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FEDERAL TRADE COMMISSION

**IN THE UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF ARIZONA**

**Federal Trade Commission;**

Plaintiff,

v.

**Vemma Nutrition Company, et al**

**No. CV-15-01578-PHX-JJT**

**PLAINTIFF FEDERAL  
TRADE COMMISSION'S  
RESPONSE TO  
DEFENDANTS' MOTION TO  
APPROVE COMPENSATION  
PLAN**

**I. INTRODUCTION**

Plaintiff Federal Trade Commission ("FTC") objects to the revised Compensation Plan (the "Plan") recently proposed by Vemma (Doc. 155-1) because it continues to incentivize recruitment activities over Customer sales. If the Plan is implemented, Vemma's marketing program will incentivize participants to recruit downline Affiliates

rather than Customers, and put pressure on all Affiliates to engage or encourage others to engage in inventory loading. This feature of the Plan will violate Sections I.A.2 and I.A.3 of the Court's September 18, 2015 preliminary injunction (Doc. 118) (the "Order"). In addition, Vemma's "51% Rule" is insufficient as a safeguard to address the natural incentives of Vemma's binary Plan, because it allows substantial compensation to be paid to an Affiliate even if the majority of the Affiliate's downline sales volume is generated by sales to or purchases by other Affiliates rather than Customers.

## II. ARGUMENT

### A. **Vemma's proposed Compensation Plan heavily incentivizes recruitment of new Affiliates rather than retail sales and is likely to lead to *de facto* inventory loading.**

Despite the many different ways Vemma could have restructured its marketing program to incentivize retail sales to ultimate users, it has elected to retain its binary compensation plan and pay compensation primarily through "Cycle Commissions" generated by downline activity. Vemma has not proposed a wholesale/retail pricing model that would make re-selling profitable, nor has it proposed a flat commission or any other structure that would provide reasonable rewards to Affiliates for direct retail sales. Instead, it forces Affiliates to obtain compensation through the binary structure. This is the same binary plan and Cycle Commission structure that previously caused Vemma Affiliates to overwhelmingly focus on recruitment of downline Affiliates rather than Customers, with the large majority of Vemma's sales being purchases by Affiliates. Vemma appears determined to stick as closely to its previous model as possible. Given that the Court has found that the FTC is likely to prevail on its claim that Vemma has

been operating an illegal pyramid scheme through its previous compensation plan, the FTC is justifiably skeptical of the new, similar Plan.

As Dr. Stacie Bosley notes in her Supplemental Declaration (attached to this Response as Exhibit A), a binary compensation plan that lacks sufficient retail incentives and safeguards “is expected to act as a money-transfer scheme, siphoning money from later entrants to compensate earlier entrants.” Ex. A, at ¶ 2. This establishes a structure where “individual earnings are dependent on the ongoing ability of a participant to recruit others into the same system,” thereby creating a system “where the vast majority of participants cannot recruit their personal investment.” *Id.*

Under Vemma’s revised binary Plan, a single sale to an end user contributes very little income. As explained by Dr. Bosley, the new Plan is even worse than the old one in this respect because Vemma decreased the point value of products without decreasing the point requirements to “cycle”:

For example, a Vemma 1-Pack before would yield 60 of 540 QV needed for a cycle (or 1/9th of a cycle) paying \$2.22 when a Consumer purchased product directly from Vemma. Under the proposed Compensation Plan, this same purchase would now yield only 25 of 540 QV needed for a cycle, paying only \$0.93.

*Id.* at ¶ 4.

Since the Plan provides no new incentives for retail sales, the effect is that “Affiliate behavior is still expected to center on recruitment of additional Affiliates who will duplicate, growing the downline teams.” *Id.* Rather than seeking to build a Customer base, Affiliates will still try to maximize earnings by focusing “on acquisition of aggregate volume from downline Affiliates.” *Id.* at ¶ 6.

Since Vemma's Plan will incentivize Affiliates to build downline volume by recruiting new Affiliates rather than selling to Customers, Affiliates will need downline Affiliates to purchase product in order to fund the compensation. Even though Affiliates will no longer be able to qualify based on their own purchases, the need for Affiliate purchases to fund compensation means that "there are still incentives to purchase the product for reasons outside of ultimate user motivation." *Id.* at ¶ 5. In fact, contrary to Defendants' assertion that the Plan removes all incentives for Affiliates to purchase product other than for personal use or re-sale,<sup>1</sup> the structure will place pressure on all members of the organization to purchase product for reasons other than personal use. For example, upline Affiliates, who can maintain qualification through purchases by downline Affiliates, will place pressure on their downlines to purchase product (likely under the guise of maintaining an inventory of "samples"), and upline Affiliates will face pressure themselves to make purchases, both to qualify their uplines and to demonstrate their commitment to the product while recruiting downlines. *See id.* This pressure will be particularly intense in already-existing downlines, which have been developed in a culture of deceptive income claims and "pay-to-play" incentives and will be incentivized to perpetuate that culture despite changes to Vemma's formal policies.<sup>2</sup>

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<sup>1</sup> *See, e.g.*, Defendants' Motion, at 3.

