

Comments and Recommendations from
Pyramid Scheme Alert
On the proposed
FTC Business Opportunity Rule, R511993



*International Association to Expose,
Study and Prevent Pyramid Schemes*

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Introduction and Credentials for Comments:

In response to the FTC request for consumer commentary on its *Notice of Proposed Rule Making*, Pyramid Scheme Alert respectfully submits information and recommendations in the following pages.

Additionally, PSA officially requests that it be invited to testify and offer its information and research at any Hearings scheduled on the proposed *Business Opportunity Rule*.

Pyramid Scheme Alert (PSA) is the Nation's largest and most active non-profit consumer organization with the specific mission of analyzing, exposing and educating consumers about pyramid marketing schemes. Formed in November 2000, PSA directly assists thousands of consumers each year with email or direct phone assistance. Its website, <http://www.pyramidschemealert.org>, offers analytical tools, research, news, and essays about distinguishing pyramid marketing schemes from legitimate direct selling.

PSA Directors and Advisors have served as expert witnesses and consultants in pyramid marketing cases for the US Dept. of Justice, State Attorneys General and State Attorney offices in Florida, North Dakota, Kansas and Tennessee. PSA advisors include a retired Asst. Attorney General of Wisconsin; a nationally recognized attorney with expertise in franchises; a nationally-known medical doctor with special expertise in quack medical remedies, many of which are promoted by pyramid marketing schemes; and a former official of the SEC and author of a book on securities fraud and internet-based scams.

Advisors include also attorneys who have handled consumer lawsuits involving deception and unfair marketing tactics by large multi-level marketing companies. Others are authors and consumer advocates with long-term personal experience in multi-level marketing companies.

PSA officers have been featured speakers at meetings of the White Collar Crime Center in Richmond, VA, and at the national meeting of the National Association of Consumer Protection Investigators. PSA president, Robert FitzPatrick has been selected to address the national meeting of the Association of Certified Fraud Specialists in San Francisco in September 2006, on the subject of distinguishing legitimate direct selling from pyramid marketing fraud.

PSA Directors been interviewed and consulted by a broad spectrum of the international media on the subject of pyramid marketing schemes and bogus business opportunity schemes masquerading as direct selling businesses. Media appearances include *NBC Dateline*, *CBS 60 Minutes*, *NBC Today* and *ABC World News*. PSA officers and advisors have been quoted in the *Wall Street Journal* and in newspapers across the nation. They have also been interviewed on the *BBC* and in the national news shows in Asia, Europe and Canada.

PSA has conducted research and analysis of the compensation plans of numerous multi-level marketing schemes. The most recent report that is available free on the PSA website, entitled, "The Myth of MLM Income Opportunity", analyzed income disclosure data from eight major multi-level marketing companies. The report reveals that the average gross incomes of the bottom 99% of all active distributors ranged from \$1.68 to \$16.57 per wk., *before product purchases and all other business expenses were deducted*.

Four independent studies by PSA Directors and Advisors have uncovered loss rates approximating 99% in multi-level marketing companies where income is primarily based on recruiting and selling product only to new salespeople rather than selling products on a retail basis to the general public.

Much of PSA's services are now provided to consumers, journalists, consultants and governments outside the USA, as US-based "business opportunity" scams spread globally. In 2005, PSA's president, Robert L. FitzPatrick, was invited by the Central Bank of Sri Lanka to assist that country in writing a law to combat pyramid marketing schemes. At an international conference in Colombo, he spoke to Central Bank representatives from Sri Lanka, India, Bangladesh, Bhutan, Nepal and Maldives, all of which expressed concern over US-based pyramid marketing schemes entering their nations and deceiving and impoverishing their citizens.

PSA has provided extensive service and information to the Chinese consulting group, Beijing Pan-Pacific Direct Selling Institute, which directly worked with the government of China in its deliberations over a new law regulating multi-level marketing. The booklet, *Pyramid Nation*, written by PSA president Robert FitzPatrick, was translated into Chinese by this group as part of its consultations.

