 710-14.
21. Id. at 729-33.
22. Id. at 715-17
23. Id. See Rowan at 18-21 (analyzing the Amway decision).
24. 79 F.3d 776, 781-82 (9th Cir. 1996), cert. denied, 117 S. Ct. 174, __ U.S. __ (1996).
25. Id. at 783.
26. Id. at 783-84.
27. Tom Hundley, Always Poor, Albanians Go for Broke, Chicago Tribune, Feb. 11, 1997 at 18.
28. Id. For an analysis of the effect of pyramid and Ponzi schemes on Eastern Europe's insurance market, see Int'l Chamber of Commerce, Pyramid sales of insurance policies condemned, Business World, July 9, 1997 at "http://www.iccwbo.org/html/pyramid.htm".
29. Ram Avrahami, FTC Workshop on Consumer Information Privacy, Transcript of June 12, 1997 at 107.
30. See FTC v. Affordable Media, LLC, Civil Action No. CV-S-98-00669-LDG) (D. Nev. filed April 23, 1998); FTC v FutureNet, Inc., No. 98-1113 FHK (AIJx) (C.D. Cal. filed Feb. 17, 1998); FTC v. Cano, No. (C.D. Cal. filed Oct. 29, 1997); FTC v. Jewelway Int'l Inc., No. CV-97-383 TUC JMR (D. Ariz. filed June 24, 1997); FTC v. World Class Network, Inc., No. SAV-97-162 AHS (Ebx) (C.D. Cal. filed Feb. 28, 1997); FTC v. Mentor Network, Inc., No. SACV 96-1104 LHM (Eex), (C.D. Cal. filed Nov. 5, 1996); FTC v. Global Assistance Network for Charities, No. CIV 96-2494 PHX RCB (D. Ariz. filed Nov. 5, 1996); FTC v. Fortuna Alliance, L.L.C., No. C96-799M (W.D. Wash. filed May 23, 1996).
31. Based on complaints the FTC has filed, the Internet was a major recruiting tool used in FutureNet, Cano, World Class Network, Mentor Network, Global Assistance Network for Charities, and Fortuna Alliance.
32. See, FTC, FutureNet Defendants Settle FTC Charges: $ 1 Million in Consumer Redress for "Distributors", Apr. 8, 1998 at "/opa/9804/futurenet.htm" (press release).
33. Int'l Loan Network, 770 F. Supp. at 678.
34. Knutson, supra, note 5.
35. Cano, supra, note 30.
36. Exhibits in Support of Motion for TRO and Asset Freeze, Ex. 2, Attachments 2, 7, Cano, supra, note 30.
37. Exhibits in Support of Motion for TRO and Asset Freeze, Ex. 2, Attachment 5 at 141, Cano, supra, note 30 (transcript of sales presentation) [hereafter "Transcript"].
38. Id. at 86.
39. Id. at 110.
40. Fortuna Alliance, supra, note 30.
41. International participants included Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Hungary, Ireland, Jamaica, Japan, Korea, Mexico, New Zealand, Norway, the Philippines, Poland, Portugal, South Africa, Spain, Sweden, Switzerland, and the United Kingdom.

Appendix 10D: Some Important MLM Cases

OFF-SHORE MLM – U.S. v. Fortuna[97]

In February, 1997, the FTC reached a settlement with Fortuna Alliance. This is how the FTC's formal press release described the FTC action:

INTERNET PYRAMID OPERATORS, FORTUNA ALLIANCE, COULD RETURN OVER $5 MILLION TO CONSUMERS

"Consumers who lost money investing in an illegal pyramid scheme on the Internet will recover their funds, under a settlement obtained by the Federal Trade Commission and the scheme's promoters, and Fortuna Alliance. Under the settlement, every Fortuna member is entitled to receive a refund in full for their membership fees.

"In the complaint detailing the charges, the FTC charged that Fortuna Alliance, L.L.C., and four officers, marketed the pyramid scheme through a home page on the World Wide Web and with printed promotional materials. Using fabulous earnings claims, they induced tens of thousands of consumers in over 60 countries around the world to pay between $250 and $1750 to join their pyramid scheme, claiming that members would receive over $5,000 per month in 'profits' as others were induced to 'enroll.' In addition, Fortuna and its officers provided advice and promotional materials for members to recruit others to join the pyramid, both through direct contact and by setting up their own web sites. The FTC's complaint asked the court to order a permanent halt to the alleged deceptive practices and to order redress for the people Fortuna signed up to the scheme.

"The redress program will offer consumers who invested in the scheme, including foreign nationals, full refunds for membership fees they paid. The money will come from a fund initially using money frozen in the U.S. and $2.8 million transferred from Antigua, W.I. If this is insufficient to meet refund requests, defendants will pay additional money to ensure full refunds for all who seek them. Consumers who receive refunds from the $2 million already distributed will not receive further payments. The FTC expects refund notices to be sent out by the end of March."

For Release: November 17, 1997

FTC SETTLEMENT WITH JEWELWAY INTERNATIONAL DEFENDANTS NETS $5 MILLION IN CONSUMER REDRESS

The Federal Trade Commission has settled charges against JewelWay International, Inc., and its corporate officers in an agreement requiring a $5 million payment, which will be distributed to harmed consumers, and provisions halting the challenged conduct. In June of this year, the FTC charged JewelWay and six individual defendants with making deceptive earnings claims, and promising lucrative earnings and other benefits to induce almost 200,000 consumers to invest more than $1000 per person in an illegal multi-level marketing plan, or pyramid scheme. The suit was filed as part of the FTC's "Project Field of Schemes" - a sweep targeted at investment-related fraud.

Legitimate multi-level marketing plans are a way of making retail sales of products or services to consumers through a network of representatives. However, in an illegal pyramid scheme the main focus is not on sales, but on recruiting new representatives into the program. Typically, each new representative must buy a certain amount of products and must recruit a specified number of new participants in order to earn money in the program. **In a pyramid scheme there is almost no emphasis on making retail sales of products to persons who are not participants in the program**. According to an FTC expert, earnings claims made in conjunction with promoting a pyramid scheme are false because pyramids inevitably collapse when no new participants can be recruited and approximately 90%

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[97] Source: Jeffrey A. Babener, Babener & Associates
121 SW Morrison, Suite 1020, Portland, OR 97204
Jeffrey A. Babener, the principal attorney in the Portland, Oregon law firm of Babener & Associates, represents many of the leading direct selling companies in the United States and abroad. Website URL for article – http://www.mlmlegal.com/fortuna.html

(or possibly more) of the participants consequently lose their money.
On June 24, the FTC filed charges against JewelWay International, Inc., Bruce A. Caruth, Robert J. Charette, Jr., Donilyn A. Walden, Greg G. Stewart, Angela D. Charette, and Beverly Stewart. The JewelWay case was part of "Project Field of Schemes," a campaign comprised of nearly 61 law-enforcement actions with a major consumer education component.

In its complaint against JewelWay, the FTC alleged that the defendants were operating a pyramid scheme because their promotional efforts focused primarily on recruiting and not on retail sales to non-participants. The FTC further alleged that the defendants made deceptive earnings claims in order to induce consumers to make a token purchase of jewelry and become a JewelWay representative able to recruit additional participants for the company. A judge immediately issued a temporary restraining order freezing the defendants' assets and placing the company into receivership. On July 1, 1997, the defendants agreed to a preliminary injunction that corrected the allegedly illegal conduct.

The FTC's settlement has been submitted to the court and requires the court's approval to become binding. The settlement would require defendants Caruth, Robert and Angela Charette, and Walden to pay $5 million in redress to the approximately 150,000 representatives who invested in JewelWay's program but earned no money. The monies would be due within five days from the date the court enters the order.

In addition, the settlement would prohibit all defendants and JewelWay representatives from operating any pyramid schemes, and:

- **prohibit them from misrepresenting the potential earnings, sales, discounts, benefits, or upgrades that a consumer can obtain, the value of any product or service offered by the company, or any other material fact;**
- prohibit them from representing that the defendants have received the approval or endorsement of the Federal Trade Commission for any product or service marketed or sold by any defendant;
- **prohibit the defendants from requiring a person to make a product purchase in order to become a participant in the program or to receive a particular level of compensation in the plan. In addition, statements suggesting that it would be beneficial to make a purchase in order to participate in the program are prohibited;**
- require the defendants to implement a refund program under which consumers will receive a 100 percent refund of the product purchase price for returns made within 60 days of the date of delivery and a 90 percent refund for returns made within 61 days to one year of the date of delivery if merchandise is returned in resalable condition. In addition, the defendants would be required to give consumers a 100 percent refund for defective products if a request is made within 60 days of delivery;
- **require the defendants and program participants to disclose the percentage of all representatives in the program who have received a particular reward (e.g., a specific income level, car or home allowance, vacation package) at the time a claim is made regarding income potential or likelihood of earning other types of rewards;**
- require the defendants to redeem any currently existing or prospectively issued gift or product certificate for products unless an expiration date is clearly stated on the certificate and the expiration date has passed;
- require the defendants to review all representatives' advertisements before allowing the ads to run;
- require the defendants to obtain from each new representative a signed verification form, which the defendants must review before depositing any of the representative's money, to ensure that none of the prohibited claims were made (if the defendants do not receive a completed verification form from a consumer, the purchase price must be refunded);
- require the defendants to institute a monitoring program to ensure that their

representatives are complying with the settlement provisions, to investigate and resolve promptly all consumer complaints, and to submit to the FTC data concerning the total amount of retail sales made by representatives on an annual basis; and

- **require the defendants to implement a 90 day "cooling off" period, under which the purchaser of JewelWay's jewelry cannot join the company as a representative for 90 days (the FTC said this provision will allow purchasers time to become acquainted with the product before committing to the network and, in conjunction with the refund policy, will bar high pressure sales tactics).**

Finally, the settlement would require the defendants to post the injunctive provisions of the settlement on the World Wide Web, distribute a copy of these provisions to all of their employees, and send a letter describing the misrepresentations and practices prohibited by the settlement agreement to all active representatives, which could total more than 40,000.

