MULTI-LEVEL MARKETING UNMASKED –

A Complete and Compelling Case against MLM as an Unfair and Deceptive Practice

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The most thorough guide to understanding MLM (multi-level marketing) ever published – MLM’s appeal, its unique features and inherent flaws, its deceptions, its devastating effects, its culpability to federal and state laws, and needed regulatory reforms. The book also explores key legal cases and answers the most frequently asked questions – all based on 20 years’ research, worldwide feedback, consultation with top experts, and analysis of over 600 MLMs by a qualified analyst. For federal and state regulators, legislators, attorneys, consumer advocates, financial advisors, researchers, educators, the media, and consumers.
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Earlier versions under similar titles: The Case against Multi-level Marketing as an Unfair and Deceptive Practice, copyrighted in 2013 and The Case (for and) Against Multi-level Marketing copyrighted in 2011 and 2012

Info-graphics by Alan Connell and Jon M. Taylor
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Printed in the USA

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ACKNOWLEDGEMENTS

My thanks go to scores of committed consumer advocates, government officials, attorneys, media representatives, investment advisors, educators, former MLM (multi-level marketing) victims and participants, web designers, and persons who have shared their experiences and feedback from countries all over the world. I want to give special recognition and thanks to my wife, JoAnn, who – after tolerating my MLM involvement for a year – challenged me to make a decision between her and a prominent MLM – which started me on this quest for the truth about MLMs, or product-based pyramid schemes.

LEGAL DISCLAIMER

These opinions, calculations, analyses, and reports are intended purely to communicate information in accordance with the right of free speech. They do not constitute legal or tax advice. Anyone seeking such advice should consult a competent professional who has expertise on endless chain or pyramid selling schemes (MLMs). Readers are invited to validate the author’s research using the analytical tools provided. Readers are also advised to obey all applicable laws, whether or not enforced in their area. Neither the Consumer Awareness Institute nor the author assumes any responsibility for the consequences of anyone acting according to this information.
# TABLE OF CONTENTS

NOTE: To allow for updates, pages are numbered separately within each chapter. Each chapter begins with a descriptive table of contents.

<table>
<thead>
<tr>
<th>Number of pages</th>
</tr>
</thead>
</table>

| TABLE OF CONTENTS, PREFACE – and ENDORSEMENTS | 4 |
| SUMMARY OF FINDINGS ABOUT MLM | 6 |
| INTRODUCTION – Summary of research, the powerful appeal of MLM, the need for this investigation, and questions to be answered | 6 |
| Chapter 1: MLM UNDER THE MICROSCOPE, Why and how the research upon which this report is based was undertaken, and why the author can speak with authority on the subject | 10 |
| Chapter 2: MLM DEFINITIONS AND LEGITIMACY – What MLM is and is not – and the difference – if any – between MLM and pyramid schemes (Includes 30 pages of appendices) | 70 |
| Chapter 3: MARKET SATURATION AND COLLAPSE – MLMs fundamental flaws, and how MLMs exploit and skirt these flaws in their systems – primarily by re-pyramiding (includes 8-page appendix) | 18 |
| Chapter 4: PRODUCTS AND PRICES – Questionable MLM product claims – and overpriced products | 10 |
| Chapter 5: RECRUITING A DOWNLINE – Why the emphasis in company communications is on selling, while in practice the emphasis is on recruiting – and what it costs to successfully recruit a downline in Nu Skin and other MLMs | 8 |
| Chapter 6: ATTRITION RATES OF MLM PARTICIPANTS – Why few recruits stay, and why it matters | 6 |
| Chapter 7: MLM’S ABYSMAL NUMBERS – What the data show about the lack of profitability of MLMs as bogus “business” or “income opportunities” (Includes 13 pages of appendices) | 56 |
| Chapter 8: MLM - A LITANY OF MISREPRESENTATIONS – MLM as a composite lie (includes 34 pages of appendices) | 40 |
| Chapter 9: VILLAINS AND VICTIMS – Who are they? (Includes 27 pages of appendices) | 36 |
| Chapter 10: IS MLM LEGAL? When is an MLM a fraudulent business opportunity? Or an illegal pyramid scheme? Are all MLMs technically illegal? What are the most significant legal precedents for MLM cases? (92 pages of appendices, including state laws relating to MLM, and $10,000 “unfair and deceptive practices” challenge) | 122 |
| Chapter 11: WHERE IS LAW ENFORCEMENT IN ALL THIS? Consumers, investors, the media, and others deserve an answer for blatant inaction by law enforcement – and why victims seldom file formal complaints (Includes 24 pages of appendices) | 48 |
| Chapter 12: IS MLM A MORAL AND ETHICAL BUSINESS? A terse answer | 4 |
| Chapter 13: ACTIONS NEEDED – To recover losses and to prevent harm to consumers (includes 9 pages of appendices) – | 16 |
| FINAL CONCLUSIONS for the book | 3 |
This book – and the research behind it – is intended to meet the need for a thorough analysis of the business model called multi-level marketing (MLM – a.k.a. “network marketing”) and its embodiment in the emergence of hundreds of MLM programs (MLMs). Worldwide, tens of thousands of consumers are approached daily with promises of income and independence from joining one of these MLMs. From the research reported here I conclude that tens of millions of consumers lose tens of billions of dollars every year.

At the outset it should be noted that Multi-level Marketing Unmasked is not strictly a report of legal arguments against any MLM, although attorneys and law enforcement officials should find it invaluable in building their cases.

I am writing from the perspective of a qualified business analyst, consumer advocate, instructor in entrepreneurship, management, and ethics, and experienced entrepreneur and salesman. Since I am not an attorney, when commenting on legal matters I have been careful to consult with qualified legal counsel and/or experts with extensive law enforcement experience.

While I have made tedious efforts to edit the report for errors, I do not claim that it is perfect or free for any errors in grammar, spelling, and other minor problems. I supplied descriptive tables of contents for easy reference, but with their detail, there may be some mistakes. Hopefully, the reader will see beyond these and acknowledge the value of the important research reported herein.
Letter of endorsement from Bruce Craig, who litigated some early pyramid scheme cases:

RE: the book **MULTI-LEVEL MARKETING UNMASKED** (revised title\(^1\)), and the separate report titled **REGULATORY CAPTURE: The FTC’s Flawed Business Opportunity Rule**

Dear Dr. Taylor:

As an Assistant Attorney General with the State of Wisconsin (1967-1997) I litigated a number of pyramid cases and drafted Wisconsin's prohibition of 'Chain Distributor Schemes'. Since retiring, I have been active in attempting to obtain a meaningful regulatory response to these highly destructive schemes. These efforts include a number of contacts with the Federal Trade Commission, the agency primarily responsible for regulation in this area.

For at least the past eight years I have been in frequent contact with you, and others, on this topic. I think it would be fair to say that the FTC has been less than effective in dealing with this problem, culminating in its exemption of Multi-level Marketing from the recently enacted Business Opportunity Rule.

Your two publications reflect an impressive body of research on this topic, detailed analyses of actual profitability and the mechanics of these plans, considerable and extensive efforts to communicate your concerns to the Commission and other interested parties, and a thoughtful effort to communicate with those contemplating joining these plans.

Further, the publications represent a detailed repository of existing pyramid legislation, earnings, evaluations of a large number of multi-level companies, the many legal cases dealing with this subject, explanations of the mechanics of these plans, and detailed communications by interested parties on the subject of effective regulation by the Federal Trade Commission. The comment on 'Regulatory Capture' is compelling and thoroughly documented.

You are to be complimented on these efforts. They fill the considerable need for a single source of virtually all information on this subject. I would recommend that those interested in these documents download them from your website, as they contain a number of active hyperlinks to the extensive documentary record involved.

Sincerely,

Bruce A. Craig, former Assistant Attorney General for Wisconsin

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\(^1\) Originally *The Case (for and) against Multi-level Marketing*, originally published in 2011
Praise from other MLM experts:

Kudos to Dr. Taylor for shining the light of truth into every nook and cranny of network marketing. Prudent readers should conclude that if the so-called "MLM business opportunity" were presented honestly, no one would buy into it.

– Stephen Barrett, M.D., sponsor, Quackwatch.org and MLMwatch.org

A truly remarkable and comprehensive resource for consumers, lawyers, legislators and regulators. I am particularly impressed with the detailed comparison of state anti-pyramid scheme laws, and the collection of many other legal materials. . . you have done a beautiful job in organizing and presenting it in a methodical fashion. I cannot imagine anyone reading this and coming to any conclusion other than that MLM is a monumental fraud. This book is truly a legacy of which you must be very proud. As I have said before, in the MLM world you are “the voice of one crying in the wilderness.”

– From letter to Jon Taylor from Douglas M. Brooks, a Boston attorney who has tried many MLM cases

NOTE: Both the methodology and calculations in my research were validated by five financial experts – See Appendix 7A at the end of Chapter 7 (“MLMs Abysmal Numbers”)
SUMMARY OF FINDINGS ABOUT MLM (MULTI-LEVEL MARKETING)

By Jon M. Taylor, MBA, Ph.D., Consumer Awareness Institute

My preparation for this book includes (but is not limited to) the following:

- MBA with 2 years study in statistics, economics, accounting, and finance
- PhD in applied (industrial) psychology
- As college and seminar instructor, taught ethics, communications, salesmanship, entrepreneurship, and management
- Initiated 47 home businesses, including several sales oriented businesses
- Conducted over 20 research studies on MLM and home business opportunities
- Received worldwide feedback for 20 years from web site: mlm-thetruth.com
- Reviewed applicable federal and state laws
- Tested the Nu Skin program for one year.
- Analyzed the compensation plans of over 600 MLMs (MLM programs) and average income (loss) figures for 50 MLMs.
- Testified as expert witness in several legal cases against MLM companies.
- Presented at state and national conferences on MLM and pyramid schemes

With all this background, I come to the conclusions below in answer to key questions about MLM. These will be fully explained in the chapters that follow.

What is the appeal of multi-level marketing?

1. The “easy money” appeal of MLM is often couched in terms such as “time freedom” (to do what you want), perpetual or “residual income” (like author’s royalties), and “unlimited income possibilities,” with the success of recruits limited only by their efforts.
2. MLMs are often sold as a viable alternative to an unfavorable job market and as a better route to retirement than traditional plans.
3. MLM programs typically sell “pills, potions, and lotions” or other products that are consumable, that have unique appeal, and that can be claimed to deliver benefits not available elsewhere.
4. One sees a strong sense of belonging, or an “us versus them” cultish mentality.

As a business model, is MLM legal and ethical?²

1. MLMs depend on unlimited recruitment of a network of endless chains of participants.
2. As endless entrepreneurial chains, or “opportunity” recruitment schemes, MLMs assume an infinite market, which does not exist in the real world. They also assume virgin markets, which don’t exist for long. They would be doomed to eventual market saturation and collapse, except that some avoid this by expanding (“re-pyramiding”) to other markets and/or through the same markets with new product offerings.
3. Participants advance to ranks or positions in a pyramid (“downline”) of participants based on timing and recruitment, rather than on merit or appointment.
4. MLMs typically finance their operations from purchases by participants who are incentivized to buy overpriced products to qualify for commissions and for “rank advancement” (to advance to higher levels in the pyramid of participants). With the exception of some party plans, the majority of sales are typically to participants.
5. Typically, MLM products are unique (making it difficult to compare with competing products), consumable (to encourage repeat purchases), and priced higher than products sold elsewhere (to pay commissions on many levels of participants).

² For a thorough analysis of what separates MLM from other business models, read Chapter 2.
6. MLM compensation plans are cleverly rigged to reward the bulk of commissions to TOPPs (top-of-the-pyramid promoters), which is typical of all pyramid schemes. This is due to a commission structure that is upside-down from a legitimate direct selling program, in which the bulk of the commissions are paid to the person making the sale. It is this extreme concentration of commissions paid to TOPPs that motivates them to tirelessly promote recruitment to expand downlines, thereby assuring not only their outsized income, but the MLM’s survival and growth. Also, continual recruitment is needed to replace large numbers of dropouts, most of whom will have lost money.

7. Another explanation for MLMs unfairness is that relative vertical equality in commission structure - which appears benign - results in extreme inequality in distribution of income to participants. (See Exhibits 7g and 7h in Chapter 7.) This extreme inequality is further proof that MLM is an unfair and deceptive practice, which the FTC and Attorneys General of the 50 states should be actively combatting.

8. Most MLMs become even more top-weighted with five or more layers in their compensation plans – more than are justified to manage the sales function.

9. MLMs are inherently flawed, unfair, and deceptive - profitable primarily for those positioned at or near the top of the hierarchy of participants, which I call “TOPPs” (top-of-the-pyramid promoters) – who are often the first ones in the endless chains of recruitment. New recruits are being sold a ticket on a flight that has already left the ground.

10. Worldwide feedback suggests that MLMs can be extremely viral and predatory. As endless chains, MLMs quickly spread from state to state and often to vulnerable foreign markets. As a result, they are far more prevalent than legitimate business opportunities.

11. I have challenged state and federal law enforcement officials to identify any packaged “business opportunity” that is systemically more unfair and deceptive, and more viral and predatory than MLM. No one has met the challenge.

12. Some ask: Is possible to design an MLM that is honest and fair to all participants. To accomplish this would require major adjustments, such as the following:
   a) Commissions would be paid only on sales to non-participants – and no overrides or commissions paid for purchases of downline participants.3
   b) For each sale, over 50% of total commissions paid by the company would be paid to the front-line person who sells the products, with amount of commissions decreasing at each higher level rank.
   c) There would be no minimum ongoing purchase quota to qualify for commissions or rank advancement.
   d) The number of levels on which commissions can be paid would be limited to four (the maximum needed to manage any standard sales function, including branch, division, regional, and national managers).
   e) Unfair features of breakage and highly leveraged breakaway programs would be banned.

Unfortunately, to my knowledge, none of the MLM founders have taken such steps to achieve honesty and fairness. (See "What would a good MLM look like" in Chapter 2)

13. The villain in MLM abuse is not so much the leaders as a flawed system of unlimited recruitment of participants as primary customers. MLMs enable the transfer of money from a rapidly churning supply of new recruits to TOPPs, founders, and the company itself.

14. MLM promises what it cannot deliver. To be successful, MLM promoters depend on a litany of deceptions, including much self-deception. Misrepresentations regarding products, income potential, and legitimacy are commonplace in MLM.4 Based on the foregoing and on the research discussed below, if asked if MLM

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3 See Omnitrition case in Chapter 10..
4 See Chapter 8
is a moral or ethical business model, I would have to answer with an unqualified “no”

MLM is clearly an unfair and deceptive practice and should be illegal under Section 5 of the FTC Act, as well as state statutes that mandate against unfair and deceptive acts or practices (UDAP). Some states also have laws against endless chains, and MLMs clearly violate these. However, the Direct Selling Association (DSA) and the MLM industry, has lobbied successfully for weakening of laws and rules and the needed enforcement that could offer needed protection for consumers.

What are the effects of MLM on participants and on society?

1. Based on available company data, approximately 99.7% of all MLM participants lose money – spending more on company purchases and promotion and operating expenses than they receive in commissions from the company. Attrition rates are high. And if one removes TOPPs from the calculations of average income, the loss rate is closer to 99.9%, which means that the chance of new recruits profiting is virtually zero.

2. As is true with any scam, those who invest the most, lose the most, having accepted deceptive claims that the MLM is a legitimate income opportunity, and having continued to invest in the vain hope of eventually profiting handsomely.

3. Sales reported by MLM companies represent losses to participants. So based on DSA statistics, aggregate losses suffered by tens of millions of victims exceeds ten billion dollars a year in the U.S., with losses suffered increasingly by vulnerable populations overseas. This means that total aggregate losses from hundreds of millions of victims worldwide since the 1979 FTC v, Amway decision (allowing Amway to continue its endless chain recruitment scheme) would amount to hundreds of billions of dollars.

4. Damages from participation in MLM are widespread among participants. In many cases, monetary losses from MLM participation lead to heavy indebtedness, bankruptcy, foreclosed mortgages, and failed education and career pursuits.

5. Some MLM participants lose more than money. Divorces and rifts among extended families are commonplace. Even suicides and murders related to participation in MLM, have been reported.

6. Addiction to MLM can result from excessive commitment to MLM – which can become a cutish lifestyle. “MLM junkies” – who have internalized its “easy money” appeal – may find it difficult to work again in a normal work setting. They may hop from one MLM to another in hopes of finding one that works for them..

7. MLM is an unfair and deceptive practice (UDAP) that siphons money away from legitimate businesses. And with the FTC’s granting of an exemption to MLMs from having to comply with its Business Opportunity Rule, the market for legitimate non-MLM direct selling and business opportunities could be virtually eliminated, as packaged business opportunities and formerly legitimate direct sales opportunities are converted to an MLM model to escape regulation.

Are MLMs legal? If not, what explains the inaction by law enforcement?

1. The case can easily be made that virtually all MLMs are violating some federal and state laws, although law enforcement seldom acts against them – partly because victims of endless chains rarely file complaints. For the same reason (as well as financial support from MLMs and the DSA – see #3 below), the Better Business Bureau seldom issues a negative report on major MLMs. The media have been largely silent about MLM abuses.

2. The DSA, together with major MLMs, function as a cartel to choreograph deceptive arguments defending the industry – and to weaken laws and regulatory efforts against product-based pyramid schemes. Through promised votes and carefully placed political contributions to Attorneys General and other key politicians, they have been
successful in getting laws passed in Utah and other states that exempt MLMs from prosecution as pyramid schemes. They have donated to the political campaigns of presidential candidates and to those with oversight responsibility for the Federal Trade Commission to assure that no significant action is taken on the federal level by the FTC or any other agency. They have also recently influenced the establishment of a “direct selling” caucus in Congress to protect their interests.

3. Even the Better Business Bureau is corrupted by support from the DSA/MLM cartel, members of which are “corporate sponsors” of the BBB. Amway, for example, gets an A+ rating from the BBB – which says more about the BBB than it says about Amway.

