



**An**  
**Evaluation**  
**of the Campaign of the**  
**Direct Selling Association**  
**to Protect Multi-Level Marketing**  
**from Prosecution as an Illegal Pyramid Scheme**

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# **An Evaluation of the Campaign of the Direct Selling Association to Protect Multi-Level Marketing from Prosecution as an Illegal Pyramid Scheme**

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## **Background:**

The Direct Selling Association (DSA) is currently engaged in a worldwide public relations and political lobbying campaign arguing that the business model and practices of most DSA members are legal and ethical. Specifically, DSA seeks to reverse federal court ruling and decades of public policy of the United States Federal Trade Commission that treat business practices common among DSA members as “unfair and deceptive,” labeling them *illegal pyramid schemes*.

The DSA campaign on behalf of pyramid marketing schemes is unparalleled in America. Business lobbying may seek tax advantages, government contracts or relaxation of regulations, but no other lobbying effort seeks to legalize business practices that have been defined by federal and state regulators and federal courts as *fraudulent*.

DSA is chiefly doing this by claiming that MLMs can legally gain revenue primarily from the salespeople they recruit with their “opportunity” solicitation and reward each new recruit with commissions based on the opportunity-related purchases of other salespeople they in turn recruit in an endless chain.

The “business opportunity,” in this model, is primarily a right to recruit others into the same business opportunity and to gain rewards based on their associated purchases and fees. A pre-determined level of purchases and fees are required of all recruits in order to participate in the scheme. The rewards extend to multiple levels of recruits that are structured in levels of a genealogical chain. Each new salesperson gains the same right to recruit others in an unbroken and ever-expanding chain. The money for this enterprise comes primarily from those within the chain.

Most MLM companies also offer each new participant the right to retail the products but few of these independent salespeople are able to earn a profit from retail selling. Consequently, they pursue the other part of the MLM business opportunity that is based on recruiting other salespeople and receiving payments from the MLM company based on the volume of the purchases by those they recruit in the multi-level pyramid. To remain qualified to receive these commissions, each MLM participant is typically required to maintain a quota of personal purchases each month or to have volume of purchases from other recruits.

One ambiguous legal decision coupled with lax law enforcement in the USA have resulted in the spread of “non-retailing” DSA members aggressively soliciting consumers with a “business opportunity” plan based upon endless chain recruiting.<sup>1</sup>

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<sup>1</sup> In a controversial and ambiguous ruling, an Administrative Law Judge ruled in 1979 that the Amway Corporation, the oldest and largest of all MLMs, could use an endless chain model. However, the business must be funded and driven primarily by the retail sales by the sales force, not from the investments of the distributors themselves. Various rules and safeguards were expected to be employed to insure that the business, despite the endless chain structure, did not operate as pyramid scheme in which investors gained profit from new investors rather than from their own retail sales or the retail sales of those they enrolled. Subsequent federal court rulings clarified this point that the MLM must be retail based and FTC prosecutions of more than a dozen MLMs have been based on a retail criteria.

Therefore the legitimacy of the entire MLM industry, including most DSA members, hinges on this question of whether a MLM can derive most of its revenue for commissions from the payments, purchases and investments of the salespeople, not end-user consumers.

DSA's campaign is based on the claim that retail sales from consumers outside the chain are unnecessary because the salespeople are actually making personal purchases for their own use, not business investments related to earning a profit. They have also claimed that the enormous loss rates among recruits are because few recruits seek a profit. They only wish to "buy at wholesale price." Paradoxically, many MLMs also claim that their extraordinary "turnover" rates among MLM recruits, as high as 50-70% typically, are normal among "direct selling" companies due to the difficulties of person to person retail selling.

DSA's own existence as a trade association depends on governments allowing the DSA members to continue operating in this manner.<sup>2</sup> Through political lobbying, MLM companies have even influenced US Trade Representatives to pressure foreign governments to allow such business practices in their respective countries. They have argued that World Trade Organization (WTO) rules require companies to allow MLMs to operate, inferring that non-retailing MLMs qualify as legitimate "direct selling."

Some countries have refused. The most significant opposition to this effort came in 2005 when the China, the largest new market in the world for MLM, banned the MLM "non-retailing" recruitment model.

Additionally, the question of MLM legality is still very much open in the USA. Besides prosecuting numerous MLMs for operating as "non-retailing" pyramid schemes, the FTC has recently proposed new rules that would require MLM to disclose to consumers such data as average incomes, business costs, loss rates and dropout rates among participants in their recruitment schemes. DSA is actively opposing these requirements.

In 2007, a significant class action lawsuit was filed against the largest MLM operating in the USA, Quixtar, Inc. (formerly Amway). The suit was filed by one of the most prominent and respected law firms in the country. The suit charges that Quixtar participants must recruit others in an endless chain in order to recoup their own investments, rather than retail Quixtar products. It charges that such a model must, by design, cause enormous consumer losses and that it must engage in deception in order to lure consumers into the fraudulent model.<sup>3</sup> Similar class action lawsuits have been filed against other prominent DSA members such as Nuskin and Herbalife.

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<sup>2</sup> The devious measures which DSA is willing to take to preserve its position are seen in what we could be characterized as a form of identity theft and a blatant effort to direct consumers away from independent consumer awareness and educational materials. In April 2003, approximately two and a half years after the non-profit organization, Pyramid Scheme Alert, had launched its independent website, <http://www.pyramidschemealert.org/> and gained worldwide recognition for its name – receiving tens of thousands of visitors monthly – DSA purchased the exact name of the Pyramid Scheme Alert site but with .com and .net endings. These bogus names were then advertised on the web by DSA. Consumers who mistakenly went to these addresses were linked back to the DSA's own site. In October, 2006, DSA repeated this trickery by purchasing the namesakes of another widely read consumer education site, <http://www.mlm-thetruth.com/>, which is published by a Pyramid Scheme Alert Advisor, Dr. Jon Taylor. Both ruses were carried out by DSA Communications Director, Amy Robinson.

