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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: Notice of Proposed Rulemaking
Business Opportunity Rule, 16 CFR Part 437

Dear Commissioners:

I respectfully submit the enclosed comments and request for hearing concerning the proposed Business Opportunity Rule, pursuant to the Notice of Proposed Rulemaking as published in the Federal Register on April 12, 2006. I believe that the Proposed Rule represents an important step forward in the Commission's effort to protect consumers from fraudulent business opportunities, particularly multi-level marketing schemes.

I. BACKGROUND AND STATEMENT OF INTEREST

I am an attorney duly licensed to practice law in the Commonwealth of Massachusetts since 1982. I have been in private practice my entire career, the first five years in a small general practice firm, the next five years in a firm specializing in franchising and distribution law, and since then have specialized in consumer protection, antitrust and securities fraud litigation, including cases involving fraudulent business opportunities. I have represented plaintiffs and plaintiff classes in litigation involving a number of Multi-Level Marketing (MLM) systems, including *Webster v. Omnitrition International, Inc.*, 79 F.3d 776 (9th Cir.), cert. den. 519 U.S. 865 (1996); *Capone v. Nu Skin Canada*, 93-c-258 S (D.Utah); *Rhodes v. Consumer Buyline, Inc.*, 868 F.Supp. 368 (D.Mass. 1993); and *Jacobs v. Herbalife International, Inc.*, No. 2:02-cv-01431 (C.D.Cal.).

I have also served *pro bono* as a consultant or counsel to the operators of non-profit consumer information web sites such as www.pyramidschemealert.org, www.mlmsurvivor.com, www.mlm-thetruth.com, www.quackwatch.com, www.merchantsofdeception.com and www.rickross.com.

I am not writing this comment on behalf of any client, nor am I receiving any compensation in connection with this matter.

II. INTRODUCTION AND SUMMARY OF COMMENTS

While the proposed rule is designed to address deception and unfairness in a variety of business opportunities, my comments are intended specifically to address the impact of the proposed rule on Multi-Level Marketing (MLM) schemes. MLM, sometimes referred to as “network marketing,” is a method of distribution in which distributors can theoretically make money both by retailing products or services and also by recruiting new participants into the scheme.¹

Over the past fourteen years I have interviewed or deposed hundreds of MLM distributors in dozens of different systems and corresponded with hundreds more. I have consulted with dozens of MLM industry critics and proponents, and have studied the securities filings of publicly traded MLM firms. In my opinion, most MLM firms operate in a deceptive or fraudulent manner and, whether by design or in effect, cause substantial damage to consumers without any redeeming benefit. In every system with which I am familiar, the vast majority of distributors lose most or all of their investments, while a small fraction, generally less than 1%, make large sums of money.

I believe that the root of the problem lies in distributor compensation schemes which reward recruitment rather than retailing, and that while prophylactic conduct or disclosure regulation may limit or avoid some harm to consumers, the only real solution is to prohibit marketing structures which will inevitably become pyramid schemes.

There is currently no effective restraint on the MLM industry, which has become an increasingly potent cause of injury to consumers, not only in the United States but world-wide. While the Commission and some state regulators have been active in prosecuting fraudulent MLM schemes, they generally act only when consumer complaints concerning a particular scheme have reached a critical mass, by which time substantial damage has already been done.

I appreciate that the Commission is taking a realistic approach by limiting the scope of its regulation to pre-sale disclosure. At this time it is probably not politically feasible to preemptively regulate the terms of MLM compensation plans. As such, the Commission’s proposed rule is an important and crucial step in the effort to prevent further consumer injury

¹ Many MLM firms refer to themselves as “direct selling” companies, probably to avoid the opprobrium attached to the term “multi-level marketing.” But direct selling does not necessarily entail a multi-level compensation scheme for recruiting new distributors. All MLM’s are direct sellers, but not all direct sellers are MLM’s.

caused by the inherently deceptive and unfair marketing practices of MLM firms and their high-level distributors. But disclosure will not prevent consumer injury caused by pyramid schemes. I would urge the Commission to continue its rule-making process to develop regulations prohibiting those forms of MLM plans which inevitably tend to function as pyramid schemes.

III. THREE CRUCIAL PROBLEMS WITH MULTI-LEVEL MARKETING

A. Deceptive Earnings Claims and the Failure to Disclose Business Expenses

The Commission has quite understandably focused on the problem of false earnings claims, which are endemic in the MLM industry.

MLM earnings claims are usually based on the experiences of high level distributors, who may in fact be earning large sums of money, without disclosing the vanishingly small chance that a new distributor will achieve similar success and without disclosing the average earnings of distributors. Sophisticated MLM firms rely on “testimonial” earnings claims which may be factually accurate - because the distributor actually earned the amount claimed - but are extremely deceptive when compared to the entire distributor force, most of who make little or nothing and drop out within a year after joining.