4. Regulators, the media, and MLM victims, have become conditioned to focus on the question of whether or not an MLM is a pyramid scheme. Since the DSA/MLM lobby has obfuscated this issue with the indeterminate question of what percentage of products are consumed, nothing gets done. The issue of whether or not MLM as a business model and industry is structurally flawed and fundamentally an unfair and deceptive practice is more easily determined, as this book proves.

5. Most MLM participants spend no more than a few hundred dollars in products and services and then drop out. They are the lucky ones. Despite having spent more than they received, few blame the company for their losses – even losses of many thousands of dollars. They have been taught that they – not the company – are responsible for any failures. They are kept in ignorance about unfair and deceptive practices in their MLM program.

6. The silence of victims of MLMs is also explained by the fact that in every endless chain, major victims are also perpetrators, having recruited as many people as possible to recover costs of participation. So they fear self-incrimination if they file a formal complaint, and they fear consequences from or to those they recruited – which often include close friends or family members.

MLM is not legitimate direct selling!

Recruitment-driven MLMs (which is virtually all MLMs) can be distinguished from legitimate direct selling by the following characteristics in their compensation plans:

1. They assume unlimited recruitment of endless chains of participants as primary customers, completely ignoring laws of supply and demand.

2. Except for TOPPs, participants advance by recruitment, rather than by appointment like other businesses.

3. In order to qualify for commissions or advancement, participant must make minimum incentivized or “pay to play” purchases of products or services.

4. Most of the commissions paid by the company are paid to those at or near the top of a pyramid of participants – often the first to join. Founders may also skim a percentage of all revenues.

5. For most MLMs, company payout is to five of more levels of participants, with commissions to those at the bottom levels seldom enough to cover the cost of “pay to play” purchases and other expenses.

Actions needed

1. Consumers, law enforcement, and the media must get informed; and regulatory officials must be willing to expose and challenge the inherent flaws and unfair and deceptive practices in the MLM industry.

2. Crucial information must be disclosed to prospects to make informed decisions about MLM participation, such as average commissions from – and payments to – the company for all participants.

3. MLM promoters must not be allowed to make (or imply) promises of substantial or residual income potential.

4. A 7-day waiting period should be required before any investment is made by prospects.

5. Victims must be more active in complaining to authorities.

6. Class action lawsuits and filings in Small Claims Courts should be pursued to recover damages.
Conclusion – definition & effects of MLM

Persons honestly seeking a good understanding of multi-level marketing (MLM) find that MLM does not yield itself to a short and simple definition. I conclude with what I believe to be the only accurate, research-based definition of the business model labeled “multi-level marketing.” This definition applies to all of over 600 MLMs I have analyzed:

Multi-level marketing (MLM) is promoted as “direct selling”; but in fact, rewards are stacked in favor of recruitment, rather than sales to the public. MLM is characterized by all of the following:

(1) Endless chains of participants are recruited into the bottom level of company-sponsored pyramids of participants,
(2) Advancement up the levels in the pyramid is achieved by recruitment and/or purchases, not by appointment,
(3) Minimum purchases are required to qualify for commissions and/or to attain or maintain ranks in the pyramid, and
(4) The bulk of rewards are paid primarily those at the top of the pyramid.

NOTE: This set of four distinct characteristics is not found in any other type of business – except pyramid schemes. In fact, the fundamental structure of MLMs is virtually identical to that of classic, no-product pyramid schemes, except that in lieu of cash exchanged directly between participants, products are purchased and commissions processed through an MLM company sponsor. Such commissions are drawn chiefly from purchases of their “downline” (those recruited beneath them). It is appropriate to refer to MLMs as “product-based pyramid schemes.”

This definition of MLM requires explanation of its assumptions and effects, which have been identified from 20 years of research and worldwide feedback. Both the definition and the effects described below provide a true and complete picture of multi-level marketing as a business model and as an industry, which again has been confirmed in analyses of over 600 MLMs:

As a business model incentivizing unlimited recruitment, MLMs (MLM programs) assume an infinite market, which does not exist in the real world. MLMs also assume virgin markets, which cannot exist for long. Since MLM compensation plans are heavily weighted towards recruitment, rather than retail sales, stable retail markets never materialize. Consequently, MLMs must “re-pyramid” (expand) into new markets to compensate for saturation of existing markets. And with its high attrition rate, constant recruitment is necessary to replace dropouts. This re-pyramiding and constant churning of recruits is necessary to prevent total market saturation and collapse, as is true of any pyramid scheme.

In addition, some MLM recruiters sell books, lead generation systems, and other “sales tools” to assure success, but which wind up increasing costs and eventual losses. MLMs depend on a myriad of misrepresentations to survive and grow and to defend against regulatory action. Exaggerated product and income claims are common in recruitment and in company communications.

Prospects are typically lured into MLM with exaggerated product and income claims. Since approximately 99% of participants lose money, most eventually drop out, to be replaced by a continual stream of new recruits, who are likewise destined for loss and disappointment.

MLMs are therefore inherently flawed and have been proven to be the most unfair and deceptive of all purported business opportunities. Technically, as extremely unfair and deceptive acts or practices UDAP), MLMs in the USA violate Section 5 of the FTC Act, as well as UDAP statutes in many states.

As recruitment-driven systems, MLMs can also be extremely viral and predatory. MLMs, or product-based pyramid schemes, do far more damage than classic, no-product pyramid schemes by any measure – loss rates, aggregate losses, and number of victims. Tens of millions of MLM victims suffer tens of billions of dollars in losses every year. MLM may be the most successful consumer fraud in history.

While financial losses can be significant, adverse effects can also sometimes be seen

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8 See Chapter 8, which lists and debunks 111 deceptions used in MLM recruitment campaigns.
9 See the author’s report titled REGULATORY CAPTURE: The FTC’s Flawed Business Opportunity Rule, which can be downloaded from his web site at mlm-thetruth.com
in bizarre or cultish behavior, divorces, loss of “social capital” or ruined relationships with family and friends, and even addiction to MLM’s empty promises. Some sacrifice careers or education to pursue MLM’s vaporous promises of easy wealth (“time freedom” or “residual income”) and a mystique of personal and spiritual fulfillment.

Closing comments

The above definition is strengthened by information from the chapters that follow. MLM is dependent on aggressive recruitment of new recruits as primary customers. Products are overpriced to accommodate large downlines. Loss rate and attrition rates are extremely high, and a myriad of misrepresentations are necessary to lure new prospects. And because MLM victims seldom file complaints with law enforcement, there is little incentive for law enforcement to act against them or for legislators to enact better laws to protect against MLM fraud.

MLM is a class of systemic fraud, meaning that it is not so much the intentional fraud of individual perpetrators that causes the damage, but it is the underlying system that is flawed and fraudulent. Though MLM is a fundamentally flawed business model manifested in bogus “business opportunities,” MLMs are protected by the FTC with an exemption from having to comply with its Business Opportunity Rule – which was originally intended to protect the public from such practices. As an unintended consequence, other packaged “business opportunities” will be incentivized to adopt the same flawed MLM model to avoid having to comply with the Rule – hurting rather than helping those they target.

*See Multi-level Marketing Unmasked, Chapter 8, which lists and debunks 111 deceptions used in MLM recruitment campaigns. ** See REGULATORY CAPTURE: The FTC’s Flawed Business Opportunity Rule
INTRODUCTION: MLM’s appeal – and questions to be answered

Contents
Table of contents 1
Preface 1
Letters of endorsement 1
Introduction: MLM’s powerful appeal 2
Intro.1
The Amway precedent 2
" 1
A much needed investigation 2
" 2
The many questions to be answered 2
" 2
Is MLM an unfair and deceptive practice? 3
" 3
The book unmasks the mystique of MLM. 3
The author’s “$10,000 ‘unfair and deceptive practices’ challenge” 4
Qualifications of author/analyst 4
Source material for this book 5
Recommended reading & web sites 5

MLM’s powerful appeal

People join an MLM for a variety of reasons. Most are recruited by a family member or friend – or from contacts as work. Some learn about a program over the Internet.

The products may seem to answer some unmet need, such as protection from illness or aging. They may be very unique and offer benefits that promoters claim are not available elsewhere.

The opportunity to be self-employed from home appeals to many who are tired of depending on fickle employers who can lay them off at any time. They see their work as dead-end jobs with no real long term potential. Others are unemployed and find in MLM the chance for at least some income. Even some professionals tire of trading time for money and like the option of owning a business that promises passive income.

MLM offers an inexpensive alternative to more expensive options for owning a business. It can cost a small fortune to buy a franchise or an established business from someone else, and starting a business from scratch may take months to get off the ground. MLM is easy to get into and appears to be a good way to be your own boss.

Some get into MLM because of a promoter’s promise of virtually unlimited income, or at least income proportional to the time and effort put forth. But some get into MLM in hopes of supplementing their income, paying off debts, or financing college for their children. Others are led to believe they can earn a little extra cash for Christmas or for family vacations by working seasonally.

And of course you can’t beat the feeling of camaraderie that MLM offers. You are told that you can be in business for yourself, but not be by yourself, and that in helping yourself, you will be helping others – often hundreds in the organization you recruit and build, who look to you for support, as they each build their own business under you.

Robert Kiyosaki, author of Rich Dad, Poor Dad stated: “MLM levels the playing field and allows the average person to become financially free. This means not having to punch a time clock, the time freedom to pursue other interests without having to worry about money, and the means to be in control of your future.”

Who would not want all that?

The Amway precedent

In 1979, James Timony, a rookie FTC Administrative Judge wrote the controversial decision that Amway was “not a pyramid scheme.” This ruling assumed Amway’s compliance with certain “retail rules” to assure that products were sold to the public and not just stockpiled. These rules were never significantly enforced.

MLM promoters cite the Amway precedent as justification for their programs, in spite of mounting evidence of misrepresentations in MLM recruitment campaigns and high loss rates among participants. Thousands of MLMs have come and gone since 1979, and many hundreds remain – spreading virally from state to state and to vulnerable markets overseas.

Anyone reading the evidence with an open mind will understand why I and other consumer advocates lament the Amway ruling – and failure to take remedial action

11 93 F.T.C. 618, 716-17 (1979).
since – as repudiation by FTC officials of the agency’s mission to protect consumers from “unfair and deceptive acts or practices in or affecting commerce.”

This is an important topic because since 1979, hundreds of millions of MLM participants have in the aggregate been affected in amounts totaling hundreds of billions of dollars worldwide. And whether these participants were benefitted or victimized is a topic of hot debate between those who see MLM as a legitimate type of direct selling or home business opportunity – and those who see it as an inherently flawed unfair, and deceptive business model – causing nearly all participants to suffer losses, only to enrich founders and those at or near the top of their respective pyramids of participants – who are generally the first ones to join the endless chains of recruitment.

A much needed investigation

This independent detailed investigation is long overdue. A survey of legal and business journals, Internet web sites, and a library of MLM promotional and training materials yields a mountain of opinions on both sides of a very contentious and ONGOING debate about the legitimacy of MLM. But nothing approaching this level of research and analysis on the underlying business model has ever been undertaken by a qualified independent research entity. I have brought together not only a brief sampling of opinions on both sides, but an assimilation of analytical thinking and independent research that effectively answers a host of questions.

To illustrate the many facets of this topic, the list below is just a sample of the many questions that have arisen in my 20 years of research on this topic – and that will be addressed in this publication. In addressing these issues, I make no claim to cover every possible aspect of MLM, but surely those who take the time to read this material will have a much more thorough understanding of what they need to know to make decisions regarding participation in and/or regulation of this industry.

The many questions to be answered in this book

- Is MLM a viable business model? Or is it seriously and fundamentally flawed?
- Is MLM a pyramid scheme in disguise?
- How can MLM be clearly differentiated from other business models?
- What is the impact of MLM on individuals, families, and on society at large?
- How much money is gained or lost individually and in the aggregate?
- Are rewards proportional to effort; or do those who invest the most, lose the most?
- Should those who fail, blame themselves for not “working the system” – or blame the MLM as a scam?
- Can MLMs with their endless chain of recruitment continue indefinitely, or are they destined for saturation and ultimate collapse?
- Are MLMs profitable as business opportunities? And is a lifetime of “residual income” possible for all who work hard at MLM?
- Can a person profit from working in MLM just part-time or seasonally?
- Is MLM an honest business, or is it a system dependent on misrepresentations and unfair business practices?
- Are some MLMs legitimate, and others scams; and how can one tell the difference?
- Is a “good MLM” an oxymoron?
- Can everyone profit from MLM? Or is it just the founders and those at the top levels that reap most of the company payout?
- Do most recruits merely join to get the products at a discount – as promoters claim?
- Are products sold by MLMs what promoters claim they are? Or are they overhyped and misrepresented?
- Does MLM cut out the middleman? Or are MLM products overpriced to pay off the many levels of distributors?
- Are prices of MLM products competitive enough to be sold at listed retail prices? Or do MLMs depend on purchases by participants for most of their sales revenues?

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• Do MLMs foster good relationships? Or does a person risk squandering one’s social capital by participating in MLM?
• Does MLM invite openness, or does it lead to more closed and cultish behavior?
• Do endorsements by famous people and support of charities make MLM legitimate?
• Do “success tools” really benefit users, or do they primarily enrich upline sponsors?
• Does the DSA (Direct Selling Association), the MLM lobby, serve only the interests of its members, or does it also – with its “Code of Ethics” – seek to protect consumers from harmful programs?
• Do its chance elements qualify MLM as a form of gambling, or as a lottery?
• Are MLMs legal everywhere? Or are they technically legal in some jurisdictions, and not legal in others?
• If MLM is technically illegal in some states, why are they still operating?
• Where are consumer protection agencies, such as the FTC, in all this? Do officials have the skills, the resources, and the will to challenge fraudulent MLMs?
• Is MLM ethical? Is unethical behavior of participants rewarded more than ethical behavior?
• What actions can a victim take to recover losses from MLM?
• Can a person be addicted to MLM? If so, what can friends and family members do to deprogram an “MLM junkie”?
• What actions are needed to protect the public from “unfair and deceptive acts or practices”?

As a business model, is MLM an unfair and deceptive practice?

Many look at MLM as a legitimate business model and attempt to single out individual programs as “bad actors.” However, in chapters 2 through 8, the reader will find compelling evidence for the extreme unfairness and deceptive nature of MLM as business model and as practiced throughout the industry. Technically, this should make MLMs subject to prosecution under Section 5 of the FTC Act, as well as statutes in some states against unfair and deceptive practices – or endless chain recruitment schemes.

Loss rates are extraordinary – averaging 99.7% (or about 99.9% for new recruits) for the MLMs for which I have been able to obtain relevant data. This in itself would not be so bad, except that it is promoted as an “income opportunity” – or even as a “business opportunity” – a misrepresentation in itself. As will be explained in Chapter 7, the odds are far better at the gaming tables in Las Vegas.

After reading these chapters, the reader may wonder if it is appropriate to refer to an MLM such as Nu Skin, with its inherent flaws, as a “business” at all. Some who are familiar with MLM’s abysmal statistics feel it is more appropriate to refer to any MLM as a scam.

The book unmasks the mystique of multi-level marketing.

MLM lobbyists and defenders have managed to confuse and obfuscate the realities of the business model called multi-level marketing. Reduced to its essence, MLM as a business model is based on unlimited recruitment of endless chains of participants, as are “pay to play” chain letters and classic no-product pyramid schemes – both of which are illegal. In fact, every one of the compensation plans of the 600 MLMs I have analyzed assume an infinite market – which does not exist in the real world. They also assume virgin markets, which don’t exist for long, necessitating that the MLM promoters enter – or “re-pyramid” into – new markets with the same deceptive promises of “residual” or even “unlimited” income.

13 The term “re-pyramid” will be explained in Chapter 3.
MLM is almost always unprofitable for participants, except for TOPPs (top-of-the-pyramid promoters) at or near the top of the pyramid — who are usually the first ones to join and who may profit from the purchases of what is often a huge “downline” of recruits churning beneath them. Typically, MLMs have little sustainable customer base and are primarily dependent for revenues from purchases of a network of participants — 99% of whom lose money.

Thus, MLM as a system is fundamentally flawed, unfair, and deceptive. In addition, worldwide feedback suggests that MLM is extremely viral and predatory. The evidence from independent research as reported in this book will clearly support these conclusions. This is why the case for MLM is not given much attention in this work, though some typical arguments put forth by MLM promoters and defenders are briefly discussed, where appropriate.

The FTC considers classic, no-product pyramid schemes unfair and deceptive and therefore illegal. Bruce Craig, former assistant to the Attorney General of Wisconsin (who worked on several early MLM/pyramid scheme cases) wrote: “The premise of ‘multi-level vs. pyramid’ marketing may well represent a distinction without a difference.” (See Appendix 2F) The addition of products may merely serve to disguise or launder the investment in a pyramid scheme.

This is not merely author bias. Looked at objectively, any independent analyst with basic understanding of markets and statistics who had objectively reviewed this research would agree with this conclusion. And to those who claim I am biased in my research and writings, I would respond that I have gone where my research has taken me. At one time I was actually quite enthusiastic about MLM. But as my research, experience, and understanding of the unfairness and deceptions in the fundamental MLM business model grew, I became increasingly critical of the MLM industry. I am now convinced that no modern business is more unfair and deceptive than multi-level marketing. Chapters 2 through 7 demonstrate the unfairness of MLM as a business model and an industry. In Chapter 8 (“A Litany of Misrepresentations”) is a list of at least 111 typical misrepresentations used in MLM recruitment — which are refuted one by one.

The author’s “$10,000 ‘unfair and deceptive practices’ challenge”

After 20 years of research, I challenged anyone in law enforcement, academia, or the media to identify any purported business opportunity that is more unfair and deceptive — and more viral and predatory than MLM. FTC and state AG officials were mailed copies of my research and told that if by September 1, 2015, any of them could meet the challenge (as specified in Appendix 10A), I would take $10,000 out of his retirement and give it to his/her favorite charity. None of them even attempted to meet the challenge.

