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A Professional Company
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July 16, 2006

Federal Trade Commission/Office of the Secretary,
Room H-135 (Annex W),
600 Pennsylvania Avenue, NW.,
Washington, DC 20580.

Re: Comment on Proposed Business Opportunity Rule - R511993

Dear FTC Commission Members:

I am submitting the following comments to the proposed Business Opportunity Rule R511993 on behalf of my law firm, Grimes & Reese, PLLC. Grimes & Reese is one of just four law firms in the United States that is dedicated exclusively to providing legal services to the direct selling industry.¹ Our firm's website, which is located at [www.grimesreese.com](#), is the most comprehensive legal resource in the direct sales field. Our firm was established in 1996, and since that time we have represented over 600 direct selling companies. Our clientele range from start-up ventures to some of the largest publicly traded corporations in the industry. Prior to forming Grimes and Reese, Kevin Grimes and I both served as in-house legal counsel to Melaleuca, Inc., which is a direct selling company located in Idaho Falls, Idaho.

As one of the few private-practice attorneys serving direct sellers, I have observed the full spectrum of business practices exercised by both direct selling companies and their independent distributors. I have seen some businesses that have no regard for the law as well as businesses that represent the pinnacle of corporate ethics. With this background, our firm has a unique perspective into the effectiveness and impact of the proposed Business Opportunity Rule.

¹ I use the term "direct selling" to include businesses that distribute their goods and services through network marketing, multilevel marketing, and party-plan distribution channels. While the mathematical compensation formulas used by these companies vary widely, with just a few exceptions all use some form of multilevel compensation format.

The Definition of “Business Opportunity”

(a) Business Opportunity Rules Should Not Require Disclosures or Other Burdensome Obligations on Direct Sellers Unless a Minimum Required Investment Threshold is Surpassed.

Section 437.1(d)(2) of the proposed rule requires that a purchaser make a “payment or provides other consideration” to participate in a new business in order to fall within the definition of a “business opportunity.” Unlike the current Franchise and Business Opportunity Rule and the 24 state business opportunity statutes, which have minimum investment thresholds ranging from \$200.00 to \$500.00 before triggering,² the proposed rule has no minimum investment threshold.

I have represented clients in dozens of state business opportunity inquiries, investigations, and administrative actions. The format adopted by the states, which is generally more stringent than the FTC’s current Franchise and Business Opportunity Rule, has proven to be quite effective at regulating work-at-home programs and other business opportunity schemes. At the same time the direct selling industry has operated within the strictures of these laws without incurring excessive burdens and expense. Ultimately, I believe that history has proven that the state approach has reached a fair balance between the need for protecting the public without unduly restricting members of the direct selling industry from market access and excessive regulatory burdens, and provides a far more appropriate model for the Commission to follow than that contained in the proposed rule.

² STATE BUSINESS OPPORTUNITY THRESHOLDS & SALES KIT EXCLUSIONS

<u>State</u>	<u>Initial Investment Threshold</u>	<u>Not-for-Profit Sales Kit Exclusion</u>
1. Alaska	\$250.00	***
2. California	\$500 or less, \$50,000 or more	***
3. Connecticut	\$200 or less	\$500 or less
4. Florida	\$500 or less	\$500 or less
5. Georgia	\$500 or less	***
6. Illinois	\$500 or less	\$500 or less
7. Indiana	\$500 or less, \$50,000 or more	\$500 or less
8. Iowa	\$500 or less	***
9. Kentucky	Less than \$500	\$500 or less
10. Louisiana	\$300 or less	\$500 or less
11. Maine	\$250 or less	\$500 or less
12. Maryland	Less than \$300	Less than \$500
13. Michigan	Less than \$500	***
14. Missouri	\$500 or less	\$500 or less
15. Nebraska	\$500 or less	***
16. North Carolina	Less than \$200	\$200 or less
17. Ohio	\$500 or less, \$50,000 or more	Less than \$500
18. Oklahoma	\$500	***
19. South Carolina	\$250 or less	No limit
20. South Dakota	\$250 or less	\$500 or less
21. Texas	\$500 or less	\$500 or less
22. Utah	Less than \$300	\$300 or less
23. Virginia	\$500 or less	No limit
24. Washington	\$300 or less	\$500 or less

(b) Optional Product and Service Purchases For Personal Use, Bona Fide Inventory and "Not-for-Profit" Sales Kits Should Not Trigger the Application of the Business Opportunity Requirements.