For instance, in or about 2004, Herbalife International, Inc., one of the largest MLM firms, displayed the following “testimonial” earnings claims on its official company web site:

Deborah and Hugh A.: “Deborah earns over \$10,000 a month, and she’s aiming for President’s Team;”

Emily C.: “When you look at Emily C. she looks like a typical happy, healthy 22-year-old woman. But how many 22 year olds are earning \$32,000 a month and heading up an international business? That’s exactly what Emily is doing and she’s not planning on stopping there, either.”

Jason F.: “Today, at age 22, Jason averages \$18,000 a month!”

Rox Anna C.: “We are earning on average \$20,000 a month.”

Laura B.: “Laura currently earns \$10,000 a month and has the freedom she’s always wanted.”

Mandy and Bob E.: “Last month we made about \$9,000, while enjoying a much better quality of life.”

Michael and Michelle B.: “Their monthly income currently totals approximately \$11,000.”

Glenn W.: “On average, we earn approximately \$20,000 plus a month.”

Ted F.: “I never would have imagined it, but now I make \$7,000 a month.”

Nancy and Frank W.: “We earn approximately \$15,000 a month working the business part time.”

The accompanying disclaimer that these claims were not representative was hardly sufficient to bring home the extremely low probability that new distributors could achieve such results. Further information and analysis concerning deceptive earnings claims in the MLM industry is being submitted to the Commission by Jon Taylor and Robert Fitzpatrick of Pyramid Scheme Alert.

In addition, MLM earnings claims never disclose the expenses incurred by distributors to obtain the represented levels of earnings. The figures used in MLM earnings representations are generally the gross amount of bonuses and commissions paid by the company to the distributor based on the sales of the distributor’s “downline.” Usually, in fact, the only reference in MLM promotional materials to expenses is the small cost of the initial startup package. There is no disclosure of the types and amounts of expenses distributors actually incur, including the purchase of promotional materials, mailing lists, postage, telephone, and travel and attendance at promotional meetings. Interestingly, there is also never any disclosure of the “retail profits” earned by the distributor. Undoubtedly this is because the percentage of a top earner’s income generated by retailing products is insignificant. Evidence that the expenses incurred by distributors are substantial is set forth below in section IV regarding the ‘Newest Way to Wealth,’ as well as in the Comments submitted by Jon Taylor and Robert Fitzpatrick.

Finally, as discussed in more detail in the section III.B. below, MLM earnings claims do not reveal that high level distributors often have opportunities to make money which are not available to the rank and file of the organization. These include fees for speaking at distributor meetings and conventions, the sale of distributor-produced promotional materials and kickbacks from third parties who sell products and services to a distributor’s downline, including telephone conferencing services, credit card service providers, mailing list vendors and the like.

B. The Role of High Level Distributors - the “Tools Business”

In all MLM schemes the role of the high level distributor is crucial. High level distributors recruit and motivate their “downline” distributors to recruit more participants. They are featured speakers at company meetings and conventions, and their success is portrayed as something achievable by the ordinary person by dint of a little time and effort. One large MLM

firm candidly describes the crucial function of its high level distributors as follows:

Supervisors contribute significantly to our sales and some key supervisors who have attained the highest levels within our distributor network are responsible for generating a substantial portion of our sales and for recruiting a substantial number of our distributors.

...

Members of the President's Team work closely with us to develop and implement new initiatives and strategies for increasing sales and distributor productivity throughout our entire distributor organization. The President's Team members have under certain conditions the opportunity to participate in the President's Team Bonus, which for 2000 consisted of a total available awards package of one percent of our 2000 total product retail sales, or approximately \$16.8 million. The distribution of the President's Team Bonus is based in part upon each President's Team member's participation in corporate-sponsored training and motivational events. In this manner, we attempt to involve our most senior distributors in our sales, training, motivation and strategic planning efforts. In addition to these programs, we periodically offer a variety of special promotions related to particular products or sales periods, involving special cash bonuses, vacations and other awards.

Herbalife International, Inc., Form 10-K for the year ended December 31, 2000. Most large MLM firms would describe the importance of their high level distributors in a similar fashion.

In recent years there has been a growing phenomenon in which high level distributors produce and sell their own marketing systems and materials to other distributors in the same system. These systems are referred to in this comment as "lead generation systems," but are also known as "the tool business," "business support materials," "motivational organizations" or "professional development programs." The role of such systems in Amway/Quixtar is particularly well documented. *See* Carter, Ruth, Amway Motivational Organizations: Beyond the Smoke and Mirrors (Backstreet Publishing, 1999); www.mlmsurvivor.com; and www.merchantsofdeception.com. *See also* Report of Professor G. Robert Blakey (copy submitted herewith as Exhibit A; the "Blakey Report").²

In the Amway system, at least, some high level distributors earn significant portions of their income from selling motivational "tools" to lower level distributors. "The income from the

² The Blakey Report, drafted by an acknowledged expert on federal and state "RICO" (Racketeer Influenced and Corrupt Organizations) statutes, was originally submitted in litigation between Amway and Procter & Gamble. It is now widely available on the Internet. *See, e.g.* http://www.cs.cmu.edu/~dst/Amway/blakey_report.pdf (visited 7/11/06).

tool business of the major uplines reportedly far eclipses their income from the Amway plan.” Blakey Report at p. 16. There is no disclosure of this feature of the MLM business to prospective distributors.