The FTC's Denver Regional Office handled this case.

The Commission vote to approve the settlement for filing in court was 4-0. The stipulated final judgment was filed on November 17, 1997, in the U.S. District Court for the District of Arizona, in Tucson.

NOTE: This consent judgment is for settlement purposes only and does not constitute an admission by the defendants of a law violation. Consent judgments have the force of law when signed by the judge.

Copies of the proposed settlement and other documents associated with Project "Field of Schemes," are available from the FTC's Public Reference Branch, Room 130, 6th Street and Pennsylvania Avenue, N.W., Washington, D.C. 20580; 202-326-2222; TTY for the hearing impaired 1-866-653-4261. To find out the latest FTC news as it is announced, call the FTC's NewsPhone recording at 202-326-2710. FTC news releases and other materials also are available on the Internet at the FTC's World Wide Web Site at: *http://www.ftc.gov* . . .

(Civil Action No. CV-97-383 TUC JMR)
(FTC Matter No. X970054)

WORLD CLASS NETWORK
For Release: November 26, 1997

DEFENDANTS IN FTC CASE TARGETING MULTI-LEVEL MARKETING OF TRAVEL BUSINESS OPPORTUNITY AND PYRAMID SCHEMES AGREES TO SETTLE CHARGES

Jerome L. Goldberg has agreed to settle Federal Trade Commission charges stemming from his involvement with World Class Network, Inc., a multi-level marketer of travel agent credentials and a work-at-home travel agency business opportunity, which was charged by the Federal Trade Commission as part of "Operation Trip-Up," a March 1997 crackdown on travel-related fraud. Goldberg is the former owner of World Class Travel, L.L.C., which purportedly provided support and ticketing for World Class Network's distributor/travel agents.

The proposed settlement with Goldberg and World Class Travel would prohibit the defendants from participating in any pyramid marketing program, and would prohibit them from misrepresenting potential earnings, benefits or other material facts in connection with the sale of a travel agent business opportunity.

On Feb. 28, the FTC filed charges against World Class Network, Inc. (WCN), of Irvine, California; World Class Travel, L.L.C., of Calabasas, California; and the following officers: WCN Board Chairman Daniel R. Dimacale and Secretary Denise L. Dimacale, both of Newport Beach; WCN Executive Vice President and CFO Robert C.K. Lee, Mission Viejo; WCN President and CEO Howard K. Cooper, of Woodland Hills; and World Class Travel Chairman and CEO Jerome L. Goldberg, of Oxnard. In its court complaint in the WCN case, the FTC alleged that the defendants offered a travel tutorial kit that purportedly would allow purchasers to receive the professional courtesy discounts and upgrades traditionally available to travel agents on their own travel accommodations, and to operate and achieve specified earnings in an at-home travel business. Distributors also could receive commissions by recruiting new distributors and reselling the tutorial to these recruits. In fact, the FTC charged, purchasers could not obtain the promised discounts and upgrades for personal travel because many travel industry service providers did not recognize World Class Network's proprietary I.D. and the travel tutorials were inadequate to allow purchasers to open and operate a functioning business. A judge immediately issued a temporary restraining order halting the challenged practices, freezing the defendants' assets, and placing the companies into receivership. WCN, the Dimacales, Lee and Cooper have previously settled charges with the FTC, and have agreed to pay more than $3 million into a consumer redress fund. The money will be used to provide refunds to many of the more than 51,000 consumers who purchased World Class Network's travel tutorial.

The proposed settlement with Goldberg and World Class Travel, which requires approval of the court, would prohibit the defendants from:

- engaging in any pyramid schemes, which the settlement defines as a program where a distributor's income is derived from commissions for recruiting additional distributors;
- misrepresenting the potential earnings, sales, discounts, upgrades or benefits that a consumer can obtain, that the defendants have received the approval or endorsement of the Federal Trade Commission, or any other material fact; and
- failing to disclose, in connection with any earnings claims they make, the number of purchasers who make at least the amount claimed and the percentage of total purchasers who earn that amount.

Finally, the proposed settlement contains a number or recordkeeping and reporting requirements designed to assist the FTC with monitoring compliance with its terms.

The FTC vote to approve the settlement for filing in court was 4-0. It was filed today in U.S. District Court for the Central District of California, in Los Angeles.

NOTE: The stipulated final judgment is for settlement purposes only and does not constitute an admission by the defendant of a law violation. The judgments have the force of law when signed by the judge.

For Release: April 8, 1998

FutureNet Defendants Settle FTC Charges; $ 1 Million in Consumer Redress for "Distributors"

Operators of FutureNet, an alleged pyramid scheme, agreed to settle Federal Trade Commission charges that their scheme violated federal law. The settlement provides $1 million for consumer redress, bans the defendants from participating in any pyramid, Ponzi or chain-marketing scheme, bars them from selling distributorships through multi-level marketing, and requires that they obtain a bond that starts at $100,000 and ratchets up to $1,000,000 as sales increase, before operating any multi-level marketing program for goods or services in the future.

On February 17, the FTC filed charges against Valencia, California-based FutureNet, Inc., FutureNet Online, Inc., and five corporate officers seeking a permanent injunction against future violations and refunds for investors. On February 23, the court issued a temporary restraining order, freezing the defendants' assets and appointing a receiver for the corporate defendants. On March 3, 1998, the Court modified the order substituting a monitor for the receiver an**d allowing the defendants to resume the sale of goods and services, but only to persons not participating in defendants' marketing program -- in effect maintaining the injunction against pyramiding included in the initial restraining order.** The stipulated final judgment announced today would settle charges with FutureNet, Inc., FutureNet Online, Inc., and two corporate officers: Alan J. Setlin and Chris Lobato. Three other defendants, Larry Huff, Robert Depew and David Soto, did not settle the FTC charges and the FTC's case against them will proceed to trial.

According to the FTC's complaint, FutureNet, Inc. claimed that its recruits could earn substantial income for the rest of their lives by joining a multi-level marketing program selling Internet access devices. Consumers paid fees ranging from $195 to $794 to become Future-Net distributors in the scheme, which was promoted on the Internet. But, according to the FTC, **a major portion of the income the defendants promised was not based on sales of the devices,**

which are easily available at other retail distributors, including Sears and Circuit City, at comparable or lower prices. Instead, the promised income came from fees paid by newly recruited distributors who would then bring on more recruits to provide a nonstop "downstream"of paying members. FutureNet claimed that their recruits -- so called "Internet Consultants" -- would receive $200 - $400 when they personally recruited another consultant, and $25 - $50 when a person in their downline recruited a new member. **The agency charged that income from the FutureNet multilevel marketing plan did not depend on sales of the Internet devices they were purportedly selling, but rather on the recruitment of new distributors -- the typical profile of an illegal pyramid. Since almost 90 percent of investors in any pyramid program actually lose money, the defendants' earnings claims were false, and violated federal law, the FTC alleged.** In addition to the pyramid based on Internet access devices, the defendants, prior to the initiation of the FTC action, also had started another, similar program to be based upon sales of deregulated electric power, even though no state had deregulated the sale of electric power at the time defendants began to offer this program.

The settlement announced today would:

- require $1,000,000 for consumer redress;
- prohibit the defendants from engaging in any pyramid scheme, which the settlement defines as a program where a distributor's income is primarily derived from commissions for recruiting additional distributors;
- prohibit the defendants from selling distributorships through multi-level marketing, which the settlement defines as a program whereby distributors' income is derived primarily from the sale of goods or services, rather than from commissions for recruitment;
- require them to review all distributors' advertisements before allowing the ads to run;
- **prohibit misrepresentations about earnings or sales and require that if the defendants make specific earnings claims, they must disclose the number and percentage of distributors who achieved those earnings or the stated level of sales figures;**
- require the defendants to be registered with appropriate state utilities offices before engaging in the sale of electric power;
- require the defendants to implement a refund program for future investors under which they will refund 100 percent when requested within 60 days of payment, and 100 percent less a 10 percent restocking fee when requested from 61 days to a year;
- **require the defendants to obtain a completed written verification form from investors before they collect payment, to assure that no one in the marketing structure made any of the prohibited claims;**
- require the defendants to post a performance bond starting in the amount of $100,000 in order to continue to operate FutureNet. Under the terms of the agreement, the amount of the bond will increase as new distributors sign up for FutureNet, to a maximum $1,000,000. This bond would be used for consumer redress in the event of future violations of the FTC order;
- prohibit the defendants from hiring any individual banned from multi-level marketing business by a court, at the request of the FTC. The FTC is currently seeking such a ban against the defendants who are not part of the settlement announced today.

In addition, the agreement contains recordkeeping provisions to allow the Commission to monitor compliance.

The proposed stipulated final judgment and order was submitted today to the Honorable George H. King, U. S. District Court Judge for the Central District of California, in Los Angeles. It is subject to court approval.

NOTE: This stipulated final judgment is for settlement purposes only and does not constitute an admission by the defendant of a law violation. Consent judgments have the force of law when signed by the judge.

