Open Letter to the Members of the US Federal Trade Commission and
Officials of the Consumer Protection Bureau

Identifying “Bright Lines” for Determining Illegality of
Any Multi-Level Marketing Company
under Section 5 of the FTC Act

Robert L. FitzPatrick,
Pres., Pyramid Scheme Alert,
Co-Founder, International Coalition of Consumer Advocates

©2014 Robert L. FitzPatrick
1800 Camden Rd. Ste. 107 #101
Charlotte, NC 28203
RFitzPatrick@falseprofits.com
http://www.falseprofits.com
704-334-2047
July 4, 2014
Robert L. FitzPatrick

1

http://pyramidschemealert.org/international-coalition-of-consumer-advocates/
Introduction

This memo is a personal follow-up to an hour-long conference call on June 9, 2014 that I participated in with Ms. Jessica Rich, Director of the FTC’s Consumer Protection Bureau and several of her associates. During this call, I and two of my colleagues, Attorney Douglas Brooks and former Asst. Attorney General of Wisconsin (Retired), Bruce Craig, presented economic data, legal citations, interpretations and references to federal court decisions relevant to pyramid selling schemes, aka multi-level marketing, (MLM). We discussed factors of legality, economic significance and the impact of the proliferation of endless chain schemes on individual lives and American society.

Additionally, I had submitted a five-page memo prior to the call, entitled, “The Economic Case for a New FTC Policy of Law Enforcement on Pyramid Selling Schemes Promoted as Business Opportunities.” The memo contained documentation and data on the reality of consumer losses among the millions of consumers who have invested in the ubiquitous MLM “business opportunities” and on the absence of what is conventionally understood as market-based retail selling among major MLM companies. The memo concluded that MLM could not be characterized as “direct selling” or as a “business opportunity”, given the absence of true retail selling and the near universal lack of income among consumer investors, euphemistically called “distributors”.2

The report showed how the MLM “industry” has falsely represented that “millions” of Americans gain full or part-time profitable income from MLM businesses, even spreading the false claim of a “median average income” for 15 million participants of $2,400. The actual data show a median income of zero or a substantial negative figure. Limiting the data only to the upper 37% of participants, who are unquestionably classified as seeking income, the median income is still zero.

My memo included 2012 hard data on three of the largest MLMs, Amway, Nu Skin and Herbalife, accounting aggregately for 10% of the entire field in America, or 1.431 million Americans who purchased goods and paid fees totaling $2.259 billion under MLM contract terms, including the granting of the right to recruit others and benefit from the endless chain pay formulas. Out of this 1.431 million Americans under contract, the data show only 5,500 gaining what might be considered a livelihood income of $60,000 or more per year, before all expenses and product purchases are subtracted. This group, accounting for about 1 out of every 250 in a one-year timeframe (far less when a longer time frame is applied), received the equivalent of 32% of the three companies’ entire USA revenues each year. The payments are based only upon the purchases – not sales – of the other 99.6%. Fifty-four percent (54%) of all reward payments were transferred to this group situated at the peak of sales chains.

In summary, while MLMs attract as many as 15 million consumers to sign the hallmark contracts offering the endless chain income plan, more than 99% never earn any net income annually. The income of the top 0.39% is not gained by “direct selling.” Indeed, few at the top or at any other level engage in what would be conventionally considered profitable direct selling. The high incomes are gained through a complex formula of money transfers tied to recruiting other recruiters.

Note: The data and analysis we presented to the FTC applied to the great majority of MLM companies that employ the one-to-one recruiting plans, rather than the smaller segment of party-plan businesses such as Tupperware.

---


© 2014 Robert L. FitzPatrick
Untenable Position

Beyond documenting the negative economic realities of MLM on American household income or employment, most of our June 9 FTC conference call addressed the unchallenged reality of the current position of the FTC concerning these schemes in which the FTC lacks a consistent or understandable standard for determining illegality, rendering effective FTC prosecution and law enforcement in this sector essentially impossible and, indeed, virtually non-existent.

The successful but extremely rare FTC prosecutions of a handful of MLM companies over the last few decades, out of the hundreds in current operation, document the reality of fraud within the ranks of these types of enterprises. These prosecutions are a great public service for which the FTC and its staff deserve gratitude and commendations. Yet, the lack of any meaningful criteria for determining illegality of this type of business makes the prosecutions arbitrary and, from a broader consumer protection perspective, largely pointless. Since virtually all MLMs appear to replicate those that were prosecuted yet are untouched by FTC regulation or law enforcement, to many people the prosecutions indicate widespread, possibly universal, fraudulence, which the FTC appears to be ignoring. To others, the few prosecutions are cited to claim that all the other MLMs are, \textit{de jure}, legitimized.

We argued that this situation, by any standard, is intolerable.

The most important fact we presented was that the current position of the FTC relative to multi-level marketing leaves millions of people in America and around the world without any means of distinguishing legitimate direct selling opportunities from pyramid swindles. This financially dangerous situation is exacerbated by the expansion and multiplication of these enterprises and their aggressive financial solicitations, which now affect virtually every household in America.

Individual household losses may range from a few hundred dollars to tens of thousands and are commonly accompanied by family disruptions, loss of credit, and derailment from other meaningful employment or educational pursuits. In recent years, these schemes have begun targeting the most vulnerable sectors of the public, students and immigrants.

It was also noted that the FTC’s untenable position for consumer protection and law enforcement toward multi-level marketing has now generated a dangerous uncertainty in the securities markets, putting pension funds at risk that are invested in MLM enterprises that are being openly challenged for operating illegally.

Our conference call presentations were respectfully received. The main response consisted of one pointed question posed to us to present our own views on “bright lines” for distinguishing illegal marketing practices among multi-level marketing companies.