Qualifications of author/analyst

One of the common criticisms by pro-industry spokesmen is that I don’t understand the MLM business or that I lack the qualifications to make rather harsh judgments of the industry.

It might be helpful to list my qualifications — which could be ideal for an expert witness in MLM cases:

- Solid business education — a two-year MLM degree with extensive training in micro economics, statistics, accounting, and finance.
- Consultant and expert witness in numerous legal cases related to MLM and consultant/advisor to hundreds of persons seeking advice.

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14 In a letter to me dated May 22, 2001, FTC attorney Robert Frisby wrote: Section 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. 45(a)(1), states that “Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful.” While the Federal Trade Commission Act does not specifically address pyramid schemes, such schemes have been deemed unlawful under the Federal Trade Commission Act. In re Koscot Interplanetary, Inc., 86 F.T.C. 1106 (1975).

15 Letter dated February 25, 2000, from Bruce Craig to Robert Pitofsky, Chairman of the FTC (Appendix 2F) — and the official who drafted the Commission’s 1979 Amway opinion.
• Ph.D., with training in performing a
research, and subsequent
experience at two universities
evaluating the research of others
• Experience teaching and writing on
entrepreneurship, business ethics,
and money management.
• At least 25 years’ experience and
research in the field of home
business opportunities, and the need
or desire to work from home
• Experience as a distributor in an
MLM program, having succeeded at
recruiting a downline for at least a
year. (Except for top distributors,
“success” did not yield profits.)
• 20 years’ experience as a consumer
advocate in the field of MLM fraud.
• Analysis of the compensation plans of
over 600 MLMs, after having
developed a model that defines MLM
(product-based pyramid schemes),
and reveals MLMs to be recruitment-
driven, top-weighted, and financed
primarily by internal consumption.
• Author of two books and numerous
research reports on MLM topics

To put anyone’s mind at ease on this
subject, I am telling my story in Chapter 1
Anyone seeking an expert for consultation
or who wants more information about me is
welcome to write for my full vita, or they can
download it from the Consumer Awareness
Institute page at – www.mlm-thetruth.com

Source material for the book
The information for this book is compiled from extensive research and
writing I and other independent analysts
have done, while incorporating over 20
years of worldwide feedback. Most of the
information about specific MLMs is
downloaded from their company web sites.
Additional input from regulators, attorneys,
Scholars, and other independent consumer
advocates has been utilized. Where
appropriate, communications from MLM
defenders has been incorporated, even
though their arguments may seem
convoluted, deceptive, and/or misleading.

In making decisions on which research
and comments to include in the book, I
assume full responsibility. However, I am
confident – based on extensive training,
research and experience (see Chapter 1) –
that this book will be the most thorough and
reliable overall source of information
available on the viability, profitability,
legality, and ethics of MLM as a business
model; on the consequent unfair and
deceptive practices in the industry as they
affect consumers; and on ways to protect
consumers from major losses.

The issue of consumer harm – which
this book addresses in depth – has
relevance both for consumer protection and
for legal or regulatory actions. It is my hope
that this book will serve as an invaluable
tool for consumer advocates, law
enforcement officials, educators, media
reporters, and MLM recruits and prospects
faced with decisions about participation. It
should also be helpful as a primary
reference guide for plaintiff attorneys
representing MLM victims.

NOTE: This information has been updated
several times. If any of the latest statistics or
references have changed slightly since this
printing, I am fully confident that the analyses
and conclusions will still remain valid.

Recommended reading and
annotated web sites
For serious students of the subject, I
would strongly suggest reading the rather
lengthy article titled “All you need to know
about MLM.” In it you will find thorough
reporting on legal issues related to MLM.
Though very factual in her approach, the
author has been sued for expressing her
opinions and prefers to remain anonymous.
For the article and interesting details, go to –
http://www.financialindustryscam.com/mlm.htm

For general legal background, the
serious student will benefit from an older, but
extremely relevant, article published in the
William and Mary Law Review entitled:
“Regulation of Pyramid Sales Ventures,” go to –
http://scholarship.law.wm.edu/wmlr/vol15/iss1/6/

Several treatises written by Robert
FitzPatrick of Pyramid Scheme Alert are
very helpful in gaining a better
understanding of the subject. They can be downloaded from his two web sites –
www.pyramidschemealert.org and
www.falseprofits.com which also has some insightful blogs worth reading.

I also highly recommend the following: “What’s Wrong with Multi-level Marketing,” by Dean VanDruff, which presents powerful arguments to help grasp the fundamental flaws in MLM. Go to – www.vandruff.com

www.mlmwatch.org, one of several informative web sites by Dr. Stephen Barrett, focusing on questionable supplements and other health quackery, which seems to be a favorite product category for MLMs.

www.sequenceinc.com – sponsored by forensic accountant Tracy Coenen. Check out her articles on pyramid schemes.

A scholarly article titled “Marketing Fraud: An Approach to Differentiating Multilevel Marketing from Pyramid Schemes” was written by economists Peter VanderNat (with the FTC) and William Keep and has been referenced by the FTC in connection with the Business Opportunity Rule, as discussed in Chapter 2. However, the article assumes that MLM is a legitimate business model, an assumption that must be challenged, based on research and analysis reported in this book.

Dave Ritchie, who lost the love of his life over her addiction to MLM, presents some interesting experiences and insights in his web site at – www.scamm.org.

Many other useful reports and blogs are available at www.mlm-thetruth.com. And check out numerous other recommended web sites, which are annotated for the reader’s convenience. Go to –
www.mlm-thetruth.com/updates/recommended-sites/

If you want specific information on specific MLM programs, by going a Google search, you can usually locate numerous web sites touting the MLM. But if you want to know the downside for any given MLM, just enter the name of the company and add search terms such as “scam,” “fraud,” “complaints,” “legal actions,” etc.

A group of us consumer advocates have a web site on which is posted a petition titled: “Global Coalition Petitions FTC to Protect Consumers against Unfair and Deceptive Practices in the MLM (multi-level marketing) Industry.” Visitors to the site are invited to sign the petition and post their complaints. Go to –

William “Bill” A. Ackman, founder of Pershing Square Capital Management, gave a presentation at a Sohn investor conference December 20, 2012, at which he claimed to have proven that Herbalife was a pyramid scheme. He shorted the stock to the tune of a billion dollars, betting the stock price would eventually drop to zero. Other hedge fund managers invested hundreds of millions of dollars against him, and a battle of counter-investments and arguments on both sides ensued. Many articles appeared on the investor web site www.seekingalpha.com. For some well-researched articles from Pershing Square Capital Management, go to - www.factsaboutherbalife.com. Particularly helpful is their video “PyramidSchemes: A Primer.” Everyone should see it.

Please read this book carefully, then pass it (and our web address) on to someone else, or better yet – send to your entire email (or Facebook) list the link for downloading it and suggest that they do the same. Then ask that they each encourage those they contacted do the same for their contacts. You can help establish an endless chain of truth-telling to counter the deceptions passed along the chains of MLM recruiters.

Chapter 1: MLM UNDER THE MICROSCOPE – why and how the research upon which this book is based was undertaken, and why the author can speak with authority on the subject

Chapter contents
My background and qualifications 1-1
I go public and initiate serious research 1-5
I share my findings with regulators, attorneys, the media, consumers, and consumer advocates. 1-7
Legislators and regulators yield to DSA/MLM lobbying, creating a vacuum in consumer protection. 1-9
My resolve to do something 1-9

My background & qualifications

Important qualifications for an authority on MLM. If a top consultant were needed to sort out complex issues related to the legitimacy of MLM, what would his ideal set of qualifications look like, including education and both life and career experiences? I think the following list, which is what I bring to the task, answers that need. This is not to boast – just a summary of my background as it applies to this topic:

- Expertise in business analytical skills – ideally an MBA degree
- Doctoral level research, training, and experience evaluating others’ research
- Many years of experience in direct selling and in sales management
- A wide range of entrepreneurial and home-based ventures
- Direct experience in a leading MLM and success in building a downline
- Experience analyzing hundreds of MLMs, using a well-researched and consistent analytical model
- Compilation of the experience of thousands of participants in a wide range of MLM programs
- Communications with top executives and communicators of leading MLMs
- Strong grounding in ethical principles, including authorship on MLM ethics
- Extensive writings on MLM quoted by attorneys, legislators, and the media
- Presentations to regulators at nation-wide conferences on MLM
- Promotion of legislation and rulings to protect against MLM fraud.
- Consultant and expert witness in many legal cases regarding MLM abuses

Some may ask what qualifies me to do this research and to pull all this material together in an authoritative book. That’s a fair question and deserves an answer.

Actually, my whole career led to my expertise and consumer advocacy in this arena. Though the following sketch of my background is lengthy, it should forever put to rest the uninformed opinions of some critics that Jon Taylor "doesn't have a clue what MLM is all about."

As a young man, the last thing I would have imagined was my stepping forth as a leading authority on multi-level marketing. But fate – or an overruling providence – seems to have pointed me in that direction from my early years as a wide-eyed seeker of what the career world had to offer. It is as though my whole life was somehow pointed toward this advocacy on behalf of consumers and regulators struggling with the exploding phenomenon of multi-level marketing, or the commonly accepted acronym “MLM.”

Analytical skills and a solid background in sales, entrepreneurship, and ethics. I graduated in education and taught religion at the secondary level for two years before returning to Brigham Young University to complete a full-time MBA program at Brigham Young University, requiring two years of coursework in economics, statistics, finance, accounting, and the analytical skills essential for business success. From this training, I gained the skills needed to analyze business options and to
assess their profitability and viability. I also performed research on entrepreneurship and led a group project surveying corporate executives on “Sales as a Career Option for College Graduates.” This was a time when both sales and entrepreneurship were not yet considered respectable topics in academia.

In subsequent years, as an adjunct instructor at four different universities, I taught personal finance, entrepreneurship, business ethics, communications, and management – all of which came in handy later as a consumer advocate, communicating about complex MLM issues. I refined and taught skills needed for successful entrepreneurship and sales programs, as well as ethical business practices.

Coincidentally, I founded the non-profit Consumer Awareness Institute to conduct research and teach seminars related to personal finance and entrepreneurship – and wrote several articles that were published by various consumer and entrepreneurship magazines. I’ve also published several consumer guides, some for the distribution through group and commercial channels and some for Internet consumption. For each project – on an ad hoc basis as needed – I consult other experts in the field or hire help – usually college students.

Home income opportunities galore. In the late 1970s, as a young widower, I was determined to find ways to support my two small children without leaving home. This led to extensive research on the whole field of home-based business opportunities. I read all I could on the topic and undertook research for a planned national Income Opportunity Directory. The project outgrew me, as I uncovered thousands of income options. But I learned of the vast opportunities available outside the standard job market.

I sponsored a trade show called “The Income Opportunity Show,” to showcase income or business opportunities, many of which could be operated from home. Interestingly, MLM promoters scrambled more aggressively than any of the other companies for the best booth locations.

Serial entrepreneur for sure. Because of my creative inclinations and familiarity with the vast array of self-employment options, I started one business after another as a “serial entrepreneur.” I didn’t enjoy managing them, just creating them from scratch – often a business concept that had never been tried before. For those ventures that failed to show positive results, I learned to cut bait early and not continue throwing good money after bad. I would shut it down and begin again with another concept for a venture waiting in the wings.

Conversely, as soon as a business began to show significant profits, I sold out and went on to create another venture. As expected, some failed, and others succeeded; but in the process I learned some valuable lessons on what is required to start and build a successful home business. With careful research and good marketing, about half of these ventures produced profits within the first few months.

Also, because my funds were limited, all these business startups were bootstrap operations, requiring little capital. Such ventures nearly always required much salesmanship, so I honed my sales and marketing skills and trained others in the skills needed to promote new ventures. I know what legitimate selling entails.

Over a period of 30 years, I founded or consulted in the founding of over 40 home-based businesses. These included an educational game simulation company, an advertising and public relations agency, a training video preview service, a national motor home rental referral agency, pre-need funeral sales programs, radio transmission for high school driver education, publishing ventures, numerous trade shows, several traveling seminars, centralized seminars transmitted by satellite, a nationwide nanny screening and referral agency, and research-based resume and self-marketing programs. One could say I was a bootstrap, serial entrepreneur.
Direct selling experience. Along the way, I often engaged in direct selling, which proved to be the most profitable of the many income options in which I participated. I paid much of my college expenses selling encyclopedias, and I won many salesmanship awards when I sold insurance and pre-arranged funeral plans. *I do know the difference between legitimate direct selling and pyramid or chain selling.*

“Residual income” – and legitimacy. I provided consultation for mid-career changers, many of whom were seeking my guidance in pursuing small business or self-employment options. Also, from authoring books and from promoting health insurance and other programs for small businesses, I experienced the luxury of “residual income” – frequently cited by MLM promoters as the inevitable result of building a downline of distributors (or so they claim).

I was careful to assure that all of these ventures were organized and operated using the strictest of legal and ethical standards. Based on my MBA training, all this experience, and the ethical principles I have always held and taught, I was in a strong position to discern between businesses that were legitimate and those that were not.

Doctoral studies, research, and teaching. Midlife in my varied career, I completed doctoral studies in Applied Psychology at the University of Utah. This gave me research skills that were extremely helpful in my consulting, in teaching adult education classes and private seminars, and in my independent research on many topics, including MLM. Also, for a brief period, I worked on the administrative staff of both Brigham Young University and the University of Utah, evaluating the research of others.

First-hand experience with MLM – “Been there, done that.” I had been aggressively recruited many times by various MLM participants and witnessed firsthand their powerful motivation to recruit, using dubious and deceptive recruiting methods. But having taught college classes in finance, entrepreneurship, and ethics, and having been a successful salesman and entrepreneur, I was skeptical of recruitment-driven schemes labeled as “network marketing” or “MLM.”

However, under pressure from respected friends to join various MLM programs in 1994, I considered doing a one-year test of an MLM that my research led me to believe was one of the best of the MLMs I could join – Nu Skin. I wanted to prove to myself and to others whether or not MLM was a legitimate business model. Those who recruited me claimed that with my capabilities and contacts, I could rise to the top level of “Blue Diamond” within two years – and that those at this exalted level earned an average of over $750,000 a year.

I told myself that if that were true, I could live on that. But if it proved to be just a money trap or disguised pyramid scheme, as I suspected, I would tell the world about it.

Prudence dictated that before finally joining, I do some “due diligence” by reading on MLM and by checking out Nu Skin and other MLMs with the Consumer Protection Division at Utah’s Department of Commerce, as well as with the Better Business Bureau, which had received few complaints against Nu Skin. Both gave out literature that was favorable to MLM, assuming the company was financially solid and that legitimate products were offered.

I later learned that at least one of the pieces of literature handed out was supplied by the Direct Selling Education Foundation, sponsored by the Direct Selling Association (DSA), which lobbies for the MLM industry. But at the time, it seemed credible.

Finally convinced, I dragged my suspicious wife JoAnn out to a couple of Nu Skin opportunity meetings. The pep rally atmosphere was a big turn-off for her. She concluded, “I have a bad feeling about this.” But I persisted, and she reluctantly gave in to my promise to try it for a year - and then re-
evaluate the program. I felt comfortable with this trial period because in all my previous ventures I could assess the potential profitability of a business within the first few months.

As recommended, I bought five of starter packages (for about $1,600) to jump-start five new recruits, which not only helped me to advance in the distributor hierarchy through their "fast start" program, but also gave me a powerful incentive to recruit to recoup my investment. Fortunately, as a researcher I kept detailed notes of my experiences and records of expenses while recruiting for Nu Skin.

"I drank the Kool-Aid." My decision was to give total dedication to the program for at least a year, as it would not be a valid test otherwise. Even with my extensive background in math, entrepreneurship, and sales, I "drank the Kool-Aid" and eventually bought into the whole MLM mentality.

Looking back, I am ashamed for having overlooked MLM's mathematical trick – the promise of an unlimited income from an endless chain of recruitment. This was "cognitive dissonance" personified. I became a believer.

I did everything my company and upline recommended – subscribed to and tried a wide range of their products, recruited people I knew, sought any referrals I could get, advertised after exhausting my "warm market" of friends and family, attended all the training and opportunity meetings (conducting some myself), and used my best efforts to train and motivate my recruits.

I tried selling Nu Skin's nutritional supplements, but they were expensive, even at wholesale. To satisfy qualifications for commissions as an "executive distributor," I purchased products to give out as samples to any potential prospects – and hyper-consumed them myself.

It soon became apparent that to get to a level where the money was made, I would have to continue my aggressive recruitment campaign, luring prospects of the Nu Skin "business opportunity" to buy a "business in a box," which consisted mostly of an expensive package of products to become a "business builder."

"Wanna play?" While introducing new recruits to Nu Skin, I often asked them to attend "opportunity meetings" at which a high level distributor would give a presentation touting the benefits of Nu Skin and of what was then referred to as "network marketing."

One of these speakers presented Nu Skin as a game. Just like any game, the person has to be willing to enter the game to gain any fun from participating. He pointed out that the "winners" in this game would be handsomely rewarded – as much as $750,000 a year, which was what Blue Diamonds were then averaging.

At the close of his presentation, he would challenge us to "play the game" of the Nu Skin version of network marketing. His question "Wanna play?" was intended to get us to sign up right then. He said you never know how a person you recruit might catch fire and make you rich from the downline he might build, from which you could draw commissions. In retrospect, this appeal to chance is grounds for the application of lottery statutes to MLM in some states. (See Chapters 2 and 10.)

The 3-foot rule. I became a serious player of this network marketing game. I read everything I could on the subject, followed suggestions of my upline to the letter, and recruited aggressively. I consistently applied the "3-foot rule" – everyone within three feet of me was a prospect.