Copies of the complaint and stipulated final judgment are available from the FTC's web site at http://www.ftc.gov and also from the FTC's Consumer Response Center, Room 130, 6th Street and Pennsylvania Avenue, N.W., Washington, D.C. 20580; 202-FTC-HELP (202-382-4357); TDD for the hearing impaired 1-866-653-4261. To find out the latest news as it is announced, call the FTC NewsPhone recording at 202-326-2710. . . (FTC File No. X98 0022)

Release: August 9, 1999

FTC, Six States Sue Equinox International; Law Enforcers Ask Court to Halt Illegal Pyramid Operation

The Federal Trade Commission and law enforcement authorities from Hawaii, Maryland, Nevada, North Carolina, Pennsylvania and South Carolina have asked a U.S. District Court in Las Vegas to halt the allegedly illegal operations of Equinox International Corporation; Advanced Marketing Seminars, Inc.; BG Enterprises, Inc.; and William Gouldd, their principal. In a suit filed jointly with the states, the FTC alleged that the defendants operated an illegal pyramid scheme, made deceptive earnings claims, and provided distributors with the means and instrumentalities to violate federal law. State law enforcers alleged violations of state securities laws, deceptive trade practices laws, false advertising laws, pyramid laws, and licensing requirements laws. At the request of the FTC and state enforcers, District Court Judge Johnnie B. Rawlinson has issued a Temporary Restraining Order, frozen the defendants' assets and appointed a receiver, pending trial. The law enforcers have asked the court to enjoin the alleged illegal pyramid operations permanently and order consumer redress. Five states also have asked the court to award civil penalties for violations of state laws.

The companies and their principal are based in Las Vegas, Nevada.

According to allegations in the complaint filed with the Court, Equinox operated a multi-level marketing company which offered distributorships for products including water filters, vitamins, nutritional supplements, and skin care products. Equinox distributors ran classified ads in the "Help Wanted" sections of newspapers which implied that a salaried position was being offered. Persons who responded to the ads were instead given a sales presentation designed to recruit new distributors. The complaint further alleges that Equinox told the recruits that they could earn money by selling products or recruiting but emphasized that the real way that Equinox distributors make money is through recruiting, not through sales. New recruits were encouraged to purchase $5,000 worth of products so they could enter the program at the manager level, to rent desk space for $300 to $500 a month, to subscribe to a phone line so they could begin recruiting others, and to attend seminars designed to train them. The seminars cost between $300 and $1000 and stressed that distributors could make substantial amounts of money. **The complaint alleges that a very small percentage of distributors who became participants in the Equinox program actually made more money than they expended for front-end expenses, and that a vast majority of distributors discontinued their participation in the program with little or no earnings. The complaint also alleges that while Equinox purported to link compensation to retail sales, it did not enforce the policies and requirements ostensibly designed to assure such sales. "The result of the structure and operation of the program is that financial gains to Equinox participants are primarily dependent upon the continued, successive recruitment of other participants, and retail sales are not required as a condition precedent to realization of such financial gains," the complaint says.**

The FTC alleged that the deceptive earnings claims made by Equinox are false and misleading and violate federal law. By furnishing distributors with promotional materials that contain false and misleading information, including the deceptive earnings claims, Equinox has supplied the means for the distributors, themselves, to violate federal law. The defendants represented that everyone who participates in the program will receive substantial income, instead of disclosing that many participants will not. That material misrepresentation violates federal law, according to the complaint. Finally, the FTC and states alleged that the program is actually a pyramid scheme and violates the FTC Act.

The FTC and state enforcers have asked the court to permanently enjoin the defendants' operation and order consumer redress. The states of Hawaii, Maryland, Nevada, and North Carolina, and the Commonwealth of Pennsylvania also have asked the court to order civil penalties.

The complaint was filed in U.S. District Court for the District of Nevada, in Las Vegas, on August 3, under seal. The seal was lifted August 6.

http://www.ftc.gov/opa/1999/08/equinox1.shtm

For Release: April 25, 2000

Equinox International Settles Case with FTC, Eight States – Nearly $40 Million in Restitution for Alleged Pyramid Victims

Consumers who lost money investing in a pyramid scheme they thought was a legitimate multi-level marketing business, will share in as much as $40 million dollars under the terms of a settlement between the Federal Trade Commission and law enforcement authorities from eight states, and William Gouldd and Equinox International of Las Vegas, Nevada. The settlement also will bar Gouldd from any future involvement in any multi-level marketing scheme, for life, and requires dissolution of Equinox, Advanced Marketing Seminars, Inc. and BG Management, Inc. **Gouldd and Equinox faced charges by the FTC and law enforcement authorities from Hawaii, Maryland, Michigan, Nevada, North Carolina, Pennsylvania, Tennessee, and Virginia.**

In a suit filed jointly with the states on August 3, 1999 **the FTC alleged that the defendants operated an illegal pyramid scheme, made deceptive earnings claims, and provided distributors with the means and instrumentalities to violate federal law. State law enforcers alleged violations of state securities laws, deceptive trade practices laws, false advertising laws, pyramid laws, and licensing requirements laws**. Private class action plaintiffs' lawyers also joined the suit. At the request of the FTC and state law enforcers, a U.S. District Court in Las Vegas halted the allegedly illegal operations of Equinox International Corporation; Advanced Marketing Seminars, Inc.; BG Management, Inc.; and William Gouldd, their principal, froze the defendants' assets, and appointed a receiver, pending trial. The trial began April 3, 2000. The settlement announced today will end the trial process.

The terms of the settlement bar Gouldd, for life, from engaging in any multi-level marketing operations. It also provides that cash and corporate and individual assets will be placed in the hands of the court-appointed receiver for liquidation. The assets have an estimated book value of nearly $50 million, and once liquidated are expected to yield approximately $40 million. Proceeds from the sale of assets will be used for consumer redress and payment of certain court-approved expenses, including the payment of states plaintiffs' fees and costs and fees and costs to defendants' and private class action plaintiffs' lawyers. Redress will be paid by the court-appointed receiver following what likely will be months of accounting and liquidation proceedings. Consumers who believe that they are eligible to participate in the redress distribution may check on the status of these proceedings by visiting the Federal Trade Commission's website, www.ftc.gov, or calling the FTC's Equinox hotline, 202-326-2103.

The provisional stipulated final judgment and order was filed on April 20, 2000 by Judge Johnnie B. Rawlinson, and the full text of the order and the consent agreement is available on the FTC's website (www.ftc.gov). The court will hold a fairness hearing before entering a final order.

http://www.ftc.gov/opa/2000/04/equinox.shtm

For Release: March 27, 2001

Bigsmart Pyramid Promoters Settle FTC Charges

$5 Million for Consumer Redress

Operators of an Internet-based business opportunity that promised easy income for investors in an Internet shopping mall network have agreed to settle Federal Trade Commission charges that their scheme was an illegal pyramid operation. Under the terms of the settlement, Bigsmart.Com L.L.C. and principals Mark and Harry Tahiliani will provide up to $5 million in consumer redress and post a $500,000 performance bond before engaging in any new multi-level marketing activity. The defendants also are prohibited from engaging in any illegal pyramid schemes.

Bigsmart is based in Mesa, Arizona.

According to the FTC complaint detailing the charges, Bigsmart marketed Internet theme "malls" that it claimed would enable investors to earn substantial income from commissions on products purchased through the Internet. The malls were a collection of links to retail sites maintained by independent third-party merchants, such as MarthaStewart.com, and to a "Superstore" maintained by Bigsmart, itself. Traffic was directed to the malls through the personalized Bigsmart "welcome pages" that members bought access to for a $10 application fee and a $99.95 "hosting" fee. Although Bigsmart claimed that members would make substantial amounts of money, the scheme was structured in such way that to realize continued financial gains, would depend on ". . . the continued, successive recruitment of other participants," not on retail sales of products and services to the public. The FTC charged that the claims that consumers who invested in Bigsmart would make substantial income were false; that promotional materials that made the false and misleading claims provided the means and instrumentalities for others to deceive consumers; and that Bigsmart was actually a pyramid scheme. All three were violations of the FTC Act.

To settle the FTC charges, Bigsmart and the Tahilianis will provide up to $5 million in consumer redress. They also will be required to post a $500,000 performance bond before engaging in any new multi-level marketing activity.

Consumers who believe they may qualify to receive consumer redress should call 202-326-3294.

This case was brought with the invaluable assistance of the Offices of the Attorney General of Texas and the Wisconsin. Department of Agriculture, Trade, & Consumer Protection, Division of Trade & Consumer Protection. It was filed in U.S. District Court for the District of Arizona, March 12, 2001.

NOTE: A Stipulated Final Judgment and Order is for settlement purposes only and does not constitute an admission by the defendant of a law violation. Consent judgments have the force of law when signed by the judge.

Copies of the Stipulated Final Judgment and Order are available from the FTC's web site at http://www.ftc.gov and also from the FTC's Consumer Response Center, Room 130, 600 Pennsylvania Avenue, N.W., Washington, D.C. 20580. The FTC works for the consumer to prevent fraudulent, deceptive and unfair business practices in the marketplace and to provide information to help consumers spot, stop and avoid them. To file a complaint, or to get free information on any of 150 consumer topics, call toll-free, 1-877-FTC-HELP (1-877-382-4357). The FTC enters Internet, telemarketing and other fraud-related complaints into Consumer Sentinel, a secure, online database available to hundreds of civil and criminal law enforcement agencies worldwide.