In this memo, I offer my own personal response to that question. Though the views contained in this memo are my own, I present them in the format of an open letter due to their public interest importance and because they are based upon and reflect the research and efforts of many other people who have courageously served as whistle-blowers and public interest advocates.

I am co-author of a book on multi-level marketing\footnote{http://www.falseprofits.com}, researcher of MLM compensation plans and marketing practices, business model analyst, expert witness, consultant, and consumer educator. Like others in this field, I have endured hate mail, threats and lawsuits from MLMs and their promoters for publishing information relevant to prosecution and enforcement. I am grateful for the personal and direct invitation from the FTC to offer my views.

I do not represent any other party in preparing and submitting this memo and have received no
compensation from anyone in connection with it. I personally have no financial interest in any company or type of company that is referenced.

The FTC’s Dilemma
As Jessica Rich publicly stated, “The Commission is first and foremost a law enforcement agency.” Yet, in the area of network marketing schemes, which aggressively solicit and persuade at least 15 million households each year to sign long and complicated commercial contracts and gain $30 billion from the public under those contract terms, the FTC acknowledges that law enforcement is severely inhibited. The difficulty is related to the lack of a legal demarcation between multi-level marketing, which is generally described by the FTC as legitimate, and pyramid schemes which are officially treated by the FTC as inherently unfair and deceptive under Section 5 of the FTC Act.

The lack of this demarcation was even cited by the FTC staff to support a recommendation that no disclosure rules be applied to multi-level marketing companies, because they could not be useful to consumers in distinguishing fraud from fairness in MLM. The FTC staff wrote to the Commission, “There is no bright line disclosure that would help consumers identify a fraudulent pyramid from a legitimate MLM.” MLMs, by far the largest of all “business opportunity” purveyors, were then exempted from the new FTC rules requiring greater disclosures in business opportunity solicitations.

Based on a reading of the FTC’s original proposal for the business opportunity rule, the basis for, ultimately, exempting MLM was a non sequitur. The “Biz Op” disclosure rule was intended only to provide information to prospective distributors about the “business opportunity.” It was never intended to enable consumers to distinguish pyramid schemes. In fact, there were many provisions of the rule that would be extremely useful to consumers for due diligence purposes when faced with MLM’s ubiquitous financial solicitations.

Thus, the FTC is not only hamstrung from performing its main role of law enforcement, but it cannot even enact preventive measures to help the individual consumers get enough information about MLM on their own to evade frauds or even to conduct reasonable “due diligence” into the investment opportunity’s true value, whether fraud is involved or not. MLMs are currently not required to make any financial disclosures at all to the millions they solicit for investments.

In its other role as a consumer education force, the FTC’s consumer warnings relative to multi-level marketing are similarly constricted and contradictory in light of the near absence enforcement actions. The box to the right is from a 2009 publication by the FTC. It appears to identify several “bright lines” of fraud in MLMs – more product sold internally than externally, and a compensation plan calibrated to reward the recruiters over the retailers. These two practices are pervasive in the MLM field, yet, the paucity of FTC prosecutions of these practices seemingly contradicts the content of the warning.6

---

5 Disclosure Requirements and Prohibitions Concerning Business Opportunities Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 437), page 21, footnote #60
6 A Google search will produce this 2009 FTC document. The current FTC site has changed some of the wording. This 2009 booklet is also being resold on Amazon.com as a Kindle eBook for $5.95 by a company called Penny Hill Press in Damascus, MD, http://www.amazon.com/dp/B00IK6B8L6/ref=pe_385040_118058080_TE_MIT1DP. Additionally,
The Business Whose Name Dare Not Be Said

In reference to the FTC challenge for regulating MLM, the term, "bright line," may be conceptually inadequate. It infers a fundamentally legal business that crosses a line and, which, if it had stayed on one side, would continue to function legally; but stepping over this line, it suddenly becomes existentially "illegal." In the case of multi-level marketing, a bright line is conceived of as a single factor that renders the entire operation illegal, worthy of an injunction to halt its operations entirely. The bright line, is therefore, a fundamental factor that identifies the business as a fraud. To properly characterize a bright line for multi-level marketing, in which the factor is fundamental, it must be acknowledged that no line would have been “crossed”, but rather the business would be founded upon a marketing practice that is inherently illegal. The illegal MLM is a not a business engaging in fraud but a fraud engaging in business.

The often-stated FTC position that determining an MLM’s illegality is intensively fact-based flies in the face of 30 years of observable and experienced reality. Even a cursory review of MLMs reveals that hundreds of them are virtually identical, all such similar companies showing an existential requirement to relentlessly recruit, with pay plans obviously designed to motivate and reward recruiting, flaunting the “infinity” factor as a means to gain income, and producing the inevitable 99% loss rates. The “fact-based” perspective infers the opposite of these realities, that each MLM is unique, that the factors of illegality are hidden and difficult to uncover and that the ones the FTC has prosecuted are anomalous.

The reality of MLM is so glaring and its use of the endless chain to gain sales and investments is so obvious that, if there is any prospect for the FTC to identify bright lines of illegality, it will require acknowledging what is staring everyone in the face. The defining characteristic of MLM is the promise of “unlimited income potential” to each new recruit. An infinite font of income is said to be possible from an obviously finite base of money, the recruits’ own purchases and that of any customers they might have, if any. Consumer activist and educator, David Brear has aptly termed this proposition a “closed market swindle.” That a tiny few at the peak of the expanding chain could indeed gain large amounts of money from the transfer plan is certainly true, though even those few are not able to gain “unlimited” income. But in MLM the “unlimited potential” promise is extended to all who join, forever. Such a fundamental premise of a business proposition can only be called deceptive from the start. It is instantly revealed as a false claim.