<sup>3</sup> <http://www.pyramidschemealert.org/PSAMain/news/AmwaySuedasPyramidScheme.html>

The question about retail sales is not just a legal technicality. Retailing in MLM is a defining characteristic used by regulators to identify predatory and destructive pyramid schemes, or what CBS correspondent Mike Wallace termed “devastating con games” in a *60 Minutes* exposé in 1999 of the MLM, International Heritage, Inc.

A fraudulent business opportunity solicitation, such as the non-retailing MLM, is far more damaging than a fraudulent product sale. Bogus business opportunity solicitations can result in consumers spending their entire life savings, ruining their credit, quitting their jobs and losing their homes. MLM solicitations involve the consumers in soliciting friends, relatives and colleagues into the scheme. If the plan is fraudulent, a person’s entire social network can be alienated or lost entirely.

The DSA effort to legalize and legitimize – effectively, to *disguise* – an endless chain scam as a legitimate direct selling business that offers a viable income opportunity to most people has enormous consequences.

To clarify the position of the DSA on this matter, I wrote Mr. Joseph Mariano, the Exec. VP of DSA in December, 2006. Some of this evaluation references the general position that he offered in a follow-up telephone conversation on Dec. 27, 2006, all of which aligned with DSA assertions on its website or which DSA has written to federal regulators.

Pyramid Scheme Alert receives daily inquiries from consumers worldwide about how to make a valid distinction between a real business opportunity in direct selling and a pyramid recruitment fraud. Many consumers specifically ask how to determine if various members of DSA are direct selling companies or pyramid marketing scams.

### **Reasons for Applying the Retail Standard**

In response to these inquiries Pyramid Scheme Alert recommend to consumers that they closely examine one key characteristic, among others. *This is the overall level of retail selling by all the distributors of the particular MLM company.* We explain that if there is little retailing occurring, just *purchasing* and *recruiting* by the distributors, then the income opportunity is, by definition, based on endless chain recruiting. Since little or no revenue comes from outside the chain of participants, only those few at the top could gain a profit. A large “downline” of unprofitable participants is required for a few to gain a profit. Such a closed structure is a money transfer system, not a market-driven sales business.

In support of our recommendation to apply a retail standard for evaluation we reference:

- The FTC on its website (<http://www.ftc.gov/bcp/online/pubs/alerts/pyrdalrt.htm>) that states, “*Some multilevel marketing plans are legitimate. However, others are illegal pyramid schemes. In pyramids, commissions are based on the number of distributors recruited. Most of the product sales are made to these distributors - not to consumers in general. The underlying goods and services, which vary from vitamins to car leases, serve only to make the schemes look legitimate.*”
- The academic article<sup>4</sup> of the FTC’s expert on pyramid sales schemes, Peter Vandernat, which details the crucial role of retailing in identifying MLM companies

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<sup>4</sup> *Marketing Fraud: An Approach to Differentiating Multilevel Marketing from Pyramid Schemes* by Peter J. Vandernat and William W. Keep, Journal. of Public. Policy & Marketing (Spring 2002), 139–151.

that are actually recruitment frauds. This article was also footnoted in the FTC Notice of Proposed Business Opportunity Rule (April 12, 2006).

- Three federal court rulings (Omnitrition, Koscot and Gold Unlimited), that the FTC has also cited in recent prosecutions and which establish a lack of retailing to ultimate end-users as the basis for defining a pyramid marketing scam.
- The long term precedent of FTC actions against MLM companies, some of which were DSA members, in which the FTC used retail selling levels as the key determining factor.
- The “retail test” used by the FTC in its prosecution of Equinox International. This test determined what minimal level of retail revenue would be required to cover 51% (a majority) of the commissions paid by the MLM to the upline recruiters. 51% was used as the absolute minimal level of rewards that must be funded from outside the pyramid chain, i.e., from retail revenue paid in by consumers who are not also distributors.

In the case of Equinox, the test revealed that at least 70% of Equinox distributor purchases would have to be resold at full retail price to generate this required outside revenue. The FTC estimated that less than 20% of Equinox goods were ever retailed, causing the FTC to determine that Equinox International, a DSA member, was a pyramid recruiting scam. The FTC successfully closed down Equinox and recovered millions of dollars in restitution for victims.

- Application of this test to other MLMs, including various DSA members, which reveals the same 70% benchmark. This 70% retail level has also been used by the state of North Carolina Attorney General in settlements with various MLMs that it prosecuted.
- A straightforward business model analysis that reveals the inherent flaw in an endless chain. Endless chain recruiting is not sustainable over time. In the pyramid design, with each level larger than the one above, the majority of all recruits are always in the lower levels where no profit can be earned, due to lack of new recruits below them. Therefore all promises or claims about an MLM recruitment model being a viable income opportunity are *false and misleading*.

### **DSA’s Lobbying and Promotions**

DSA’s website appears to support a retail criteria<sup>5</sup>, however, its code of ethics specifically references a few state statutes in which retail sales are not required. In the ethics code, DSA appears to claim that as long as rewards to recruiters are sourced from

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<sup>5</sup> At the page <http://www.dsa.org/aboutselling/consumer/index.cfm?fuseaction=pyramid>, DSA advises consumers: “Avoid dealing with companies that sell few or no products to consumers.” At <http://www.dsa.org/aboutselling/consumer/index.cfm?fuseaction=pyramid#multilevel> DSA describes MLM as “like other methods of retailing” and recommends the consumer to ask, “Are the company’s products sold to consumers? IF THE ANSWER IS NO (OR NOT MANY), STAY AWAY! This is a key element. Multilevel marketing (like other methods of retailing) depends on selling to consumers and establishing a market. This requires quality products, competitively priced. Pyramid schemes, on the other hand, are not concerned with sales to end users of the product. Profits are made on volume sales to new recruits, who buy the products, not because they are useful or attractively priced, but because they must buy them to participate. Inventory purchases should never be more than you can realistically expect to sell or use yourself.”

wholesales purchases of other salespeople (investments) inside the MLM, the model is legitimate and meets the DSA's ethical test.

DSA's position is also questionable because the largest multi-level marketing company ever prosecuted by the FTC, Equinox International, was a dues-paying member of DSA; and one of the experts who testified on behalf of Equinox, defending the company against the FTC charges that it was a pyramid scheme, had been a member of the Direct Selling Association Education Foundation. The FTC applied a retail sales standard for determining that Equinox was a pyramid scheme.