Skybiz - For Release: June 18, 2001

Court Appoints Temporary Receiver over International Pyramid Operation

Illegal Scheme Claims It Is Operating in 200 Countries World Wide

The Federal Trade Commission has asked a U. S. District Court Judge to halt the unlawful operations of SkyBiz.com, **charging that the operation that purports to sell online tutorials on Web-based products is actually a massive illegal pyramid scheme which may have conned consumers around the world out of approximately $175,000,000.** At the request of the FTC, Chief Judge Terry C. Kern has temporarily halted all unlawful activities of the SkyBiz operation, frozen the defendants' assets to preserve them for consumer redress, and appointed a receiver, pending the preliminary injunction hearing scheduled for June 26, 2001.

The FTC suit was filed in U. S. District Court in the Northern District of Oklahoma. The corporate and individual defendants are based in Tulsa. The corporate entities named in the suit include: SkyBiz.com, Inc; World Service Corporation; Nanci Corporation International; and WorldWide Service Corporation. Several individual defendants were also named, including: James S. Brown; Stephen D. McCullough; Elias F. Masso; Nanci H. Masso; Kier E. Masso; and Ronald E. Blanton.

In papers filed with the court, the FTC alleges that since late 1998, the defendants have promoted a work-at-home business opportunity with claims of quick riches. One SkyBiz presentation claimed, "*This system was put together by a gentleman named Eric Rasmussen who basically joined SkyBiz and six months later was able to retire with an income of about 400,000 a month. Currently, [he] lives in the Gold Coast of Australia and he's making 76,000 a week and growing.*" **In in-person sales presentations, seminars, teleconferences, Web site presentations and in other marketing material, the defendants touted the opportunity to earn thousands of dollars a week by recruiting new "Associates" into the program. They provided CD-Roms, computer disks, videos and books promoting the SkyBiz programs and they provide a PowerPoint presentation on their website that can be downloaded to aid in recruiting new members. The cost to join the SkyBiz Program is $125, ostensibly used to buy an "e-Commerce Web Pak," but in reality was to purchase the right to receive compensation for recruiting additional participants. Participants were urged to invest in more than one "Web Pak," to maximize their earning potential**.

The FTC charged that the claims that consumers who invested in SkyBiz would

make substantial income were false; that failure to disclose that most people in pyramid schemes lose money is deceptive; that defendant provided the means and instrumentalities for others to deceive consumers by providing speakers and promotional materials that made the false and misleading claims; and that SkyBiz was actually an illegal pyramid scheme. All four violate the FTC Act.
The complaint was filed by the FTC in U.S. District Court for the Northern District of Oklahoma on May 30, 2001, under seal. The seal was lifted June 8, 2001.[98]

http://www.ftc.gov/opa/2001/06/sky.shtm

For Release: August 4, 2003

Court Halts Trek Alliance Pyramid Scheme

A federal district court judge has issued a preliminary injunction halting the alleged illegal activities of Trek Alliance, freezing its assets and those of its principals pending trial, and appointing a receiver to oversee the business assets. **In his order, Judge J. Spencer Letts barred the defendants from making misrepresentations about the potential earnings, financial gain, or benefits of any multi-level marketing program, business investment opportunity, or pyramid marketing scheme. In addition, the order prohibits the defendants from participating in any illegal pyramid schemes. The order also prohibits the defendants from failing to disclose all information material to a consumer's decision to participate in such programs.** Defendants also are prohibited from falsely representing that salaries or permanent employment opportunities are available. **Finally, the defendants are prohibited from making any false or misleading representation of material fact in connection with the advertising, promotion, marketing, distribution, offering for sale or sale of any good or service.**

Judge Letts, of the United States District Court for the Central District of California in Los Angeles, found that there is good cause to believe that defendants have violated Section 5(a) of the FTC Act, and that the FTC is likely to prevail on the merits of this action. The parties will continue to conduct discovery, after which a trial will be scheduled.

In December 2002, **the Federal Trade Commission sued the California-based operation for using deceptive earnings claims to lure recruits into investing hundreds or thousands of dollars in their illegal scheme**. The FTC charged that Trek Alliance was patterned after Equinox International, an operation that in April 2000 agreed to liquidate assets worth roughly $40 million to settle charges by the FTC and eight state attorneys general that it was operating an illegal pyramid scheme. Two of the four individual defendants associated with Trek were top distributors with Equinox.

According to the FTC, Trek Alliance operated a multilevel marketing company that offered distributorships for products including water filters, cleaning products, and nutritional supplements. The FTC alleged that Trek distributors ran classified ads in the "Help Wanted" sections of newspapers that implied that they were offering salaried positions. According to the FTC, **people who responded to the ads were instead given a sales presentation designed to recruit new distributors. The FTC alleged that Trek told recruits that they could earn money by selling products or recruiting, but emphasized that more money could be made through recruiting.** The recruits were expected to attend training seminars around the country, **purchase hundreds of dollars worth of products so they could enter the program at a higher level,** rent desk space in regional offices, and subscribe to phone lines so they could begin recruiting others, all at their own expense. **While the company promised monthly incomes ranging from $2,000 to $20,000, the FTC complaint alleged that the vast majority of consumers made less money than they had paid for front-end expenses, and that many made little or nothing. The complaint also alleged that compensation was not sufficiently linked to retail sales, and that Trek did not adequately enforce policies and requirements that were ostensibly designed to assure such a link.**

The FTC charged that Trek's earnings claims, as well as its claims implying that employment opportunities were available, were false. The FTC also charged that the defendants deceptively failed to disclose that most investors would not make substantial income. Finally, the FTC alleged that the program is a pyramid scheme and most

98 *F.T.C. v. Skybiz.Com, Inc., et al.* (Dist. Ct., N.D. Oklahoma)

participants lose money. The practices violate federal law, the complaint says. The FTC has asked the court to permanently enjoin the defendants' deceptive practices and to order consumer redress as final relief in the matter.

The FTC's complaint names as defendants Trek Alliance Inc., Trek Education Corporation, VonFlagg Corporation, and individual defendants J. Kale Flagg, Harry Flagg, and Richard and Tiffani Von Alvensleben.

http://www.ftc.gov/opa/2003/08/trek.shtm

BurnLounge, Inc.:

For Release: June 12, 2007

FTC Asks Court to Shut Down Illegal Pyramid Operation

On June 6, 2007, the FTC filed a complaint in the U.S. District Court for the Central District of California against BurnLounge, Inc. **The complaint charges that BurnLounge sold opportunities to operate on-line digital music stores that was, in fact, an illegal pyramid scheme.** The agency is seeking a permanent halt to the illegal pyramid practices as well as other illegal practices alleged in the complaint.

According to the FTC, BurnLounge recruited consumers through the Internet, telephone calls, and in-person meetings. The sales pitch represented that participants in BurnLounge were likely to make substantial income. BurnLounge recruited participants by selling them so-called "product packages," ranging from $29.95 to $429.95 per year. More expensive packages purportedly provided participants with an increased ability to earn rewards through the BurnLounge compensation program.

The BurnLounge compensation program primarily provided payments to participants for recruiting of new participants, not on the retail sale of products or services, which the FTC alleges would result in a substantial percentage of participants losing money.

The FTC specifically alleges that the defendants operate an illegal pyramid scheme, make deceptive earnings claims, and fail to disclose that most consumers who invest in pyramid schemes don't receive substantial income, but lose money, instead. These practices violate the FTC Act, the agency alleges.

The FTC has asked the court to halt the deceptive practices and misrepresentations and to freeze the defendants assets, pending a trial, to preserve them for consumer redress. At a hearing on the FTC's request for a temporary restraining order, on June 8, 2007, BurnLounge's attorneys asked for more time to respond fully, and U. S. District Court Judge George Wu ordered that a full hearing on the FTC's request for a preliminary injunction and asset freeze be held on June 19, 2007, after which he will rule on the FTC's requests.

In addition to naming BurnLounge, Inc., a Delaware corporation based in New York City, the Commission's complaint also names: Juan Alexander Arnold, of Studio City, California; John Taylor, of Houston, Texas; Rob DeBoer of Irmo, South Carolina; and Scott Elliott of Forney, Texas.

This case was brought with the invaluable assistance of the Office of the Attorney General of South Carolina.

Over the last 10 years, the Commission has halted 17 pyramid schemes and has collected almost $90 million in consumer redress and tens of millions of additional dollars in suspended judgments.

Copies of the legal documents associated with this case are available from the FTC's Web site at http://www.ftc.gov and also from the FTC's Consumer Response Center, Room 130, 600 Pennsylvania Avenue, N.W., Washington, D.C. 20580. **The FTC works for the consumer to prevent fraudulent, deceptive, and unfair business practices in the marketplace and to provide information to help consumers spot, stop, and avoid them**. To file a complaint in English or Spanish or to get free information on any of 150 consumer topics, call toll-free, 1-877-FTC-HELP (1-877-382-4357), or use the complaint form at http://www.ftc.gov/ftc/complaint.shtm. The FTC enters Internet, telemarketing, identity theft, and other fraud-related complaints into Consumer Sentinel, a secure, online database available to more than 1,600 civil and criminal law enforcement agencies in the U.S. and abroad.

YTB – "YourTravelBiz.com

News Release August 05, 2008
Office of the Attorney General – Edmond G. Brown, Jr.

Brown Sues To Topple Online Pyramid Scheme

LOS ANGELES--California Attorney General Edmund G. Brown Jr. today announced a lawsuit against YourTravelBiz.com for operating a "gigantic pyramid scheme" that recruited tens of thousands of members with deceptive claims that members could earn huge sums of money through its online travel agencies.