The "payment or other consideration" language of §437.1(d)(2) is vague and rife with pitfalls for legitimate direct sellers. It is quite common in direct selling for independent distributors to enroll in a program and, although no product purchases are required to participate in the compensation plan, they nevertheless make an initial product purchase or sign up for the services offered by the direct selling company at the time they join. They do so for several reasons, but one of the most predominate is that by signing up as a distributor they are able to purchase the company's goods or services at the lowest possible price. Therefore, it makes perfect economic sense for a consumer to enroll as a distributor and purchase a sales kit even though they have no intention of participating in the business opportunity aspect of the program. The savings they will experience in buying at the "distributor price" will quickly offset the sales kit fee. Section 437.1(d)(2) misses this reality if a product or service purchase at the time of enrollment satisfies the "payment or other consideration" element of the business opportunity test.

I am not oblivious to the fact that there are direct sellers that promote their goods and services as "optional" purchases to the program participants, but in reality the optional nature of the purchases is just a ruse. In these situations the real motive of the seller is to entice new participants to buy excessive quantities of merchandise for the single purpose of fueling the company's compensation plan. The Commission has the tools to address these situations by prosecuting them as pyramid schemes. Historically, the Commission has aggressively attacked these programs and has had great success in doing so (by my count, when the Commission freezes direct seller's assets, they have been 100% effective at permanently shutting the company down).

The remarks of the Commission at 79 F.R. 19060 indicate that the proposed Business Opportunity Rule is designed to be another rule in the FTC's arsenal to attack pyramid schemes. Unfortunately, in failing to distinguish programs that make *bona fide* sales of goods and services from those that are inventory loading schemes, the proposed rule places undue and excessive obligations on legitimate direct selling businesses that are engaged in valid and genuine sales transactions. I submit therefore that it is more appropriate, and carries far less economic burden on legitimate direct sellers, for the Commission to continue to attack pyramid schemes with the tools that it has so effectively wielded in the past, and to narrow the scope of the Proposed Business Opportunity Rule to follow the approach of the states. Simply stated, the proposed rule is more akin to a baseball bat which, when swung, will impact everything within a 360 degree swath. Yes, it will hit pyramid schemes, but it will also crush legitimate direct selling programs. Instead, the Commission should be using a surgical scalpel as the instrument of choice to attack pyramid schemes, and not a baseball bat.

In addition, most of the state business opportunity statutes expressly exclude from their investment threshold calculation the cost of a sales kit so long as it is sold "at cost"

and falls below a specified sum (*see fn. 2*). Again, this is an appropriate exemption since the risk of loss to the consumer is mitigated while the burden on companies is also reduced. This approach has proven to strike a fair balance between avoiding excessive and burdensome corporate regulation and appropriate levels of consumer protection.

(c) The “Payment or Other Consideration” Element of the Definition Requires Greater Specificity.

The phrase “payment or other consideration” in proposed §437.1(d)(2) is overbroad, vague, and ambiguous. As discussed above, the “payment” component could be interpreted to apply to a legitimate purchase of goods and services, and that discussion will not be repeated here. The “other consideration” element is similarly problematic since different areas of the law interpret the term “consideration” in inconsistent fashion.