Hundreds of multi-level marketing companies openly highlight, publicly celebrate and obviously base their entire operations on the deceptive illusion of the endless chain income proposition. Surely FTC staff have attended MLM recruitment meetings and observed this plain truth. How else could a company offer ordinary cosmetics, vitamins, soap or protein shakes as a product for consumers to sell one-to-one to other consumers from their homes, without any marketing or advertising support and claim that the income opportunity is a means to achieve “total wealth”?

---

most of the content of the 2009 version is republished by the Better Business Bureau, see http://www.bbb.org/us/article/fe-the-bottom-line-about-multilevel-marketing-plans-4557

7 For example, the recent Reuters interview with Commissioner Julie Brill. See http://www.reuters.com/video/2014/07/01/herbalife-investigation-untainted-by-act?videoid=316609078&videoChannel=5

8 For those who might not have been exposed to the culture, marketing narratives, promises, claims and testimonials that characterize MLM recruiting and are based on the endless chain income promise, a new novel, entitled, Downline, has just been published by MLM veteran, Robert E. Smith, that dramatically describes the MLM world. It should be required reading for all FTC economists, attorneys and investigators. See http://www.amazon.com/Downline-intolerable-potential-Wordwell-Publications-ebook/dp/B00ICB77BQ. Another valuable resource is the short documentary produced by Herb Greenberg of CNBC entitled, “Selling the American Dream.” See http://www.cnbc.com/id/100359541

© 2014 Robert L. FitzPatrick
The past position of the FTC that MLM investigations are nearly beyond the scope of the agency’s capacity or that the illegality is so hidden, even disclosures will not help a consumer, are only evidence of the failure to establish a legal standard, not of MLM reality.

The Limits of the Endless Chain

As a non-attorney, I will not attempt to present chapter and verse of the federal court rulings that treat the endless chain income proposition as a sufficient bright line indicator of fraud when it is used to solicit investments or purchases from consumers. The Commission’s own notation in the Koscot case about the endless chain’s “intolerable capacity to mislead” addresses the inherent fraudulence of the endless chain proposition. It does not require complex economic analysis to conclude that the endless chain is unsustainable as a marketing plan and, as the FTC’s Dr. Peter Vandernat has repeatedly explained in his declarations, the model, by its design, requires that the vast majority of all participants must always be in unprofitable positions at the bottom of the chain. Thus, regulators have no need to await “ultimate collapse” before recognizing the ongoing and growing harm once an endless chain is set in motion. The loss rate is mathematically pre-determined, inevitable and unchangeable. The endless chain proposition, by its very nature, makes a deceptive promise – one that it cannot keep.

Additionally, there is ample evidence of how the endless chain’s “intolerable capacity to mislead” produces mass manias, altered personalities and extraordinary social disruption with its utopian – and utterly false – promise of “unlimited income” potential for all. When attached to a purchase and sales scheme, the endless chain, as FTC and other state prosecutions have repeatedly shown, can rapidly enroll hundreds of thousands of hopeful and misguided consumers to pay fees and purchase goods they would normally not have acquired and at prices beyond market standards – and generate millions in ill-gotten revenue for the perpetrators.

Yet, the FTC, based on its enforcement record and its citation of the 1979 Amway ruling, does not currently treat the existence of an endless chain income proposition as a sufficient “bright line”, by itself, to initiate a prosecution.

The 1979 Amway ruling appears to be the FTC’s main reason for not citing the existence of an endless chain proposition in MLM enterprises and the repeated manifestations of massive consumer losses among people who enroll in them as a sufficient bright line indicator of unfairness and deception. The Amway ruling complicated enforcement since it did not accept the 1975 FTC claim that Amway’s endless chain model was inherently deceptive and unsustainable, a fraud per se.

Amway’s Obsolescence

Current business practices of MLM companies, however, render that court ruling irrelevant in practice. MLM, including Amway, today operates far differently from the way Amway did in the pre-computer 1970s. The market transactions that characterized MLM practices then and which were examined in the case have changed. Thirty-five years of MLM expansion have altered popular perceptions. Much greater understanding of the place of MLM as a distinct business sector in the overall market exists today, in contrast to 1975-9, when the judge characterized Amway as an upstart competitor of the oligopolistic Procter & Gamble. Few today would characterize Amway’s $11 billion, 100 country-reach that way. Most important, the FTC faces an entirely new defense by the MLM industry that is not based on the Amway case but on new interpretations of facts. Additionally,

---

9 For a summary of previous FTC cases in which the endless chain is defined as inherently deceptive, see former Asst. Attorney General (Ret.) of Wisconsin, Bruce Craig’s article, “An Investor's Guide To Identifying Pyramid Schemes” (http://seekingalpha.com/article/918831-an-investors-guide-to-identifying-pyramid-schemes)

© 2014 Robert L. FitzPatrick
there has been a succession of new court rulings that alter the legal landscape relative to MLM.

Clarity and consensus, based on math, law, subsequent court rulings, geometry, and common sense, remain in the conviction that an endless chain incentive plan that induces investments and promises rewards is inherently deceptive and unfair. But, today, the FTC must reveal the reality of endless chain frauds in MLMs that employ today’s disguises and defenses.

The proviso in the 1979 Amway ruling was that Amway’s revenue was to be based on retail sales by the distributors to end-user consumers, making the individual Amway distributorship valuable and viable, without an existential requirement for endless chain recruiting. The pyramid structure and the pyramid-like recruiting was allowed by the court, as Amway swore under oath that it was intended, only as an efficient means of coping with normally high attrition rates in the direct selling field. Existing salespeople could recruit replacements and be compensated for that service to the company, but the endless chain incentive could not be the primary driver for distributor rewards or for company revenue.