MLM firms permit lead generation systems to operate alongside the primary MLM business for several reasons. The sale of lead generation systems enables high level distributors to supplement their income, and thereby provides an additional incentive for them to remain with the MLM firm. Moreover, high level distributors whose downlines constitute a large portion of a MLM firm’s business have substantial influence and “clout,” based in part on the implicit threat that if the distributors terminated their association with the company, it would have a material adverse effect on the company’s sales. “[L]arge distributors such as Yager could simply take his downline out of Amway, with potentially devastating results to DeVos and Van Andel.” Blakey Report at p. 16. Finally, the use of lead generation systems permits high level distributors to use more aggressive promotional materials and methods than the official company materials, which benefits the MLM firm by increasing artificial demand for their products while incidentally providing the MLM firm with a plausible defense (i.e., the materials were developed by over-zealous distributors without company authorization) in the event of regulatory problems with the distributor-generated promotional materials.

C. Compensation Plans That Reward Recruitment and Discourage Retailing

The fundamental problem with MLM is that the typical distributor compensation plan provides economic incentives which reward recruitment and discourage retailing. In every MLM system the income of high level distributors is almost entirely derived from bonuses and commissions paid based on the purchases of their downline distributors. On the other hand, MLM products and services typically carry suggested retail prices which far exceed similar products and services available through traditional venues. I respectfully refer to the comment to the Proposed Rule submitted by Bruce Craig, former Assistant Attorney General for the State of Wisconsin, in which Mr. Craig makes a compelling case that the Commission should prohibit MLM compensation plans which operate in effect as pyramid schemes.

In most systems, there are ostensibly no minimum purchase requirements for the lowest level of the distributor chain. However, there are almost always minimum purchase requirements for higher level distributors to qualify to receive bonuses and commissions based on purchases by their downline distributors. These minimum requirements create an artificial market for the MLM firm’s products and services, as distributors are exhorted to meet their qualifying purchase amounts.

One simple method for reducing the damage caused by MLM systems would be to prohibit minimum purchase requirements at any level. In conventional distribution or franchise systems, the distributorship or franchise includes a territory or market with some degree of

exclusivity. With such systems, the imposition of minimum purchase requirements is not unfair, since the franchisee or distributor has some degree of protection from competition by other franchisees or distributors in the same system and therefore has a reasonable opportunity to meet the required level of purchases or sales.³ With most MLM systems, however, there are never any protected territories or markets and there is no limit on the number of distributorships would may be granted in a given market. In fact, distributors are urged to recruit new distributors, all of whom are potential competitors in the market for selling the MLM firm's goods or services. When the number of potential distributors in a given market is unlimited, there is no functional justification for minimum purchase requirements of any kind.

IV. THE 'NEWEST WAY TO WEALTH' EXPERIENCE

A useful case study that demonstrates many of the problems identified above involves a defunct lead generation system developed by several Herbalife distributors called "The Newest Way to Wealth" (NWTW). NWTW was the subject of a class action lawsuit in the U.S. District Court for the Central District of California, *Jacobs v. Herbalife International, Inc.*, No. CV-02-01431 SJO. The NWTW system was designed to assist Herbalife distributors to recruit more distributors, through the use of a series of promotional mailings which were produced and sold by top level Herbalife distributors to their respective downlines, along with carefully scripted presentations which accompanied each mailing. The system violated Herbalife's own distributor rules and regulations against making unsubstantiated earnings claims and was terminated by Herbalife several weeks after the lawsuit was filed, although there was evidence that some Herbalife officers knew of the existence of NWTW and tacitly - at least - condoned it.

The NWTW promotional materials made numerous representations concerning the "incredible" incomes which participants could achieve if they "bought in" at the Herbalife Plan's "Supervisor" level and followed the NWTW System, including but not limited to the following:

- a. "The Second Package Video will show you how so many others are making incredible incomes with this opportunity. Herbalife has created more millionaires than any other company in the history! Currently, Herbalife has over 500 people on its prestigious President's Team who are earning between \$200,000 per year and \$5,000,000 per year! (Yes, you read the amount correctly - \$5 Million Per

³ Many franchise and distribution systems have no express minimum sales requirements, although there are generally other performance standards which ultimately have a similar effect. Even so, most franchise and distribution systems have some degree of market protection. This may range from expressly defined exclusive sales territories to more elastic concepts. In some large franchise systems, for example McDonald's and Burger King, there are no expressly defined territories assigned to each franchise. In both of those systems, however, the franchisor has developed sophisticated economic models for predicting the impact of proposed new stores upon existing stores. If these studies predict an impact on an existing store above a given threshold, say 10%, the new store will either not be built or the existing operator will be given the option to purchase it.