"YourTravelBiz.com operates a gigantic pyramid scheme that is immensely profitable to a few individuals on top and a complete rip-off for most everyone else," Attorney General Brown said. "Today's lawsuit seeks to shut down the company's unlawful operation before more people are exploited by the scam."

YourTravelBiz.com and its affiliates operate an illegal pyramid scheme that only benefits members if and when they find enough new members to join the scam. Once enrolled, members who join the pyramid scheme earn compensation for each new person they enlist, regardless of whether they sell any travel. The company lures new members by offering huge income opportunities through online travel agencies yet the typical person actually makes nothing selling travel.

According to company records there were over 200,000 members in 2007 who typically pay more than $1,000 per year--$449.95 to set up an "online travel agency" with a monthly fee of $49.95. In 2007, only 38 percent of the company's members made any travel commissions. For the minority of members who made any travel commission in 2007, the median income was $39.00--less than one month's cost to keep the Website. There are at least 139,000 of the company's travel Websites, all virtually identical, on the Internet.

YourTravelBiz's extensive marketing materials include videos of people driving Porsches and other luxury cars, holding ten-thousand dollar checks, and claiming to be raking in millions of dollars in profits. The company advertises through its Website www.ytb.com, and at conventions, workshops and nationwide sales meetings which have been held in California locations such as Los Angeles, Sacramento, San Francisco and San Diego.

Brown charges the company, its affiliates, and the company's founders J. Lloyd Tomer, J. Scott Tomer, J. Kim Sorensen and Andrew Cauthen with operating an "endless chain scheme," an unlawful pyramid in which a person pays money for the chance to receive money by recruiting new members to join the pyramid. Brown also charges the company with unfair business practices and false advertising practices including:

* Deceptive claims that members can earn millions of dollars with the company
* Operating without filing legally mandated documents with the attorney general and the Department of Corporations
* Selling an illegal travel discount program

Under California's unfair business practices statue, the company is liable for $2,500 per violation of law. Attorney General Brown is suing YourTravelBiz.com to get a court order that:

* Bars the company from making false or misleading statements
* Assesses a civil penalty of at least $15,000,000 and at least $10,000,000 in restitution for Californians who were ripped off by the company.

From August 6 through 10, thousands of members are preparing to travel to St. Louis for a national convention to learn new techniques to recruit more victims into the illegal pyramid scheme. Last year at least 10,000 people attended a similar national conference. For more details on the company's plan to perpetuate its scheme visit: http://www.yourtravelbiz.com/bizRep/BizReports/BIZREPORT_07-18-08.htm

For more information on pyramid schemes visit: http://ag.ca.gov/consumers/general/pyramid_schemes.php

Consumers who believe they have been bilked by YTB should send a written complaint with copies of any supporting documentation to:

Office of the Attorney General
Public Inquiry Unit, P.O. Box 944255
Sacramento, CA 94244-2550

Or through an on-line complaint form: http://ag.ca.gov/contact/complaint_form.php?cmplt=CL.

Today's lawsuit against YourTravelBiz.com, filed yesterady in Los Angeles Superior Court, also names affiliates which include YTB Travel Network, Inc., YTB Travel Network of Illinois, Inc., as well as the company's founders J. Lloyd Tomer, J. Scott Tomer, J. Kim Sorensen and Andrew Cauthen.

Appendix 10E: How to Start a Pyramid Scheme that Is Very Profitable for the Founders – and Get Away with It

By Jon M. Taylor, President, Consumer Awareness Institute

Given the current passive regulatory environment and DSA-promoted weakening of laws against pyramid schemes, it is interesting to see what a person motivated to create and profit from a pyramid scheme might do. One could very deliberately accomplish this and get away with it by following these steps:

1. Decide on a compensation system (binary, breakaway, matrix, etc.) that would operate in pyramid fashion using products as a vehicle for getting people to pay into the pyramid. Offer a complex system of incentives for progressing to higher and higher levels through intense recruiting, with upline participants getting as much or more per sale as the person actually selling the products – to fuel recruitment into an expanding pyramid of participants. The income to those at the top of their respective pyramids will be huge from leveraging the efforts and purchases of hundreds or even thousands of downline participants. Everyone will recruit like crazy to get to the top level. *[Beautiful!]*

2. Develop a product that has emotional or mystical appeal, is too unique to be compared with something that could be purchased at retail outlets, and is highly consumable. For simplicity, hire a qualified nutritionist or herbalist to search the scientific journals for some newly-discovered substance that has been shown (even if only minimally) to help prevent cancer, minimize heart disease, slow aging, enhance sexual function, and/or stimulate energy and brain cells. It is best if this substance comes from some exotic rain forest or other remote location. *[Many consumers will think anything this exotic with such magical benefits must be perfectly OK even if health consumer advocates warn against it.]*

3. Then combine this exotic substance with proven ingredients found to be effective for combating certain ills and arrange to have it manufactured by any of a number of formulating companies that do this routinely. But make certain it is unique enough that it cannot be compared with existing off-the-shelf products. This will enable you to price it well above any competitive products sold in standard retail outlets.

4. Give your program a name that has a ring of success attached to it, such as "Wealth Plus." Then give your product a magic sounding name, such as "Health Plus."

5. Price all of the variations of the product at a price that allows plenty of margin to support the distributor network that will sell it, with a nice profit margin for your firm. *[This margin would be large enough that it could be considered the pyramid premium contribution to your pyramid scheme. But don't tell anybody.]*

6. Since the product cannot be compared exactly with any existing product, you may produce it for $3 or $4 a bottle, while listing it for sale to consumers for $60-70 a bottle. Of course, participants in your scheme would be able to buy it wholesale for about $40. *[What a great way to fool the regulators! Participants may actually be paying $20-$30 a month from the pyramid premium portion of the price—or large multiples of that amount— into the pyramid, but because of the "legitimate product" disguise, this can be done over and over ad infinitum without detection and appear perfectly legal – especially if purchased "for personal use or consumption" (Some DSA-initiated legislation allows this).]*

7. Prepare literature touting your formulation as one of the greatest advances in nutrition, and offer it in conjunction with a compensation system that is "truly a revolutionary money-making program," one destined to make those persons who "get in on the ground floor" an obscene amount of money – or at the very least, a nice "residual income" for the rest of their lives. Promise them an early retirement with the money to travel or pursue their favorite interests if they will get in early and build "an organization." Even students and financially strapped prospects will see the MLM as their chance to enhance their income. *[But we wont tell anyone that a participant has to work his tail off recruiting a large downline to realize any actual profits after expenses.]*

8. Set up your compensation plan so as to create the illusion for recruits that they can achieve success. *[Hire a statistician to hide the numbers so that new recruits and enforcement agencies will not realize that this "great opportunity" will be profitable primarily to you and the participants at the top of the pyramid.]*

9. Set up minimum purchase requirements and volume incentives to qualify for progression into ascending distributor payout levels. Make these volume requirements high enough that participants will be on a continual treadmill trying to achieve that "next level." Remember, purchases by participants is the engine of any product-based pyramid scheme. *[In some states with statutes influenced by the DSA, an MLM is not a pyramid scheme as long as it has an inventory buyback provision – or (in other states) as long as purchases are for personal consumption by any one (including participants).]*. Of course, to comply with the FTC's "Amway rules," it would be best to write into your "Policies and Procedures" manual the requirement that 70% of the products must be sold at retail to at least ten actual (non-participating) customers to give credence to your claim to be a direct sales company. *[Fortunately, you know that you won't need to enforce the rule, as no one in law enforcement will check up on you.]*

10. Join the Direct Selling Association (DSA). If you encounter any suspicion that your actual customers are participants stocking up on products, enlist the help of the DSA to make the case that you are a legitimate direct seller. *[Of course, with DSA-influenced legislation in place, there is really no need to sell products outside the network of participants,, except for a few "preferred customers" to give the appearance that you are doing legitimate direct selling. These could be close family members of participants - who may actually be funded by participants. Your newly recruited participants will be your primary customers. The sellers are the buyers and the buyers are the sellers. Who cares?]*

11. Put together a starter kit of sales materials, and enough products to get started. But check out local state laws regarding pyramid schemes to make certain the charge for the kit and products fall within what is legally acceptable. *[This is not hard to do. The impression of "legitimate products" is easy to satisfy. You may not even need an attorney will keep you out of hot water. You can conduct your pyramid scheme with impunity – so long as you sell products "for actual use or consumption."]*

12. Begin selling this pre-launch "ground-floor opportunity" to MLM enthusiasts and through MLM publications, announcing a launch date when all who enter can expect to prosper beyond their wildest dreams. Set

up a web page and promote it heavily to those seeking an inside track on a “pre-launch opportunity.” *[They will scramble to be the "first ones in."]*

13. Train the "ground floor" participants in how to recruit, advertise, hold opportunity meetings, etc. *[and most of all – to stock up on products to "build their downline." Better yet, promote monthly product subscriptions to qualify for commissions. This avoids the charge of front-end loading.]*

14. Pump up new recruits with promises of huge paychecks soon to come. They will even pay to attend weekend retreats and “sales training” programs *[actually recruiting programs]*—and for tapes, books, company T-shirts, web sites, and all the other programs and paraphernalia that will help them to be “successful.” *[This can become a separate " success tools" business, or a pyramid within a pyramid" – expanding the income of the top people – so you won't have to reward and motivate them solely on product sales to participants.]*

15. Build your infrastructure as you go, developing new products and geographical divisions as needed to continue the illusion of a “ground-floor opportunity.” *[Or – If the “first wave” is successful—you can take your money and run as soon as market (de facto) saturation causes sales (to recruits) to level off.]*

16. Spend some of your abundant supply of money supporting the political party in power. Donate to the campaigns of all likely candidates for Attorney General, regardless of party. *[They will then be obligated to indefinitely delay action should any zealous investigators suspect you are conducting a disguised pyramid scheme.]*

17. Donate to university scholarship funds and popular charities, making certain that timely press releases accompany all such giving. Support local athletic programs, with priority to highly visible scoreboards and other showy paraphernalia. *[Enforcement agencies will not get popular support for going after an MLM that is doing so many good things, if your largesse is well placed and very noticeable.]*

Appendix 10F: Comments on FTC'S RPBOR Workshop June 1, 2009

Jon M. Taylor, MBA, Ph.D., President
In cooperation with other experts
291 E. 1850 South
Bountiful, UT 84010
Tel. /Fax (801) 298-2425
E-mail: jonmtaylor@juno.com
Web site: www.mlm-thetruth.com

CONSUMER AWARENESS INSTITUTE

Research, education, and advocacy for consumers on selected issues

The Revised Business Opportunity Rule Is Invalid and Must Be Vacated.