The ruling allowed the direct selling business to employ an endless chain income “opportunity” in its compensation plan, as Amway does, but prohibited it from actually using its electrifying power to alter behavior for the purpose of generating revenue or incentivizing personal purchases and recruiting activity. The lucrative fruit of profiting from the salespeople’s own investments in fees, product purchases and recruiting efforts as they pursued the mesmerizing “unlimited income” offer. That tempting deception was to be kept just out of reach, through the use of enforced “rules” that ensured the sales program was to be unwaveringly focused on conventional one-to-one retail sales and retail sales profits on Amway’s unremarkable and unadvertised products, offering modest and clearly “finite” income potential for the participants.

Maintaining such a thin wall of legality between a pyramid recruitment fraud that used the “infinite” income potential of the endless chain plan as its driver and a legal direct selling operation that included an endless chain plan, but did not utilize its extraordinary – and deceptive – power would have required close FTC monitoring. At a minimum, retail sales levels would have had to be proven by the company as well as financial data showing how many distributors gained or lost. It would have had to include full disclosure of the sources of income – retail-based or downline purchase-based – to those at the top of the chain and at other levels. The FTC would have had to ensure that the Amway business model, which it had prosecuted for four years as inherently fraudulent, would remain focused on external retail sales. As we all know, no such monitoring occurred.

New Realities and the Irrelevance of the Amway Ruling

Reconciling the Amway court decision with today’s MLM realities is, in my view, largely irrelevant and unnecessary. Similarly, application of the famous Amway “rules” of 70% reselling of inventory and maintenance of 10 customers, has become obsolete and has proven to be impossible on an industry-wide basis. Due to the enormous size and political power of MLM today and the fact that business practices on which the Amway decision was based have changed, the FTC faces a new kind of challenge and a new opportunity in its law enforcement role.

Today, few MLMs sell goods to consumers who then personally resell them to others, whether inside the channel or traditional retail customer, out of their own inventory. Today, it is more common for MLMs to drop ship the goods directly to the purchasers and credit the entire chain of recruiters with the rewards. Additionally, retail profit margins have been largely eliminated. No evidence exists of any significant retail selling in most MLMs, however, some MLMs do promote a status of “preferred customers” who are not part of the channel, yet pay the same discounted price as
the distributors do. Purchases made by the “preferred customers” offer no retail profit to distributors but can modestly add to the distributors’ total “group volume” which is primarily a recruitment-driven incentive.

“Front loading”, which for many years was seen as the main evidence of a pyramid scheme and on which the Amway decision was fixated, is also largely an obsolete notion. Today, MLMs rely on monthly purchase quotas and/or "structure" requirements or a combination of the two, driven by the utopian income dream to induce ongoing purchases and payments. To achieve the dream the participant needs to maintain a quota of volume or to have, for example, “two legs” of other recruiters “active.” The monthly personal volume is usually claimed to be a personally “consumable” or “personally usable” amount, not a base of inventory to resell.

Average annual purchases induced by MLM schemes are usually under $2-3,000 a year, if they stay in the scheme that long, which only a small minority ever do, though some may buy much more and spend far more in related costs, reaching into the tens of thousands, over time. The current practices of Nu Skin and Herbalife, for example, to offer instant high level status and significantly higher rewards based on a single, large, up-front, personal purchase of product is actually unusual today. Today, MLMs find ways other than up-front inventory loading to get more money from participants, including training, certification, “back office”, website maintenance, sales of “leads,” “motivation” seminar registrations, renewal fees, etc. All of these are variations on how to manipulate the endless chain offer or on the various disguises to conceal its operation and inevitable outcome.

Many of the MLMs are based on the claim of no one selling anything to anyone, just “buying from your own store and finding others to do the same.” Some sell no tangible product, but rather services offered by other companies, such as the utility and energy MLM schemes do. Others require several personal "customers", for example, to reach the income chain options for income, but the customers can be retail clients or other salespeople. The “customer” quota does not produce retail profitability for distributors but does subvert an aggregate economic analysis of total revenue coming from inside or outside the chain as a basis for determining a “pyramid scheme.” The requirement of a small number of retail customers merely serves to add disguise and to increase the pay-to-play investment of each new participant. In sum, applying Amway “rules” to the modern MLM is impractical in many cases.

Finally, the claim of unsustainability leading to ultimate collapse, which the FTC made in its 1975 case brought against Amway must also be reconsidered after 35 years experience. In 1979, the court ignored cumulative growth and considered only the potential for “total collapse”, which appeared implausible, thereby refuting the FTC’s projections.

In 2000, I recalculated Amway’s recruiting totals, using Amway’s data. Data showed that approximately 6 million people had by then signed contracts as Amway salespeople in the USA alone, or about 1 out of every 33 members of the present adult population at that time. Today the number would far larger,10 Virtually all had quit, after suffering financial losses.

---

10 In the mid-70’s Amway claimed just over 300,000 distributors in the USA. In the court case brought by the FTC, Amway presented five-year historical net growth figures of its distributor sales force that averaged about 4% annually after factoring in the drop-out rate. This modest expansion of its sales force was accepted by the judge as convincing evidence that there was little chance that the sales plan would collapse due to lack of recruits, as the FTC claimed it eventually would. Calculating the 50% attrition rate that Amway attested to, I calculated the continued average 4% net growth annually through year 2000, which matched Amway’s reported 2000 distributor total in the USA. The data on the cumulative enrollment of Amway salespeople, showing recruitment levels far beyond what the market could support for viable sales, is included in the booklet, “The Case for Reopening the Amway Pyramid Scheme Case.” See http://www.pyramidschemealert.org/PSAMain/resources/case.html
As long as today’s endless chain schemes can successfully replace the inevitable losers, euphemistically called “dropouts” though they are doomed from the start, the scheme can endure for many years, leaving a massive trail of consumer losses in its wake. The ability to jump to international markets also salvages the domestic MLM, which should be properly termed in a state of “continuous collapse,” and can create the false impression to new recruits of domestic sustainability. Saturation of the market for new recruits to be able to build downlines is the dooming scenario for new recruits, not imminent collapse. For the losing consumer, however, the result is the same as if the scheme had collapsed like a Ponzi would – loss of money, time and other opportunity costs.