Year). In addition, there are thousands other [sic] people earning 6-figure income of \$100,000 per year or more. These people come from various backgrounds and ethnicity from welfare moms and 80-year-old grandmothers to teenagers and young adults between the ages of 17 and 19.”

- b. “Several of these people reached the \$100,000 per year income level within 1 year by using our incredible mail order and Internet marketing program.”
- c. “Your income at the supervisor level is practically UNLIMITED.”
- d. “The supervisor position is undoubtedly the most advantageous and lucrative position to start your business, however, if you are not able to start at this level, please consult with your mentor to help you work your way to this level as quickly as possible.”
- e. “distributors earn 30-50% more than almost any other company’s distributors assuming the same sales volume. In fact, the company’s compensation plan returns 73% OF THE TOTAL NET SALES to its distributors. That means that out of the \$1.8 Billion in sales in 1998, \$1.3 Billion was paid out to us, the distributors! That translates into incredible earning power for the individual distributor.”
- f. Numerous “testimonial” earnings claims including “Larry & SK Clark, TX: In their first 60 days earned \$2,500”; “John & Leslee Beall, IN: By my 11th month in business I was earning over \$10,000 per month ... still part-time”; “TJ Juneja, DC: Made over \$7,000 per month within 7 months of starting with this program and quit his full time job as a CPA”; “Steve & Debbie Combs, CA: Less than five years ago our financial situation was a disaster. Thanks to this business opportunity we now have financial freedom and a monthly income of more than \$28,000”; “Leah Graham, WA: \$30,000 check last month”; and “Bret & Amber Bartholomew, NV: February’s check over *\$60,000 just nine months using mail order!”

After several years of litigation, the Court approved a classwide settlement in 2004. The class was comprised of Herbalife distributors who had reached the “Supervisor” level - meaning that they had purchased at least \$4000 worth of Herbalife products in one month or at least \$2500 worth of Herbalife products in each of two consecutive months - and who had purchased any NWTW promotional materials between February 15, 1998 and May 2, 2003. For “Former Supervisors” (persons who had either formally terminated their distributorships or had not been active for one year) the settlement established both a “settlement fund” which called for class members to submit claim forms with documentation detailing their economic losses from

operating their Herbalife distributorships, as well as a “refund pool” by which they could claim the amount of their purchases of NWTW promotional materials. The claims were reviewed and evaluated by a professional claims administrator, whose report⁴ revealed the following:

- * The parties identified 8,772 potential class members. Notice of the settlement and claim form were mailed to each of these persons, and notice was also published in *USA Today*.
- * There were 7,779 class members who were potentially identified as Former Supervisors. These persons - comprising approximately 89% of the class - were entitled to make claims for economic losses.
- * Of these, 2,481 or about 32%, submitted eligible claims.
- * The aggregate economic losses of eligible claimants totaled \$19,731,186, indicating an average loss of \$7,953. Several individuals claimed - and proved to the satisfaction of the claims administrator - losses in excess of \$100,000.

The NWTW experience provides compelling evidence in favor of the Commission’s proposed rule, as well as more proactive regulation of MLM business opportunities. If adequate disclosures had been made to participants in NWTW at least some of these losses could have been avoided. Proponents of the MLM industry generally concede that there is a high rate of attrition among MLM distributors but they assert that losses are minimal because the costs to start and operate an MLM distributorship are so low. The NWTW data refute this dogma.

MLM industry proponents can be expected to argue that the NWTW claims data is not statistically representative of the industry. They may assert that the NWTW system violated industry norms and/or that the claimants are a self-selected group and not representative of the average MLM distributor. Two points can be made in rebuttal: First, the NWTW system operated without sanction for over five years in one of the largest MLM systems in the world. Second, if the MLM industry truly wants more accurate statistics, it is within their power to collect such statistics. The fact that they have not done so suggests that they know they will be uncomfortable with the inferences which may be drawn from the information they collect.

I would urge the Commission to request the largest MLM systems to provide lists of current and former distributors for the purpose of conducting a survey of actual earnings experience.

⁴ See Declaration of Michael Rosenbaum in Support for an Order Authorizing Distribution of Net Settlement Fund, relevant portions of which are submitted herewith as Exhibit B.