"It's Nu Skin or me – take your pick." My wife began asking questions after a few months of pitifully small commissions, even though I had risen to a level of the top 1% of distributors – assuming all recruits were counted. She did not like the changes that were occurring in me and in our relationships with treasured friends and family members, whom I was attempting to recruit.
Finally, at the end of a year, JoAnn threatened to leave me if I continued, as it was changing for the worse the man she married. “It’s Nu Skin or me – take your pick,” she warned. Where I had ignored my wife's negative impressions when I first joined Nu Skin, now her ultimatum caused me to take a closer look at my participation – and at our finances.

“IT'S Nu Skin or me – take your pick,” she warned.

Ethical conflicts. As a former teacher of ethics and one who considers himself an honest man, one facet of MLM fascinated me even more than the money. In re-examining my participation in MLM, I discovered a whole range of ethical conflicts that for me made MLM an unacceptable way of conducting a business.

In fact, before I quit Nu Skin, after about a year of concentrated effort, I could see clearly what I would have to do to earn the huge commission checks that were held out to new recruits. I decided it was simply not worth it. Why? Because I would have to recruit by convincing prospects (like I had been deceived) into believing they too could achieve what I claimed to have achieved – or was on the road to achieving.

For me to receive the income that was held up as possible, thousands (in such a highly leveraged program) would have to lose their investment. The money would have to come from somewhere. Also, I would have to continue to insist that MLMs were not illegal pyramid schemes, but legitimate direct selling programs.

Top 1% and losing over $1,200 a month. Though I was successful at recruiting and climbing the ladder of distributors (again, in the top 1% if all distributors were counted), I was still losing about $1,000 a month, after subtracting all expenses, including purchases required to maintain qualification for the “Executive” level in the compensation plan – which was necessary to have any hope of profiting after expenses.

Top 1% of distributors, but losing $1,000/month. This was NOT what I signed up for!

It soon became apparent that to earn the huge income that was promised, I would have to be at or near the top of a huge pyramid of participants, which I believed was possible. But after carefully considering my situation and coming to recognize the foolishness I had fallen into, I quit Nu Skin and decided to tell the world what I had learned – not just about Nu Skin, but about the entire field of MLM (a.k.a., “network marketing”), about which I had undertaken an intensive research overview.

For me to receive that level of income, thousands would have to lose their investment. The money would have to come from somewhere. Also, I would have to continue to insist that MLMs were not illegal pyramid schemes, but legitimate direct selling programs.

I go public and initiate some serious research

I publish the story of my experience and lessons learned from MLM. After conducting surveys to determine the amount of MLM activity in my state and a cross section of citizens’ opinions about it, I wrote a book titled The Network Marketing Game, which exposed the ethical problems of exploiting friends and family for personal gain. While on a speaking tour promoting the book, I got feedback from tax accountants who asked why – with all the MLM promoters’ promises of “residual income” – they were not seeing profits reported on tax returns of MLM participants.
The tax man knows. I decided to interview tax professionals in several counties—totaling almost 300 of them over a period of several months. This included interviews with programmers of tax software and persons involved in seminars for tax professionals. With a total of over two million tax returns represented nationwide, a clear picture emerged of who was making—and who was losing—money in MLM. The results were startling. Finally, in 2004, this research was published in a report published on my website entitled *Who Profits from Multi-Level Marketing? Preparers of Utah Tax Returns Have the Answer.*

From MLM recruiter to consumer advocate. In 1998, I mailed my initial conclusions to the presidents of 60 of the most prominent MLM companies, asking them to provide specific data to “prove me wrong.” To this day, this challenge remains unmet. It was published on my website as *Network Marketing Payout Distributions Study.* I also published *MLM or Network Marketing – the Ultimate Pyramid Scheme, 12 Tests for Evaluating a Network Marketing ‘Opportunity, and Product-based Pyramid Schemes: When Should an MLM or Network Marketing Program Be Considered an Illegal Pyramid Scheme?* All of these created quite a stir when posted on the internet.

Why all this detail on my background? My reasons for recounting all of the above is to answer the common charge of critics that “Jon Taylor hasn’t a clue of what MLM is about” – or that I have “no real world experience in how to sell or to manage a business.” The foregoing should put all such blind assertions to rest. At least, it answers all the qualifications for an ideal expert for this project as outlined above.

Other MLM promoters charge that my experience with MLM was with a “bad MLM” – Nu Skin. Their typical comment goes something like this. “But – our MLM is different. Everyone can make money at this MLM,” or “We have the most powerful compensation plan in the industry,” or “We’re not really MLM, we sign up referral customers,” etc., etc.

My response is that after analyzing the compensation plans of hundreds of MLMs and the average income for those that have released such data, it is now possible for me to make reliable generalizations about MLMs (i.e., multi-level or network marketing, entrepreneurial chains, product-based pyramid schemes - or whatever you choose to call them) – as a business model that applies to all MLMs. And I have yet to find any exceptions to these generalizations, in spite of 20 years of research and worldwide feedback.

This is not to boast, just a statement of fact: I DO know what I am talking about - if anyone does. And I DO have the background to test and evaluate MLM as a business model, as well as specific MLM programs - if anyone does.

Sour grapes – or moral imperative? Other critics see my analysis of the MLM industry as merely the ‘sour grapes’ attitude of a disgruntled ex-distributor who failed at MLM. I can only respond that I was successful at becoming one of the company’s top 1% in the hierarchy of distributors – only a small percentage of all recruits reach even “Executive” level. In Nu Skin’s reporting, dropouts are not counted, as these people “never intended to do the business.” This is a convenient falsehood.

However, such success was not reflected in any profits, but instead in substantial losses, after all purchases and operating expenses were subtracted, to say nothing of $50,000-$100,000 lost from not working at a profitable sales-oriented business during that year. Also, I was fulfilling my initial pledge to myself to make public what my experiment with MLM taught me, and I feel a moral imperative to help others avoid the pitfalls inherent in this “industry.”
Shortly after I began posting my findings to educate and warn consumers against MLMs like Nu Skin, I also reported on the FTC’s Order for Nu Skin to discontinue its misrepresentations about distributor earnings. This information can be downloaded from a page on my web site titled “Nu Skin’s Naughty Numbers at – http://mlm-thetruth.com/research/mlm-statistics/nuskins-numbers/

I share my findings with regulators, the media, attorneys, academia, and consumer advocates – as well as with victims and potential victims.

To reach out to a broader audience of consumers, I initiated a website and cooperated with other consumer advocates and top experts who were reporting their findings and experiences with MLM. These included Robert FitzPatrick, President of Pyramid Scheme Alert; Bruce Craig, former assistant Attorney General in Wisconsin; Kristine Lanning, (former) Assistant Attorney General of North Carolina; Doug Brooks, plaintiff attorney dealing with MLM cases; Susanna Perkins, author and sponsor of mlmsurvivor.com, and Eric Schiebeler, author of Merchants of Deception.

With the cooperation of these extremely knowledgeable and capable experts, I organized seminars on product-based pyramid schemes for state and federal regulators in Washington, D.C., and at the National White Collar Crime Center in Richmond, Virginia. I also cooperated with sponsors of other web sites offering useful information on MLM.

My research was also presented at other national and state anti-fraud conferences. Robert Fitz-Patrick and I have been called upon as expert witnesses in several legal cases against MLM companies. However, the most gratifying rewards from all this research have been the thousands of emails and responses to my web site from persons all over the world who express their thanks for saving them from potential losses.19

Finally – multi-level marketing, or product-based pyramid schemes, defined - based on extensive research. I spent months analyzing features of MLM and classic pyramid schemes and comparing them with features of legitimate direct selling and other home businesses. With my extensive background in sales and entrepreneurship, I was able to make some clear distinctions missed by other analysts.

In fact, I had not only done direct selling (which MLM adherents claim to be doing), but had recruited, hired, and trained sales persons and telemarketers. I knew what characterized legitimate direct selling – and even legitimate recruiting. After months of comparative analysis and discussions with top experts, five “red flags” or characteristics became apparent that clearly distinguished chain or pyramid selling schemes (MLMs) from legitimate direct selling businesses. The first four applied to all MLMs, the fifth to most.

These features, which could be identified in MLM’s compensation plans, resulted in extremely high loss rates and helped to identify MLMs that could be considered in violation of laws in most states, as well as FTC guidelines. In fact, wherever I could get the earnings reports of participants in MLMs with these “5 Red Flags” in their pay plan, approximately 99.7% of all participants (including dropouts) lost money, after subtracting all expenses. In fact, with a more strict interpretation of the data (and eliminating TOPPs, or top-of-the-pyramid promoters from the calculation), the loss rate for new recruits is closer to 99.9%.20

These expenses included minimal operating expenses and “incentivized purchases” of goods and services from the company (necessary to qualify for commissions or rank advancement).21 MLMs even make obviously illegal no-product pyramid schemes look profitable in comparison – with the likelihood of profiting 10-100 times as great.

19 For sample feedback, see Appendix for Chapter 9.
20 See Chapter 7.
21 See Chapters 5 and 7

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17 Sponsor of pyramidschemealert.org
18 Sole practitioner in Concord, Mass..
The “5 Red Flags.” These five red flags were then presented in the form of a “5-step do-it-yourself MLM Evaluation” quiz. It soon caught hold, and thousands of MLM prospects have used it to keep themselves out of MLMs that could have caused considerable financial loss.

I also published for presentation THE 5 RED FLAGS: Five Causal and Defining Characteristics of Product-Based Pyramid Schemes, or Recruiting MLMs at the 2002 and 2004 Economic Crime Summit Conference, co-sponsored by the National White Collar Crime Center.

Over the past several years, I have used this “5 Red Flags”\textsuperscript{22} model to analyze the compensation plans of over 600 MLMs – and correlated them with average income data of participants (where such data was available). All of this has enabled me to make generalizable observations of consistent structures and practices of MLM as an industry – and losses suffered by participants – that would not otherwise have been possible. These observations and the research underlying them will be explained in subsequent chapters.

It should be noted that I now include only four causative and defining characteristics of a recruitment-driven MLM. The fifth (five or more levels in the pay plan) does not always apply because in rare cases, some MLMs have only four or five levels. They make up for it by increasing the payout to TOPPs. However, the added levels definitely enhance this unfair payout.

Roulette or Craps – or MLM? The numbers don’t lie. Other critics see me as biased against MLM in my research and reporting. This can be answered with a gambling analogy to explain my position. If the owner of a gambling casino in Las Vegas were to post a “Business Opportunity” sign at his craps or Roulette tables, the Nevada gaming authorities would take action against him. And no one would argue that a writer covering the issue should be impartial in reporting on whether or not gambling is a legitimate business opportunity. It is gambling.

In fact, I called Las Vegas gambling casinos and learned that the odds of profiting from craps or Roulette are far better than the likelihood of profiting from MLM\textsuperscript{23}. Please don’t misunderstand me. I am not promoting gambling; I never gamble. But I am all for honest and ethical business practices in any endeavor. At least gambling casinos are honest enough not to claim that those who play at their gaming tables are investing in a “business opportunity.”

Business opportunity?

One can do better in Las Vegas – than in MLM!

MLM is not the only game in town. From feedback all over the world it became apparent that many people are drawn into MLM because they are unaware of the many self-employment alternatives open to them. So using my past research and experience, I wrote the report 1,357 Ways to Make More Money than in MLM. I began posting on my web site the research making up this book, along with suggestions for successful self-employment and links to websites that provide additional information and point to helpful resources.

Legislators and regulators yield to DSA/MLM lobbying, creating a vacuum in consumer protection.

Utah and other states duped by DSA.

In 2006, the DSA and local MLM companies lobbied

\textsuperscript{22} The first four causative and defining characteristics apply to all MLMs, the fifth to all but a few.

\textsuperscript{23} See Chapter 7.
intensely for a bill weakening Utah’s Pyramid Scheme Act. I testified at hearings on behalf of consumers who were being victimized by what I dubbed “product-based pyramid schemes,” or MLMs. But with well-placed political donations and the implication of a powerful voting block of MLM participants, the bill was passed in 2006, exempting MLMs with consumable products from prosecution as pyramid schemes. Even the Attorney General testified in favor of the bill, but without disclosing that MLMs were his chief political donors. Several other states have been similarly affected by DSA-initiated legislation.

The FTC’s flawed Business Opportunity Rule. In 2006, the FTC proposed a Business Opportunity Rule that would require sellers of business opportunities to disclose average incomes, references, and other information crucial to a decision on whether or not to participate. Comments were invited, and the DSA and its members issued appeals to millions of MLM participants to use their form letters to write in objections to including MLM in the Rule. Some 17,000 offered comments following their company’s suggested form letters. I wrote comments rebutting the comments of participants and spokesmen for over 30 MLMs.

Also, the DSA influenced 86 Congressmen to object to including MLM in the Rule. The FTC gave in to the pressure, and in 2008 a Revised Rule was proposed, exempting MLM. Commenting for consumers, I objected to this exemption with additional comments, and in 2009 participated in a workshop at the FTC offices on the proposed final version of the Rule — again objecting to the FTC’s exemption of MLM from having to provide transparency needed to protect consumers from unfair and deceptive practices, which protection is a core mission of the FTC. However, in 2011, the FTC announced its final Business Opportunity Rule — exempting MLM! The details of how this happened are provided in the report titled “REGULATORY CAPTURE: The FTC’s Flawed Business Opportunity Rule”

My resolve to do something

Something to get passionate about. Knowing my grasshopper approach to career decisions in the past, hopping from one startup business to another, friends have asked me what has driven me to stay with my consumer advocacy, focusing so intently on this one business model for 20 years.

My answer is that when I discovered how deceptive, unfair, viral, and predatory this industry is, and how few people — including regulators — understand the consequences of MLM participation — to individuals, to families, and to society, it seemed appropriate to stand up and use my unique background and skills to challenge the industry and to provide guidance to prevent consumers from being victimized by fraudulent MLM schemes. It is both the outrage I feel at the unchecked growth of this deeply flawed practice, as well as letters of deep appreciation from persons around the world who used my information to remain solvent by refusing MLM recruiters, that keeps me going.

I go where the facts take me. The abysmal average income (losses) for new MLM recruits confirms the fundamental flaws in MLM as a business model, depending as it does on the unlimited recruitment of endless chains of participants as primary customers. MLM is built on the same endless chain concept as the clearly illegal chain letters of the past, where each person sends $5 to all the persons on a list and is asked to add his name at the end and forward it on to all his/her friends, asking them to do the same.

So I have no hesitation in gathering the evidence and arguments on both sides and then showing the flaws in the arguments justifying MLM as a “business opportunity.” All of this has been posted on my web site — mlm-thetruth.com.
When I discovered how unfair and deceptive, and how viral and predatory this industry is and how few people – including regulators – understand the consequences of MLM participation, it seemed appropriate to use my unique background and skills to challenge the industry, to inform regulators, the media, and academia – and to provide guidance to help prevent consumers from being victimized.
Chapter 2: MLM DEFINITIONS AND LEGITIMACY: what MLM is and is not, and the difference – if any – between MLM and pyramid schemes

Chapter contents:
Introduction and summary 2-1
Examples of Definitions of MLM by others 2-2
Needed: A research-based definition of MLM 2-6
Four CDCs of recruitment-driven MLMs that cause harm & distinguish MLM from legitimate direct selling 2-10
#1: Endless chains of recruitment 2-10
   Exhibit 2a: CDC #1 2-11
   Exhibit 2b: CDC #2 2-15
#2: Advancement by recruitment 2-16
#3: Pay-to-play requirements 2-16
   Exhibit 2c: CDC #3 2-17
#4: Top-weighted compensation plans 2-21
   Exhibit 2d: CDC #4 2-23
#5: (in most MLMs) Five levels or more 2-24
   Exhibit 2e: CDC #5 2-25
4 CDCs confirmed by industry-wide research 2-27
MLM not legitimate direct selling 2-27
Harmful effects of recruitment-driven MLMs 2-27
   Exhibit 2f: Does MLM qualify as legitimate direct selling? – a 7-point checklist 2-29
   Exhibit 2g: Legit. direct selling v. MLM 2-31
   Exhibit 2h: Characteristics & effects of product-based pyramid schemes 2-32
MLM’s unsavory reputation 2-32
MLM’s problem with legal identity 2-33
What is the difference between Ponzi schemes and pyramid schemes? 2-34
Are all MLMs pyramid schemes? 2-35
What about MLM’s that claim they are “not MLM” 2-36
A more descriptive term: “pancake schemes” 2-36
Comp plans designed for company not particular’s 2-37
Some MLM “players” game the system 2-37
What would a “good MLM” look like? 2-38
Conclusions, including research-based definition and effects 2-39
A testable hypothesis for MLMs legitimacy 2-40

Appendix for Chapter 2
2A: Definitions of relevant terms 2-41
2B: Explanation of compensation plans 2-44
2C: Sample MLM compensation plans 2-45
2D: Comparative analysis of direct sales, no-product pyramid schemes & MLMs 2-49
2E: List of MLMs evaluated by Dr. Jon Taylor 2-53
2F: Petition – Bruce Craig to FTC’s Pitofsky 2-57
2G: Letter – Bruce Craig to Peter Vander Nat 2-59
2H: Definitions of or related to illegal pyramid schemes in state statutes 2-63
2I: Are All MLMs Pyramid Schemes? A closer look 2-69
2J: MLM programs can be considered flat line or pancake schemes 2-70

Introduction and summary
One of the biggest problems with multi-level marketing (a.k.a., “network marketing”, or “MLM” for short) is the wide variety of definitions of what is – and what is not – multi-level marketing. We will consider a sampling of definitions and then discuss a much more objective definition based on comparative research on structural characteristics and confirmations of its validity in over 600 MLMs (MLM programs).

This research has yielded four (and in most cases five) causative and defining characteristics (“red flags”) that can be recognized in the compensation plans of all MLMs – which motivates the behavior of participants. This definitional model makes possible a clear distinction between (1) legitimate direct selling or home-based businesses, (2) classic no-product pyramid schemes, and (3) recruitment-driven MLMs – or what I call “product-based pyramid schemes.”