In 2005, after a long period of study and analysis, China banned the business practices of multi-level marketing schemes which reward recruiters based on the investments of later recruits in an endless chain. This was in compliance with the recommendations that Pyramid Scheme Alert made to its Chinese consultant counterparts. Effectively, China has now outlawed the MLM business model as it is widely practiced in the USA today while allowing direct selling that is retail-based.

Overview and Summary:

The FTC “Notice of Proposed Rule Making” for a new rule entitled “the Business Opportunity Rule” states,

“The proposed Business Opportunity Rule would also address the sale of other business arrangements that are currently outside the scope of the Franchise Rule, but have been shown by the Commission’s law enforcement experience and complaint data to be sources of prevalent and persistent problems. *Two important types of fraudulent or deceptive opportunities that would fall within the proposed Rule’s coverage are work-at-home schemes and pyramid marketing schemes.*”¹

Pyramid marketing schemes are distinguished from other business opportunity frauds by the scale of harm they cause and the specific tactics used to solicit victims. In terms of directly affecting the largest number of US consumers as well as consumers in other parts of the world, pyramid marketing schemes clearly harm more people than any other type of “business opportunity” fraud. They employ mass meetings involving thousands of people to solicit and entrap consumers. They deceptively enroll each new recruit to expand the recruitment program by promising income based on “geometric expansion.” Each new recruit is urged, incentivized to enroll additional members in an endless and ever-expanding chain.

As just one example of many that reveal the enormous number of victims harmed by these schemes each year, it is estimated that the pyramid marketing scheme, SkyBiz – which was ultimately closed down by the FTC – tricked more than one million people into investing in its multi-level marketing “home-based business” as SkyBiz “distributors.” Government agencies in Australia, New Zealand, the UK, South Africa and Canada cooperated in the prosecution.

PSA receives requests daily from consumers all over the world asking for information related to multi-level marketing companies and pyramid marketing schemes. *The number-one question posed to PSA by consumers all over the world is how to know the difference between legitimate multi-level marketing (MLM) and a pyramid scheme.* The PSA site receives more than 150,000 hits per month.

Virtually every inquiry received by PSA regarding multi-level marketing companies concerns income claims of MLM promoters and organizers. PSA leaders have amassed thousands of testimonials of consumers who assert that they were deceived and misled by MLM promoters. The harm suffered by consumers ranges from the loss of a few hundred dollars and several months of wasted effort to bankruptcies, heavy debts, divorces, loss of careers, and alienation from friends and family, all directly attributable to deceptive earnings claims made by promoters.²

¹ Federal Register / Vol. 71, No. 70 / Wednesday, April 12, 2006 / Proposed Rules, 19059

² In a recently settled class action lawsuit brought by consumers against a multi-level marketing company – a member of the Direct Selling Association and its affiliated recruiting organizations – 2,700 former distributors filed claims with aggregate losses totaling approximately \$19 million. (Nancy Jacobs, Individually on behalf of herself and all others similarly situated, and on behalf of the General Public, Plaintiff, vs. Herbalife International, Inc., Herbalife International of America, Inc., Dream Builders & Associates International, Inc., et. al., Class Action Complaint, Feb. 15, 2002 filed before the United States District Court for the Central District of California Los Angeles Division)

Many have been told by pyramid promoters that if “a product is sold, the business opportunity cannot be a pyramid scheme.” Thus confusion, disinformation, and subsequent consumer losses grow annually.

The proposed rule offers a unique opportunity to aid consumers in recognizing a pyramid marketing scheme by requiring all multi-level marketing companies to make basic disclosures that will reveal their veracity. Such a rule would also aid the FTC and the states in regulating such pyramid scams and protecting consumers from fraud through fair application of the Rule.