The New Legal Defense of MLM

MLMs themselves no longer argue that the endless chain is legal and non-deceptive due to its focus on external retail sales, as Amway did in its famous case. The Amway “legal defense” is a relic from the past. Instead, Amway itself now claims that the endless chain plan is merely a referral system for “customers.” Instead of claiming the distributors are not affected by the “infinite income” incentive due to their personal retail focus as resellers, which is company-enforced by “rules,” Amway and most other MLMs now claim most distributors are unaffected by the infinite income potential because they only want to buy the product as customers and not to earn any money at all. The rules requiring reselling of goods, therefore, are irrelevant. Everyone is claimed to be a customer.11

This amazing and perplexing change of explanation essentially argues that internal purchases, which the FTC and the federal courts (see the FTC brochure referenced earlier and the Ommitrition decision by the federal court) have treated as the bright line of endless chain fraud, are no longer a valid indicator. Indeed, internal sales are now claimed to be the proof of the system’s legitimacy as a sales business, since the purchases by the distributors, it is claimed, indicate ordinary, market-based, rational purchasing behavior that is unrelated to and unaffected by the endless chain pay plan incentives. The MLM legal argument for why MLM people are not affected by the “endless chain” when they make purchases or pay fees in MLMs has changed from their true activity, previously said to be retail sales, to their true motives, now said to be their love of the MLM product. In both defenses, it is claimed that the endless chain with its illusory promise of rewards is not an incentivizing factor leading to investments and recruitment activity.

The tactical legal and economic defense strategy, in turn, has shifted from the old maneuvers of withholding retail sales data and distributor loss rates to challenging regulators to prove that the inner motives of participants are related to the illusory income proposition. This would be a task

11 In a Feb. 29, 2012 video interview (Minutes: 16:20 - 17:00) of Amway executives, Doug Devos and Steve Van Andel by Wall Street Journal reporter, Dennis Berman, the new MLM narrative in which the distributors are the retail customers was made plain. See http://online.wsj.com/article/FE12F29C-D022-42B8-8ACD-16A114E0DA96.html%23!FE12F29C-D022-42B8-8ACD-16A114E0DA96 - !FE12F29C-D022-42B8-8ACD-16A114E0DA96

WSJ Dennis Berman: What percentage of the end products are sold to the general public and not to the Amway salespeople directly?

Amway Doug Devos: That's always a challenge to kind of find exactly what that number is. But its a large percentage. Probably... our research probably about at least half or more would go to an end-user and ultimately all of its goes to an end-user. Even if somebody happens to be a distributor, they are their own best customer. So I would say on a strictly speaking standpoint, a hundred percent, because everyone, at the end of the day, is a customer and they see value in the product or else they wouldn't buy it.

Berman: Right

© 2014 Robert L. FitzPatrick
even more daunting that overseeing retail sales levels, perhaps requiring an army of psychologists!\(^{12}\) Observers are told not to believe what they see with their own eyes – that an endless chain proposition is the heart and soul of the enterprise and drives consumer responses.

Additionally, whereas MLM previously obscured the extraordinary fact that 99% or more of all distributors never gained a profit, today those very same figures are touted as evidence that virtually all distributors have no interest at all in the endless chain plan’s rewards. The evidence for this claim is that few actually gained any income! Consumer losses are no longer hidden; they are redefined out of existence on the claim that millions joined with absolutely no interest in making any money in the first place, despite the MLM’s promotional images of luxury cars, exotic vacations, testimonials about high incomes, “freedom” and fulfillment, all gained from the MLM income opportunity.

The new legal defense makes the audacious claim that as many as 75% or more of all people who join some MLMs never intended to pursue the “business opportunity” but were only interested in obtaining the products for personal use and therefore cannot be considered business opportunity victims. Proof that they were not pursuing the business is that they never successfully recruited other participants! The “unsustainable” or saturation arguments are not refuted but averted by this remarkable ploy.

As incredible as it might seem to some analysts, this MLM claim that all purchases by contract salespeople are purely product-based, not income-driven or influenced by the endless chain offer is bolstered by the stark fact that the MLMs that produce the largest consumer losses have never been prosecuted. The new rationalization of loss rates, the sheer size and persistence of MLMs, and the lack of any significant regulatory actions for 35 years are powerfully affecting popular perceptions. It is becoming almost unthinkable, even for judges, that such large and longstanding enterprises could be illegal rackets.

The factor of “plausible deniability” for MLM participants is also enhanced in the environment of MLM rationalizations and general immunity from regulators. All pyramid participants need a rationalization. The naked facts of seeking income from commercializing friends and neighbors into “warm list” prospects and the pursuit of a get-rich scheme based on exponential recruiting must be ameliorated by less selfish and more uplifting narratives. The specter of illegality and the term “pyramid scheme” must also be firmly banished in order for the participants to actively promote the plan to close associates. It must be acknowledged that today’s MLM environment is characterized by greater public confusion, more entrenched denial and even greater reluctance to come forward with fraud accusations than ever before.\(^{13}\)

\(^{12}\) There is empirical evidence to test the proposition that the bottom ranks of MLMs are self-defined “customers” with no interest in gaining income, namely, the attrition rate of “customers,” i.e., the bottom level of the pyramid. The hypothesis is that bona fide customers, who sign up at minimal cost only to obtain the unadvertised product at a “discount” should have relatively low attrition rates, comparable to members of buying clubs like Costco. Yet, the evidence shows that the attrition rates at the bottom levels of MLM plans are far higher, approaching 100% yearly. In its 2005 10K filing with the SEC the MLM, Herbalife, for example, reported that 90% of all those below the “supervisor” level, which was the upper 25% of the chain, did not continue participation for more than one year. Even the majority at the upper end last no more than a year. Many other data on this pattern in other MLMs could be cited. This empirical evidence contradicts the MLM industry’s “discount customer” hypothesis and supports the hypothesis that the lost customers are in fact failed income-seekers, who had been influenced by the endless chain income plan. MLM companies usually do not disclose attrition rates at all, or if they do, they do not disclose attrition rates at different levels of the plan.