<sup>2</sup> Vemma previously had a formal policy against inventory loading (*see* Vemma Affiliate Agreement Terms and Conditions (Preliminary Injunction Hearing Exhibit 14), at Sec. 29), but actively encouraged Affiliates to violate that policy by purchasing product to qualify for commissions. *See* Order, at 3-4 (finding that Vemma taught Affiliates to purchase product to maintain eligibility). The Court also found that Vemma's "70% Rule" was ineffective and inadequately enforced. *See* Order, at 7.

Section I.A.2 of the Order prohibits Vemma from engaging in a Marketing Program that “incentivizes members to purchase goods or services to maintain eligibility for bonuses, rewards, or commissions rather than for resale or personal use.” Section I.A.3 prohibits Vemma from inducing others to encourage or incentive members to engage in the same conduct prohibited by Section I.A.2. The foreseeable result of Vemma’s revised Plan is that Affiliates will still be incentivized to purchase products for reasons related to their “eligibility for bonuses, rewards, or commissions” rather than resale or personal use, and encourage others to do the same, in violation of Sections I.A.2 and I.A.3 of the Order.<sup>3</sup>

**B. Vemma’s “51% Rule” is an insufficient safeguard to prevent undue emphasis on recruitment of Affiliates and *de facto* inventory loading.**

Section I.A.4 of the Order prohibits Vemma from engaging in a Marketing Program that “pays any compensation related to the purchase or sale of goods or services unless the majority of such compensation is derived from sales to or purchases by persons who are not members of the Marketing Program.” Order, at Section I.A.4. Vemma’s Compensation Plan includes a “51% Rule” (Ex. 1 to Defendants’ Motion, at 3) that allows substantial compensation to be paid to Affiliates even if the majority of their

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<sup>3</sup> The Court need not find that the proposed Plan facially violates the Order or the FTC Act in order to reject it. Despite repeated assertions by Defendants that the Plan is compliant as a matter of law (*see, e.g.*, Defendants’ Motion, at 6 (arguing that the Plan “as a matter of law” does not violate either prong of the *Koscot* test)), it is well established that courts must look beyond a company’s policies and procedures and examine how the company operates in practice to determine if it is an illegal pyramid. *FTC v. BurnLounge, Inc.*, 753 F.3d 878, 883 (9th Cir. 2014). The Court’s broad equitable authority to enjoin violations of the FTC Act is not limited to disallowing materials that facially violate the Act or even the Order itself.

downline sales go to other Affiliates, in conflict with the intent of the Order and previous anti-pyramiding rules that have been found to be effective. The 51% Rule allows payment to Affiliates for a portion of their downline Affiliate sales volume as long as the portion of compensation based on Affiliate volume that is actually paid is less than the portion based on Customer volume that is actually paid. For example, in Vemma's illustration, an Affiliate who has \$40 in Customer sales volume and \$60 in Affiliate sales volume is entitled to receive \$39 of the Affiliate volume, even though the total Affiliate volume exceeds the total Customer volume. *Id.* The end result in the illustration is that the Affiliate will receive \$79 out of the \$100 potential compensation. *Id.*

As explained by Dr. Bosley, under Vemma's 51% Rule, if \$501 of an Affiliate's total \$1,000 in volume was from Affiliate purchases, an Affiliate would still be entitled to compensation of \$997 (\$499 in Customer purchases and \$498 in Affiliate purchases). Ex. A, at ¶ 3. Practically speaking, Vemma's 51% Rule allows Affiliates to obtain substantial compensation even if the bulk of their efforts are directed at recruiting Affiliates rather than Customers, as incentivized by the Compensation Plan. As such, it is insufficient to shift Affiliates' behavior toward retail sales to ultimate users.

The Court should interpret and apply Section I.A.4 to require that an Affiliate receive *no* commissions unless the majority of the Affiliate's sales volume that would otherwise generate commissions is derived from sales to Customers. Prohibiting the payment of any commissions unless the majority is derived from Customer sales is consistent with the anti-pyramiding rules found to be effective in *In re Amway Corp.*, 93 FTC 618, (1979). In *Amway*, the company was found to have strictly enforced anti-

pyramiding rules, including the “70 percent rule” and the “10 customer rule.” *Id.* at 716. Under both of these rules, commissions were forfeited (not proportionally reduced) if the rules were violated. The “70 percent rule” required distributors to sell at wholesale or retail at least 70% of the products bought “during a given month in order to receive the Performance Bonus due on all products bought . . . [.]” *Id.* Under the “10 customer rule,” distributors were required to present proof of sales to 10 different retail customers during a given month “in order to obtain the right to earn Performance Bonuses on the volume of products sold by [the distributor] to his sponsored distributors during a given month.” *Id.* The Commission found that these safeguards were sufficient to prevent the structure from being a pyramid. *Id.*<sup>4</sup>