PSA recommends and requests that the FTC adopt rules that require:

- 1. All multi-level marketing companies must comply with earnings-claims disclosure rules. No multi-level marketing company should be given an option of making “no earnings claims”.**
- 2. Disclosure by all multi-level marketing companies of the average *retail-based* income earned by participants in each level of the hierarchy. This retail income average must be documented with verifiable data on actual retail sales.**
- 3. Income disclosures of multi-level marketing companies must include:**
 - ***the total number of all participants who have joined in the past year, not just a subset of so called “active participants” in one part of a year.***
 - ***the average net, not gross, income of participants in each level. Average net income is defined as the average of all monies received from the company by participants in each level minus the average of all moneys paid to the company by participants in each level. Expenditures paid to the company include product purchases, renewal fees, shipping costs, books, audio and video tapes, training and motivation seminars, computer fees, etc.***

Supporting Analysis and Explanation:

Since 1990, according to the *Notice of Proposed Rule Making*, the Federal Trade Commission has brought 20 cases against pyramid schemes under section 5. As defined by the FTC’s expert on pyramids, Peter J. Vandernat, whose academic paper is referenced in the Notice of Proposed Rule Making³ and whose declarations have been used to prosecute schemes such SkyBiz, Trek Alliance, Equinox International and many others among the 20 cases, “pyramid marketing schemes” can be defined and characterized by the following summary:⁴

³ The Notice of Proposed Rule Making references the article by Peter J. Vandernat and William W. Keep, *Marketing Fraud: An Approach to Differentiating Multilevel Marketing from Pyramid Schemes*, 21 J. of Pub. Pol’y & Marketing (Spring 2002), at 139– 151. (Federal Register / Vol. 71, No. 70 / Wednesday, April 12, 2006 / Proposed Rules, 19060

⁴ Count 5 of FTC Complaint for Permanent Injunction and other Equitable Relief, filed in the United States District Court, District Of Nevada, August, 1999, stated, “the Equinox program is an inherently unlawful scheme whose essential element is 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 the sale of the product to the ultimate users.... 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... This type of scheme is often referred to as a pyramid.”

In his formal declaration that concluded Equinox was a pyramid scheme, FTC pyramid expert, Peter Vandernat wrote, “In distinguishing between a pyramid scheme and a legitimate business, the critical issue is whether rewards paid in connection with recruitment are tied to, or are derived from, the sales of goods and services to the general

- Pyramid marketing schemes are multi-level marketing companies that are disguised as “direct selling” businesses. In the pyramid marketing scheme, very little of the goods or services are ever sold “directly” to the general public (ultimate end users) and virtually none of the pyramid marketing scheme’s participants earn a net profit from retail selling. The scheme emphasizes recruiting and expanding the number of salespeople, which reduces or interferes with the opportunity for profitable retail selling. Some require token amounts of retail selling and tout these requirements as evidence of a retail-based model, however, the amounts are grossly inadequate for reseller profitability and in fact, served as part of a retail disguise. Some advertise rules for reselling goods, but include sales to other salespeople at wholesale prices as fulfillment of retail requirements. Some require participants to certify they have “resold” a majority of previous orders before reordering. These certifications are not monitored and, in fact, are generally understood to be official fiction.
- The salespeople’s purchases of goods serve as “consideration” paid to join the scheme or to maintain a position in the scheme. In addition to product purchases, “consideration” frequently also include ongoing monthly purchases required to maintain qualification for receipt of commissions, bonuses and overrides (payments based on investments of later recruits), membership fees, computer fees, marketing materials, books, tapes, seminar registration fees and training fees, all of which are incentivized or presented as mandatory or necessary to succeed in the scheme.
- As new sales people are recruited, a portion of the costs of their purchases (usually about 40% of the product cost) and other fees gained from new participants are paid as “compensation” to the recruiters. Since the great majority of the money for the commissions, bonuses and overrides comes directly and ultimately from the investments of the newest recruits, these payments are, de facto, recruiting payments.⁵
- In a pyramid marketing scheme, the only feasible way, to recoup investments is to bring in new investors (salespeople). The more people who are recruited, the higher one ascends on the pyramid. Additionally, the pyramid pay plans commonly assign a greater share of the commissions, overrides and bonuses be paid to the higher levels. In many of the schemes, approximately 50% of all rebates – derived from product purchases and other consideration paid in by later recruits – is transferred to the top 1% of the pyramid chain.⁶

public (i.e. retail sales)...The Koscot case affirmed the stated issue to be the critical factor. Later, cases such as Webster v Omnitrition and Gold Unlimited affirmed Koscot. In Webster the court also found that for pyramid analysis the sales that are made to a distributor’s downline do not count as retail sales. A “retail sale” refers to a sales of product to general consumer, i.e., someone who is not a member of the organization.”