\(^{13}\) The factor of denial about motives for joining, the purpose of payments, and the nature of rewards in all pyramid schemes is dramatically recounted in my book, *False Profits*, through the experience of thousands of people joining “gifting clubs.” These schemes have been prosecuted in many states as classic endless chain frauds, resulting in some

© 2014 Robert L. FitzPatrick
Such is the whirlwind that the FTC is reaping for allowing pyramid schemes to imbed themselves into the legitimate marketplace in the thin disguise of “direct selling.”

The New Realities
To summarize the new conditions faced by the FTC:

- With millions of consumers placed in vulnerable positions as targets of ubiquitous financial solicitations from MLM promoters and billions in market securities placed at risk due to the lack of a legal standard for MLM, the FTC must finally establish a set of conditions which, if present, identify a fraudulent MLM operation. These conditions must be generally understandable for consumers as well as standing on sound legal and economic ground. The current position, lacking a legal standard, is untenable and violates the mandate of the FTC as a law enforcement agency, negates its roles in consumer protection and public education, and damages the FTC’s credibility.

- The reliance on the Amway decision that tied rewards to undisclosed or unrecorded retail sales and on which the FTC used a complex “economic” rather than a primarily legal argument to identify MLM frauds is largely unusable under current conditions. It also is unusable for public understanding and education. As experience has shown, it also severely limits the FTC’s enforcement abilities since it was based on a long and costly one-off, fact-based system, of prosecutions seemingly unrelated to all other MLMs and lacking a clear legal foundation.

Participants being sentenced to jail. An estimated million people or more have joined Gifting Clubs in the USA with total losses far exceeding a billion. These schemes assume many names (Women Helping Women, Airplane Game, Original Dinner Party, etc.) and they often target ethnic groups or other demographic subgroups with tailored narratives and terms, yet are all essentially the same classic 1-2-4-8 recruiting pyramid. The bottom eight transfer their investments to persons at the top, thus enabling the scheme to promise an 800% return. With each payment cycle the number of people paying must double. To objective observers, the scheme is an obvious fraud that dooms at least 90% who are always in unrewarded positions. Basic math reveals that the gifting scheme will reach local saturation points quickly. No products are involved at all. Yet, as experience has shown, participants generally believe the scheme is perfectly legal due to the preposterous claim that payments and rewards are actually “gifts”. As retold in my book, well educated, and generally well off participants solemnly told each other they were just paying for products or economic reasons or learning about business or getting a discount, or at least 90% of participants surveyed about their participation or about the consequences of their participation. The rationales of “loving the product” or “social reasons” or “learning about business” or “getting a discount” will overwhelm harsher and unseemly realities.

Lest FTC regulators dismiss the denial and mania of Gifting Clubs as irrelevant to the question of illegality of MLM “businesses”, consider that the state legislature of Texas deliberated on a bill to legalize them. In February 2001, Rep. Gary Elkins, a Houston Republican, introduced a bill in the Texas legislature that sought to make pyramid schemes legal “if each participant has signed a document stating that all money contributed is a gift and that the participant has not been promised any compensation in return for the contribution.” Bill Clayton, a former Speaker of the House of the Texas legislature, had promoted the bill (which never made it to the floor due to pressure from police departments and district attorneys). To lobby for the bill, he was paid more than $25,000 by a group composed mostly of women who were involved in pyramid schemes in several counties in Texas. (see “Bill would OK ‘gifting clubs’” by Janet Elliott, Houston Chronicle, 02/17/01, Page 33)

In a perfect parallel, in 2003, a bill was written by the Direct Selling Association and introduced in the House of Representatives of the US Congress by Texas Republican, Joe Barton. The bill, HR1220, would have legalized endless chain schemes in which the money transfer was transacted through product purchases (rather than gifts). HR1220 was essentially a replica of the bill that Utah adopted with Attorney General Shurtleff’s endorsement, as have several other states, such as Texas, where the DSA has held sway. Co-sponsors of HR1220 were all Republicans, including Congresswoman Sue Myrick of Charlotte, NC, whose main campaign funds were raised by Amway’s largest distributor, Dexter Yager who is based in the Charlotte area.

© 2014 Robert L. FitzPatrick
The MLM industry which previously claimed that MLM purchases were primarily for resale has now sought to make the very act of purchasing an MLM product or service by an MLM participant prima facie evidence of legitimacy, that is, the very act of the participants’ making product purchases exempts the enterprise from any definition of pyramid fraud. Buying a product is treated as exculpatory for the enterprise, regardless of all other factors of pyramid structure and recruiting inducements, rewards to recruiters, payment formulas or financial loss and dropout rates among participants.

Recent court decisions, such as Burnlounge, which have shifted the defining issues away from hidden, indefinable or incalculable factors such as retail sales versus internal sales levels and toward the fundamental purpose of the reward plan – in practice. Rather than an economic formula requiring extensive data collection, the FTC could identify a set of characteristics, which, in combination, define an endless chain/recruitment-driven business opportunity scheme that is inherently unfair and deceptive, based on its defining elements. ¹⁴

The latest court rulings appear to offer the FTC greater capacity to focus on the obvious pyramid structural requirements and the transparent recruiting-based pay formulas of a MLM along with the verifiable aggregate expenditures and rewards gained by participants, indicating nearly total losses among the “last ones in” to serve as a set of guidelines for legality.