V. INDUSTRY REACTION TO THE NPR

The Commission can anticipate a vigorous, well-funded opposition to the Proposed Rule. One MLM advocate outlined a multi-pronged attack, including not only filing a formal opposition via the Commission's rule-making procedures, but utilizing personal contacts with Commission staff members, lobbying "key members" of Congress to delay or defang the Commission, drafting legislation to neutralize the impact of any Rule that the Commission ultimately adopts, funding press and media campaigns against the Proposed Rule, and organizing grassroots initiatives by distributors.⁵

A large portion of the negative responses already received by the Commission as of the date of this Comment are obviously the result of several such initiatives which -- far from being "grassroots" -- are obviously being funded and directed by large MLM firms, including several members of the Direct Selling Association (DSA). Given that the attrition rates among MLM distributors frequently approach 100% or higher per annum, it would be interesting to determine how many of these respondents will still be associated with their respective companies a year from now. It would also be interesting to learn what these respondents are actually earning today. It is a sadly frequent phenomenon of MLM that participants who are caught up in the evangelical excitement of "the business" find it difficult to admit to themselves that the anticipated financial rewards have not come to pass.

VI. RESPONSES TO THE COMMISSION'S QUESTIONS ON SPECIFIC PROPOSALS

Definitions

1. Definitions of "business opportunity" and "new business"

The Commission requested comments concerning whether the definition of "business opportunity" in § 437.1(d) should be limited to solicitations to enter into a "new business," with "new business" defined in § 437.1(k) as "a business in which the prospective purchaser is not currently engaged, or a new type or line of business." The purpose of this part of the definition is to distinguish sales of business opportunities from ordinary sales of goods and services.

The Commission's intent is to include a variety of different types of business opportunities within the scope of the Proposed Rule, including vending machine and rack display

⁵ See FTC Proposed Business Opportunity Rule Analysis by Jeffrey Babener, <http://www.mlmllegal.com/FTC%20Business%20Opportunity%20Rule/FTCProposed.html> (visited 7/1/2006).

sales, work-at-home schemes and pyramid schemes. While it might be easier to design a regulation for each type of opportunity, the continuous development of new schemes and the creativity of business opportunity sellers would quickly have rendered some regulations irrelevant and required new regulations for new types of opportunities. Given the Commission's goals, the proposed definition of "business opportunity" is appropriate and necessary. I propose that the definition of "new business" be modified so that it would read "a business in which either the prospective purchaser is not engaged, or which involves the sale of a new type or line of products or services in which the prospective purchaser is not engaged business." The modification is necessary in order to eliminate potential ambiguity in certain recurring situations in the MLM industry.

For instance, a distributor in one MLM plan may recruit his or her downline distributors into another MLM. This may occur in a number of different contexts, including when the original MLM plan goes out of business, when the distributor terminates their involvement in the original MLM, when the original MLM terminates the distributorship of the distributor, or when the distributor intends to go into a new MLM while maintaining his or her distributorship with the new MLM. In each case, the solicited distributors may be said to be "currently engaged" in the business of recruiting distributors and selling a variety of products. Distributors who are solicited in such circumstances should be protected by the Rule, and the modified definitions will eliminate any ambiguity as to whether they are covered.

The Rule should also cover "serial" business opportunity purchasers, sometimes known as "MLM junkies." The modified definition of "new business" makes clear that such a distributor is entitled to the protections of the Rule with each new business opportunity they purchase even though it may be similar to business opportunities in which they are already engaged.

Finally, faced with actual or perceived market saturation, MLM firms develop "new" business opportunities and solicit their existing distributors to sell them. For instance, Nu Skin, a seller of personal care products, developed "Interior Design Nutritionals" and "Pharmanex", separate MLM business opportunities involving the sale of vitamins and nutritional products, and "Big Planet," a separate MLM business opportunity involving the sale of web site development tools. NSA, a multi-level marketer of home water filters, created the "Juice Plus" marketing network. In a somewhat different manner, Amway developed the "Quixtar" business opportunity, which is sold in North America while the Amway business opportunity is sold worldwide. Distributors who purchase such "new" opportunities should be entitled to the disclosures mandated by the Rule.

2. Definition of "business opportunity" involving "business assistance" or "earnings claims"

The Commission requested comments as to whether the definition of “business opportunity” needed to be qualified by including only opportunities which promise “business assistance” or which make “earnings claims.” Every MLM opportunity involves both promises of assistance and earnings claims.⁶ However, as the Commission has recognized with respect to the Franchise Rule, it is very likely that business opportunity sellers will attempt to structure or characterize their offerings in a manner designed to circumvent the application of the Proposed Rule. Phrasing the business assistance and earnings claims elements in the disjunctive, as in the Proposed Rule, will frustrate efforts to evade compliance.