By Jon M. Taylor, MBA, Ph.D.
Consumer Awareness Institute (web site – mlm-thetruth.com)

What began as a consumer-friendly Business Opportunity Rule (IPBOR) quickly degenerated into a corrupt rulemaking procedure, manipulated by the DSA (Direct Selling Association), a lobbying organization now dominated by MLMs (multi-level marketing companies). As a result, the Revised Rule (RPBOR) is invalid and will provide little consumer protection, thanks to the DSA and complicit FTC officials. Below are some of the reasons for this conclusion:

1. False and misleading statements of material facts

Below is just one crucial and glaring example among many of falsehood with the imprint of the DSA. Either A or B below is true, but not both.

A. In the text of the Federal Register Notice for the Workshop, and for the Revised Rule, the following is noted about the Revised Rule:

1) (RPBOR) narrows the scope of the proposed Rule to avoid broadly sweeping in sellers of multi-level marketing opportunities. (Workshop Notice, Footnote 7)
2) In addition, the revised proposal does not attempt to cover MLMs. (In Section C. Scope of the Proposed Rule – 1st paragraph)
3) The Commission does not believe it is practicable or sufficiently beneficial to consumers to attempt to apply the proposals advanced in this rulemaking against multi-level marketing companies. (In Section C-2 The MLM Industry: Scope of the Proposed Rule)
4) The Commission takes MLM companies out of the ambit of the Rule.
5) The MLM industry articulated concerns peculiar to its business model, but these provisions would no longer apply to ***MLM companies*** inasmuch as these companies, and their representatives, ***are excluded from the ambit of the RPBOR.*** (Section D-2-d)

B. In stark contrast to the above, the following is found in Footnote 7 on page 3:

The RNPR did not exempt MLMs from coverage of the RPBOR. Instead, it narrowed the scope of the IPBOR by significantly revising Section 437.1 by redefining the term "business opportunity." The RNPR noted that while some MLMs do engage in unfair or deceptive acts or practices, including the operation of pyramid schemes or unsubstantiated earnings claims that cause consumer harm,[MLM]commenters generally agreed that the IPBOR's required disclosures would not help consumers identify a fraudulent pyramid scheme. In the RNPR, the Commission stated its belief that consumer harm flowing from deceptive practices in the MLM industry could be more effectively addressed through the use of Section 5 of the FTC Act.

If A (above) is true, the opening statement for B is false. If B is true, A is false. Either way, one or the other is false and misleading to the public.

2. In all of the Rulemaking procedures, from the original IPBOR announcement to the June 1 Workshop, I was struck with how much the FTC has underestimated the scope of and the harm done by MLM schemes, which may (or may not) be excluded from the Rule.

The DSA claims that the vast majority (98.2%) of direct sellers are now using a multi-level pay structure and that there are over 15 million people selling over $30 billion in products and services using a direct selling model[99]. If we assume these DSA figures are correct, and if we use figures on MLM loss rates from analyses from qualified independent analysts of approximately 99%[100], the losses to consumers are staggering. **In the aggregate, millions of MLM participants are losing tens of billions of dollars every year in the U.S. alone. To exempt this leading class of business opportunity fraud from the Business Opportunity Rule is unthinkable to any informed consumer advocate.**

Those familiar with the harm done by MLMs, including DSA members, often ask why law enforcement at both state and federal levels seem unaware of the extent of the losses. My answer from having worked with victims worldwide is not the obvious one often given out – embarrassment at having not succeeded at "making the plan work." Most are not aware that they have been scammed unless and until they have gone through some deprogramming, similar to what is done with victims of cults.

Perhaps the strongest explanation for the lack of law enforcement action against MLMs is that victims of endless chain business opportunity schemes rarely file complaints. This is because nearly every major victim has of necessity become a perpetrator – having recruited some of his close friends and family in the hope of eventually recouping enough in commissions to meet their ongoing purchases necessary to qualify for commissions and/or advancement in the scheme. So they fear going public for fear of consequences from or to those who they recruited or persons who recruited them – often close family or friends.

MLM is perhaps the cleverest con game of all time. The very people who are perpetrators are themselves victims until they run out of money and drop off the vine. And since they don't complain, law enforcement does nothing. So the game goes on.

[99] DSA Industry statistics – www.dsa.org

[100] Available for download at www.mlm-thetruth.com and www.pyramidschemealert.org

3. The Revised Rule will apply to no one and will therefore provide no consumer protection against unfair and deceptive practices, which the FTC is pledged to protect.

In her closing comments, Ms. Morrissey applauded the Commission and Staff for narrowing the scope of the proposed Business Opportunity Rule. Other DSA members present were obviously please with this apparent exclusion. (I say apparent advisedly, given #1, above)

However, according to the Revised Rule[101], all Business Opportunities that pay commissions to two or more individuals as the result of a sale of the company's products or services are MLMs for purposes of the proposed MLM exemption. Given the facts that (1) there are few, if any, business opportunities sellers ("direct sellers") that do not currently engage in this practice and that (2) the minuscule number of sellers that do not engage in same will do so to gain exemption from the ambit of a final Rule, **the end result, if the MLM exemption is included in a final rule, will be a Business Opportunity Rule that will exclude virtually every single business opportunity in the US from the ambit of the Rule.**

As explained in earlier comments and in FTC announcements regarding both IPBOR and RPBOR, fraudulent practices are common in business opportunity schemes. By exempting virtually all such schemes through RPBOR, the FTC could thereby be complicit in aiding and abetting massive consumer fraud by direct sellers of "business opportunities" -- many of them members of the DSA, which is the lobbying group primarily responsible for the MLM exemption. With RPBOR, the FTC is clearly siding with the DSA in direct contradiction to its responsibility to protect consumers from unfair and deceptive practices.

4. The RPBOR and the whole rulemaking process for a Business Opportunity Rule have been corrupted by ex parte communications between FTC officials and the DSA.

After the comment period closed for RPBOR, I and other parties sought to give additional input to correct facts regarding interpretation of prior comments. Such communications were refused on the grounds that they would be ex parte communications. However, **in a DSA revenue generating event after the close of the comment period, certain FTC officials met with DSA members on October 23-24, 2008, in Alexandria, Virginia.** Details of these ex parte communications are included in the Notice of Corruption at the end of these comments. It should also be noted that **no transcript has been provided by the FTC of such ex parte communications where the Business Opportunity Rule was discussed.**

These ex parte communications are just one of many strong pieces of evidence of collusion between certain present and former FTC officials and the DSA. Another revealing example is the attempt to influence the IPBOR by comments on behalf of DSA members from former high level FTC officials, including Timothy Muris, Howard Beales III, and Jodi Bernstein. It is very disturbing to us as consumer advocates to see this radical transformation by these officials we once trusted from consumer protection to fraud protection.

This also raises the question of what direct or implied enticements DSA members have offered to current officials for supporting the MLM exemption in promises of lucrative

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[101] Footnote 34 of the RPBOR announcement:

"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.' "• See Peter J. Vander Nat and William W. Keep, *Marketing Fraud: An Approach to Differentiating Multilevel Marketing from Pyramid Schemes*, 21 J. of Pub. Policy & Marketing (Spring 2002), ("Vander Nat and Keep") at 140. See a;lso rebuttal to DSA Comments,

Part 1: www.ftc.gov/os/comments/bizoprevised/rebuttals/535221-00081.pdf consulting jobs, etc., following FTC employment. This and related corruption of the rulemaking procedure deserve Congressional investigation. **At the very least, the Commissioners should be asking how it is that certain FTC officials have allowed the DSA to roam so unbridled over the rulemaking process.**

5. Other rulemaking irregularities include refusal to answer one key question at the Workshop, while responding to others.

At the June 1 Workshop, Ms. Benway answered Mr. Hailey's question about the legal action section of the form – and even discussed Tupperware's lead generation system with Ms. Morrissey (to whom was shown great deference and who was allowed to pitch both Tupperware and the DSA), as well as defending her use of the DSA Code of Ethics, but refused to answer my question about the obvious contradiction discussed in #1 above.

6. The cost effectiveness of a Rule promoting transparency – vs. utilizing Section 5 on a case-by-case basis – was ignored in RPBOR. Without hugely increasing the personnel at the FTC, it would be impossible to keep up with the MLMs that are forming every year, many if not most of them violating Section 5.

In the April 24 announcement of the Workshop, the FTC also stated in Footnote 7:

> . . . In the RPBOR, the Commission stated its belief that consumer harm flowing form deceptive practices in the MLM industry could be more effectively addressed through the use of Section 5 of the FTC Act.