Further, DSA has lobbied for a bill, referred to as HR 1220<sup>6</sup>, in Congress and at the state level that pointedly omits retail selling as a criteria. The bill seeks to exempt from the definition of a pyramid scheme any multi-level marketing scheme that derives its revenue from product purchases. According to the wording of the DSA-lobbied bill, schemes that gain all their revenue from distributors, without any retailing, would be *exempt* from the definition of a pyramid scheme.

### **The DSA Position**

In a 12/27/06 telephone conversation, Mr. Mariano offered nothing, only repeating DSA's seemingly contradictory position that is presented on the DSA website. He stated that the DSA does, in fact, hold that retail selling is an essential element of a legitimate direct selling business.

However, he also confirmed DSA lobbying efforts that oppose any method, as the FTC has used in prosecutions, of determining when a company is primarily based on wholesale purchases and endless chain recruiting rather than retail selling.

Mr. Mariano emphasized the economic role of consumers who join MLM businesses but *deliberately* never make any retail sales. These persons, he claimed, invest in the business only to buy the MLM products at a wholesale price or perhaps just to socialize with other MLM participants, *but specifically not to earn any income at all.*<sup>7</sup>

He said DSA considers the people who don't want to make any money to be a fundamental constituency of MLM. He said their lack of income was *voluntary* and, therefore, should not be counted as consumer losses caused by the MLM model. Since they did not intend to make money, their lack of income should not be considered a *harm*. And, since they voluntarily entered the MLM with no intention to earn an income from retailing, their lack of retail income should not be used in any statistical standard established for required levels of retail selling.

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<sup>6</sup> For the full text and analysis of this proposed law see <http://www.pyramidschemealert.org/PSAMain/news/DSABill/DSAbill.html>

<sup>7</sup> In its letter to the FTC opposing the FTC proposed rules to regulate schemes that promote "business opportunities", (<http://www.ftc.gov/os/comments/businessopp/522418-12055.pdf>) DSA segments MLM participants according to various motivations such as "social contacts, recognition and product advocate." Some of these "motives" are presented as alternatives and exclusive of the goal of earning a profit. Though DSA states that it cannot assign a percentage of the total to each group, it infers that the proportion of those who are not trying to earn any money is so large that DSA argues that MLM should, therefore, be exempt from any regulations that target companies that promote "business opportunities." The very first group identified by DSA among the seven subgroups is "Wholesale or Discount Buyers: These individuals technically are salespeople in that they sign up as salespeople but do so primarily to buy the company's products at the wholesale or discount price accorded members of the salesforce. Generally, they do not sell or recruit."

Further, since the purchases were not intended as investments or “consideration” for the right to recruit and resell in the business opportunity, then payments derived from these purchases are not rewards for having recruited these non-retailing participants. They are “commissions” from “sales” to them.

The proposed law that the DSA lobbies for continues this rationale by seeking to eliminate any reference to retail sales in defining a pyramid scheme. If rewards are tied to product sales “to anyone”, as the DSA sponsored bill states, the scheme cannot be defined as a pyramid scheme. Thus a scheme that only sells to its own salespeople – who pursue the business opportunity of seeking rewards based on fees and purchases of new recruits – would now be legal. The need for retail selling would be legally *erased* and the massive loss rates that such as recruitment program necessarily would inflict would no longer be an “unfair” business practice. Recruiting people into this type of program that will inflict these losses and promoting it as “the opportunity of a lifetime” would no longer be “deceptive.”

This political campaign is matched with a DSA publicity campaign that continuously states that MLMs are not pyramid schemes if “they sell a product.”

Mr. Mariano said the exact percentage of MLM participants who deliberately choose not to seek a profit is unknown, but he indicated it is substantial, perhaps the majority. He and others characterize this group as a fundamental constituency of MLM. He compared them to conventional retail customers or to members of a buying club and rejected any evaluation that would include them as people who lost money in pursuit of the MLM “business opportunity.”

### **Feasibility of MLM Retailing**

Before evaluating DSA’s claim that lack of retailing in MLM is “voluntary” and that millions of people become MLM resellers only to avoid retail pricing and explicitly not to earn any income, it is important to consider the feasibility for successful MLM retailing, if a reseller did want to pursue it.

That there is little or no evidence that MLM resellers actually resell any significant amount of products at retail prices is also borne out by nearly universal consumer experience of seldom encountering a door to door *product sales* solicitation by an MLM reseller. However, virtually everyone in America has been solicited or pressured by an MLM participant to invest in an MLM *business opportunity*.

The MLM industry and individual MLMs offer no data about retail sales other than the counts of “Preferred Customers” who are buying at *wholesale prices* and many of which may be former distributors or the immediate family members of distributors. Some may be accounted as phantom purchases needed by the distributor to meet purchase quotas for receiving commissions related to recruiting.

However some data is available and a market analysis can be made to shed light on the feasibility of successful MLM retailing.

1. Per capita purchases by MLM resellers are typically about \$1,000 - \$2,000 per year or even less. This small annual inventory investment generates very little potential retail profit. And this retail profit potential would be even smaller if actual personal purchases, product giveaways and discounting were considered.
2. Door to door selling has nearly vanished from the marketplace due to the availability of products through other more convenient and economical channels such as big box

stores and direct internet purchasing. Only a few market sectors remain where person-to-person selling outside a retail store prevails such as real estate, home improvement, some forms for insurance, funeral plans and personal financial planning. Some “party planning” products also generate retail sales in the home, aimed chiefly at women.