3. Definition of “business opportunity” requiring consideration

The Commission requested comments concerning whether there should be a minimum payment threshold for a “business opportunity.” The Proposed Rule does not contain a minimum payment threshold. The undersigned concurs most emphatically with the Commission that there should be no minimum threshold because, as the Commission states, “fraudulent business opportunity sellers will price their opportunities at an amount just under the threshold in order to avoid compliance.”

Most MLM business opportunities involve a nominal initial payment - well under the \$500 threshold which might invoke application of the Franchise Rule - which typically covers the cost of an introductory package, including promotional brochures, a distributor agreement, operating manual and sample products. MLM sellers frequently tout the low cost of this package in comparison to the relatively high cost for purchasing a traditional franchise. The true cost of the opportunity, however, does not become apparent until after the initial plunge. As with the ‘Newest Way to Wealth’ system discussed above, prospective distributors are typically told that the ‘real money’ is made by participants who advance to the next level of the plan, by purchasing a given amount of inventory. In addition, as discussed above, in many MLM companies, high level distributors are promoting ‘lead generation systems’ which require additional payments for promotional materials, mailing lists and support services. These payments can quickly mount.

4. Definition of “business assistance”

The Commission requested comments concerning whether the examples of business assistance set forth in § 437.1(c) are warranted. MLM opportunities typically promise training

⁶ See *Meadow Fresh Farms, Inc. v. Sandstrom*, Bus.Franch.Guide [CCH] ¶ 8064 (N.D. 1983) (finding “marketing plan” element of franchise under North Dakota statute met where multilevel marketer of dry milk “alternate products” provided marketing plan with following elements: (1) detailed compensation and bonus structure, (2) centralized bookkeeping, (3) prescribed scheme for advancement through various levels of the program, (4) reservation of right to approve all promotional materials, (5) prohibition on repackaging of products, (6) assistance in conducting “opportunity meetings”, (7) suggested retail prices, and (8) comprehensive advertising and promotional program).

and support for distributors, which is covered under subsection (v), and administering the distributor compensation plan, which is covered under subsection (iv). These provisions are reasonable and necessary to accomplish the purposes of the Proposed Rule.

5. Definition of “business assistance” as including administering compensation plans

The Commission states that subsection (iv) of § 437.1 (c) is intended to capture pyramid marketing programs that promise to track commissions based on the participant’s purchases and recruitment of other distributors. This type of promise is universal in the MLM industry, and is reasonable and necessary to accomplish the purposes of the Proposed Rule. The reference to recruitment of other distributors is sufficient to preclude unintended coverage of traditional types of commercial distribution arrangements.

6. Definition of “new business”

The definition of “new business” in the Proposed Rule should be modified as set forth in Comment 1 above.

7. Timing of Disclosures

The Commission requested comment concerning the requirement in § 437.2 that the disclosure document be provided at least seven calendar days before the purchaser signs a contract or pays any consideration in connection with the opportunity. This “cooling-off” period is analogous to a similar requirement in the Franchise Rule.

I recommend that not only should there be a cooling-off period for the initial purchase of business opportunities, but that existing distributors should be provided with updated disclosures on a quarterly basis.

The cooling-off provision recognizes one of the realities of distributor recruitment in the MLM industry. MLM promoters typically attempt to create an atmosphere of mystery and excitement concerning the new opportunity. Prospects are often invited to an “opportunity meeting” without being told the name of the company sponsoring the opportunity. Promotional events are designed to induce the prospect to “willingly suspend disbelief” when making the decision to join the scheme. A seven-day cooling off period is a reasonable requirement to permit the prospect to carefully consider the costs and risks of the proposed opportunity.

Industry opposition to this provision will be vigorous. The point will be made that the seven-day waiting period will be difficult or impossible to enforce in MLM systems because recruitment is done by distributors over whom the sponsoring company has limited control.

MLM recruiters will undoubtedly develop methods to “game the system” to avoid the effect of this provision, with the tacit acceptance of the MLM firm. Nonetheless, the benefits of a cooling-off period far exceed the costs.

In addition, quarterly disclosures for existing distributors would impose minimal burdens on MLM Sellers while providing distributors the opportunity to assess their own performance in light of updated disclosures. It should be noted that, as discussed in more detail above, the typical MLM opportunity is presented as a involving limited risk because the initial “investment” is nominal. Distributors may participate in an MLM system for several months before they realize the actual costs incurred in running the “business” exceed their gross receipts. Imposing a seven-day (or shorter) waiting period will not avoid such losses. For this reason, I recommend that business opportunity sellers be required to provide the updated disclosures mandated by the Proposed Rule to existing distributors as well as prospective distributors. This will provide the distributor with important information relevant to his or her decision as to whether to continue investing time and money in their business. Since business opportunity sellers will already have the obligation to prepare updated disclosures on a quarterly basis, there would be little burden in requiring them to provide the updated disclosures to their existing distributors.