⁵ In the prepared statement on "pyramid schemes" presented at the International Monetary Fund's Seminar on Current Legal Issues Affecting Central Banks, Washington, D.C., May 13, 1998, Debra A. Valentine, General Counsel for the U.S. Federal Trade Commission stated, “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... 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.” (<http://www.ftc.gov/speeches/other/dvimf16.htm>)

⁶ In an August 4, 2003 release regarding prosecution of the multi-level marketing company, Trek Alliance, the FTC stated,

- With a multi-tiered structure in place, and a compensation program based on recruiting to gain a position at the higher levels of the structure, a relatively fixed and ongoing ratio is established between those few at the top who *could ever* be profitable and the many more at the lower levels who *must always* be unprofitable. This ratio is as high as 90% or more. A 99% annual loss rate characterizes the recruitment-driven multi-level marketing schemes. *The loss rates in these disguised “direct selling” schemes that involve products are, in fact, considerably worse than in the naked non-product pyramid schemes, often called gifting schemes, which have been much publicized targets of regulators.*
- With a fixed, continuous loss rate inherent in the pyramid selling scheme model, all claims about “income opportunity” in such schemes are deceptive and misleading. In fact, virtually no new recruits are able to earn a profit.
- In addition to and in support of numerous FTC actions that have characterized and defined “pyramid marketing schemes” as recruitment-based, non-retailing, disguised direct selling companies, three federal court rulings have been cited by the FTC as a legal foundation – Gold Unlimited, Koscot and Omnitrition.

Proposed Rules

A new FTC rule to cover pyramid marketing schemes must, therefore, require:

1. **All multi-level marketing companies must comply with “earnings claim” disclosure rules. No multi-level marketing company should be allowed an option of making no earnings claims.**

The Notice of Proposed Rule Making states that “...in connection with section 437.4, the Rule would permit sellers to make an earnings claim, provided there is a reasonable basis for the claim and the seller can substantiate the claim at the time it is made. If the seller makes no earnings claim, then section 437.3(a)(2) would direct the seller simply to check the “no” box.”⁷

Making an “income claim”, as defined in Notice of Proposed Rule Making,⁸ is *inherent* in all multi-level marketing companies that, by definition, are “income opportunities.” These schemes are manifestly characterized for their emotional, continuous, and extraordinary income claims, inferences, promises and testimonials, often presented at mass meetings of thousands of recruits and participants. The structure of the multi-level marketing company –

- Trek told recruits that they could earn money by selling products or recruiting, but emphasized that more money could be made through recruiting.

- The vast majority of consumers made less money than they had paid for front-end expenses, and many made little or nothing

- Compensation was not sufficiently linked to retail sales

⁷ Federal Register / Vol. 71, No. 70 / Wednesday, April 12, 2006 / Proposed Rules, 19068

⁸ *Earnings claim* means any oral, written, or visual representation to a prospective purchaser that conveys, expressly or by implication, a specific level or range of actual or potential sales, or gross or net income or profits. Earnings claims include, but are not limited to:

(1) Any chart, table, or mathematical calculation that demonstrates possible results based upon a combination of variables; and

(2) any statements from which a prospective purchaser can reasonably infer that he or she will earn a minimum level of income (e.g., “earn enough to buy a Porsche,” “earn a six-figure income,” or “earn your investment back within one year”). (Federal Register / Vol. 71, No. 70 / Wednesday, April 12, 2006 / Proposed Rules, 19087)

an endless chain of salespeople on which every new recruit can “potentially” earn “unlimited” income – makes an income claim inherent to the model. Therefore no option should be allowed for multi-level marketing companies to check the box indicating it makes “no earnings claim”.