3. Door to door selling has dissipated also because few consumers have time for product demonstrations and sales presentations in their homes or on a one-to-one basis.
4. While most consumers *refer* products or services to friends and relatives, actually buying from or seeking to profit from close friends in commercial transactions is uncomfortable or inappropriate to many people who recognize that it can result in lost or alienated relationships.
5. The retail profit margin offer in most MLMs is less than what is traditionally offered in direct selling.
6. Personal advertising using the company logo is prohibited in most MLMs.
7. MLMs do not offer national brand advertising to support retail sales.
8. MLMs do not conduct marketing programs to generate sales leads for MLM resellers.
9. Most MLM products are unknown or are undifferentiated.
10. Most MLM products are higher priced than similar products.
11. Some MLMs interfere with retail sales by their own selling program to “Preferred Customers” who can purchase products at the same price distributors pay.
12. All MLMs authorize *every* reseller to recruit other resellers thereby thwarting those would seek to sell the products at retail prices to the public. The unlimited authorization exponentially increases competitors to a would-be retailer and offers all retail customers the opportunity to buy at wholesale pricing, The MLM compensation program rewards *recruiting* activity which generates commissions from the company more so than one-to-one retailing. 40% - 50% of net value of all *purchases* made by the Associates is transferred by MLMs to the recruiters in the form of commissions. The lure of recruiting is further compounded by MLM’s granting greater percentages of reward to those at the highest level of the recruitment chain. 50% of all commissions from most MLMs are transferred to the top 1% of recruiters.
13. An MLM reseller gains potentially more reward from recruiting another reseller who purchases at wholesale than a retail customer. The newly recruited reseller likely generates more purchase volumes over time along with the additional potential reward from their own respective recruitment activity that accrues benefits to the earlier recruiter.



## **Evaluation of DSA Position**

In my view, no legitimate business analysis could treat such non-retailing resellers as “ultimate end-users” or in any way equate them to retail consumers or as members of a discount buying club, as DSA attempts to characterize them. Nor could participation of such people be treated as central or fundamental to the MLM business model to justify opposing a proper assessment of retail sales levels for regulatory purposes, as DSA is doing.

The lack of retailing success or effort by some MLM participants is no basis for claiming they are not also participants in the “business opportunity.” This is all the more true given that feasibility of MLM retailing is severely limited and DSA and all MLMs have no data on actual retail levels

Perhaps most important, previous FTC prosecutions and evaluations of MLM companies fully allowed for the existence of many participants who, *for whatever reason*, did not retail the products. The existence of these people in MLM, therefore, cannot be said to preclude a formal method of evaluating MLMs or be a basis to change laws to explicitly allow pyramid recruitment schemes.

*The DSA lobbying effort and this line of rationalization for opposing a method of evaluating MLMs with a retail criteria appear to be a thinly disguised effort to defend and protect recruitment scams within the membership of the DSA.*

## **Gifting Club Revisited**

The DSA claim – that the people who purchase MLM products “for personal use” are effectively the same as retail customers and that their purchases should not be viewed in any way as “business investments” necessary for gaining rewards from recruits who make similar investments – has a familiar ring.

It is reminiscent of the women who were arrested in several states during the national epidemic of “gifting club” pyramid schemes in 2002-2004.<sup>8</sup> The schemes operated under various names but were essentially identical. They spread to more than 30 states as well as to Europe, Australia and Africa.

In those scams, the perpetrators insisted that no one was investing or paying money to join the scheme. No, they were only making “gifts” and in fact had no thought of reaping rewards from recruiting. They acknowledged that the “gifting” plan was organized in a pyramid structure, with four levels, each one twice the size of the one above. And each person did recruit others to advance to higher positions in the plan. And, when a person got to the top of a four-level structure they did receive money paid in by the last eight people to join the bottom level. But that was not a reward based on recruiting, they claimed. That money was a *gift* from those eight! All that the gifting club did, they said, was transfer money that was given and received as “gifts.” This, they claimed was *voluntary* and *legal* and *no one was harmed* from the process of “giving and receiving.” In fact, they said, government action to restrict this voluntary activity was oppressive and intrusive. In Texas, one group hired a lobbying firm to draft a bill that would legalize such clubs.

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<sup>8</sup> See *Ladies Home Journal*, April 2004, “More Money Than You Ever Dreamed Of”, by Michael J. Weiss, an exposé of “gifting” pyramid schemes recruiting women throughout the United States.

MLMs, correspondingly, require the recruits to pay fees in order to join and sign a formal contract for participating. They require each recruit to maintain a monthly purchase levels, usually achieved through a pre-paid monthly order of products, in order to receive rewards based on the purchases of those they recruit. Some also require purchases of training programs or on-line tracking programs. Though not required, some exert extreme pressure on recruits to invest in seminars, books and tapes that they say are essential for success.

The MLM plan operates with a multi-level structure with each level larger than those above. And a formula is applied in which the *majority of all the money* paid in by the latest participants to join – who are also the *majority of all participants* – is transferred directly to those at the top levels.

But, when the rewards are paid, the DSA, like the women in the gifting schemes, claims that the payments did not come from anyone "paying consideration" to join the scheme with the intention of earning rewards. No, these people just purchased products for their "personal use" just as the women were making "gifts." Similarly, the rewards paid to the MLM "upline" were not for *recruiting* anyone. It's just that new recruits purchased products for their personal use and the plan transferred some of that money as commissions on *sales* to them.

The gifting clubs claimed that the payments were *gifts given* and the rewards gained were *gifts received*. MLMs claim payment made by recruits are *purchases for personal use* and rewards gained are *commissions on sales*. Both claim that the losses of nearly all who participate – since in a closed pyramid system only a few at the top can be profitable – are harmless since the people are not trying to make money!

The MLM industry's claim that many, perhaps most, recruits are not seeking rewards and the payments to recruiters are not connected to recruiting is as legally fictional as the claims of the perpetrators of the gifting scheme frauds. The payments made by MLM recruits are no more *purely* "purchases for personal use" (totally unconnected to a business opportunity) than the gifting club participants were earnestly giving and receiving "gifts."

### **Dropouts, Failure and Collapse Clarified**

The DSA reclassification of lack of retailing as "purchasing for personal use" and consequent massive loss rates as "voluntary" follows previous DSA manipulations of realities concerning the nature of endless chain sales schemes. Earlier manipulations of reality include the reclassification of victims of pyramid expansion as "failures, quitters and dropouts." The massive loss rates suffered by the churning of these consumers were redefined as normal "high turnover" and "low retention."

MLMs are *designed* (structure and compensation plan) as endless chain recruitment programs. Unless the revenue to the recruiters would come from real customers who are not part of the chain, (retail selling) the only way for all new MLM salespersons to recoup their investments and gain a profit would be to recruit a multiple of new salespeople *in a never-ending expansion*.