8. Liability limited to “Seller”

The Commission requested comments concerning whether liability for failure to provide the disclosure document should be limited to the “seller,” as provided in § 437.3. The Proposed Rule defines “seller” as “a person who offers for sale or sells a business opportunity.” In the typical MLM sales situation, the business opportunity is “offered” for sale by an existing distributor, but the opportunity is “sold” by the MLM company. In its Request for Comments number 8, the Commission seems to have assumed that the language “offers for sale” excludes brokers or “other individuals or entities involved in a business opportunity sale.” It would exclude, for instance, high level distributors who are frequently involved in the sales of MLM distributorships several levels below them in their “downlines.” In light of the phenomenon of distributor-produced promotional materials discussed above, I recommend that liability be extended to distributors who produce or sell their own promotional materials.

- 9. Disclosure Document - Boilerplate Disclosures**
- 10. Disclosure Document - Presentation**
- 11. Disclosure Document - Clarity**

The boilerplate disclosures required by the Proposed Rule are necessary and appropriate to alert prospective purchasers about the potential risks. The presentation of the Disclosure Document is direct and to the point.

12. Identification of Sellers

It is essential that prospective business opportunity purchasers know about the previous business opportunities offered by the Seller's officers, directors, sales managers and persons performing similar functions, including high level distributors who produce and sell their own promotional materials. Such persons often have a history of involvement with other, failed business opportunity schemes.

13. Persons Required to Disclose Litigation History

The required disclosure of litigation history should include the Seller's officers, directors, sales managers and persons performing similar functions, including high level distributors who produce and sell their own promotional materials.

14. Disclosure of Types of Litigation

The disclosure of litigation should include not only civil and criminal actions but also arbitrations, bankruptcies and breach of contract lawsuits by and against the Seller, its officers, directors, sales managers and persons performing similar functions, including high level distributors who produce and sell their own promotional materials. The requirement to include lawsuits brought by such persons is important because prospective distributors should know, for instance, if the Seller has seen fit to bring lawsuits against former distributors to enforce the terms of non-competition covenants or other terms of distributor agreements. Such disclosures may indicate potential problems with the business opportunity that are relevant to prospective purchasers.

15. Disclosure of Litigation History

The litigation history should include not only the caption, identification of parties, court, case number and filing date but also a brief summary of the disposition of the action, as suggested in the Commission's Request for Comment number 15. Business opportunity purchasers are not likely to have access to legal counsel who could obtain or explain such information, so a mere listing of cases would be of limited utility. Moreover, business opportunity Sellers will likely want to identify instances where the final disposition of the case was in their favor. Requiring disclosure of the disposition of litigation would not materially add to the Seller's burden.

16. Disclosure of Cancellation Policy and Attrition Rate

Section 437.3(a)(4) of the Proposed Rule requires the Seller to make disclosures concerning the terms and conditions of any refund or cancellation policy. Section 437.3(a)(5)

requires disclosure of information concerning prior cancellation or refund requests.

Disclosure of the existence and terms of any cancellation or refund policy is essential. In particular, Sellers should be required to disclose whether the refund policy extends to items or services which are recommended to be purchased

Sellers should be required to state the numbers of cancellation or refund requests on a monthly or quarterly basis, as well as the number of new and existing distributors. Such information will enable the prospective purchaser to assess whether there is any trend of increasing or decreasing requests for cancellation or refunds, and also whether such requests constitute a large or small portion of new and existing participants. Sellers in the MLM industry generally acknowledge that there is a high rate of attrition amongst MLM distributors. Disclosure of the actual attrition rate is essential information for prospective distributors.

The Commission states, in its comment to Proposed Rule section 437.3(a)(5), that it believes that "it would be impracticable to mandate a drop-out rate disclosure." This statement is not correct as to MLM firms, which, like business format franchises, maintain close, continuing contact with their distributors. MLM firms typically have sophisticated computer systems which track distributor purchases in order, among other things, to track and calculate commission and bonus payments. Providing information concerning the attrition of distributors, including refund and cancellation requests, would not be burdensome. Industry protestations to the contrary should be viewed with skepticism.

- 17. Disclosure of 10 Prior Purchasers**
- 18. Disclosure of National List of Purchasers**
- 19. Privacy Concerns of Distributors**
- 20. Contact Information for Prior Purchasers**

One of the fraudulent promotional techniques used by MLM firms is the use of "shills" - i.e., persons who have supposedly (or even actually) succeeded in the business by following the promoters' plan. MLM recruitment meetings typically include the introduction of one or more highly successful distributors, who make express or implied claims about their income from the plan. Written promotional materials also typically include testimonial earnings claims as in the NWTW system described above. Section 437.3(a)(6) of the Proposed Rule is a creative response to the inherently deceptive use of earnings testimonials by requiring the Seller to provide either a list of the 10 prior purchasers nearest to the prospective purchaser, or a national list of prior purchasers, with contact information.