As I shall explain, there are inherent flaws in any MLM, since all assume unlimited recruitment of endless chains of participants – and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves. I have looked for exceptions to this generalization in the 600 MLMs I have analyzed, but have found none.

As a business model, MLM operates on the same principle as a chain letter, in which a person receives a letter with a list of names on it, mails a $5 bill to everyone on the list, adds his/her name to the bottom, and then forwards it to friends and relatives to do the same – in an endless chain of such letters. In such schemes, the vast majority are mathematically doomed to lose money. “Pay to play” chain letters are illegal. (For the history of how chain letters evolved into MLMs, see Chapter 10.)

Just like the chain letter, MLM founders assume an infinite market, which does not exist in the real world. They also assume a virgin market, which cannot exist for long – which necessitates that an MLM expand – or “re-pyramid” (my term) – into new markets. Thus, MLM with its endless chains
of recruitment, is inherently flawed, unfair, and deceptive.

Twenty years of worldwide feedback tells me that MLM is also extremely viral and predatory. This is advantageous for the founders, TOPPs (top-of-the-pyramid promoters), and the MLM company itself, but works to the detriment of new recruits – who are being sold a ticket on a flight that has already left the ground. MLM is an unfair and deceptive practice, if there ever was one. MLM takes new recruits from the real world into a world of make-believe “business opportunities” – and in the process fattens the coffers of the company, its founders, and TOPPs.

When discussing the legitimacy of MLM in this book, I use the word “legitimate” in the broadest sense; i.e., “conforming to recognized principles or accepted rules or standards,” as opposed to narrow legal definitions, which may or may not conform to accepted standards in business practices.

This chapter concludes with likely the only accurate real-world, research-based, and consumer friendly, definition of the business model termed “multi-level marketing,” or “MLM.” In my opinion, a good definition would accomplish the following criteria:

1. Distinguish MLM from all other forms of business activity.
2. Distinguish MLM, or product-based pyramid schemes from Ponzi schemes (although there are some similarities)
3. Address the question of legitimacy – or lack thereof – of the business model.
4. Address fundamental flaws of all MLMs.
5. Explain the problem of incentivizing purchases by participants.
6. Point to the litany of misrepresentations characteristic of MLM recruitment.
7. Highlight the industry-wide high loss rates experienced by participants.
8. Emphasize the high attrition rate among MLM participants.

A problem of definitions. Much confusion exists on the subject of what is – and is not – multi-level marketing and whether and how it can be distinguished from illegal pyramid schemes. All of the definitions by industry defenders as well as government agencies focus primarily on the behavior of participants and the existence of two or more levels for payout purposes, rather than on the fundamental structural characteristics that clearly distinguish MLM from all other forms of business activities. We will begin by looking at how others define it and then bring together what light can be shed on the subject from legal and regulatory sources and from recent research.

We will first look at the definitions of multi-level marketing offered by others before advancing a set of causative and defining characteristics of a “recruitment-driven MLM,” or “product-based pyramid scheme.” Then I will offer a definition of MLM that satisfies all of the above criteria.

Examples of Definitions of MLM by others – with commentary

From Wikipedia (March 2010):

Multi-level marketing (MLM), (also called network marketing, direct selling, referral marketing, and pyramid selling) is a term that describes a marketing structure used by some companies as part of their overall marketing strategy. The structure is designed to create a marketing and sales force by compensating promoters of company products not only for sales they personally generate, but also for the sales of other promoters they introduce to the company, creating a downline of distributors and a hierarchy of multiple levels of compensation in the form of a pyramid.

The products and company are usually marketed directly to consumers and potential business partners by means of relationship referrals and word of mouth marketing.

“Independent, unsalaried salespeople of multi-level marketing, referred to as distributors (or associates, independent business owners, dealers, franchise owners, sales consultants, consultants, independent agents, etc.), represent the company that produces the products or provides the services they sell. They are awarded a commission based upon the volume of product sold through their own sales efforts as well as that of their downline organization.

Independent distributors develop their organizations by either building an active
customer base, who buy direct from the company, or by recruiting a downline of independent distributors who also build a customer base, thereby expanding the overall organization. Additionally, distributors can also earn a profit by retailing products they purchased from the company at wholesale price.

MLM spokesmen clearly crafted this definition, which Wikipedia uncritically accepted in lieu of definitions of consumer advocates that would highlight the inherent flaws in MLM. For example, no mention is made of the endless chains of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves. These critical features will be explained later in this chapter.

From author Richard Poe:

Network marketing is not defined in any standard dictionary of business terms. Nor do network marketers themselves agree on what it means. For lack of any clear standard, I suggest the following definition: “Any method of marketing that allows independent sales representatives to recruit other sales representatives and to draw commissions from the sales of those recruits.”

This overbroad definition would take in many sales organizations that are not considered MLM, such as some insurance and real estate agencies. And as with the Wikipedia definition, no mention is made of the inherent flaws in any MLM system – the endless chain of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves.

Zig Ziglar (with Dr. John Hayes) offers his “technical definition” of what he claims network marketing (MLM) is – and is not. Below is an interesting definition put forth by Dr. John Hayes, in cooperation with prominent salesmanship author Zig Ziglar,

Ziglar, who incidentally makes no mention of MLM or network marketing in his books directed to professional salesmen:

Would you like a technical definition? Network marketing is a system for distributing goods and services through networks of thousands of independent salespeople, or distributors. The distributors earn money by selling goods and services and also by recruiting and sponsoring other salespeople who become part of their downline, or sales organization. Distributors earn monthly commissions or bonuses on the sales revenues generated by their downline.

Here’s what network marketing is and is not:

- Network marketing, or multi-level marketing (MLM), isn’t illegal, fraudulent, or unethical.
- Network marketing isn’t an opportunity to get rich quick off the payments of others who join the organization. That’s a pyramid scheme.
- Network marketing isn’t a pyramid scheme, which is illegal and unethical.
- Network marketing isn’t an opportunity to get rich quick. Period.
- Network marketing isn’t built on simple mathematics where many losers pay a few winners. That’s also a pyramid scheme.
- Network marketing isn’t just for salespeople.
- Network marketing isn’t expensive. Unlike most other business opportunities, the start-up costs are low, almost always less than $500 and often under $100.
- Network marketing isn’t a way for companies to sell huge amounts of inventory to distributors. Network marketing isn’t a way for distributors to sell stuff that nobody wants or uses.
- Network marketing isn’t a license to sell products and services at inflated prices.
- Network marketing isn’t for people who aren’t willing to work hard.
- Network marketing isn’t for anyone who can’t or won’t follow a proven system that leads to business success.

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While the first paragraph is quite descriptive and somewhat accurate, as is the Wikipedia definition, no mention is made of the inherent flaws in MLM – the endless chains of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves. These critical features will be explained later.

Also, most of the items on the list of what network marketing is not would be vigorously challenged by knowledgeable experts advocating for consumers, based on extensive research as reported in this book.

**Other authors on multi-level marketing offer weak definitions – or don’t even attempt to define MLM.** Another prominent MLM author, Dr. Charles King, professor of marketing at the University of Illinois at Chicago (with James Robinson), offers an even weaker – and I would suggest misleading – definition that would be almost useless in making the distinctions discussed above:

*Network marketing is the low-cost, and now high-tech, industry that invites you to build your own business and earn a potentially high income while working from home on your own schedule. You earn immediate income and serious long-term residual income by selling products and services directly to consumers and convincing others to do the same.*

Again, as with the Wikipedia definition, no mention is made of the fundamental flaws inherent in any MLM system – endless chains of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves.

As an example of other authors who have made weak attempts to define multi-level marketing, MLM author David Roller suggests a definition that is rosy and descriptive, but not very helpful in making clear distinctions between MLM and other home-based businesses:

*Multi-level marketing or network marketing is a system by which a parent company distributes its services or products through a network of independent business people, not only in the United States but throughout the world. These independent business people or entrepreneurs then sponsor other people to help them distribute the product or service. This people-helping-people process may be continued through one or more levels of earnings.*

A search of the business section of a local bookstore store reveals that other authors have written on how to be successful at MLM, but without offering any substantive definition of what they are talking about, apparently assuming readers all know precisely what they are talking about. This may be true of MLM veterans, but feedback I have received tells me this assumption may not always be correct, especially for those being recruited for the first time.

**The FTC chooses a definition of MLM that only creates confusion.** In its 2008 announcement by the FTC of its Revised Proposed Business Opportunity Rule, exempting MLM from having to comply with the Rule, the FTC quoted an article in which the following definition was advanced:

*Multi-level marketing is one form of direct selling, and refers to a business model in which a company distributes products through a network of distributors who earn income from their own retail sales of the product and from retail sales made by the distributors’ direct and indirect recruits. Because they earn a commission from the sales their recruits make, each member in the MLM network has an incentive to continue recruiting additional sales representatives into their “downlines.”* 

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At a workshop hearing on the form for the final Business Opportunity Rule, I pointed out that almost any direct selling company could circumvent the Rule by paying commissions to two or more levels of sales persons, who would have in some way been involved in recruiting new sales persons. In fact, many sales organizations do this, but do not consider themselves “multi-level marketing.”

With this definition, together with the MLM exemption, the Rule was rendered almost totally ineffective in curbing abuse. It is a tacit admission by the FTC that it is giving up on its mission to protect consumers against “unfair and deceptive practices” in this very important arena. As will be seen from further analysis, it would be difficult to conceive of a more unfair and deceptive practice than MLM, to say nothing of its extremely viral and predatory nature.

Again, in this FTC definition, as with the Wikipedia definition, no mention is made of the inherent flaws in any MLM system – endless chains of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves.

The DSA re-brands MLM as “direct selling.” The DSA (Direct Selling Association) was once dedicated to advancing the interests of what were then legitimate direct selling companies like Fuller Brush and World Book Encyclopedia. But what has happened in recent decades could be illustrated by a farmer who has pigs and horses for sale. He gets more money for horses, so he attaches horse hairs on the buttocks of the pigs and marches them into the horse corral and proclaims, “See there, they are no longer pigs, but horses - because they are in the horse corral.”

Similarly, since “multi-level marketing” sounded too much like a pyramid scheme, MLM promoters coined the term “network marketing.” Then, since it would sound even less pyramid-like, they sought to be called “direct selling” companies. So one by one, MLMS joined the Direct Selling Association and now boldly declare that they are “direct selling companies,” since they are members of the DSA.

The DSA now divides its membership into “single level” and “multi-level” pay plans. **MLM is no more legitimate direct selling than pigs are horses, no matter how much money is spent positioning pigs as horses!**

The Direct Selling Association, has in recent years lobbied aggressively on behalf of the MLM industry to stop or water down proposed or existing legislation that protects consumers against what I call “product-based pyramid schemes”; i.e., MLMS. They also work to defeat efforts of consumer advocates to warn against product-based pyramid schemes, and to convince the public and the media of the legitimacy of MLM and of their stated intent to protect the public from unethical practices.

In 2006, the FTC proposed its Initial Business Opportunity Rule, which would require sellers of business opportunities to disclose certain information to protect consumers. The excerpt below is taken from comments the DSA submitted, objecting to including MLMS in the Rule. The DSA’s efforts to equate MLM with legitimate direct selling and to justify its exclusion from the Rule are spelled out, as is their definition of MLM:

**The DSA defines direct selling as:** The sale of a consumer product or service, in a face-to-face manner, away from a fixed retail location. **. . . Multilevel marketing, also known as network marketing, is a compensation structure, not a sales strategy. In a multilevel compensation plan, independent consultants are compensated based not only on one’s own product sales, but on the product sales of one’s downline (those individuals the direct sales-person has recruited, or recruits of recruits.)**

In contrast, in a single level compensation plan, independent consultants are compensated based solely on one’s own product sales. Companies using a multilevel compensation structure may use either a person-to-

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31 See the section “The DSA/MLM lobby” in Chapter 10
person or party plan sales strategy. Eighty-four percent of direct selling firms use some form of multilevel compensation, and virtually all new companies entering direct selling are using some form of multilevel compensation. 32

It should be noted that the DSA definition of direct selling as “the sale of a consumer product or service, in a face-to-face manner, away from a fixed retail location” could apply to MLMs that do much direct selling. But what the DSA definition fails to do is to state what legitimate direct selling is not; i.e., unlimited recruitment of endless chains of participants as primary customers.

Another statement in the DSA comments is remarkable: “Recruiting is the lifeblood of the industry.” This is a startling admission of the focus on recruitment, which is true of all product-based pyramid schemes. My analysis of the compensation plans of over 600 MLMs, including DSA firms, confirms this. Slight rewards for retailing, together with overpriced products, make the effort to sell products to non-participants a comparative waste of time. Recruiting must be the focus for anyone seeking to profit from MLM.

The suggestion that “the vast majority of salespeople work only a few hours per week, with modest financial goals in mind” will be found in subsequent chapters to be totally misleading because one cannot build and maintain a large downline working part-time, seasonally, or with modest financial goals. And without a large downline, it is very unlikely that an MLM participant will profit. (See Chapter 7.) Virtually all who work part-time in MLM lose money, after subtracting all expenses, including purchase of products necessary to qualify for commissions.

And again, as with the Wikipedia definition, no mention is made of the inherent flaws in any MLM system – endless chains of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants themselves. These critical features will be explained later in this chapter.

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**Needed: A more accurate, research-based definition of MLM that addresses structural flaws in the model – and harm to participants**

This book uses the terms “Recruitment-driven MLM” (implying an emphasis of recruitment over selling) and “Product-based Pyramid Scheme” as interchangeable terms. And as discussed previously, these programs have also been called “Multi-level Marketing,” “Network Marketing,” even “direct selling” – though little selling to the public may take place.

More negative sounding titles include “pyramid selling,” “entrepreneurial chains,” “chain selling,” “multi-level selling,” etc. In this book, a “recruitment-driven MLM” uses a compensation plan that rewards recruiting so much more than selling that there is little incentive to sell products. “MLM” is a generic acronym for any type of multi-level or endless chain selling program, so for brevity, we will use ‘MLM’ most of the time.

No-product pyramid schemes are fairly easy to identify, and they seldom last long without law enforcement shutting them down. But when products are offered, and when consumers are presented with an income “opportunity” with multiple levels of “distributors,” it is not easy for some to decide whether or not it is in fact an exploitive pyramid scheme. Unfortunately, some of the most damaging programs manage to escape legal action.

After processing extensive data and posting analytical reports on a web site, I found myself interacting with the top experts in the field. I began offering research and training through the non-profit Consumer Awareness Institute that I had formed years earlier for other projects – all financed out of my own pocket.

**FTC rationale for considering pyramid schemes unlawful.** The Federal Trade Commission Act states that “Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are

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33 For a brief history of classic, no-product pyramid schemes, and MLM, or product-based pyramid schemes, see Chapter 10.
hereby declared unlawful.”34 While the FTC Act does not specifically address pyramid schemes, such schemes have been deemed unlawful under the above clause in the Federal Trade Commission Act.35

As will be demonstrated in subsequent chapters, using the same rationale, MLM should likewise be declared unlawful, as it is even more unfair and deceptive – and more viral and predatory – than are classic, no-product pyramid schemes. The harm is many times that for a no-product scheme.

For example, in a 1-2-4-8 no-product pyramid scheme, 14 persons lose their investment which goes to one person at the top. But in a typical MLM, or product-based pyramid, a handful of participants profit at the expense of thousands beneath them who lose money after paying for products, sales “tools,” and other business expenses. The average loss rate for MLMs is approximately 99.7%.

In fact, it can be demonstrated that the chances of profiting from a classic no-product pyramid scheme is 50-100 times as great as the odds of profiting from a typical MLM, or product-based pyramid scheme.36 And over 100 typical misrepresentations have been identified that are used in MLM recruitment campaigns.37

MLMs are recruitment-driven. I refer to MLMs which recruit aggressively as “recruitment-driven MLMs,” as opposed to hypothetical “retail-focused MLMs,” which would allow a person to earn significant profits from retailing products to end users. Understanding the difference is the key to identifying the features in MLM that cause harm to participants – which will be explained in later chapters. Actually, retail MLMs would be extremely rare. In fact, I found no retail-focused MLM compensation plans out of hundreds that I have reviewed. So I feel justified in concluding they do not exist. Such a retail focus would contradict the basic nature of MLM as a business model.

Party plans do some retailing. The closest to a retail-focused MLM would be an “in-home demonstration” program, or “party plan,” which features sales at parties sponsored by demonstrators. But determining whether or not the party plan is still recruitment-driven and financed primarily through purchases by participants would require analysis of their compensation plans and average earnings data, which most such companies have not as yet been willing to provide to the general public. So they remain in somewhat of a grey area in my research.

Confusing comparisons. MLM is often compared to legitimate alternative business models, such as franchising, direct sales, insurance, and product distributorships. This adds confusion in the minds of consumers and law enforcement officials. However, my research suggests that clear differences can be seen.

As explained above, one common strategy for MLM companies to build credibility is to go to great lengths to be

35 In re Koscot Interplanetary, Inc., 86 F.T.C. 1106 (1975)
36 See Chapter 7.
37 See Chapter 8: “MLM – a Litany of Misrepresentations.”
identified as “direct sales” organizations. However, after rigorous comparisons of legitimate business models with compensation plans of “recruitment-driven MLMs”, when the four characteristics described below are taken together, clear distinctions between legitimate and illegitimate (using the FTC standard of “unfair and deceptive practices”) can be seen.

Interestingly, the four characteristics, which when taken together differentiate these programs from legitimate businesses, are the same features that cause an extremely high loss rate and other problems for participants. I call them “causal and defining characteristics of product-based pyramid schemes” because they both cause the harm and also serve to define MLMs as product-based pyramid selling schemes, or recruitment-driven MLMs. Properly applied, they can also be highly effective in identifying programs that violate federal and state laws against pyramid schemes.

Inadequate legal definitions. Most of the laws and statutes were crafted before the structure, dynamics, and effects of product-based pyramid schemes were fully understood, so the definitions within anti-pyramid statutes do not accurately reflect the root causes of the problems. They tend to focus on behavior of participants, rather than on underlying structural features.