Of course, this is not possible, any more than a chain letter could continue indefinitely. *It must collapse*. And collapse must cause losses to the great majority at the end of the chain. An endless chain cannot fulfill its promise of profit to any but a few; and to operate, it must deceive. This is why they are treated as "inherent" frauds.

However, when chartered as a “business” an MLM can continue for many years. When loss rates are covered up, it can even give the illusion of sustainability and stability. Its continuation and growth over time have been cited by Amway, the oldest and largest of MLMs, as an argument that it could not be a pyramid scheme, since, its promoters say, pyramid schemes are destined to collapse quickly by “running out of participants.”

In reality, pyramid schemes do not “run out of participants.” Rather, the latest participants perceive that they cannot recruit *enough people to move up the chain*. Many more people could still join the scheme, but not in the numbers to allow the large group at the bottom to be successful. When large numbers of people in the bottom levels “quit” the scheme, the plan will stop functioning – *unless the hapless “quitters” can be replaced*.

With little or no law enforcement<sup>9</sup> and with most “losers” silenced by ignorance or shame<sup>10</sup> and through expansion to more and more territories an MLM pyramid scheme can delay total collapse for many years. It can replace the doomed bottom levels of “losers and quitters” year after year.

For as long as it operates, the MLM scheme is collapsing *every year*. But due to the ability of the corporate entity to continue recruiting, the scheme can go on, while the collapse is borne by the latest recruits. This takes the form of 50-70% rates of “failures” or “dropouts” among those in the bottom levels – the last to join. These consumers who inevitably must lose in the pyramid model are falsely reclassified as “failures,” meaning *personal* failures, or as dropouts, meaning consumers who make a *private decision* to leave the program, much like a student that “drops out” of college.

It must be remembered that the burden of collapse in *all* pyramid schemes is *always* borne by the latest recruits, since the latest recruits will always represent 70%-90% or

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<sup>9</sup> In 2001 George W. Bush appointed Timothy Muris to head the FTC. From that point, the FTC effectively stopped investigating and prosecuting MLM pyramid schemes. In the four previous years, the FTC had prosecuted more MLMs than it had in the previous 17 years. Muris’ last job before chairman of the federal agency that regulates multi-level marketing was as an attorney with the antitrust division of the firm Howrey, Simon, Arnold and White, LLP. The antitrust division of Howrey counted among its largest clients the Amway Corporation. While Muris was with Howrey and while he was in charge of the FTC, his former partners in the antitrust division at Howrey represented Amway Corporation in a class action lawsuit initiated by a former Emerald-level distributor in the US District Court for the Southern District of Texas. The suit charged that the recruitment program of Amway is an illegal pyramid scheme.

<sup>10</sup> Seven key factors are manipulated by MLM schemes to assure silence of victims:

1. **Gullibility** – MLMs convince the new recruit that the scheme is entirely workable, legal and viable. The only reasons a person might fail, they are told emphatically and repeatedly, include laziness, lack of ambition, fear of success, poor character, lack of adequate effort, fear, or refusal to follow the prescribed marketing plan. In short, the people are told that those who fail are just “losers” or “quitters.” Therefore anyone who loses money will have no one to blame but themselves. Thus, when they do quit, most do so silently, shamefully and with great personal disappointment in themselves.
2. **Personal Shame** – few people are willing to admit to their own folly in losing money in the MLM scheme,
3. **Social Embarrassment** – Most people enrolled friends, family and neighbors while they were in the scheme. They harmed people who trusted them.
4. **Self-incrimination** – by getting each recruit to recruit others pyramid schemes make each victim, to some extent, also a perpetrator.
5. **Intimidation** – MLMs have been known to vilify, bully intimidate or to sue those who challenge them.
6. **Loyalty** – Most people who join the schemes were recruited by friends or relatives, some of whom may still be in the scheme.
7. **Cutting Losses** – The victims of MLM schemes (99% of all participants each year) have already lost significant time and money. Some may have quit their jobs or taken on debt. Their immediate and urgent need is to cut their losses and rebuild their personal and financial conditions.

more of the total. Often, those who got in early enough will have gotten their money before the scam collapses. The same scenario occurs with MLMs except that the scheme is allowed to resurrect each year and repeat the recruitment activity. Those who “got in early” in their respective territories or recruitment networks, the top 3-4%, receive the great majority of all rewards gained from the purchases of the newest recruits *each year*. In MLM, as in all pyramids, the last ones in are the source of all the money that is fed to the small group at the top. As data shows on Amway, the largest and best established of all MLMs, within five years, 96% of all who ever join have quit. 72% quit within the first year.<sup>11</sup>

This is not normal "dropout" or "failure." This is *collapse*. MLMs collapse every year with 50-70% of all participants “quitting”, after suffering financial losses. *But, they are replaced.*

This annual collapse must happen because if it did not, the entire scheme would *totally* collapse as the market would be saturated quickly with MLM recruits. Consider a hypothetical "successful" scenario of an MLM with 150,000 distributors and in which no one quit over a period of just two years and each person *recruited only two other people*. If each of the 150,000 recruited just two other salespeople as required in the "binary" plan used by many MLMs, there would already be at 450,000 (150,000 + 300,000). If the newly recruited 300,000 during this same year did the same thing – which *seems* likely given that the entire pay plan offers the incentives based on this kind of modest recruitment rate – then they would add another 600,000 in the same year. (300,000 x 2 = 600,000) That would mean a total 1.05 million (450,000 + 600,000) sales reps if just everybody stayed in for *one year* and recruited two and their recruits did the same.

If this was repeated the next year, the latest 600,000 recruited last year then recruited their two enrollments, that would add about another 1.2 million, (600,000 x 2) resulting in a total of about 2.25 million MLM reps *for this one company*. And if the newly recruited 1.2 million recruited their "binary" requirement of two people each, we would have another 2.4 million new MLM reps for a grand total of 4.65 million sales reps in just two years. This would be achieved if each person only recruited two other people!

This “successful” scenario or anything near it is obviously impossible. The market could not sustain nearly 4.65 million sales reps for this one company in this time frame. The scheme would collapse *totally*. If it did not collapse at that point, then the “sales force” would increase by 15 million more in the next year, etc.