As a business model predicated upon infinite expansion (endless chain of recruitment) in a finite marketplace, MLMs are inherently flawed, uneconomic, and fraudulent. In spite of this mathematical reality, the FTC admitted in the RPGOR announcement that the FTC had used Section 5 in actions against only 14 MLMs in the past ten years. However, FTC officials were in a position to know of the research I cited in my comments showing evidence that at least 250 MLMs (out of over 1,000 extant, according to some industry observers), are currently violating Section 5 and that at least 81 of these are members of the DSA, which has so vigorously objected to a rule requiring their members to provide greater transparency to protect consumers against unfair and deceptive practices.

Extensive research I and others have performed (reported on mlm-thetruth.com) has demonstrated that the compensation plan of an MLM can determine the extent to which a program depends upon aggressive recruitment by new recruits of a large downline of self-consuming participants in order to profit from the scheme. When this is the case, the MLM is merely a money transfer scheme. (See FTC Staff Advisory letter dated January 14, 2004, from James Kohm to DSA president Neil H. Offen). In other words, they are structured to transfer money from those at the bottom to founders and TOPPs (Top-of-the-pyramid promoters). They accomplish this by using purchases of (usually overpriced) products to disguise or launder their investments in a product-based pyramid scheme.

Such emphasis on revenues from "internal consumption" is positive proof that an MLM is conducting an unfair and deceptive practice in violation of Section 5. Please review the speech on "Pyramid Schemes" by Debra Valentine, General Counsel of the FTC, delivered May 13, 1998, sponsored by the International Monetary Fund. Note the section titled: "What is a Pyramid Scheme and What is Legitimate Marketing?" *Note that she asked "What is legitimate marketing? – not* *legitimate multi-level marketing* –an oxymoron to those who understand how sales and recruiting are incentivized in typical MLMs.

In every MLM for which I could obtain the compensation plan, I found five causative and defining characteristics of a recruiting MLM, or product-based pyramid scheme. Please read my *"5 Red Flags: Five Causative and Defining Characteristics of Recruiting MLMs, or Product-based Pyramid Schemes"* on my web site – mlm-thetruth.com. This report is a summary of literally thousands of pages of research and feedback from all over the world. In every case where data was available on MLMs with these five red flags, the percentage of people losing money was about 99%. Robert Fitzpatrick of Pyramid Scheme Alert found essentially the same thing in his report "*The Myth of 'Income Opportunity' in Multi-level Marketing" (pyramidschemealert.org).* The FTC is in possession of this information as recorded in prior comments by myself and Mr. Fitzpatrick.

Since nearly every MLM I have studied (by now over 300) has these five characteristics, it can be assumed that the vast majority of all MLMs will also have these characteristics, making them likewise unfair and deceptive practices. Army Diller lists over 1,000 past and present MLMs at - www.armydiller.com/financial-scam/links.htm#complaintsmlm

Even if we assume that the number of MLMs with compensation plans that make them merely money transfer schemes – or product-based pyramid schemes – totaled only 500, with at least 50 new schemes originating every year (I personally encounter about one new MLM every week), it would be impossible for the FTC to keep up with them using Section 5 on a case-by-case basis. At the rate of 14 cases every ten years, **applying Section 5 would require 357 years for the FTC to act against the existing base of MLMs, and the FTC would have to increase its staff at least tenfold just to keep up with fraudulent new MLMs forming every year. The DSA recognizes that it is in its members' best interest to get the FTC to exclude them from having to make meaningful disclosures, and to instead fall back on Section 5, since it would make the threat that any of their many members (violating Section 5) would have to deal with FTC regulation rare to non-existent. By the time the FTC finally got around to investigating any given MLM using Section 5, all the principals would likely be long dead.**

The Business Opportunity Rule requiring meaningful disclosure by ALL sellers of business opportunities would be far more cost effective than exempting MLMs from the Rule – and instead relying upon section 5 to protect against unfair and deceptive practices. I seriously doubt that had the Commissioners been informed of this reality, they would have voted 4-0 in favor of RPBOR. The exemption of MLMs is not consistent with the FTC's practice of using industry-wide rules to more efficiently discourage unfair and deceptive practices than relying on case-by-case enforcement.

7. The FTC may have exceeded its authority in defining "business opportunity" so narrowly by excluding MLM in RPBOR.

In the announcement of the Workshop, the FTC also states:

> . . . It [the RNBOR] narrowed the scope of the IPBOR by significantly revising Section 437.1 by redefining the term "business opportunity. (April 24 Federal Register, Footnote 7)

The DSA is a lobbying and trade organization representing direct sellers in the United States, many of whom – especially MLMs – could be classified as business opportunity sellers. In 2007, according to the DSA, 98.2% of all individual sellers in the United States were compensated under an MLM compensation plan, leaving only 1.8% compensated under a single level compensation plan. (http://www.dsa.org/pubs/numbers/07gofactsheet.pdf) And in 2007 the DSA claimed to have 285 MLM direct sellers whose collective MLM sales forces total 15 million distributors. This would suggest that DSA members comprise by far the largest group of business opportunity sellers in the United States. The FTC notice states: "Business opportunity ventures include vending machine routes, rack display operations, and medical billing ventures." To anyone familiar with the business opportunity market, complaints about these three represent only a tiny percentage of problems needing consumer protection.

There is a real question as to whether or not the FTC even has the authority to define business opportunity so narrowly as to limit the Rule to such a miniscule portion of the marketplace of business opportunities; i.e., non-MLM sellers. This makes about as much sense as a Franchise Rule exempting all food services because requiring them to disclose information might contribute to world hunger.

8. The acceptance of the "too great a burden" argument against a one-page disclosure form by MLMs is such an obvious absurdity that only FTC officials partial to the DSA/MLM lobby or those unaware of other disclosure requirements, such as franchises or securities, would have accepted it.

Several panel members at the workshop referred to the issue of the burden of disclosing certain information on a one-page form to those being sold Business Opportunities. However, the FTC requires a Franchise Disclosure Document by franchisors be supplied to prospective franchisees that can be hundreds of pages in length. The IPBOR would have required only a single page disclosure form (plus any supporting information of average earnings, etc.) be provided by business opportunity sellers. But the DSA/MLM and their minions protested it would be "too great a burden" to supply each prospect with only a couple pieces of paper provided by the company. This makes about as much sense as the FTC not requiring franchisors to provide a Franchise Disclosure Document – or the SEC exempting all private corporations from having to publish annual and quarterly reports because it would place "too great a burden" on them to comply.

The "too great a burden" argument is just one of many put forth by the DSA and its many minions and accepted by the FTC. The "too great a burden" argument is so absurd as to not require further comment, yet the RPBOR clearly shows FTC officials accepting it, again raising serious questions about the motivation behind such cooperation between certain FTC officials and the DSA/MLM lobby. Two and two do not equal five, even if 17,000 commenters claim it is so.

9. The suggestion in the Workshop announcement that disclosures by MLMs would not help consumers is a manifestly bogus argument – as are other arguments for exempting MLM from the Rule. Two and two do not equal five, even if 17,000 commenters claim it is so.

In the April 24 announcement of the Workshop, the FTC stated in Footnote 7:

> . . .The RNPR noted that while some MLMs do engage in unfair or deceptive acts or practices, including the operation of pyramid schemes or unsubstantiated earnings claims that cause consumer harm, commenters generally agreed that the IPBORs required disclosures would not help consumers identify a fraudulent pyramid scheme.

In my comments regarding IPBOR, I suggested that MLMs would attempt to circumvent honest disclosure in such a Rule, such as Nu Skin has done in its compliance with the 1994 Order for Nu Skin to cease its misrepresentations of earnings of distributors[102]. When MLMs do disclose earnings, they do everything they can to report in such a way as to disguise the truth; viz., that it is extremely rare for anyone to realize a net profit from their pay plan. However, I was in no way suggesting that such disclosures could not help any consumers identify a fraudulent scheme. Some sophisticated consumers may understand the statistics. And such data could be analyzed, debunked, reported by independent analysts, and then conveyed to consumers in print or online. This would not be possible if no data were made available.

Of course, nearly all the DSA/MLM commenters "generally agreed that the IPBOR's required disclosures would not help consumers identify a fraudulent pyramid scheme." This response from MLM parties should have been expected, as the last thing MLM promoters want is for the truth to be made obvious – that they are unprofitable for all but the founders and a few TOPPs (top-of-the-pyramid promoters). But regardless of the number of MLM proponents who agreed that disclosure would not help consumers, this should not be accepted by the FTC as fact, but recognized for what it is – desire by MLMs to protect their capability to continue defrauding consumers without regulatory scrutiny.

Other typical DSA arguments that were used to gain an exemption for its member MLM firms (many of which were reiterated by Ms. Morrissey and others at the workshop) include:

- Multi-level marketing is equated to legitimate direct selling. My analysis of over 300 MLM programs reveals that MLMs rarely incentivize direct selling to the public sufficiently to outweigh the enormous incentives to recruit a huge downline, which is where any profits are realized. Participants are primarily incentivized to do pyramid or chain selling, not direct selling.
- MLM is presented as a business with little risk, as the signup fee is small. But this is merely a ruse, as major ongoing incentivized purchases (often $50 to $300 a month) are required in nearly all MLMs in order to qualify for commissions or advancement in the scheme. And those who invest the most tend to lose the most – some many thousands of dollars.
- MLM companies who are members of the DSA are subject to its Code of Ethics. But members who were found guilty of conducting illegal pyramid schemes were members of the DSA in good standing at the time[103]. And it is clear from its Code of Ethics that the DSA allows pyramid or endless chains schemes among its membership.[104]
- Many MLM participants merely work part-time or seasonally to earn enough for Christmas or to meet other temporary needs. Only a person unfamiliar with the compensation plans of MLM companies would accept such a claim. All of the MLMs who are members of the DSA use compensation plans that require enormous full-time and long-term commitment to building and maintaining large downlines before they can

[102] See REPORT OF VIOLATIONS of the FTC Order for Nu Skin to case its misrepresentations of distributor earnings, linked from the Law Enforcement page of my web site – www.mlm-thetruth.com

[103] Equinox, Trek Alliance, etc.