2. Disclosure of the average *retail-based* income earned by each level of the hierarchy. This average must be documented with verifiable data on actual retail sales.

The distinguishing feature of the pyramid selling scam is the lack of retail sales. Retail sales activity is the dividing line between bogus, deceptive scams and legitimate direct selling. This standard has been applied consistently by the FTC, written into various state laws⁹ on pyramid schemes, and repeatedly confirmed and upheld by federal courts. *Any rule seeking to cover multi-level marketing schemes that does not require disclosure of verifiable retail sales revenues will fail to protect consumers.* A rule that omits the critical retail sales level component could actually aid fraudulent schemes by seeming to endorse them for complying with less relevant and significant disclosures.

Withholding data on actual income from retail selling is the central element of deception in of disguised pyramid selling scam. By withholding this data, while also claiming to operate as a “direct selling” company, the pyramid scheme maintains the fiction of legitimacy and is able to convince consumers that it offers a viable income opportunity to large numbers of participants. Lack of retail sales, in fact, results in virtually no income opportunity being available to nearly all investors (recruited salespeople). The non-retailing, recruitment-based MLM is, in reality, nothing more than an endless chain recruitment scheme with a built-in 99% loss ratio.

In the disguised direct selling company, virtually no participants sell a significant amount of products to non-participants (retail) or earn an overall net profit from retailing. The only participants that achieve profitability do so from rebates gained from investments of new investors (salespeople). The end-users in the pyramid are the salespeople themselves. Recruiting is the essential and primary income activity for all new participants in order to recoup their investments.

A common practice of pyramid selling schemes is to claim to be retail-based “direct selling” businesses but to state that they are unable to supply income data from retailing. They frequently make the disclaimer, *“Independent Consultants can buy products from the Company at wholesale prices for resale to Clients or for personal use... Most Consultants personally use the products in addition to retailing them. As a result of these different scenarios, the company does not provide an estimate of average or actual Consultant income from retail sales.”*

If the proposed Business Opportunity Rule requires the disclosure of actual retail-based income *for each level of the scheme*, a consumer will be able to identify if income in the

⁹ The state of North Carolina imposed a 70% standard in four pyramid scheme cases that it prosecuted in 1999. Indicating the vast reach of MLM pyramid frauds, the four relatively small MLM companies, Club Atlanta Travel, Destiny Telecomm International, Inc., Tele-Card International, and International Heritage, Inc., had enrolled 40,000 distributors in that one state alone. The settlement agreement between Destiny Telcomm International and North Carolina stated: “...at least 70% of all North Carolina sales shall be retail sales to persons who are not connected in any way to the Destiny sales force.” The ruling also excluded from the 70% portion, sales to individuals who subsequently became Destiny representatives.”

scheme is actually based almost entirely upon endless chain recruiting. Disclosure of retail sales income at each level will enable consumers to assess the validity of any MLM company's claim that it is a legitimate "direct selling" business.

3. **Income disclosures of multi-level marketing companies must include:**

- **the total number of all participants who have joined in the past year, not just a subset of so called "active participants" in one part of a year.**
- **the average net, not gross, income of participants in each level. Average net income is defined as the average of all monies received from the company by participants in each level minus the average of all moneys paid to the company by participants in each level. Expenditures paid to the company include product purchases, renewal fees, shipping costs, books, audio and video tapes, training and motivation seminars, computer fees, etc. These data are known to the company, would not be burdensome to the company to gather and disclose and could be easily audited.**

Misleading "Averages"

A common deceptive practice of pyramid marketing schemes is to provide new recruits with a *mean average of revenue* for each level in the scheme's hierarchy or an overall mean average of "income" for all "active" participants. These mean averages are misleading and deceptive in two fundamental and important ways. They skew the average upward by reducing total participants, and they omit all costs associated with the business opportunity, thus confusing revenue with profit and hiding large-scale losses by nearly all participants. In some cases, the multi-level marketing company reports as "income" to the participants rebates paid to the participants' on their own inventory purchases. This is grossly misleading since they are effectively just returning a portion of participants' own money. No money at all was "earned" and is therefore not "income."