Instead of this explosive collapse scenario in which eventually all of us would become MLM salespeople, the "dropout rates" of 50-70% slow the advance, thereby *enabling* the MLM company to operate for a longer period. In this way the scheme can go on for longer – but not forever. New territories are continuously needed. Exponential expansion does not occur, but extraordinary numbers of new people are needed every year to replenish the bottom ranks that fund the entire scam, triggering the need for geographic expansion.

When these terms, "dropout," "turnover" and “retention” carry or infer *personal* failure, this is deceptive and misleading. When MLMs use these terms to imply normal business

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<sup>11</sup> “Company data from 2005 obtained by the Free Press show that about 72% of distributors drop out during their first year, and 96% are gone within five years.” (*Soap and Hope Model Criticized, Only Those at Top Get Rich, Some Say* by John Gallagher, Sept. 24, 2006)

failure among resellers or the rate of dropout as a result of “choice” or lack of talent or ambition among the resellers, they obscure and cover-up the reality of inevitable pyramid collapse. *When these terms are used in this way in SEC filings and other public documents, they are inaccurate and misleading descriptions of what is occurring each year and they disguise the true nature of the business that depends totally of a new base of “losers” each year.*

MLM “dropouts” are *pre-determined and unchangeable*. They are the result of unbending market limitations about which the MLMs have misled the resellers and the investors. 50-70% annual “failure” rates in MLMs and 99% financial loss rates each year among the resellers<sup>12</sup> are not by choice. Consumers “fail” at these staggering rates in MLM in the same way that nearly all lose in a lottery. The losses at these huge rates are *required* since they are the source of the “winnings.” (The great majority of the MLM commissions are transferred from the “losers” to the top 3% as “earnings”). Such a failure is not by choice and it is not for lack of effort or ability. It is mathematically planned and determined. And those organizing and managing the MLM know this will and must occur even as they recruit consumers with promotions about “unlimited” income and the “opportunity of a lifetime.”

### **FTC Prosecutions and Retail Benchmarking**

Without assigning any motive or reasons, the Federal Trade Commission prosecutions of MLMs in which a retail standard was applied took into consideration that many MLM participants do not retail the products. The FTC retail test used in the Equinox case, for example, allowed 49% of all commissions to be sourced from wholesale purchases of the distributors. It only required that the commissions be *primarily* based on retail revenue, that is, revenue from outside the chain.

The FTC considered this to be the minimal level of outside funding of an MLM business, which allows and rewards endless chain recruiting, without *being* an endless chain. Effectively, it allowed that the MLM scheme could operate legally, even though it is structured as a pyramid and in fact pays participants to recruit, so long as the majority (51%) of the payments (commissions) came from sources outside the chain, that is, from retail customers.<sup>13</sup>

Less than that, and the FTC prosecution treated the scheme as *primarily based on rewarding recruiting with payments derived from the later recruits in a classic endless chain fashion*. In that scenario the money for the pyramid transactions was simply laundered through product purchases. 40-50% of the price paid by the new recruit was transferred to the recruiters through these purchase transactions, and in most MLMs one-half of all the commission money on each purchase by a new recruit is transferred directly to the promoters in the top 1% of the chain. As the FTC website states, “The

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<sup>12</sup> Pyramid Scheme Alert has statistically documented 99% loss rates among all “active” participants in major MLMs, even before product purchases and other business costs are factored. See <http://www.pyramidschemealert.org/PSAMain/news/MythofIncomeReport.html>

<sup>13</sup> In the Equinox case, the FTC determined that at least 70% of all Equinox products sold to the distributors would have to be retailed at full retail price, without discounting, in order to pass the test. Pyramid Scheme Alert has applied the same test to other MLMs, some that are members of DSA, and produced the same mathematical result – 70% of all goods would need to be retailed at full price to be legal operations.

underlying goods and services, which vary from vitamins to car leases, serve only to make the schemes look legitimate.”<sup>14</sup>

### **Evaluating the Identity and Role of MLM Distributors**

The existence of the non-retailing MLM participants cannot justify a redefinition of their role in the system from reseller, as they are legally defined by the contract they sign, to “ultimate end-user,” as the DSA appears to be claiming. It is possible for an MLM to establish a category of end-users who buy at the wholesale price and is not authorized to resell the products or to recruit resellers for the MLM. But even where that status exists, it does change the basic model. The “preferred customers” are just retail customers who buy at distributor cost. Their payments are counted as retail sales.

It should be noted, however, that establishing a category of end-users who can buy at distributor cost serves to undercut the MLM as a “direct selling” business. The practice of selling to one group of “end users” at wholesale prices harms all the distributors who seek to earn profits from retail sales.

The legitimacy of all MLMs, even those with “preferred customers,” rests on a retail foundation. If a retail foundation does not exist, the MLMs operate as endless chain recruiting schemes that are only *disguised* as retail operations.

- MLM distributors sign a legally binding business contract that defines them as authorized independent *resellers*.
- The contract is an agreement to participate in a “business opportunity.”
- The contract authorizes the signer to function as an independent representative of the company empowered to recruit other resellers and to resell the product. It also establishes a formal system of rewards for doing so. Whether certain people purposefully choose not to retail the product or to seek rewards from recruiting other resellers, they are empowered to do so and could exercise that right at any time while the contract is in force.
- The signers are required to purchase a “sales” starter kit.
- Many of those who never retail any product purchase the MLM goods on an auto-ship monthly minimal order level, the level that the company establishes and requires for participants to maintain their qualification for commissions if they recruit others. *Purchasing at these specified amounts is tied to seeking profits and constitutes participation in the business opportunity.*
- The signers purchase the product at a fixed, non-negotiable price. No distributor can offer another distributor a discount within the MLM sales channel. If the MLM considered these people its prime market, not the retail end-users, this pricing practice would be illegal price fixing.
- Upon signing the agreement, the signers are henceforth restricted to purchasing goods only through the channel members in their direct upline. They are prohibited by the company from purchasing products through distributors of their choice. Likewise, the upliners cannot distribute goods to people in other lines, also an illegal practice if non-retailing people were actual “consumers” and the upline distributors are truly “independent resellers.”