This approach is also consistent with the language of Section I.A.4, which prohibits “any compensation” unless the underlying conditions are met, and will be far more effective to safeguard against over-emphasis on recruiting downline Affiliates and the resulting inventory loading. This Court should reject the Plan, including the ineffective 51% Rule, as inconsistent with the Order’s stated intent to enjoin “features of Defendant’s Marketing Program and bonus structure that tie bonuses primarily to recruiting and to the purchase of product principally to stay eligible for those bonuses.” Order, at 15.

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<sup>4</sup> For this reason, Defendants’ claim that the FTC’s position on the 51% Rule is inconsistent with *Amway* and other cases interpreting *Amway*, such as *BurnLounge*, defies logic. See Defendants’ Motion, at 9. It is Defendants’ position that is inconsistent with the safeguards discussed in those decisions.

### III. CONCLUSION

For the reasons stated above, the FTC respectfully requests that the Court deny Defendants' Motion and prohibit Defendants Vemma Nutrition Company and Vemma International Holdings, Inc. from implementing the Plan attached to the Motion.

Dated: October 20, 2015.

Respectfully submitted,

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General Counsel

/s/ Jason C. Moon

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FEDERAL TRADE COMMISSION

**CERTIFICATE OF SERVICE**

I certify that on October 20, 2015, Plaintiff Federal Trade Commission electronically transmitted the attached Document to the Clerk's Office using the CM/ECF System for filing and transmittal of a Notice of Filing to all CM/ECF registrants including:

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/s/ Jason C. Moon

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Jason C. Moon

# EXHIBIT A



### Supplemental Declaration

1. My name is Dr. Stacie A. Bosley. I have written a declaration regarding Vemma Nutrition Company (August 11, 2015). This supplemental declaration addresses a revised Vemma Compensation Plan and Terms & Conditions document, received on October 16, 2015. The revised Compensation Plan contains new definitions and some changes to the terms of participation, qualification, and compensation. Affiliate Packs are no longer sold and personal purchases can no longer be used to qualify for compensation (in accordance with the Court Order dated September 18, 2015). Additional changes include the following:

- A participant is defined as an Affiliate if he/she “intends to participate in and earn rewards under Vemma’s Marketing Plan” and is defined as a Customer if he/she “is interested in purchasing and using” Vemma products.
- Qualification for commissions in a period is now achieved with a minimum of 50 PV (100% of QV from personally enrolled Customers or Affiliates) and two active personally enrolled Customer(s)/Affiliate(s), one on the left team and one on the right team.
- Active status is now achieved with a minimum of 25 PV, based on 100% of QV purchased by personally enrolled Customers/Affiliates (higher threshold for Platinum and above).
- Item points have been altered to maintain the same thresholds as prior Compensation Plan (*e.g.*, a Vemma 1-Pack that was 60 QV is now 25 QV and a Vemma 2-Pack that was 120 QV is now 50 QV).
- The proposed 51% Rule pays full commissions if Customer purchases are at least 51% of an individual’s total sales. If Customer purchases are less than the 51% threshold, the revised plan would pay compensation based on Affiliate purchases so long as the majority of that individual’s compensation is derived from Customer purchases.
- Cycle Commissions, Rank Advancement Rewards, Matching Commission, 2<sup>nd</sup> Tier Matching Commission, Vemma Loyalty Rewards, and Balanced Team Bonus are maintained but the Balanced Team Bonus is not paid unless at least 51% sales are to Customers.
- Certain bonuses, including the Frenzy Bonus, Double Frenzy Bonus, and New Customer Bonus are eliminated.
- Points needed for a cycle remain 360 + 180, while points per item have been reduced.

2. While these changes alter some aspects of the Compensation Plan, the primary incentives remain centered on recruitment and incentivized purchases over retail sales. As stated in my original declaration<sup>1</sup>, a binary compensation structure that lacks sufficient retail incentives and safeguards is expected to act as a money-transfer scheme, siphoning money from later entrants to compensate earlier entrants. In such a structure, individual earnings are dependent on the ongoing ability of a participant to recruit others into the same system. By design, this creates a system where the vast majority of participants cannot recoup their personal investment. As discussed further below, the proposed changes to Vemma’s Terms and Conditions and Compensation Plan (a) fail to shift the balance toward retail sales to ultimate users and (b) offer a 51% Rule that pays significant compensation even when the majority of sales are tied to Affiliate purchases. This combination

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<sup>1</sup> See paragraphs 17-18 in the original declaration.

provides an incentive for recruitment without an effective safeguard to ensure sufficient retail activity. It is my judgment that the proposed marketing program still presents risks for pyramid-like behavior and corresponding harm. The following paragraphs describe specific concerns connected to this conclusion.