MLM industry proponents will certainly attack this proposal as both unworkable and violative of the privacy rights of distributors.

As between the two alternatives, the requirement to provide a national list of distributors would be less burdensome on MLM Sellers than the 10 closest distributors, especially given the nature of the MLM recruitment process. All MLM firms must keep their list of distributors current in order to track orders and pay commissions. Such a list could certainly be sorted by geographic area, which would enable prospective purchasers to contact distributors near them. However, prospective purchasers should have the ability to contact distributors in other geographic areas. A given MLM system may be relatively new in one state, with the result that many participants on the contact list may have limited experience, while contacting distributors in areas where the company has been active for a longer period will yield a richer range of experience.

Any assertion by MLM firms that they are concerned about the privacy rights of their distributors should be viewed with extreme suspicion. In traditional distribution systems, no distributor has any interest in keeping his or her distributorship "secret." All publicity is good publicity. The real concern of MLM proponents is that, due to the high attrition rates of most MLMs, many of the persons on the contact list will inevitably be failed distributors. Given the widespread use of testimonial earnings claims by successful distributors, the Commission's proposal will provide crucial balance to the prospective MLM distributor.

MLM firms will also complain that the requirement to provide a national list of distributors will enable their competitors to contact and recruit their distributors. The Commission could prohibit such use by other business opportunity sellers. In addition, the disclosure of contact information could provide prospective distributors with the option of checking a box stating that they do not want to be contacted by other business opportunity Sellers, in a manner similar to the "Do Not Call Registry" maintained by the Commission and state regulators.

New business opportunity purchasers should not be given the option to opt-out of disclosure of their contact information to prospective purchasers. The MLM recruitment process is very susceptible to the type of manipulation anticipated by the Commission, which would result in the list being limited to shells. However, business opportunity purchasers who purchased prior to the adoption of the Proposed Rule - including not only existing distributors but terminated distributors - should probably be given the right to opt-out of disclosure.

21. Other Disclosures

There is a need for other types of disclosures by business opportunity Sellers. As discussed above, the actual costs of operating a MLM distributorship are significant. The MLM Seller should be required to list the types of business expenses incurred by distributors, with approximate ranges based on surveys of distributors. There should also be disclosure of any arrangements under which the Seller or high level distributors receive consideration from third

parties who provide products or services to distributors. This is addressed in part in section 437.5(r)(1) of the Proposed Rule, but should be expanded expressly to cover third parties.

22. Earnings Claims
23. Use of Industry Information

I concur with the comments of Robert Fitzpatrick of Pyramid Scheme Alert and Dr. Jon Taylor concerning the content and depiction of earnings claims disclosures.

24. Prohibited Acts or Practices

In addition to the matters listed in section 437.5 of the Proposed rule, MLM Sellers should be prohibited from limiting any private right of action a purchaser may have arising from conduct which may violate the Proposed Rule. There is no private right of action for violation of section 5 of the FTC Act, although most states provide a private right of action under their own "little FTC" statutes. Since the Commission cannot possibly take enforcement actions for every violation of the rule, which may involve thousands of distributors in hundreds of different MLM systems, preserving private rights of action is essential to accomplish the purposes of the Proposed Rule. Sellers should be prohibited from including mandatory arbitration clauses, bans on class actions, choice of forum or venue clauses, or other limitations of remedies, in their distributor agreements.

25. Liability of Third Parties

In light of the phenomenon of distributor-produced promotional materials (see sections III.B. and IV above), liability for violation of the Proposed Rule should be extended to high level distributors who produce and/or sell their own promotional materials. MLM Sellers should also be liable for the conduct of such high level distributors. This requirement will motivate Sellers to police the actions of their own distributors, which is essential in order to accomplish the purposes of the Proposed Rule.

26. Interplay of State and Federal Regulation

The Commission's approach is appropriate in light of the fact that very few states have disclosure statements applicable to all of the various types of business opportunities covered by the Proposed Rule.

27. Record Retention

The Proposed Rule requires MLM Sellers to retain records for a period of only three years. A longer period would be essential, since some violations may not come to light within

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three years. Since most companies retain their tax records for at least seven years, a record retention requirement of seven years would not be too burdensome.

The Commission queried concerning record keeping of cancellation requests. Most such requests already generate a written record (because of the necessity of writing a refund check to the distributor) and it would not be burdensome to require Sellers to keep and maintain such records.

VII. REQUEST FOR HEARING

The undersigned requests a hearing pursuant to Section 18(c) of the Federal Trade Commission Act and Section F. of the April 12, 2006 Notice of Proposed Rulemaking. I would be prepared to testify as to the matters set forth above.

Respectfully submitted.

 Douglas M. Brooks

DMB/s
encl.