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<sup>14</sup> <http://www.ftc.gov/bcp/online/pubs/alerts/pyrdalrt.htm>

- Upon purchasing goods, the resellers are restricted from reselling in any manner other than the company allows. They cannot publicly advertise to sell them or even to sell them on eBay, for example. Few “consumers” would buy any goods under what are clearly *commercial* restrictions that are intended to regulate the MLM sales channel, not the end-users.
- If they meet minimal monthly purchasing requirements, the signers are contractually entitled to receive rewards from purchases of a long line of other members. The rewards to this long line of upliners are built into the price paid by the new recruits (40-50% of the “wholesale price” is transferred to the recruiters). Many are told that they can recoup their entire costs of products if they should recruit even one other person who then recruits others in an eventual chain. So, whether they choose to seek a reward, an incentive is always presented to them and built into the price they pay.
- The signers contractually surrender rights that a consumer would normally have as a purchaser, e.g., agreeing never to disparage the company privately or publicly and to settle disputes only by binding arbitration, not in court.
- As a reseller, the signers could be implicated in any illegal or fraudulent activity of the company or upliners.<sup>15</sup>
- Upon signing the reseller agreement, they contractually surrender the right to promote other similar product lines or, in many cases, they must agree not to participate any other MLM companies at all, thereby limiting other income opportunities.
- The historical behavior of most MLM participants does not match those of consumers who would be so committed to a product that they would contractually obligate themselves as legal resellers. Most MLMs experience a 50-70% annual dropout rate among recruits. Based on sales data disclosed by the MLMs, these dropouts also stop buying the MLM products upon resigning from the contract. It would be extraordinary that so many would take on the costs and responsibilities of contracting as resellers only to stop buying the goods even as consumers in just several months. This pattern is, rather, the classic behavior of entrepreneurs who were not profitable and soon determined the cost of the “business opportunity” to be not worth further financial investment, time or effort. The dropout levels indicate failure among seekers of the business opportunity, not disgruntled consumers, who somehow abruptly and totally changed their mind about a product they had earlier sought so avidly.

These conditions clearly separate these MLM participants from consumers or even from a category of a member of a buying club. They are obviously what the contract defines them as, *authorized resellers*. That some might choose or by circumstance be unable to resell the products and earn a retail profit does not change their status.

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<sup>15</sup> The (January 2007) FTC website advisory entitled *The Bottom Line on Multilevel Marketing Plans*, advises consumers, “If you decide to become a distributor, you are legally responsible for the claims you make about the company, its product and the business opportunities it offers. That applies even if you're repeating claims you read in a company brochure or advertising flyer. The Federal Trade Commission advises you to verify the research behind any claims about a product's performance before repeating those claims to a potential customer.

In addition, if you solicit new distributors, you are responsible for the claims you make about a distributor's earnings potential. Be sure to represent the opportunity honestly and avoid making unrealistic promises. If those promises fall through, remember that you could be held liable.”

(<http://www.ftc.gov/bcp/conline/pubs/alerts/pyrdalrt.htm>)

It is not reasonable that large numbers of people would take on all of these legally binding restrictions and obligations only to purchase goods at a discount *without any interest whatsoever in the attached “income opportunity.”*

The question also arises as to why these consumers would not just seek a discount from any of thousands of existing MLM resellers that are available. Any of these resellers can sell the MLM goods at any price they choose, *including at cost.*

### **Evaluating the MLM Business Model**

It is not reasonable that any group that purposefully chooses not to retail the MLM products would be central or fundamental to the MLM company’s marketing or business model and the “income opportunity” that it offers. In any event, such a group of “non-performing” resellers, does not change the business model. The MLM income opportunity is still based on each reseller recruiting others in an endless chain.

- If selling directly to consumers at the wholesale price is the core mission of an MLM company, that company could not claim also to support “authorized resellers.” All those who do try to resell the goods at a retail price would be competing with the company that is offering to sell the goods to consumers at wholesale price.
- Despite the damage such activity does to retail efforts of other resellers, several MLMs have, in fact, established a “preferred customer” category of consumers that can buy at wholesale but cannot resell or recruit. These are ultimate end users, however, the resellers earn no retail profit from soliciting them. They can, however, earn commissions on the purchases under the MLM pay plan. Often the pay plans require the recruitment of other resellers before income can be earned from the “preferred customer” purchases.

In no case do these people constitute more than 20% of the company’s revenue. Many are ex-resellers and remain “preferred customers” only a short period before quitting the scheme completely. In all cases, the MLM company promotes efforts to upgrade or reinstate their status from Preferred Customer to authorized reseller.

- Where income is based primarily on resellers recruiting other resellers, the existence of a large group of non-performing resellers, whether they are purposefully unprofitable or not, does not change the pyramid recruitment model. Rather, the large group at the bottom who, according to DSA rationalization, voluntarily chooses not to even try to make a profit, serves to restrict the incomes of the lower ranks of recruiters. The non-performers “break the chain.”

### **Evaluating the Financial Results**

Whatever the number of “consuming-only” MLM distributors, it would not appreciably affect the devastating financial realities inherent to a multi-level pyramid structure and recruitment-based pay plan *affecting those who do pursue the business opportunity.* If the income of those who seek a profit depends primarily on commissions derived from the purchases of a downline, the ratio of the downline to the upline is fixed. A large number of downline participants will be required for a small upline to be profitable. The percentage of commissions paid to those at each level of the hierarchy is also established in the pay plan formula. *The loss rates among those pursuing the recruitment-based business opportunity, based on these pre-determined ratios and pay plan formulas that send most of the money to the top ranks, will be extreme.*



In such a plan, regardless of “consuming-only” MLM distributors, the largest number of those seeking an income must, by the design of the pyramid structure, be at the bottom levels. If the majority of the rest of the participants are just interested in buying the goods from time to time, and not in reselling them or in recruiting other participants, then those at the lower levels cannot earn a profit.

In a recruitment-based program, the existence a large number of non-performing distributors at the base is the same as the end of the “endless chain.” They could not provide nearly enough revenue from their own “personal” purchases or be in large enough number to be profitable to the entire upline, only to the few at the top. Moreover, this group quits the scheme at rates of 50-70% each year, adding to the costly recruitment work of those in the lower ranks.