However, there is enough validity in the present legal definitions of pyramid schemes in most jurisdictions that enforcement against such schemes can be effective if the principles in this paper are understood and applied. This is true regardless of the complexity of the compensation plan of any given MLM.

FTC guidelines and most state statutes include a key element in defining pyramid schemes – the payment of money by the company in return for the right to recruit other participants into the scheme. If the primary emphasis is compensation from recruiting, rather than from the sale of products to end users, it is considered a pyramid scheme. How such primary emphasis is to be determined has until now been a formidable challenge for investigators.

For some of the relevant terms used in discussions about MLM, go to Appendix 2A.

Persons investigating MLM must understand compensation plans and why they are so important. Decades ago, psychologists experimenting with both animals and people learned that you get the behavior you reward. For example, if you place a dog in a room with two bowls, the first containing a pound of beef, and the second an ounce of dry dog food, invariably the dog will choose to eat from the first bowl.

You get the behavior you reward.

Similarly, since an MLM compensation plan specifies how participants are rewarded, it reveals whether the primary income emphasis is on recruiting or on retailing – and therefore, whether or not a given MLM is a disguised pyramid scheme.

MLM spokesmen maneuver to divert authorities from examining how participants are rewarded. They speak of the validity of a company’s products, the integrity of its leaders, and the company’s solid financial condition. It seems that the one thing MLM leaders do not want regulators to understand – the compensation plan – is the one thing investigators must grasp in order to answer the question of where the emphasis is – on company payout resulting primarily from recruiting (usually from commissions for product sales to downline recruits), or primarily from retailing to consumers outside of the MLM’s network of participants. To dramatize the importance of concentrating on the compensation plan, rather than people or products, read and enjoy “The Parable of the Missing Children” in Appendix 9A (Chapter 9).

The problem of evaluating MLM programs is further complicated by a wide array of complex MLM payout formulas, or compensation plans. The problem of identifying emphasis on recruiting vs. retailing in a compensation plan, as well as consumer harm, can be greatly simplified by understanding the four characteristics discussed below – commonalities which are
generic to all MLMs, or product-based pyramid schemes. (There is also a fifth characteristic that appears in almost all MLMs which amplifies the fourth characteristic.) For explanations of various types of MLM compensation plans, go to Appendix 2B.

It is vital that we understand the commonalities and distinguishing features that separate MLM from all other forms of business activity.

MLM compensation plans can get quite complex. Appendix 2C illustrates just two examples out of hundreds of MLM compensation plans, showing the complexity of only a portion of a typical MLM compensation plan. Many of the plans are far more extensive and complex than these. This makes it difficult to compare plans from different MLMs. These widely varying plans also illustrate the need for an understanding of the commonalities and distinguishing features that separate MLM from all other forms of business activity.

What is the difference between recruitment-driven MLMs and (hypothetical) retail-focused MLMs? Companies with all four of the following characteristics of a product-based pyramid scheme can be classified as recruitment-driven MLMs, as differentiated from hypothetical retail-focused MLMs, which would primarily reward those who sell products. In reality, MLMs (with the possible exception of some party plans) are essentially closed systems, which sell products at retail primarily to program participants and cooperating family members – seldom to the general public.

These product purchases could be considered disguised or laundered investments in a product-based pyramid scheme. TOPPs (top-of-the-pyramid promoters), founders, and company executives are rewarded in commissions for the sale of products to a revolving door of unwitting downline recruits.

How these defining characteristics were derived. Early in my research, after comparative analysis, I was able to identify a list of characteristics that are common to all MLMs, including the 600 MLMs I have since analyzed. These were compared to characteristics of no-product pyramid schemes, as well as to legitimate businesses to which MLM is often compared, such as direct sales, franchises, distributorships, etc. (See Appendix 2D for details of this analysis.)

From this comparative analysis, a trained eye can see that when one focuses on the causes of the problems with MLMs, which are compensation plans with perverse reward features (enriching a few at the top at the expense of a huge downline who lose money), certain characteristics, or “red flags,” become apparent. Four key characteristics are both causative (causing high loss rates) and defining (clearly distinguishing pyramid schemes from legitimate businesses). I’ll refer to these causative and defining characteristics as “CDCs.”

The four characteristics (CDCs) of recruitment-driven MLMs are causal, defining, and legally significant. The set of four characteristics below were found to be exclusive to recruitment-driven MLMs (which included all MLMs in my sample of 600 programs). Based on careful analysis of available data, MLM programs with all of these characteristics have a shocking loss rate – approximately 99.7% of ALL participants lose money (after subtracting ALL expenses)! And if you eliminate TOPPs (top-of-the-pyramid promoters) from the calculation, the loss rate is closer to 99.9%. This is not a legitimate business by any reasonable measure.

In the light of these odds, typical promises made by MLM promoters of lucrative incomes are misleading, except for a few at the top of the pyramid who got in early.

Again, it is important to recognize that –

- These four characteristics are causal because they identify the cause of the harm or consumer losses.
- They are defining because they clearly separate MLMs, or product-based

38 See Chapter 7: “MLMs Abysmal Numbers”
pyramid schemes, from all other forms of commercial activity.

- And they are *legally significant* because they answer the question that law enforcement has not answered in cases before; i.e., how the *primary emphasis on income from recruiting* (as opposed to selling direct to consumers at retail prices) can be determined from the reward system (compensation plan) – rather than from complaints, which simply are too cumbersome and unreliable in this arena. Besides, as will be discussed in Chapter 9, victims of endless chains rarely file complaints with law enforcement.

It is the synergistic effects of these four CDCs working together in an MLM that cause the extraordinary loss rates characteristic of these schemes. Interestingly, *most of the laws that might implicate MLMs as pyramid schemes are based on one or more behavioral effects of the scheme (such as whether or not sales are made to non-participants) or behavior of participants, and not the essential causes of the problems; i.e., the underlying structure, or compensation plan. As explained already, rewards drive behavior.*

No wonder law enforcement has been so confused and inconsistent in this arena. Even so, using this analysis, law enforcement agencies can work within existing laws. Attempting to change the laws is risky, since the MLM lobby (Direct Selling Association) could then influence legislators to pass deceptive “anti-pyramid” laws that are actually favorable to MLM, as they have already done in several states.

Twenty years of research and feedback confirm this analysis, including a one-year experiential test, direct observations of numerous MLM opportunity meetings; communications with thousands of participants (and ex-participants and family members), executives from a variety of MLMs, and with consumers as MLM prospects; consultations with top MLM experts and attorneys; the collection and processing of available data (including official company reports); analysis of over 600 MLMs with all types of compensation plans; and surveys of consumers and tax professionals.

Four CDCs of recruitment-driven MLMs, or product-based pyramid schemes, cause the harm and clearly distinguish between MLM and legitimate direct selling and all other businesses:

1. Each person recruited is empowered and incentivized to recruit other participants, who are likewise empowered and motivated to recruit still other participants, etc. – in endless chains of empowered and motivated recruiters recruiting recruiters – without regard to market saturation.

   *When analyzing a program, prospects could ask: Is unlimited recruiting allowed, and are those who are recruited empowered and spurred on by incentives (such as overrides from downline purchases, rank advancement, etc.) to recruit additional participants, etc. – so that the effect is unlimited recruiting of empowered and motivated recruiters in an endless chain of recruitment?*

   This unlimited recruitment of endless chains of participants is the great underlying flaw in MLM. In fact, all pyramid schemes, chain letters, and MLMs have this unlimited recruitment characteristic in common. They also assume virgin markets, which don’t exist for long – which means they either collapse or expand (“re-pyramid”[39]) into new markets.

   Since MLM depends on unlimited recruitment of endless chains of participants, it is fundamentally flawed, unfair, and deceptive. It is deceptive because prospects are sold on an income opportunity that is primarily an opportunity for those placed at the beginning of the endless chains of recruitment – usually those at or near the top of the pyramid of participants. New recruits are being sold a ticket to a flight that has already left the ground.

   For important background information on the endless chain feature of MLMs, read the letters to FTC officials by Bruce Craig, former assistant to the Wisconsin Attorney General in Appendixes 2E and 2F.

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[39] “Re-pyramid” will be explained in Chapter 3.
CDC* (“Red Flag”) #1: Every MLM incentivizes unlimited recruitment of a network of endless chains of participants. This dependence on recruitment is not the case with legitimate direct selling, which focuses on sales to customers, not to the network of participants.

*NOTE: These CDCs (or “red flags”) are causative and defining characteristics of recruitment-driven MLMs, or product-based pyramid schemes. They are causative in that – taken together – they cause the extremely high loss rates suffered by participants, and they are defining in that they clearly define product-based pyramid schemes as differentiated from legitimate direct selling and other packaged business opportunities. All 600 MLMs I studied demonstrated this characteristic in their compensation plans.
MLM is also viral and predatory – rapidly expanding chains of recruitment from state to state and from country to country as it targets and defrauds the most vulnerable in the population. But it is sufficiently deceptive that even some people who should know better are victimized.

These features should have been sufficient grounds for the FTC to consider MLMs as unfair and deceptive practices, and therefore illegal. However, that opportunity was missed in the 1979 ruling that Amway was not a pyramid scheme, assuming certain “retail rules” were followed.

It is interesting to note that in the earlier Koscot case, the court noted, “The Commission has previously condemned so-called “entrepreneurial chains” as possessing an intolerable capacity to mislead.” This capacity has been demonstrated in literally thousands of MLMs (many now defunct) fashioned after the model of entrepreneurial chains which the FTC has allowed following the 1979 Amway decision. Unfortunately, this prophetic warning of an “intolerable capacity to mislead” was set aside, and the deceptions continued unabated. (See Chapter 8 for lists of at least 111 typical MLM misrepresentations.)

MLM promoters often argue that all organizations are organized as pyramids, with a few at the top and many at the bottom and with those at the top being paid the most. If this were the only distinguishing characteristic of a pyramid scheme, they would be right. But the endless chains of recruitment of participants as primary customers – with money to those at the top coming from purchases (amounting to losses) of those at the bottom – is far more accurate and discriminating.

So the stacking of recruits into a pyramid of participants for the purposes of payout is secondary to the chaining aspects. However, it should be noted that in corporations and government organizations, even those at the very bottom at least earn a minimum wage – as opposed to all those on the bottom of a pyramid scheme actually losing money. A more apt analogy for MLM as an income opportunity would be that of an iceberg, instead of a pyramid. Those few who profit from MLM stick out like an iceberg, with the vast majority under water, or in a losing position, after subtracting expenses.

Had all forms of endless chain marketing schemes been declared illegal (as happened in Wisconsin in 1970, but seldom enforced since), this confusion over definitions would be minimal. Based on DSA data on worldwide sales by MLMs (which represent losses to 99% of participants) I estimate that since 1979, aggregate losses totaling hundreds of billions of dollars by hundreds of millions of unwitting victims worldwide could have been prevented. MLM in its present form would not have existed, and you would not be reading this.

The ill-fated Amway decision – and the “retail rules.” In 1979, FTC attorneys were outfitted and outgunned by Amway attorneys. FTC Administrative Law Judge James Timony ruled that Amway was “not a pyramid scheme,” assuming the implementation of its “retail rules” that Amway claimed it would voluntarily enforce. These rules can be summarized as follows: (1) distributors were to sell or consume 70% of the products they purchased each month (refined in later court cases to mean sales to non-participants), (2) they must be able to prove a sale to each of ten customers each month, and (3) reasonable buy-back provisions would be permitted. Though not enforced by the FTC or by the MLMs, these retail rules have been used as a benchmark in other MLM cases.

The rules were merely given lip service. In practice, the first two of these rules are unenforceable (in the present regulatory environment) and are generally ignored by MLMs. The Amway decision opened the floodgates for thousands of the most unfair, deceptive, viral, and predatory MLMs ever devised. Tens of millions of consumers

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40 In re Koscot Interplanetary Inc., 86 F.T.C. 1106, 1181 (1975), aff’d, Turner F.T.C., 580 F. 2d 701 (D.C. Cir. 1978)
42 Tax Returns of the Top Amway Direct Distributors in Wisconsin, Bruce Craig, op cit
43 Webster v. Omnitrion, IIB, filed in the Appeals court for the U.S. District Court for the Northern District of California, March 4, 1996. Also statements by FTC officials James Kohm and Debra Valentine – referred to later in this report.
44 See 93 F.T.C. 618, 716-17 (1979).
recruited into MLMs worldwide will continue to pay heavy prices for that decision – unless FTC and/or state legislators and law enforcement officials muster the will to address the issue of widespread MLM abuse.

In spite of the confusion over definitions of what constitutes a pyramid scheme, much can still be accomplished within the present legal framework. This chapter focuses on clarifying those definitions and on identifying the combination of features in the compensation plan that cause the greatest harm.

**Market collapse happens quickly.** MLM defenders argue that saturation never happens, which proves an MLM is not a pyramid scheme. But total saturation is absurd. Why would McDonald’s need 100,000 fast food outlets in a city of 100,000 people? One or two may be adequate. So with MLM. *Market saturation* may be reached when a city has only five or ten distributors, with new ones finding it more and more difficult to recruit more participants.

**Re-pyramiding to avoid market saturation and collapse.** When pyramid promoters introduced product purchases as the means for financing their schemes (then dubbed “multi-level marketing”), some found ways to avoid ultimate collapse. First, MLM recruiters used a hard-sell approach to focus attention on the quality of the products, and away from endless chain recruiting.

As a second strategy, major MLMs introduce new product lines or divisions, enter new demographic markets or countries, or change the name of the company and introduce the package as a whole new company with a “different” product or service emphasis – as Amway did when it morphed into “Quixtar” in the U.S., while keeping the “Amway” name in overseas markets. Nu Skin shifted it’s recruiting to Asia to the point that 85% of its revenues came from Asia. And Nu Skin developed new product divisions, such as Interior Design Nutritional (IDN), Big Planet (internet services), and Pharmanex, and Photo-Max – through which it could cycle new recruits. *This is a process* I call “re-pyramiding;” i.e., opening new markets in other countries and/or by starting new product divisions and repeating the cycle all over again.

Third, MLMs engage in aggressive and unlimited recruitment campaigns and use the DSA to influence public opinion to accept and define their recruitment schemes as legitimate direct selling opportunities.

And fourth, there is a revolving door of newly recruited participants who are constantly replacing those who quit. Thus, in MLM there is a continuous collapse of the base of the pyramid, involving the churning of newly recruited participants. This allows those at or near the top of the pyramid to maintain their positions and their high income levels.

It is through actions like this, indicative of continuous collapse, that MLMs, or product-based pyramid schemes, can survive longer without total collapse than no-product pyramid schemes. Losses from the continuous collapse of the pyramid are borne by the new recruits cycling through. Furthermore, because of the prolonged saturation and collapse, many more participants are adversely affected in product-based schemes than in no-product schemes.

Strategies used by MLMs to compensate for market saturation and to avoid market collapse will be discussed further in Chapter 3.

**Are participants buyers or sellers?** Unlimited recruiting in MLMs also changes the marketing nature of the system from one of a network of “distributors” to a network of buyers. The normal distinction between buyers and sellers is blurred – even evaporated. The sellers are the buyers, and the buyers are the sellers – to themselves and their families. Also, we see the fallacy of the claim that MLM is removing the “middle man” in their marketing. Actually, in an MLM, middlemen may number in the thousands in multiplying downlines.

New MLM recruits buy products mainly to qualify for profits from recruiting others, rather than from any real need for the products or from any expectation of profit from retailing. And as people tire of being solicited, the perceived opportunity to find willing buyers eventually diminishes to a trickle. Since the retail market is a phantom one, in order to increase the base of recruiting prospects who will pay retail to “play the game,” we see promoters introducing new product divisions or opening up new markets to recruit in other areas.
Recruitment-driven MLMs engage in re-pyramiding to continue growing—and can become like Ponzi schemes. When MLM promoters re-pyramid into other areas to make it possible for the first investing participants to earn commissions from purchases of new recruits, the MLM can be said to have evolved from a pyramid scheme into a type of Ponzi scheme—which is illegal in almost all jurisdictions. Ponzi schemes are programs in which new investors are repaid, from the investments of new investors.\(^\text{45}\) (The persons doing the selling remain the same.) In MLM, without re-pyramiding, into new markets, collapse is inevitable as market saturation makes future prospects resistant to participation.

MLM proponents argue that replacement of continual dropouts by ongoing recruitment is like other direct sales businesses. But this is a fallacy. Later recruits never have the same opportunity as earlier entrants due to market saturation.

Why is recruiting emphasized over retailing? Unlimited recruiting of recruiters, combined with the other factors explained here, creates enormous leverage. Rewards for recruiting a large downline are so much greater than for retailing products that participants see no point in spending time and effort retailing, except for token sales (often purchases in the names of relatives who become “counterfeit customers”) to satisfy “retail rules.” Again, “you get the behavior you reward.” The “primary emphasis on income from recruiting” test of a pyramid scheme is thus satisfied.

The following items summarize the evidence that recruitment-driven MLMs do not engender any significant retail market:

1. The compensation plan rewards the recruitment of a downline so well that there is little incentive to sell directly to consumers.

2. An analyst can subtract all incentivized purchases by new distributors and their families from total revenues from that area on the company’s financial report. If the volume left over is minimal, direct selling is not the major thrust of the company.

3. Surveys of ex-distributors reveal that few continue buying the products after quitting. They recall that little if any direct selling occurred outside of the network of distributors and their own families. (Surveys of ex-distributors are more valid than those of current distributors, who may have contracted to do a limited amount of selling to non-participants to keep their distributor license.)

4. We know from surveys conducted in areas of intense MLM activity that few sales are made directly to consumers who are not in the network of participants.\(^\text{46}\)

5. Little if any direct selling continues in an area two or three years after an MLM finishes its recruitment blitz through the area.