The endless chain income lure and the practice of a recruiting-based marketing program remain the fundamental elements of fraud to be identified and exposed in MLM frauds. The courts have upheld the inherent fraudulence of an endless chain reward plan. It must be the centerpiece of the establishment of bright lines. It is the fraud in plain sight.

Bright Lines

In response to the specific question posed to me and my colleagues during the June 9 conference call, I offer the following approach to bright line factors:

• The first principle of a bright line for legality in multi-level marketing is that the endless chain is an unfair and deceptive marketing practice. The bright line, therefore, consists of uncovering evidence of the actual use of the endless chain proposition to gain revenue from MLM participants. This is the primary indicator of deceptive marketing. Gaining purchases or investments from consumers on the basis of an endless chain reward proposition – offering rewards based on recruiting others who are similarly offered rewards to recruit others; basing the potential rewards on infinite, exponential expansion; providing escalating rewards based on recruiting scales; providing no physical, mathematical or geographical limits related to actual market demands and potential – is deemed an unfair and deceptive trade practice.

• The establishment of a bright line requires that the FTC take a strong and clearly stated legal stand against the unsupportable and preposterous claims of MLM that purchasing products by

¹⁴ The telltale elements that add up to a “product-based” pyramid scheme have been identified, argued and explained for years by MLM researcher and consumer educator, Dr. Jon Taylor. See http://www.mlm-thetruth.com for “Five Red Flags.”

Identifying these elements is a matter of hours, not months and years as the current FTC intensive fact-based approach requires. Dr. Taylor has applied the “test” to hundreds of MLM companies. The ability to quickly and readily recognize an MLM pyramid recruitment scheme, which will always cause 99% loss rates - because of the “red flag” factors - is mirrored in whistle-blower Harry Markopolos’ statement regarding his private investigation of Bernard Madoff’s hedge fund. Markopolos said that he knew within five minutes that Madoff’s numbers didn’t add up and that it only took him another four hours to mathematically prove that they could have only been obtained by fraud. See http://en.wikipedia.org/wiki/Harry_Markopolos

© 2014 Robert L. FitzPatrick
the participants automatically exempts the enterprise from a pyramid definition (in the same way that gifting clubs adherents claimed that the money transfers self-defined as “gifts”, made those schemes legal). The MLM argument that when products are purchased by MLM participants, the law against endless chains does not apply must be directly and unequivocally refuted, based on law.  

- FTC establishes and publishes a set of factors that it considers indicative of the use of the endless chain as a marketing device, once it is established that it exists in the business model.
- The evidence of the use of endless chain marketing is found in the MLM’s pay formula and in the statement of policies and procedures, both of which are generally published. Additional information may be found in income disclosure documents, website, webinars and in SEC filings. Among the red flag factors for the actual use of the endless chain proposition are:
  1. There is no status of salesperson that is not allowed to recruit other salespeople but can only sell the products to retail customers (virtually all MLMs include the universal recruitment authorization though some offer no rewards from recruiting until some threshold of recruiting or a volume of sales/self-purchasing is reached); the sales chain is designed as an open-ended expansion structure, without limit, and without geographic restriction; and each new participant, upon payment of consideration, is authorized to seek profit from extending it. (existence of endless chain system established)
  2. Sales/purchase quotas with specific dollar volumes of product purchases (either by the distributor personally or some group of distributors in his or her downline), or structural requirements based on recruiting specific numbers of other distributors or in some specific configuration, are required to maintain a position on the recruiting chain. (endless chain investment and recruiting inducements)
  3. Compensation formula that rewards, overwhelmingly, chain extension activity over personal retail sales activity that is based on market demand. Evidence would include the formula that allocates total commission payout to recruiters in excess of total retail profits that are

15 That the MLM industry’s claim that product purchases exempt the business from a pyramid scheme definition has no legal standing is revealed in the Direct Selling Association’s campaign to change state laws and to enact a federal law that would override the 1996 Omnitrition decision and contains specific language about product purchases as exculpatory. House Bill 1220, which the DSA and other MLM supporters introduced to Congress in 2003, had the following language:

“This Act may be cited as the ‘Anti-Pyramid Promotional Scheme Act of 2003’.

“The Ninth Circuit Court of Appeals erred in defining a pyramid promotional scheme in Webster v. Omnitrition Int’l, Inc. (79 F.3d 776; 9th Cir. 1996) and

“PYRAMID PROMOTIONAL SCHEME- The term ‘pyramid promotional scheme’ means any plan or operation in which a participant gives consideration for the right to receive compensation that is derived primarily from the recruitment of other persons as participants in the plan or operation, rather than from the sales of goods, services, or intangible property to participants or by participants to others.” (emphasis added)

The proposed federal law, which never got out of committee but has been passed in other states such as Texas and Utah, specifically exempts MLM so long as funds are filtered through product purchases. The seemingly innocuous phrase, “sales of goods, services or intangible property to participants” would eviscerate the foundation of all previous MLM prosecutions by the FTC and prevent future ones, unless the scheme’s pay plan was nakedly and exclusively based on fee payments that could not be construed as having any value other than to qualify for recruiting-based rewards. But, to ensure that the meaning of the phrase could not be missed, the bill also specifically refuted and rejected the 1996 Omnitrition decision that spelled out the meaning of a retail sale to prevent a scheme based on qualifying product purchases as a “pay to play” requirement and a method of money transfer. Clearly, the DSA feels that existing law and the record of court rulings regarding endless chain schemes do not support current MLM practices and new law is required to establish legality. See: http://www.pyramidschemecentral.org/PSAMain/news/DSABill/DSAbill_text.html

© 2014 Robert L. FitzPatrick
verifiable, showing the focus and reliance upon the recruiting incentives, and in the actual payout, revealing concentration of payments to those at the upper end of the recruiting chain. (more endless chain and recruiting inducements)

4. The actual activity of the business is characterized by relentless recruiting, churning and transferring funds from later participants to earlier ones.