Without a large base of retail customers for *all* resellers, profitability in a recruitment-based pay plan requires *multiple and ever-expanding* levels of a downline, which is impossible.

### **Illustration**

To illustrate how reclassifying the no-profit participants does not appreciably change the harm caused by a recruitment-based MLM scheme, consider the actual data from one representative DSA member, Usana Health Sciences, a publicly traded company that has disclosed some payout data.

On its website<sup>16</sup> Usana reports that 60% of its entire sales force earns no commissions at all. Additionally, Usana also offers a “preferred customer” status to consumers who can buy Usana products at wholesale price. These consumers represent only 14% of Usana annual revenue. Resellers earn no retail profit from preferred customers but, under certain conditions, can receive company commissions based on their purchases.

If every single person among the no-commission resellers is excluded from average income evaluations and is treated as *purposefully unprofitable* and only those who pursued the income opportunity are counted, the following data are revealed:

- The bottom two levels of the multi-level structure – counting only those who pursued the income opportunity -- constitutes 69% of the entire sales force. The mean average income of this group is \$3.87 per week, before product purchases costs, business expenses and taxes, *meaning a substantial financial loss*.
- The mean average income of the bottom 99% of all resellers who pursued the business opportunity was \$21.73 per week, before product purchases costs, business expenses and taxes – *indicating an average loss*.
- Less than 1% (0.86%) of the sales force who constitute the top ranks of the sales chain received 44% of the entire company commission payout.
- The bottom two levels, who constitute 69% of the entire sales force received just 8% of the entire company commission payout

Even when the losses suffered by 60% of the other members of the chain are reclassified as “voluntary,” dismissed as “no harm” and are excluded from the calculation, the devastating pyramid pattern remains – a concentration of profit at the very top of the chain and the vast majority of others positioned at the bottom where they are doomed to

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<sup>16</sup> [http://www.usana.com/media/File/Policies and Procedures page/US/US AveIncome.pdf](http://www.usana.com/media/File/Policies%20and%20Procedures%20page/US/US%20AveIncome.pdf)

financial loss (being at the bottom of the “endless” chain.) *Any characterization of this system as a viable business opportunity for consumers would be deceptive.*

Finally, whether a significant number of recruits purposefully choose never to seek a profit, it would not change the fact that the commissions that are paid to the upline are based primarily on recruitment efforts. It would still be a closed system with fixed prices and based on endless chain recruiting.

### **Evaluating the Offer of Refunds**

The associated DSA claim – that MLMs’ offer of limited refunds to recruits serve to protect consumers from harm – deserves only brief disproof and repudiation.

- Either the non-retailing, recruitment MLM model is unfair and deceptive and constitutes a pyramid scheme or not. If it is, a refund would hardly serve as restitution and would not change the fact that a systematic fraud was perpetrated.
- Said another way, the DSA claim is that if a consumer is quick witted enough to discover the fraud, the perpetrators will allow the victim to recoup some, but not all, losses, while the promoters retain the right to continue perpetrating the scam on others.
- The victims that discover the odds of success in the recruitment model are insurmountable may have a limited opportunity to recoup some losses from product purchases, but not from fees, the costs of bogus “motivation” programs and the possibly large amounts of time and effort invested in the scheme, all of which accrued to the benefit of the perpetrators.

Other more mundane realities about nature of MLM operations also negate the value of a limited refund offer.

- MLM participants are told emphatically that the *cause* of failure is *quitting*. Quitting is vilified as the hallmark of “pathetic losers” and lazy people. The thrust of the solicitation is to induce people to remain in the scheme as long as possible, thereby inflicting larger losses and also *forfeiting some of the refund opportunity*.
- The MLM recruits are told to use, consume or give away the goods, also forfeiting the opportunity to limited refunds.
- The refund offers are fraught with limitations, including conditions of goods, continued offer of the exact product by the company (often packaging is changed, negating the refund offer), time restrictions, methods of application for a refund, and packaging and shipping the returned goods for refund.
- Consumers enter MLM as a *business venture*. They sign legally binding reseller agreements. Seeking a refund requires a recognition that entry into the program was an error in judgment or that lack of success was caused by the program itself, not the recruit’s lack of ability. These are insights and realizations few recruits have at the time of quitting. The MLM companies emphatically claim and repeatedly tell the recruits that if they fail, *it will be only their own fault*. To seek a refund, a participant must overcome and reject this powerful message of condemnation and self-blame.
- Consumers who quit the MLMs are coping with disappointment, shame, pressure from colleagues, concern for others that they may have implicated, worry about legalities, etc. Typically, consumers leaving MLM schemes want to distance themselves from the bad experience, move quickly to some other enterprise,

rationalize their losses or try to forget about their “failure.” All such emotions and concerns weigh against a rational and calculated decision to go through the procedures for a limited refund.

The refund offer is of little actual value to victims. It is a ruse to divert proper regulation and evaluation.

### **DSA’s Disinformation Campaign**

DSA’s claim that the existence of non-retailing MLM participants should preclude a retail level criteria for evaluating an MLM’s legitimacy is without merit. An effort to redefine as “ultimate end users” tens of thousands of consumers who suffer financial losses in MLMs or to ascribe a no-income *intention* to them – and therefore no harm – is unsubstantiated, unreasonable, and absurd. Considering the extraordinary marketing campaigns of MLM companies based on the lure of a “unique income opportunity” and MLM’s self-definition as “direct selling” and “home based business” the claim is disturbingly disingenuous.

Not only is the claim unfounded and unreasonable but it does not appreciably change the devastating financial outcome of a pyramid recruiting scheme, masquerading as a direct selling business.

The claim turns out to be the cornerstone of a political campaign by DSA to change state and federal laws in order to legalize behavior that currently is treated as fraudulent. This campaign chiefly would protect DSA members from future prosecution. The effort to reclassify those who suffer losses in the MLM business opportunity as ultimate end-users who never sought to earn a profit in the MLM program is a dis-information campaign to obscure reality. It is also an egregious insult to the millions of consumers who responded to MLM business opportunity solicitations and suffered financial and personal harm due to an inherently fraudulent model and deceptive business practices.