6. To counter dwindling sales due to a drop-off in recruiting, the MLM engages in re-pyramiding; i.e., recruiting in other areas or shifting to new product divisions. MLM promoters can then sell to new recruits.

6. Signs of reporting inconsistencies can reveal a lack of direct sales. In the case of Nu Skin, sharp discrepancies appeared between U.S. revenues reported to the SEC and those reported to the FTC and to recruits in the amount of sales that were occurring at retail prices. This was blatant evidence of misrepresentation.\(^\text{47}\)

7. In my test of Nu Skin’s program, I saw over 400 Nu Skin distributors over a one-year period, but I can recall only one who made a serious effort to sell very many of Nu Skin’s expensive supplements directly to non-distributors. She sold to rich neighbors who were sympathetic to her desire to “succeed.”

For an excellent analysis of the problems resulting from the FTC’s allowing endless chain recruitment schemes (MLMs) to continue, read the letters written by Bruce Craig, former Wisconsin Assistant AG, to FTC Chairman Robert Pitofski\(^\text{48}\) in Appendix 2F and to FTC economist Dr. Peter J. Vander Nat\(^\text{49}\) in Appendix 2G.


\(^{46}\) “Survey of Tax Preparers”, by Jon M. Taylor, (posted in 2004 on website for mlm-thetruth.com)

\(^{47}\) *REPORT OF VIOLATIONS of the FTC Order for Nu Skin to Stop Misrepresenting Earnings of Distributors*, by Jon M. Taylor, filed with the FTC November 20, 2002 Since that time, Nu Skin has not reported retail sales that they could not prove had occurred.

\(^{48}\) Dated February 20, 2000

\(^{49}\) Dated April 24, 2001
CDC* ("Red Flag") #2: Advancement in a hierarchy of multiple levels of participants ("distributors," "associates," etc.) is achieved by recruitment and/or by purchase amounts, rather than by appointment.

*NOTE: These CDCs (or "red flags") are causative and defining characteristics of recruitment-driven MLMs, or product-based pyramid schemes. They are causative in that – taken together – they cause the extremely high loss rates suffered by participants, and they are defining in that they clearly define product-based pyramid schemes as differentiated from legitimate direct selling and other packaged business opportunities. All 600 MLMs I studied demonstrated this characteristic in their compensation plans.
2. Advancement in a hierarchy of multiple levels of participants is achieved by recruitment and/or by purchases, rather than by appointment.

Ask: Does a participating “distributor” advance one’s position or rank (and potential income) in a hierarchy of multiple levels of participants by recruiting other “distributors” under him/her, who in turn advance by recruiting distributors under them, etc.? Or by buying products to qualify at certain levels in the compensation plan?

Rank advancement in the pyramid is determined not by appointment, but by time of entrance into the program, by recruiting success, and by volume of products purchased by one’s group. When recruited into such a program and then given incentives to buy products, participants are being “leveraged” for the profit of those above them. They may think they are advancing, when in fact they are often being manipulated into buying more products and recruiting more people to benefit those above them.

Are MLM “distributors” really distributors? When the pay plan rewards recruits far more for recruiting others than for selling products or services, and when purchases are “incentivized,” or tied more to advancement in the scheme than to the sale of products and services to non-participants, it is a misnomer to refer to them as “distributors.” (or “representatives,” “associates,” etc.) It is more correct to refer to them as “investing participants.”

Correctly viewed, an accumulation of such incentivized purchases over a period of time constitutes a substantial investment in a pyramid scheme. (See #3 below)

Participants are typically not wise business managers so the customary subtraction of all costs from revenues to figure profits is ignored – including products and services from the company. Such purchases would be made from less expensive sources if serious comparison shopping were done.

Close examination reveals that both advancement and income are dependent primarily on downline recruiting and on “internal consumption” (sales to participants in the scheme). If participants must recruit and buy products to be successful, and if the pay plan’s primary rewards are for building a downline, it should be considered an illegal pyramid scheme.

**Exception – Selected distributors given priority.** Often during the startup of a new MLM, or when an MLM enters a new country, selected distributors, or TOPPs (top-of-the-pyramid promoters), are assigned top positions arbitrarily by the founders. Nepotism sometimes appears, such as when favored positions are extended to family members of the founders. This is unfair to those who come in later, who must aggressively recruit and buy products to have any hope of advancing to the top where the money is made.

3. “Pay to play” requirements are met by ongoing “incentivized purchases” and/or recruitment minimums, with participants the primary buyers.

Ask: Are “distributors” who are recruited presented with significant “pay to play” options; i.e., are they encouraged to make initial or ongoing investments in “incentivized purchases” and/or to satisfy recruitment minimums, in order to take advantage of the “business opportunity,” and to continue qualifying for advancement in – or overrides and bonuses from – the MLM company?

What are “incentivized purchases?” – or “pay-to-play” purchases – or “pay for your paycheck”? I coined the term “incentivized purchases” to refer to the practice of tying purchases of products from an MLM company with requirements to enter the “business opportunity” option, to qualify for commissions, and to qualify for rank advancement in the hierarchy of “distributors” – who are in effect merely participants making pyramid scheme investments disguised (or laundered) as purchases. They are also called “pay to play” purchases. (See Appendix 2A for definitions of relevant terms.)

Incidentally, William Ackman in his attack on Herbalife used very descriptive term for this feature – “pay for your paycheck.”

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This insight resulted from discussions with Kristine Lanning, former assistant to the Attorney General for North Carolina.
Exhibit 2c

CDC* ("Red Flag") #3: "Pay to play" requirements are met by ongoing "incentivized purchases," with participants the primary buyers.

*NOTE: These CDCs (or "red flags") are causative and defining characteristics of recruitment-driven MLMs, or product-based pyramid schemes. They are causative in that – taken together – they cause the extremely high loss rates suffered by participants, and they are defining in that they clearly define product-based pyramid schemes as differentiated from legitimate direct selling and other packaged business opportunities. All 600 MLMs I studied demonstrated this characteristic in their compensation plans.
Percentage of revenues accounted for by internal consumption – a key legal issue. In pyramid scheme cases, the percentage of purchases accounted for by participants’ personal consumption – as opposed to sales to non-participants – has become a litmus test for determining if an MLM is an illegal pyramid scheme. MLM executives may attempt to excuse lack of evidence of retail sales by pointing to company rules that require sales to non-participants as proof of such sales. However, the existence of “rules” aimed at encouraging retail sales and discouraging inventory loading will not protect a company from being an illegal pyramid scheme if not properly incentivized and adequately enforced.51

Investing in the form of incentivized and ongoing product purchases could be considered a device for disguising or laundering pyramid scheme investments.

How much is actually invested in the scheme? MLMs typically charge a nominal fee for initial registration to be licensed as a distributor. This is usually less than $100 to avoid raising the eyebrows of law enforcement officials – and to escape subjecting the MLM program to more strict guidelines as a franchise, security, or “business opportunity.”

However, in the typical scenario, the fee for initial registration is merely the beginning of the total MLM investment. One must add incentivized ongoing purchases, which may total hundreds, or even thousands of dollars a year.52 They constitute a substantial portion of the cost of participating in the “business opportunity.” Whether they are used, sold, given away, or stored, is irrelevant to the analysis.

Escalating incentives to continue purchasing products to qualify for higher commissions rates and/or ever-higher levels in the hierarchy of participants often lead “distributors” to hyper-consume products or to give away a lot of samples. Many fill their garages with products they don’t need. The argument that they would have purchased the products anyway, and that these purchases should not be considered an expense of doing business, does not hold water. Upon quitting, most cancel product subscriptions.

So when participants subtracted purchases and the operating costs of recruiting from commissions, they would find a high breakeven bar rarely exceeded by revenues. In other words, almost all participants below the TOPPs lose money.

Why are incentivized MLM product purchases not widely recognized as investments in a pyramid scheme? Most MLMs offer lucrative incentives for recruiting an increasing number of “distributors” (or other term for participants) and for revenues from product sales. So many participants recruit “dummy distributors” from friends and relatives and buy products in their names – or simply buy products for them as “counterfeit customers.” They believe this will qualify them for “the really big bucks.” Few realize that they have in effect paid a very large fee for participation in a pyramid scheme. Through a variety of misrepresentations about the “opportunity,” large sums of money may thus be extorted from them.

52 The minimum 100 PV (personal volume) for Quixtar (Amway) participants was “roughly equal to $260/mo.” ($3,120 per year) . . . and “because Quixtar’s overpriced products are not sellable to anyone except through distributors who are buying to qualify for bonuses, Quixtar distributors’ earnings are a direct function of how much product they and their downline consume. The more internal consumption and the larger the downline, the higher the bonus.” (Complaint and demand for jury trial, US Dist. Ct., Central District of Calif., Western Div., Case No. CV 07-05194), § 97
53 In FTC v. Amway (1979 – 142-145), Webster v. Omnitrition (Discussion on “Pyramid”), and FTC v. Skybiz (29)
Such an amount paid at the start into a no-product pyramid scheme would immediately arouse suspicions of its’ being an illegal pyramid scheme. But since the money paid into an MLM is paid for legitimate products and over a period of time, most participants and investigators fail to see it as an investment in a pyramid scheme. In reality, this means of investing in the form of incentivized and ongoing product purchases could be considered a device for disguising or laundering pyramid scheme investments.

MLMs typically sell overpriced potions and lotions touted to prevent or cure a wide range of maladies. This could be compared to a bushel of apples selling for $20 a bushel. The seller paints blue stripes on them and sells them for $80 – $60 more because of the “magical properties” attributed to the blue stripes – the old “snake oil” pitch.

Many MLM products are sold at a premium so that commissions can be paid to many levels of distributors. If an MLM product were sold for $20 more than a comparable one sold through other outlets, this $20 premium could be considered the pyramid investment portion of the price, which would flow to the top of the hierarchy of participants in typical pyramid fashion.

Do MLM participants sell products at listed retail prices to non-participants? MLM promoters have convinced many regulators that MLM distributors sell a significant amount of products to persons not participating in the scheme. In most MLMs, this is patently false. We know from surveys conducted in areas where intense MLM activity is occurring that few sales are made directly to consumers who are not connected to the recruitment scheme. As discussed earlier, in a randomized survey of households in Utah County, Utah, where many MLMs are located, we found four MLM distributors for every one non-participating customer.

It is generally motivated participants who are induced into paying for overpriced “pills, potions, and lotions” typically sold by MLMs.

We know from surveys that few sales are made directly to consumers who are not connected to the recruitment scheme. It is generally motivated participants who are induced into paying for overpriced “pills, potions, and lotions” typically sold by MLMs.

A startling admission. We usually see a “wink-wink, nod-nod” attitude of MLM promoters on how they get participants to purchase most of the products from the company. “Pay-to-play” or incentivized purchases play a bigger role than most are willing to admit. But occasionally the truth leaks out. Consider this quote from Advocare’s “Policy and Procedures” manual regarding its compensation plan:

You may choose any method you like to achieve Advisor status. These examples point out the practical reasons you always want to track your volume if you think you’re close to qualifying Advisor status – and if necessary, cover the $500 Personal Volume with your own purchases.

“... if necessary, cover the $500 Personal Volume with your own purchases.”
– Advocare P&P manual

MLM not recognized as legitimate selling. Additional evidence that little actual direct selling takes place in MLM can be found on the business shelves of any bookstore. I searched the contents of books on salesmanship of major bookstores and found no mention of MLM or multi-level or network marketing as an arena for professional salespersons. The only exceptions were when networking (not MLM) was discussed, and only when a professional sales person mentioned a bad experience with MLM on his way to becoming a real

54 Randomized survey conducted in Utah County, Utah, by Consumer Awareness Institute, 2004

salesperson\textsuperscript{56}. And even in the books that Zig Ziglar (who has written on MLM\textsuperscript{57}) has written on salesmanship, he is careful not to include MLM as a form of selling. Apparently, MLM is only respectable to those doing it.

When as a young man I sold encyclopedias to help pay my way through college, it was not a requirement that I buy a set for myself or to meet a certain quota in order to qualify for commissions. And later, as an insurance agent, I was not required to buy the insurance I was selling. This would not be true in an MLM, which depends for much of its revenues on minimum purchases by participants who buy to qualify for commissions and/or rank advancement.

For a list of criteria to distinguish between MLM and legitimate direct selling, see Exhibit 21: “Does Multi-level Marketing* Qualify as a Form of Direct Selling? – a 7-Point Checklist.”

How recruitment-driven MLMs kill their own retail market. In many MLMs, purchases at inflated retail prices are primarily made by new recruits as a form of entry fee – after which they pay wholesale for products. Recruiters at MLM opportunity meetings often kill their own retail market. Why would anyone pay full retail price when there are plenty of “distributors” who would gladly sell at wholesale prices to meet their “pay to play” quota of purchases?

Most ex-distributors of MLMs I have interviewed have said they cancelled automatic bank draft payments for monthly product shipments or sharply reduced purchases from the company following their quitting an MLM. This supports the conclusion that the retail market for the products is more contrived than real. “Pay to play” purchases usually cease upon termination.

What about the refund policy of MLMs? Many MLMs have a 30-day or one-year return policy, allowing for a refund for unused and unopened merchandise, minus a small re-stocking fee. While this sounds acceptable to recruits and regulators, hundreds of interviews with ex-distributors lead to the conclusion that this offers little actual protection to participants. It is extremely rare for MLM victims to recognize the fraud in an MLM without intensive de-programming by a knowledgeable consumer advocate. They have been told by their upline that anyone can succeed and are conditioned to blame themselves – not the MLM program – for their “failure.” And many have opened their product packages to sample or share the contents, so they don’t “qualify” for a refund. Or they may fail to qualify on other technicalities.

“Tools for success” – or just more money down the drain.” Top distributors may sell “tools” (books, audio/video training, etc.) to aid recruits in “building their business.” Their message to participants is that if they are not succeeding in selling products or recruiting a downline, it is because they are not doing it right – not because the program itself is inherently flawed. If they want to be successful, they need the proper “tools.”

The sellers of these tools may make more money on them than on the sale of products to or through their downline. While not required “pay to play” items, some upline promoters will not provide training and other support to downline participants who do not buy the tools. So these tools become in fact a necessary cost to “play the game” – further reducing the likelihood that these hapless recruits will realize a profit.

Incentivized purchases are typical of a pyramid scheme. On the FTC web site is an article entitled “The Bottom Line about Multi-level Marketing Plans.”\textsuperscript{68} Under the heading “Evaluating a Plan,” the following advice is given: “Beware of plans that ask new distributors to purchase expensive products and marketing materials. These plans may be pyramids in disguise.”

The FTC ruling that Amway was not a pyramid scheme was conditioned on the assumption that its “retail rules” would be enforced. Yet it was disclosed in a recent California case involving Quixtar’s (Amway’s) “top guns” that only 3.4% of sales were to non-participants!\textsuperscript{59}

\textsuperscript{57} Ziglar, op cit
\textsuperscript{58} www.ftc.gov
\textsuperscript{59} Notice of Errata re exhibits E, F and G to Affidavit of Billy Florence submitted with complaint, US Dist. Ct., Central District of Calif., Western Div., Case No. CV 07-05194, § 97) p. 13
In summary, MLMs typically require significant purchases in order to participate in the financial rewards outlined in the compensation plan. While the actual enrollment fee may be small, the cost to qualify for commissions and rank advancement can be substantial. This is one of the earmarks of a pyramid scheme, as opposed to legitimate direct selling.

CAUTION: Many MLMs are now claiming they have no “pay-to-play” requirement, or that there is little or no cost to join. However, there is always a requirement for full participation that leads to more money for the company and for TOPPs. It may be a requirement for a certain number of recruits, some of whom will do the same and eventually buy products to advance in the scheme. In these cases, we could call them “play to pay” schemes, but the effect is the same.

If participants must recruit and buy products to be successful, or if the pay plan’s primary rewards are for building a downline, it should be considered an illegal pyramid scheme.

4. Company payout (in commissions & bonuses) per sale for the total of all upline participants equals or exceeds that for the person selling the product – resulting in inadequate incentive to retail and excessive incentive to recruit. This is what is meant by a “top-weighted” pay plan.

Ask: Would a “distributor” purchasing products for resale receive less in total payout (in commissions, bonuses, etc.) from the company as would the total of all upline participants? In other words, does most of the money paid to distributors go to those at the higher or lower levels in the pyramid of participants?

While the previous three features are fairly easy to identify, this one requires understanding of alternative distribution models and complex incentives in the MLM pay plan. Group bonuses and other incentives must be factored in to determine actual payout per sale. Sometimes the bonuses come in the form of larger discounts or higher commissions per sale at higher levels.

Why does this “top-weighted” feature of recruitment-driven MLMs discourage retailing of products to end-users? MLMs offer small rewards to front line “distributors” for selling products, which are usually overpriced to support the large network of participants. So to achieve significant income one must recruit a large downline from which to draw commissions from their combined purchases.

This “top weighted” characteristic, more than any other, determines whether a program is biased towards recruitment or towards retailing (direct selling to end users). It is also an important red flag signaling an illegal pyramid scheme in most jurisdictions because it shows a primary emphasis on compensation from recruitment rather than from sales to end users who are not participating in the scheme.

For a more complete discussion of why MLM compensation plans are so top-weighted, read “My explanation for the extremely unfair income distribution in MLM” in Chapter 7. Note especially Exhibits 5a&amp;b).
Why is this top-weighted feature one of the main problems with MLMs? MLM compensation plans of recruitment-driven MLMs lead to extreme inequality in company payout to participants. There are a few “winners” who profit at the expense of a multitude of “losers.” When plotted on an income distribution chart, the graph resembles a candlestick, with a handful on the left receiving huge earnings, and a multitude of participants to the right losing money.