3. The proposed 51% Rule pays an Affiliate the majority of rewards even when a majority of his/her sales are Affiliate purchases. The plan proposes to pay full compensation when Customer purchases are at least 51% of sales. If Customer purchases fall below this level, compensation will be paid on both Customer and Affiliate purchases so long as the compensation derived from Affiliate purchases is \$1 less than the compensation derived from Customer purchases. This proposal creates a wide array of outcomes. When an individual's volume is almost exclusively based on Affiliate purchases, this rule does provide some limit on compensation. On the other hand, a more even balance between Customer and Affiliate sales would effectively provide full compensation, even if Affiliate purchases represent the majority of sales volume. For example, if \$501 of \$1,000 in volume is from Affiliate purchases, compensation would be based on \$997 of that volume (\$499 in Customer purchases and \$498 in Affiliate purchases). To ensure the Rule's effectiveness as a safeguard, *no* compensation should be paid when a majority of volume is coming from Affiliate purchases.

4. Participants pursuing the business opportunity are assumed to behave in a way that is consistent with the incentive structure presented, in pursuit of maximum profit.<sup>2</sup> The proposed Compensation Plan maintains the incentives for recruitment over retail sales. No new incentives have been established to promote retail sales to ultimate users. While there is the appearance of lower thresholds for both "active" and "qualified" status, changes to product points mean there is no actual change to these thresholds. It is difficult to see the purpose of these changes as being anything other than creating the illusion of lower thresholds. In addition, since the points needed to earn a cycle have remained the same (360 + 180), returns to participants for retail sales (via the website) are reduced. For example, a Vemma 1-Pack before would yield 60 of 540 QV needed for a cycle (or 1/9<sup>th</sup> of a cycle) paying \$2.22 when a Consumer purchased product directly from Vemma. Under the proposed Compensation Plan, this same purchase would now yield only 25 of 540 QV needed for a cycle, paying only \$0.93<sup>3</sup>. The New Customer Bonus is also removed, which would have paid compensation for the first purchase made by a Customer (e.g., \$20 for a Vemma 2-pack purchase). Given that changes do not increase incentives for sales to ultimate users, Affiliate behavior is still expected to center on recruitment of additional Affiliates who will duplicate, growing the downline teams.

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<sup>2</sup> Standard economic theory holds that decision-makers are rational actors, meaning that individuals make choices that align with maximum expected outcomes. Furthermore, such choices can be viewed as optimal responses to the incentive structure introduced. Rational actor assumptions are commonplace in economic texts (see, e.g., N. Gregory Mankiw's discussion of rational consumers and profit-maximizing businesses in *Principles of Economics*, 2014, 7<sup>th</sup> ed.). In this context, the introduction of this assumption means that participants will evaluate the incentive structure and act to maximize possible returns from the marketing program.

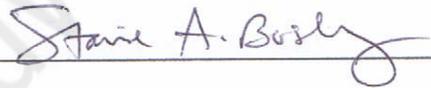
<sup>3</sup>  $\$0.93 = (25/540) * \$20$ , where \$20 is paid for each cycle.

5. While personal purchases no longer qualify the participant for rewards, there are still incentives to purchase the product for reasons outside of ultimate user motivation. Product might be purchased for samples, as often encouraged by the company, or for intended resale. In addition, while personal purchases do not qualify an individual for compensation, those purchases do qualify the upline Affiliate. In the absence of a shift of rewards from recruitment toward retail sales (discussed below), recruitment and duplication remain the primary methods of acquiring income. As such, there is expected to be pressure to purchase to ensure the team members remain qualified month-to-month. As part of the duplication strategy, Affiliates may use personal purchases to establish credibility, as they encourage downline Affiliates to do the same.

6. Without yet seeing how the Plan will be marketed by Vemma and its Affiliates, it is difficult to know the degree to which they will attempt to enforce the buy and recruit strategy that was central to the prior Vemma Compensation Plan and "Two & Go" Program. However, the incentive structure remains intact. Given modest compensation available from true Customer (*i.e.*, ultimate user) acquisition, those seeking to maximize earnings are expected to focus on acquisition of aggregate volume from downline Affiliates. Changes to qualification standards are superficial, the 51% Rule still provides significant compensation for Affiliate purchase volume, and no new retail incentives have been established. It is my determination that the revised compensation plan would still, in practice, incentivize recruitment over retail without effective safeguards to ensure sufficient sales to ultimate users.

7. I understand that this declaration may be used in a law enforcement proceeding.

Pursuant to 28 USC Section 1746, I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct to the best of my knowledge and belief.

  
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