For example, the United States Postal Service (USPS) is charged with enforcing the postal lottery laws. There are three elements to a postal lottery: (1) a participant provides *consideration*, (2) given for a *chance*; (3) to win a *prize*. The USPS has held that a distributor’s time and efforts in promoting the business of a network marketing program satisfies the consideration element of the test. *In re Jeffrey Walker, dba High Opportunity Petroleum Enterprises*, P.S. Docket No. FR 97-167 (1998). On the other hand, some state statutes regulating pyramid schemes expressly recognize that a participant’s time and effort in attempting to build a network marketing business does not satisfy the consideration element of a pyramid analysis. (*See e.g.* MD Crim L. § 8-404; UT Code §76-6a-2; TX Code §17.461; ID Code §18-3101; OK ST T. 21 §1072; KY ST §367.830; MT ST §30-10-324; LA R.S. §51:361).

The proposed Business Opportunity Rule must specify that “time and effort” expended in pursuing a network marketing opportunity does not constitute “consideration.” While time and effort may satisfy the consideration element in a postal lottery analysis because the prize is awarded based on the element of chance (luck), such is not the case in legitimate direct selling businesses. Unlike a lottery, success or failure in a direct sales business is dependent on an independent distributor’s performance. If a distributor for a direct selling company is not successful, his or her efforts will not benefit the direct sales company. Consequently, an unsuccessful distributor’s time and effort is ultimately of no value and does not constitute consideration.

Earnings Claim Disclosures

(a) The FTC Already Has Adequate Means at its Disposal to Address Earnings Claims Issues.

Additional regulation of earnings claims is not necessary. Existing FTC case law has established ample precedent to guide business opportunity sellers about what is fair in the area of earnings claims. Kevin Grimes authored a comprehensive article analyzing the FTC’s case law on earnings claims which is available on our firm’s website at

As is evident from the ana-
lysis in the article, the FTC already has ample means of regulating earnings claims at its disposal – it simply needs to utilize them in a more efficient fashion.

(b) Hypothetical Examples Illustrating the Mathematical Computation of a Multi-level Compensation Plan Should Not Be Classified as Earnings Claims.

The definition of an “earnings claim” under proposed § 437.1(h) is too broadly fashioned. In many cases the only effective way to explain the mathematical computation of a multilevel compensation plan to a prospect is to walk through several hypothetical examples. Indeed, imagine trying to teach a high-school algebra class by simply explaining the formulas but not illustrating the application of the formulas to actual problems. Such a proposition is ludicrous; you must work math problems to understand math. The same holds true for explaining a multilevel compensation plan - you can explain the theory and formulas, but until you actually walk through some examples, people will not understand it. Therefore, direct sellers must be able to use hypothetical examples to show how their multilevel compensation plans work, and this exercise should not be classified as an “earnings claim.”

In fact, in most cases, complying with the proposed rule would require that an example illustrating the operation of the compensation plan. Proposed §437.5(g) provides that it would be a deceptive act to misrepresent “how or when commissions, bonuses, ... or other payments from the seller to the purchaser will be calculated or distributed.” Without using specific hypothetical examples, it will be exceedingly difficult and quite confusing to explain how compensation plans operate. This is particularly true in light of the fact that it is quite common for multilevel companies to use five or more different components to form their compensation plans, and each component has its own unique calculation.

The Commission has long recognized that a properly worded, clear and conspicuous disclosure or disclaimer is sufficient to remedy an otherwise potentially misleading representation. I submit that in the case of mathematical examples illustrating the operation of a multilevel compensation plan, such a disclaimer is all that is necessary to ensure that hypothetical mathematical examples are not misunderstood to be earnings claims, and that if a hypothetical example bears a proper and conspicuous disclaimer, it should not fall within the definition of an “earnings claim.”

Disclosure of Prior Criminal, Civil and Administrative Actions

(a) The Disclosure of Legal Actions Against Business Opportunities is Arbitrary and Capriciously Applied to Business Opportunity Sellers in the Proposed Rule.