Limiting the averages to only a one-year time frame and restricting the number of participants to those who are "active" within an even much shorter time frame excludes huge numbers of participants that drop out during the year. However, the "average annual income" includes the investments of all participants, which were transferred to those in upper echelons as part of their annual "income." The mean averages are thereby increased by reducing the total number of participants while increasing the dollars used in the calculations.

Falsifying "Income"

An even more harmful practice of this type of deceptive disclosure is the omission of any money paid out by participants to the income-opportunity-scheme. "Money paid out" includes everything from incentivized purchases (in order to qualify for commissions or to advance in the pay plan) to associated business costs that are presented as mandatory or necessary to success, such as motivation seminar registrations, training programs, company internet fees, books, samples, renewal fees, shipping costs, audio and video tapes, etc. They would include all products purchased from the company, regardless of whether they were resold, used, stored, given away as samples, or disposed of.

The resulting mean averages, absent all such costs, are grossly misleading by seeming to show that the "average participant" is profitable. In fact, virtually none is. Costs for products, training, marketing and other operating costs far exceed the revenue for nearly all participants other than those in the top 1% or even less.

In many of the schemes that PSA has examined the participants actually incur more costs for related expenses such as seminar registrations, training, books, tapes and other marketing materials than for product costs. A 2004 *NBC Dateline* report uncovered what many consumers have been charging – the selling of “tools” such as books, tapes and seminars to MLM recruits not only adds to consumer losses but is an additional pyramid scheme involving MLM recruits. Some MLM promoters have made the multi-tiered sales of these tools another closed pyramid sales scheme, generating more income for them than the MLM scheme itself. Data on these costs or income sources are not revealed to new recruits.

Conclusion

Multi-level Marketing Schemes have operated under the legal radar for 25 years since the landmark FTC decision on the Amway Corporation in 1979. Lacking a “rule” specific to MLMs, it has been extremely difficult for state and federal agencies to properly regulate these types of business opportunity sales schemes.

The courts and the FTC have determined retail sales levels to be a critical factor in determining legitimacy among MLM companies. Yet, with no rule that required disclosure and proof of retail sales revenues, the application of this standard has proved costly, time consuming, and ineffectual in preventing large-scale abuses.

Additionally, with no specific “earnings claim” disclosure for MLMs that charged initial fees below the threshold set by the Franchising Rule, MLMs have operated in a regulatory limbo. The result has been pervasive and global abuse in the sales of MLM “business opportunities.” MLM promoters have publicly called their schemes the “greatest business opportunity in the world” while hiding 99% loss rates among all investors (recruited salespeople). Skewed and manipulated earnings data have been used to lure consumers into what is portrayed as a low cost and viable new income opportunity, only to inflict extraordinary losses from monthly product purchases, seminar registrations, books, mandatory travel and other monthly fees – none of which were disclosed at the time they solicited consumers to sign contracts. Deceptive charts, false formulas, bogus testimonials from shills and grandiose claims and promises are regularly employed at MLM recruitment meetings regarding “unlimited income”, residual income, and claims of producing “more millionaires than any other type of business.”

It is clearly time for the FTC to place reasonable regulations on these pervasive abuses. The lack of regulation in America where MLM was invented and most such schemes are based has resulted in even worse abuses being perpetrated by such schemes in the rest of the world. They carry out frauds in other countries with the claim, “We are legal in America.”

The business practices they are perpetrating are not legal in America but, lacking any effective rules that cover the MLMs and the inability of regulators to effectively and fairly regulate them, the effect is the same. The application of the basic rules that Pyramid Scheme Alert has outlined – earnings disclosures, retail sales levels disclosures and disclosure of net income and total participants involved in the schemes – *is the minimum regulation* needed to protect consumers from widespread business opportunity frauds.