5. Little evidence, gained from an examination of marketing materials, website, and anecdotal reports from participants or researchers, of market-based retail purchasing or little evidence of retail profit-making among the sales force and no significant actions by the company to ensure the salespeople are retailing or to support retail selling (indicating little market demand, absent the endless chain pay plan incentives, and little direction from the company toward retailing)

6. Evidence of large-scale losses, (indicating the inevitable mathematical consequences of a recruitment-based reward plan).
Reforms

How could an MLM take corrective measures that would bring it back on the legal side of the “bright line” or prevent an FTC investigation or prosecution? Just as the basis for a legal standard is the use of the endless chain to gain purchases or investments, reforms would be measured by that same standard, showing that consumer purchases or other investments in the business opportunity are not affected by the inherently deceptive “infinity” factor but are market-based, indicating public demand, preference and enduring brand loyalty, the conventional measures of market validity.

Some that would repurpose an MLM toward direct selling and away from pyramid recruiting include:

- Limiting the number of levels that any individual salesperson can personally recruit and gain override commissions to one or several. This criteria would satisfy Amway’s earlier claim that the primary purpose of the universal recruiting authorization was to economically offset the normally high attrition rates in direct selling by offering modest compensation to distributors for taking on the recruiting function, rather than the company’s engaging in a costly recruiting program. This measure would eliminate the infinity factor entirely.

- Pay commissions only on consummated retail sales, that is to persons who are not signers of the company’s sales contract and are not eligible for recruiting-based rewards. The corollary is that no commissions are paid on any purchases made by other salespeople or on the salesperson’s own account. This reform eliminates a major incentive for recruiting and for making personal purchases. It eliminates the conflict of interest inherent in profiting from the person the recruiter is supposed to be managing by promoting personal purchases. It would also clearly indicate that all purchases made by the sales force are market-based and not affected by the recruiting program, since no one in the chain would profit from another’s purchases and would have no cause to influence their personal purchases. It would also eliminate the ability of the MLM company to offer instant high status to a new recruit for making a large upfront personal purchase that generates a large commission to the recruiter.

- Eliminate all purchase/sales volume or recruiting requirements in order to maintain sales and recruiting authorization. With no geographic limitations or protections placed on MLM salespeople, and no information available on market saturation factors, these volume and recruiting requirements, which are common in MLM pay plans, are unwarranted and serve only as compelling recruiting inducements. The quotas are also responsible for a critical factor in MLM pay plans, called “breakage,” in which the inevitable failure among participants at lower levels to meet the impossible quotas (due to saturation) results in all their accumulated and accruing rewards being transferred to recruiters at the higher levels. Along with other pay formulas that offer higher commission rates – per transaction – to those at the higher ranks, the quota/breakage factors serve to sharply concentrate total commission at the top, facilitating the continuous bottom-to-top transfer. As the data from my earlier memo documented, this quota/breakage system is responsible, for example, for Nu Skin’s paying 82% of all its commissions to the top 1.29% of its “active” sales force, which is 0.5% of the entire network. This tiny group at the top of the pyramid gains $103,000 on average in rewards yearly, while the mean average for the bottom 99% of the “active” sector is only $300 per year.

- Establish limited territories for distributors who want to develop sales teams with authorization based upon management selection. The current practice of open-ended, even global territories and escalation on the sales chain being based purely on volume/recruiting performance is a telltale indicator of the “endless chain” inducement.
The FTC’s Challenge

It is not an exaggeration to say that the whole world is watching the FTC regarding its mandate to develop a legal standard for multi-level marketing. Billions of dollars in securities, and billions of dollars of household savings and credit are the financial stakes, but perhaps even greater than the financial resources is the societal impact of endless chain fraud upon communities, families, and entire countries.

It is well understood that the Ponzi scheme is a dangerous form of fraud, capable of destroying entire economies and toppling governments, as occurred in Albania. The pyramid scheme or endless chain-business scheme may be similarly viewed as an insidious financial virus, threatening the foundation of a legitimate market, subverting legitimate entrepreneurship, harming extraordinary numbers of vulnerable people and destroying trust in the American Dream.

The Ponzi scheme relies on concealment of its money transfer, while the pyramid, more dangerously, relies on mass deception and political influence-buying to prevent law enforcement. The Ponzi is based on one big lie, whereas the pyramid must cultivate an intricate web of lies. The Ponzi perpetrator personally assumes the nefarious role of perpetrator and organizer, while the pyramid promoters entangle the victims in a network of legal liabilities and personal deceptions to spread to family and close associates. And whereas the Ponzi enables all its victims to grasp the nature of the fraud once it is revealed and to identify themselves as innocent victims, the pyramid must engage in mind control, cultivate a predatory value system among participants and subject the victims to a debilitating narrative of self-blame, leaving many unaware of how or why they lost their money and destined to repeat the folly. The Ponzi scheme may mushroom in scale but quickly and totally collapses upon exposure or prosecution. The pyramid scheme, on the other hand, can mobilize its very own victims in cult formations to expand its reach, attack whistle-blowers and protect itself from law enforcement, even when exposed. It can, therefore, be reasonably argued that the pyramid scheme is a far more destructive force in a society than the Ponzi is. It contains elements of cultism, mind-control, authoritarianism, political corruption and social disruption.

It is obvious that that law has not kept pace with the development of endless chain rackets disguised as direct selling enterprises. Yet, in recent years, public interest advocates, attorneys, financial managers, academics and thousands of victims have come forward to expose the realities of MLM and to demand that the FTC finally enforce the laws that are available and applicable.

My own expectations mirror the aspirations of millions of other people that the FTC will seize this moment in history to do the right thing.