The proposed disclosures of civil or criminal legal actions alleging misrepresentation, fraud, securities violations, unfair or deceptive practices within the preceding ten

years strikes me as information a consumer would want. Of course, as a consumer I would also like a written disclosure of the same information pertaining to any car dealership where I shop, every doctor that I see (add malpractice to the list as well), every stockbrokerage with which I do business, every construction contractor whom I hire, every electrician, plumber or other journeyman that I retain, and every computer repair shop whose services I purchase, and every charity to which I donate. This list goes on forever – the point is that there are the ethical and the unscrupulous in every profession. In the Proposed Business Opportunity Rule the Commission is singling out business opportunities for disclosure of legal actions based on anecdotal evidence which could be gathered against individuals in every profession. What the Commission has not presented is competent and reliable evidence indicating that business opportunities present a greater risk financial injury compared to other businesses and professions, and therefore the disclosure of legal actions is arbitrarily and capriciously applied to business opportunities.

(b) The Proposed Rule Creates a Presumption of Guilt or Wrongdoing

The portion of the rule requiring disclosure of legal proceedings utilizes a “guilty until proven innocent” approach. The rule does not take into account the fact that a defendant may have prevailed against the allegations, or that a defendant may have settled a case without admission of liability simply avoid the extreme financial burden of protracted litigation. Rather than following the “innocent until proven guilty” approach of our judicial system, the proposed rule plants a seed in the mind of the consumer that if the company was even involved in a legal action there is something improper or troublesome about the company. To further exacerbate the problem, even if a court or jury found a company innocent of the claims, §437.5(c) prohibits the company from stating this fact in the disclosure document because it is information that is not “explicitly required or permitted by [this] Rule.”

Even if a company was permitted to disclose that it prevailed in a case, it will be too little, too late. Civil lawsuits usually take years to get to trial. By requiring a company to disclose the existence of a lawsuit, yet not discuss the merits, the taint of being on the defense is sufficient to prejudice the company in the eyes of the public. This is particularly true in the direct selling industry since the vast majority of independent distributors have not been exposed to litigation and can easily be scared away from a legitimate program by mere allegations of wrongdoing, even if the allegations are completely frivolous.

To bring these points to reality, I have been involved in three lawsuits in the last two years in which the reason for the litigation stemmed from the direct selling company terminating the contract of the plaintiff distributors for violating the company’s policies. Under each of these cases the proper cause of action (assuming the facts warranted it) stems from a breach of the independent distributor contract. However, in each case the plaintiff’s attorney added claims of securities fraud, promotion of an illegal pyramid scheme, and RICO. There is no merit to these allegations, yet the plaintiff’s attorney

makes the claims to give the case notoriety within the industry and to obtain settlement leverage. While we can argue the Rule 11 ramifications of such pleading practices, there is no denying the reality that strike suits occur with regularity and that courts rarely issue Rule 11 sanctions. If the mandatory disclosures of legal actions in which a direct selling company is involved is included in the final rule, the Commission will unwittingly promote the filing of pyramid, fraud and securities causes of action against direct sellers simply to obtain additional settlement leverage despite that the cases that have nothing to do with securities violations, fraud, deceit, or misrepresentation. The plaintiff's bar will recognize the leverage that they will acquire if a direct selling company must disclose legal actions that are filed against it and will use this leverage to extract settlements from legitimate direct selling businesses.

I have also personally experienced this situation in class action litigation against a direct seller. One of my former clients was sued in a class action case in which the plaintiffs' alleged the company was operating a pyramid scheme, selling unregistered securities, and engaged in RICO violations. The plaintiffs' claims were meritless and we vigorously defended the case. However, the plaintiffs realized that once the class was certified and notice of the action was sent to the putative class of the company's current and former distributors, the company would suffer a severe drop in sales due to the taint of impropriety. The company realized this as well, and therefore moved the court to bifurcate the class certification issues from the liability issues, thereby forcing the plaintiffs to prove their liability case *before* the class was certified by the court and notice could be issued. My client prevailed on the bifurcation motion. The plaintiffs immediately realized that they had lost their leverage since they would actually have to prove their case, and there was no risk of harm to my client's business because the threat of notice to the proposed class was off the table. The plaintiffs therefore voluntarily dismissed the action.