[104] **Pyramid Schemes (DSA Code of Ethics #6)** For the purpose of this Code, pyramid or endless chain schemes shall be considered consumer transactions actionable under this Code. **The Code Administrator shall determine whether such pyramid or endless chain schemes constitute a violation of this Code** in accordance with applicable federal, state and/or local law or regulation.

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realize significant profits. The only way a person could earn enough in commissions to exceed incentivized purchases and minimal operating expenses is if products were priced competitively to make possible sales to the general public. But my studies and those of other independent analysts has shown prices anywhere from two to six times as much as products sold through more standard outlets.

- For the same reason, the DSA argument that many join one of their MLMs just to get the products at retail just does not hold water. Even at wholesale, the products cannot compete with alternative outlets.

Refer to my previous comments in IPBOR and RPBOR for other weak arguments put forth by the DSA and apparently accepted by the FTC to gain the MLM exemption. FTC personnel had access to all of the information rebutting with irrefutable evidence the fallacy of DSA arguments. If you take away these bogus arguments, there is no justification - for any informed official or analyst not sponsored by the MLM industry - for exempting MLM from the Rule. So this again calls into question the motivation of those FTC personnel who used these bogus arguments as justification for exempting MLM from the ambit of the Rule.

10. For the RPBOR form, the most important disclosure a business opportunity seller can provide is breakdown of earnings of participants. False earnings claims are typical of MLM sellers, so MLMs must not be excluded from the Rule.

After reading IPBOR, RPBOR, the consultant's report on the BOR form, and related materials, one can safely conclude the following:

a) The making of false earnings claims is the most prevalent problem in the offer and sale of business opportunities.
b) The making of false earnings claims underlies virtually all fraudulent business opportunity schemes.
c) Earnings claims lie at the heart of business opportunity fraud, and are typically the enticement that persuades consumers to invest their money.
d) Earnings claims are highly relevant to consumers in making their investment decisions and typically are the single most decisive factor in such decisions.
e) Earnings claims are the most salient feature of sales (and recruiting) presentations made by business opportunity sellers.
f) MLMs as business opportunities, often deceive consumers with the promise of large potential income and are thereby highly successful in attracting prospective investors.
g) By far, the most frequent allegations in business opportunity cases pertain to false or unsubstantiated earnings claims.

The FTC has brought over 140 cases against a multitude of business opportunities and related schemes (including MLMs and pyramid schemes), each of which lured unsuspecting consumers through false or deceptive earnings representations.

Narrowing the definition of "earnings claims" could weaken protections regarding the most salient feature of the sales presentation by allowing sellers to avoid disclosing the average incomes of participants at ascending levels in the pay plan.

For MLMs, the impetus for making false income claims is the compensation plan which incentivizes promising whatever will entice prospects to join one's downline.

According to the FTC, the catalyst for making false earnings claims is the MLM compensation model "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." (Revised Rule, p. 15)

As independent analysts, both Robert Fitzpatrick[105] and I[106] have done extensive analyses based on the actual reports of average incomes of participants in MLM programs for which data is available to prove that 99-99.9% of participants in their programs lose money. Even promoting such MLMs as income or business opportunities, when the odds of profiting are far greater for gambling in Las Vegas, is deceptive.

This all adds up to the necessity, not just advisability, to include MLMs in the Rule, primarily to assure meaningful disclosure of average earnings of participants at the different levels in the pay plan. This is essential to protect against unfair and deceptive practices, especially false earnings claims.

11. If the Revised Rule (RPBOR) were enacted, consumers would be misled into believing that the FTC's Business Opportunity Rule provides protection against fraudulent, unfair, and deceptive practices, when in fact it will do just the opposite.

Since any business opportunity seller can easily qualify as an MLM and thereby gain exemption from the Rule, they will likely do so, leaving virtually no business opportunity sellers covered by the Rule. Also, it is not difficult to envision MLM promoters emboldened in their deceptive recruiting practices and saying to prospective recruits: "Our MLM is a legitimate business model. If it were not, it would certainly come under scrutiny by the FTC or other regulatory agencies set up to protect against unfair and deceptive practices."

While a Business Opportunity rule is certainly needed, this Revised Rule is not the answer, but could have extremely harmful unintended consequences for consumers. It would be far better for the FTC to scrap the Rule altogether than to let it go forward with the MLM exemption.

This is one of those cases in which **no rule is better than a bad rule.**

12. Considering the above, the Workshop was a sham, and the form is irrelevant. In exempting MLM from the Rule to satisfy the DSA, the FTC is abandoning its mission to protect consumers from unfair and deceptive practices.

As an analyst and advocate for the tens of thousands of victims and their families who have visited my web site (www.mlm-thetruth.com, as well as www.pyramidschemealert.org – for which I am an advisor), there is ample reason for the DSA to so vigorously object to requiring transparency among its members. Those reasons are all tied to the FTCs role to "prevent fraudulent, deceptive, and unfair business practices and to provide information to help spot, stop, and avoid them." The DSA thereby presents a direct challenge to all that the FTC is about.

As one who has by now studied the compensation plans of over 300 MLMs, I can testify that **virtually all MLMs employ a business model that assumes infinite expansion in finite markets, which makes them inherently flawed, uneconomic, and fraudulent**. What should surprise FTC officials is that there were only 17,000 comments out of approximately 30

[105] "The Myth of Income Opportunity in Multi-level Marketing" is available for downloading from the web site – www.pyramidschemealert.org.

[106] Several reports on MLM loss rates are linked from the Statistics page on my web site – www.mlm-thetruth.com.

million participants (according to the DSA) in several hundred MLMs, some with gigantic pyramids of participants – all hoping to eventually earn a profit, but with less than 1% ever receiving enough to exceed their expenses; i.e., meeting quotas of product purchases, training costs, and minimal operating expenses. In other words, for those MLMs for which reliable data is available, approximately 99 out of every 100 participants lose money. And yet these same MLMs are promoted by sellers as the answer to consumers' financial woes. **MLM is almost by definition (infinite expansion within finite markets) an unfair and deceptive practice**, and in addition is both **viral** (all are built up by an endless chain of aggressive recruitment) and **predatory** – taking advantage of the most vulnerable populations among us. If FTC staff were to attend (unannounced) very many MLM recruitment rallies, as I have, they would see the truth of all that I am saying – and reporting on my web site. With 99% doomed to financial loss, why would FTC officials cave to the DSA's demand that MLMs be excluded from the RPBOR? Their motivation must be examined.

It is my hope that the FTC will stop pursuing a disastrous course in abandoning its mission to protect consumers by yielding to the enormous pressure placed upon certain FTC officials by the DSA. Relying on Section 5, rather than the Rule for MLMs would be allowing consumers to be victimized by endless chains of MLM recruiters, and then left like sheep wandering without protection in an enclosure full of wolves.

The Case (for and) against Multi-level Marketing

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

Chapter 11: IS MULTI-LEVEL MARKETING A MORAL AND ETHICAL BUSINESS MODEL?

No.

If one has read the prior chapters, the answer is all too obvious. From decades of analysis of packaged home business opportunities, it is clear to me – and to anyone who reads this book with an open mind – that MLM is the most unfair and deceptive of them all. All recruitment-driven MLMs[107] are built on an endless chain of recruitment of participants as primary customers. Their compensation plans assume infinite markets and virgin markets, neither of which exists. They are therefore inherently flawed, deceptive, and unprofitable except for the founders and those at or near the top of a pyramid of participants – which are often those who got in at the beginning of an endless chain of recruitment.

In fact, recent research shows that MLM is the most harmful category of pyramid schemes. With a much higher loss rate and with typically far more misrepresentations, MLM is more unfair and deceptive than no-product pyramid schemes, which are treated as illegal by the FTC on the grounds that they are inherently an unfair and deceptive practice. Since MLM is a fundamentally flawed business model, the question of whether or not MLM is a moral and ethical business then becomes self-evident. [108]

[107] The compensation plans of all of the hundreds of MLMs I have personally analyzed are recruitment-driven, based on the four causative and defining characteristics of product-based pyramid schemes, or recruitment-driven MLMs. (See 5-step do-it-yourself evaluation on the research-based web site – mlm-thetruth.com). The only possible exception to this is the party plan model, which depends at least in part on sales to non-participants. However, even for these the top levels of the compensation plan must be analyzed closely to see if they are recruitment-driven and top weighted.

[108] If one wants to explore further the moral and ethical issues relating to MLM participation, he/she may want to read my book *The Network Marketing Game: Gospel Perspectives in Multi-level Marketing* (1997). The book describes my experience with a major MLM company and my subsequent treatise called “The principles of True Wealth,” drawn from “sages of the ages” – quotes from scriptures and some of the greatest books of all time. MLM is then compared with these principles, and a final score is given. Inquiries about the book can be sent to my email address – jonmtaylor@juno.com.