If the proposed rule were to go into effect, this story would have had a very different ending. For ten years my client would have been required to disclose that it had been sued to every prospective distributor, even though the case was voluntarily dismissed by the plaintiffs and the claims were frivolous. The company would have suffered a severe setback in sales due to the taint of impropriety that would have attached to the business.

Finally, even if a defendant is permitted to discuss the case in its disclosure documents, this will not decrease the damage that the rule would cause. Ninety five percent of lawsuits that are filed end up settling, and cases involving network marketing businesses are no different from any others in this respect. As pointed out above, there are very legitimate business reasons to settle a case even if one has the upper hand (*e.g.*, extreme expense of litigation, usurpation of corporate resources).

The proposed rule would put direct selling companies backs against the wall. If the rule allowed them to discuss the outcome of a case, they would lose all incentive to try to settle. This is due to the fact that the rule would require that they disclose the exist-

tence of the action. Once this is disclosed, in the eyes of consumers they will be tainted as a suspect company and the only way to undo that prejudice is to prevail at trial. A settlement would be out of the question because the direct selling company would have nothing to gain and everything to lose. If they lose the case, the damage to their reputation and business has already been done vis-à-vis the disclosure. If they win the case however, they get the chance to *try* to redeem their reputation (this of course after incurring several years of damage to their goodwill due to the existence of the case on the disclosure document during the years of trial). The bottom line in this situation is that direct selling companies will be forced to litigate rather than settle cases. The expense of litigation is enormous, and the damage to their goodwill while fighting the case, even if they ultimately prevail, will never be fully recovered.

(c) *Direct Selling Companies will be Required to Conduct Background Checks on All Management and Sales Employees.*

The proposed rule will also place the expense and burden on direct selling companies to conduct a background check on its management and sales employees. An example of the format of one of my clients will illustrate this point. My client employs hundreds of people in its sales department. Many of these people work on the telephones accepting phone-in product orders and data entry of enrollments of new independent distributors. These employees are certainly involved in sales activities for the opportunity but are in no way involved in any management capacity. Nevertheless, under §437.3(3)(i)(D), since they are “involved” in sales of the business opportunity, the disclosure requirement would apply to every one of them. Assuming that a reliable background check on such a large group of employees was possible, the burden and expense clearly makes it infeasible and an extraordinary burden on the direct sales industry.

(d) *Appropriate Disclosures*

Should the Commission determine that disclosure of legal actions be required, any final rule must also take into consideration the rights those who are accused. Therefore, at the very least the proposed rule must be amended to require the disclosure of legal actions against business opportunity sellers alleging misrepresentation, fraud, securities violations, unfair or deceptive practices within the preceding ten years *if* all of the following are satisfied:

- The business opportunity seller was an owner or in the senior management of the defendant company;
- There was a determination of guilt or a finding of liability against the defendant by a court, jury, or arbitration panel;
- The decision was not overturned on appeal;
- Because cases normally involve multiple causes of action, and juries and courts seldom find in favor of one party on all claims, the business opportunity seller should be entitled to explain in the disclosure document those causes of action on which it prevailed and those which on which it did not prevail. If the seller pre-

vailed on all of the fraud, deceit, securities, deceptive practices claims, but did not prevail on an unassociated claim such as breach of contract or a tort that did not involve an element of fraud, no disclosure should be required.

Disclosure of Distributor Lists

The proposed disclosures of references in §§ 437.3(a)(6) and .3(b) are poorly conceived at best, and inherently dangerous at worst. Consider the following problems:

(a) *The Disclosure of Local Personal Contact Information Presents a Real and Substantial Threat of Personal Injury to Independent Salespersons.*

Industry statistics bear out that 79.9% of the 13.3 million independent salespersons representing direct selling companies in the United States are women.³ That means approximately eight out of ten people identified in every disclosure document will be women. Given this fact, it strikes me that the proposed disclosure of references wholly overlooks the fact that publicly disclosing the names, city and state and telephone numbers of these women compromises their security and places them at risk of physical violence since with this information it is quite easy to locate a physical address.

The reality of direct selling is that independent salespeople have the opportunity to screen the people they want to work with. Through the person-to-person selling model, the majority of sales people accomplish this screening process by working with their family, friends and neighbors. Even those who expand their recruiting efforts beyond their personal circles have the chance to vet those with whom they become close. Initial meetings commonly occur at the home or office of the prospective customer or at a neutral location such as a coffee shop. Through this process an independent sales person can evaluate a prospect before disclosing her home address.

The proposed disclosure of personal contact information of references will obliterate the protection for those individuals who are on the disclosure list. Furthermore, given that the proposed rule contemplates disclosing the personal information of the ten persons located nearest to the prospective purchaser's location, this will leave direct sellers, and particularly new and small companies, in the difficult position of disclosing their entire trade secret list of distributors or investing in expensive software that can identify associate their distributors by geographic proximity to a prospect. While larger, established direct selling companies may be able to absorb this expense, small and start-up companies are commonly on limited budgets and have no extra funds for such expenses.

³ 2003 data provided by the Direct Selling Association, available at <http://www.dsa.org/pubs/numbers/index.cfm?fuseaction=03numbers#GENDER>

(b) *The Disclosure of References Obligates Direct Sellers to Disclose Trade Secret Information.*

Courts uniformly recognize customer lists as trade secrets so long as the business seeking protection takes the appropriate measures to maintain trade secret status. In the direct selling field, independent sales persons (“distributors”) are also the company’s customers. Companies go to great lengths to protect their trade secret data because it represents the life-blood of their businesses. In fact, in every direct selling business our firm has represented over the last ten years, all have classified their distributor lists as trade secret information. In fact, the overwhelming majority of disputes between direct selling companies and their independent sales force relate to misuse of trade secret information and proselytizing members of the sales force for another company.

The proposed reference disclosure requirements will have two serious negative impacts in the trade secret area if accepted by the Commission. First, there is no way that a company could maintain trade secret status of its distributor lists. Because the law would require public disclosure of trade secret data, direct selling companies would lose large pieces of their most valuable assets. Furthermore, small and start-up companies would be particularly impacted since in the early stages of the business they will not have a large database of distributors. Therefore, on a percentage basis, they will be forced to disclose a large percentage, if not all, of their customer lists.

Secondly, the proposed reference disclosure requirement will have the unintended effect of creating a free-for-all among competing independent distributors. Distributors for Company A will pose as prospective buyers of the opportunity presented by Company B. In truth, they have no intention of joining Company B. Rather, all they will want is the list of references in the area. Once they obtain this list, they will then prospect these individuals for Company A.

The above scenario is also not limited to competition among direct sellers. Those who amass and sell mailing and contact lists and “leads” of “opportunity seekers” will make it a common practice to harvest the reference lists disclosed by direct selling businesses that follow the law. Those who are unfortunate to find themselves on the reference list will be bombarded with unwanted solicitations.

(c) *Disclosure of Personal Information Will Have a Deleterious Effect on the Business.*

The FTC fully recognizes how ardently U.S. citizens value their privacy. The overwhelming response to the *Do Not Call* list provides ample evidence that citizens don’t want to receive unsolicited calls and interruptions. Furthermore, identity theft is a critical concern for both the Commission and other law enforcement agencies. The Commission must therefore recognize that subjecting participants in direct selling to the disclosure of their personal information will have a significant chilling effect on direct seller’s ability to engage in their trade. Quite simply, many who would otherwise want to

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participate in direct selling will be scared away for fear of their personal information being publicly disclosed or out of concern that they will receive numerous unwanted phone calls.

While I support the Commission's objective of protecting consumers in the proposed business opportunity rule, at least with regard to direct selling businesses the requirements of the rule are far too burdensome and will have far reaching impact that will seriously harm the industry. A far better model to follow is that of the majority of states that requires a \$500.00 investment before the business opportunity regulations are triggered.

Respectfully submitted,

/s/

Spencer M. Reese