For example, Nu Skin has published average income figures of its distributors, having been ordered by the FTC to cease its misrepresentations of distributor earnings. Based on its own report entitled “2011 Nu Skin Enterprises, Inc. Distributor Compensation Summary,” on discussions with top executives and high level ex-distributors, and on my one-year experiential test of their system, I concluded the following:

At best, one out of about 3,000 distributors profited; i.e., received more in commissions than they spent on products and minimum operating expenses. But of those few who profited, only a few netted anywhere near the average incomes that promoters at opportunity meetings stated were earned by “Blue Diamond” distributors. It is likely that less than one in 10,000 new recruits received the potential Blue Diamond incomes held out to them! All others just “didn’t try hard enough.”

Often these “losers” will invest considerable amounts of time and money and then quit, blaming themselves. But their “failure” is due not so much to their lack of effort, as to an exploitive and unfair system, which dooms approximately 99.7% of all participants (including dropouts) to losses – after subtracting “pay to play” purchases and minimal operating expenses. A 99% loss rate would not be so serious, except that in MLM opportunity meetings, the program is typically touted as the path to financial freedom, or “time freedom,” and the earnings of top distributors is posted – but with no mention of the abysmal odds of getting there.

In legitimate direct sales programs, it is typical for successful commissioned sales persons to receive more income than their sales managers. This is because the person doing the selling usually makes more in commissions per sale (often 20-40%) than managers two or three management levels above him or her. But the distribution of commissions in MLM programs is upside-down from legitimate direct selling. Upline distributors several layers removed from the actual sale may receive as much or more in commissions and bonuses per sale from the company as the person who actually sold the product. The latter may only get a sales commission of 5-15% from the company – not enough to make selling profitable, even if the products were priced competitively.

Since the total payout per sale is limited, when upline participants receive substantial income in overrides from downline purchases, this tightens any resale margin and limits the percentage of commissions to any participants selling products to actual customers. So the potential income of front line “distributors” is extremely limited, forcing him or her to recruit a large downline in order to realize a significant income from commissions on downline purchases. Powerful incentives are at work to recruit a downline of hundreds, even thousands, of participants.

This “top-weighted” characteristic is an important red flag signaling an illegal pyramid scheme in most jurisdictions because it shows a primary emphasis on compensation from recruitment rather than from sales to end users who are not participating in the scheme.

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To see how this was calculated, see Chapter 7. Again, read “My explanation for the extremely unfair income distribution in MLM” in Chapter 7, noting especially Exhibits 5a and 5b.

For examples of complex top-weighted compensation plans, see Appendix 2C. Nu Skin is one of the most top weighted of MLMs.
Exhibit 2d

CDC* ("Red Flag") #4: Company payout (in commissions & bonuses) per sale for the total of all upline participants equals or exceeds that for the person selling the product – resulting in inadequate incentive to retail and excessive incentive to recruit. This is what is meant by a “top-weighted” pay plan.

MLM’s typically top-weighted compensation plans disproportionately reward founders and TOPPs (top-of-the-pyramid promoters – at the expense of those at the bottom levels.

*NOTE: These CDCs ("red flags") are causative and defining characteristics of recruitment-driven MLMs, or product-based pyramid schemes. They are causative in that – taken together – they cause the extremely high loss rates suffered by participants, and they are defining in that they clearly define product-based pyramid schemes as differentiated from legitimate direct selling and other packaged business opportunities. All 600 MLMs I studied demonstrated this characteristic in their compensation plans.
Can't low commissions to front-line distributors be offset by retailing products at marked up retail prices? MLM promoters claim "distributors" who buy MLM products at wholesale prices can then sell them at a higher retail price, such as in conventional retail outlets, which allow for a retail profit margin. MLM communicators then go to great lengths to assure regulators that they are legitimate direct sales operations and that participants can make money buying wholesale and selling products at retail prices. They also tout the unique qualities of their products to justify the high prices they must charge to pay commissions on huge pyramids of participants.

The problem is that suggested retail prices for MLM products are generally too high to be competitive with other outlets. So MLM "distributors" purchase large quantities for themselves and their families and/or sell products at wholesale prices to downline participants and others in order to meet volume requirements for bonuses or discounts at different levels. Again, the payment of full retail listed price generally occurs with new recruits who are "buying into" the system. This is how they "pay to play" (the game).

How does this feature distinguish recruitment MLMs from (hypothetical) retail-focused MLMs? This "top weighted" characteristic is primarily what would separate recruitment-driven MLMs from "retail-focused MLMs" – if such were to exist. Retail-focused MLMs would make it possible for participants to make money from the sale of products with only a small downline of participants, or with none at all – by assigning the majority of commission payments to front-line distributors for actual sales, as is the case in legitimate direct selling or retail settings.

However, out of over 600 MLM programs I have analyzed, I did not find any that could clearly be classified as retail-focused MLMs. Possible exceptions are the party plans that emphasize income from the sale of products at in-home parties, though they may allow for recruitment of a downline. But even then, one must look at the compensation plan to see if the program is so top-weighted as to encourage recruitment and self-consumption over selling to the general public.

In summary, this "top-weighting" of MLM compensation plans is what drives TOPPs to feverishly build their downlines; i.e., to recruit a revolving door of new recruits who buy products in order to participate in the "opportunity."

5. In addition to the four CDCs above, nearly all MLMs also have a fifth CDC, making it even more top-weighted. The MLM company pays commissions and bonuses on more "distributor" levels than are functionally justified; i.e., five or more levels, which only further enriches those at the top of the pyramid.

Ask: Does the company pay overrides (commissions and bonuses) to distributors in a hierarchy of more levels than are functionally justified; i.e., five or more levels?"64

For even the largest of conventional distributor arrangements, the entire U.S. can be covered by four supervisory levels in the sales hierarchy; e.g., branch managers, district managers, regional managers, and national sales manager. More than that is superfluous and bloated, driving up prices and making sales at a competitive retail markup unrealistic and unprofitable.

Why do five or more levels signal a recruitment-driven MLM? There is seldom any functional justification for five or more levels in an MLM hierarchy of participants, other than to encourage recruiting and the illusion of very large potential incomes – which only a few enjoy.

Combined with other factors, this feature hugely enriches those participants at the top of the pyramid at the expense of those beneath them, 99% of whom lose money. Such exorbitant incomes result from the reaping of huge overrides from the combined product investments of as many as thousands of downline participants, which increase exponentially with each added level. It is a money transfer scheme – transferring money from those at the bottom to those at the top.

64 For this insight, I am indebted to Douglas M. Brooks, a Boston attorney, who has for many years worked on cases related to franchises and MLMs.
CDC* (“Red Flag”) #5: In addition to the four CDCs above, nearly all MLMs also have a fifth CDC, making it even more top-weighted. The MLM company pays commissions and bonuses on more “distributor” levels than are functionally justified; i.e., five or more levels, which only further enriches those at the top of the pyramid.

*NOTE: These CDCs (“red flags”) are causative and defining characteristics of recruitment-driven MLMs, or product-based pyramid schemes. They are causative in that – taken together – they cause the extremely high loss rates suffered by participants, and they are defining in that they clearly define product-based pyramid schemes as differentiated from legitimate direct selling and other packaged business opportunities. All 600 MLMs I studied demonstrated the prior four characteristics in their compensation plans, and most included this fifth characteristic. Those that did not make up for it by extra rewards paid to those at the top levels.
It should be noted that in the aforementioned 1979 FTC v. Amway ruling, the prosecution had argued that as the number of levels in an MLM compensation plan increased, so did the opportunity for fraud. It is interesting that in 1979, Amway had ten payout levels. By 2008, the number of levels had increased to an astonishing 22 levels! But no one at the FTC noticed this worsening of Amway’s highly leveraged compensation plan.

Generally, but not always, this characteristic of excessive payout levels is a key feature (other than products for sale) separating many recruitment-driven MLMs from classic, no-product pyramid schemes. The latter typically pay on only four or five levels before the person atop the pyramid collects and moves on to start a new pyramid. It also helps explain why the loss rate for MLMs is much higher than for classic, no-product pyramid schemes.

How does extreme leverage result from excessive payout levels? MLM promoters refer to such residuals as “leverage” – large company payouts, disproportionate to effort expended, to top-level participants. The effects of leverage can be illustrated in a downline of six levels of participants. For example, assume that a “distributor” recruits five “active distributors,” each of whom recruits five more, and so on through six levels of distributors.

We see the pyramid grow exponentially:

*Level 1:* 5 distributors
  \[ x \$5 \text{ in commissions & bonuses} = \$25/\text{month} \]

*Level 2:* (5x5=) 25 + 5 = 30 total distributors
  \[ x \$5 \times x \times x = \$150/\text{month} \]

*Level 3:* (25x5=) 125 + 30 = 155 total distributors
  \[ x \$5 \times x \times x = \$775/\text{month} \]

*Level 4:* (125x5=) 625 + 155 = 780 total distributors
  \[ x \$5 \times x \times x = \$3,900/\text{month} \]

*Level 5:* (625x5=) 3,125 + 780 = 3,905 total distributors
  \[ x \$5 \times x \times x = \$19,525/\text{month} \]

*Level 6:* (3,125x5=) 15,625 + 3,905 = 19,530 total distributors
  \[ x \$5 \times x \times x \times x = \$97,650/\text{month}! \]

If each “distributor” were to buy enough products each month to yield an override of $5 in commissions and bonuses to the original upline distributor, then with a five-level downline, the upline distributor gets $19,525 per month, while with a six-level downline the same distributor can get $97,650 per month – five times as much as for five levels. The incentive to recruit to get to the sixth level becomes enormous. Of course, it seldom works out that way, but this illustrates why recruiting is emphasized over selling products to persons outside the pyramid. An income of $97,650 is far more appealing to a Level 1 participant than $100 that might be earned by selling the products at the full retail price (assuming $20 markup on products sold to each of five customers).

The FTC prosecution argued that as the number of levels in an MLM compensation plan increased, so did the opportunity for fraud (FTC v. Amway). But no one at the FTC noticed that the number of levels since that time has more than doubled at Amway.

Compared to recruiting, selling products at full retail price becomes a waste of time in such a system. The incentive to recruit to move up a level becomes very great. Again, one can see that the legal requirement of “primary emphasis” on income from recruiting fees (in the form of downline purchases) is satisfied.

In legitimate direct selling or retailing operations, management looks at what value each link in the distribution chain contributes to a profitable operation. They are always on the lookout to streamline operations, not to cut profits by adding more levels of sales management. Rational corporate behavior in this scenario would be to quickly jettison passive commission recipients in their distribution chains, not recruit more. But with a MLM, the opposite is true – the more levels, the better, thus exponentially enriching those at the top, who recruit aggressively to maximize their gains. Also, company revenues are enhanced by recruitment more than by sales to end users.
Exploitive breakaway compensation plans – legal or not? One category of compensation plans, the “breakaway” deserves mention, as it is so highly leveraged that the losses of participants are staggering.

In a breakaway system, the levels in the hierarchy are made up of “breakaway organizations” (or pyramids) – groups of participants who have met requirements to “break away,” allowing a small commission override from all participants in the breakaway unit. So a hierarchy of six levels is actually six levels of groups of participants, which makes it a constellation of pyramids within a giant mega-pyramid – with most of the payout going to TOPPs.

The extreme loss rate results from each profitable top-level “distributor” being supported by a downline of many groups of participants (often totaling thousands), almost all of them victims who lose money – after subtracting purchases and other expenses. In my opinion, MLMs with breakaway compensation plans are the most extreme and exploitive type of pyramid scheme and therefore should be illegal.

“Australian two-up,” and other schemes that limit the number of levels for payout, make up for it in other ways. The fact that an MLM compensation plan limits the number of levels upon which any distributor can be paid overrides from the company does not negate the “endless chain” feature of the scheme. For example, in “Australian two-up” plans, new recruits must forfeit commissions for the first two sales to an upline sponsor before qualifying for commissions. The mathematical impossibility of later recruits enjoying the same financial benefit as earlier participants is apparent. It should be noted that 2-up recruits who fail to recruit two others become in effect the downline of someone above them. This could continue for several levels.

These four CDC’s confirmed by industry-wide research

In 100% of the compensation plans of over 600 MLMs I have analyzed, I found at least the first four of the five causal and defining characteristics (CDCs) discussed above, and the fifth CDC exists for the vast majority of them. These pay plans are clearly recruitment-driven and top-weighted, meaning they are driven by incentives to recruit, with company payout of commissions (after “skimming” by founders) going primarily to a select few “TOPPs” (top-of-the-pyramid promoters) who are often those who were positioned at or near the beginning of the recruitment chain.

Where data was available, I found loss rates averaging about 99.7%. A list of the MLMs for which I have analyzed the compensation plans and which displayed at least the four of the five causative and defining characteristics of recruitment-driven MLMs is found in Appendix 2E.

The same four CDC’s are found in all classic, no-product pyramid schemes as in all MLMs. It is important to recognize that the structural elements (CDCs) of both no-product and product-based pyramid schemes are identical. To ask if an MLM is a pyramid scheme is like asking if a hybrid vehicle is a car. It may have advanced features, but it’s still a car. So with MLM, which is merely an elaborate form of a pyramid scheme.

MLM not legitimate direct selling.

Based on the above CDCs, of the over 600 MLMs we analyzed, none qualified as legitimate direct selling. (To clearly separate MLM from legitimate direct selling, review again the 7-point checklist in Exhibit 2f.) I should also note that these four CDCs exist in none of the hundreds of alternative income options I have reviewed over many years of teaching and researching in the field of income or business opportunities.

Harmful effects of MLMs

MLM compensation plans with all of the characteristics discussed above inevitably lead to the following negative effects:

1. Loss rates are extremely high – far worse than for legitimate direct selling. See comparison in Exhibit 2g, which is based on

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65 Chapter 7, Exhibit 7d
data from Nu Skin’s reports – and similar to those in other MLMs analyzed in Chapter 7. To those who understand the numbers, this is the harm that is most objectionable – especially in light of the MLM being presented as a profitable income opportunity.

For nearly all MLM participants, money paid out exceeds money coming in.

Because of the extreme leverage in the compensation plan, the founders, early entrants into the program, and a few TOPPs get huge gains – who are held up as examples for all to see. But for the vast majority of participants, actual profits are rare.

When discussing average income of MLM participants, it should be noted that there are three statistical measures used to indicate “average” – the mean, median, and mode. The most talked about is the arithmetic mean, or the aggregate income of all divided by the number of participants – which is negative if all recruits are counted and minimal expenses (including incentivized purchases) are subtracted.

The median, or middle measure, for all MLMs I have studied is zero or less. And the mode, or most common measure, is also zero or less. Also, if TOPPs – whose disproportionately large incomes skew the averages – are removed from the calculation, the average will nearly always be a significant minus figure.

By any measure, MLM is a losing proposition. This explains why the DSA and MLM spokespersons and statisticians do everything they can to skew the numbers in their favor. A more detailed analysis of the abysmal statistics on average earnings will be presented in Chapter 7.

2. Since the compensation and marketing system is weighted towards recruitment, instead of retailing of products, MLMs are technically illegal in many jurisdictions. This one effect is the basis of most statutes against pyramid schemes. MLM promoters often go to great lengths to make it appear that revenues of participants come from (unreported) direct selling of products, which is simply not the case.

3. Misrepresentations abound. Deception is essential for MLM to survive and grow. If the truth were told about the abysmal odds of success, only the numerically challenged would join.

Some MLM promoters make exaggerated product claims to draw in new recruits. I have concluded that success in a recruiting MLM requires one first to be deceived, then to maintain a high level of self-deception, and finally to go about deceiving others. Chapter 8 lists at least 111 typical misrepresentations used in MLM recruitment campaigns. With MLMs dependent on so many falsehoods, it would not be an exaggeration to consider the income earned by MLM sponsors as “theft by deception,” and certainly as ill-gotten gain.

4. MLMs become somewhat like Ponzi schemes, with promoters moving from one location to another, as each area is increasingly perceived to be saturated. What happens is that the MLM grows rapidly until it reaches market saturation in a given area. All later entrants are severely disadvantaged in their recruiting efforts and lose money. MLMs sometimes get around this by starting new product divisions or entering new geographic regions to start new pyramids, a process I have labelled “re-pyramiding.”

So investing participants recover their investments by recruiting in other areas – in Ponzi fashion – to get new participants to invest. If they don’t do this, they can lose their income stream and the rank they achieved. Company officials cooperate – or the company may collapse, along with their jobs.

5. The distinction between seller and buyer becomes confused and blurred. The seller becomes the buyer, and the buyer becomes the seller – to themselves and their families.

6. When most of the buyers are participants, MLM is simply a money transfer scheme, transferring money from those at the bottom to those at the top – through the infrastructure of the MLM company.
Exhibit 2f: Does MLM (multi-level or network marketing) qualify as a legitimate form of direct selling? — a 7-point checklist

Much confusion exists on whether or not MLM can qualify as direct selling. Since the MLM industry has much to gain by being classed as direct selling, MLM promoters and the industry's lobbying arm, the Direct Selling Association, work hard to convince legislators, regulators, and the public that they are direct selling companies. Since few officials have much experience in direct sales, they are often misled on this key point.

Based on several years of experience, observation and research related to both direct sales and MLM, I can safely conclude that the typical MLM business model constitutes what I call a “product-based pyramid scheme” and NOT a form of legitimate direct selling. They should be considered “recruitment-driven MLMs”; i.e., MLMs that require aggressive recruiting of a large downline to earn a significant income. However, it is true that selling — mostly in the form of recruiting — is involved in building an MLM downline.

Based on this analysis, below is a comparison of two marketing models — direct sales, as represented by traditional Fuller Brush sales persons (or any non-MLM direct sales company, including life insurance) — with prominent MLM programs, such as Amway and Nu Skin.

**CONCLUSION:** The typical MLM company is no more a direct sales company than a pig is a horse. MLM companies use highly leveraged compensation systems (rewarding top distributors at the expense of a large downline of recruits who invest in products to “play the game” — almost all of whom lose money), its participants are primarily recruiting to build downlines, not to sell products directly to end users.

When was the last time you were approached by an Amway or Nu Skin “distributor” to buy products without some mention of the “business opportunity”? With millions of “distributors” recruited over the last twenty years, if they were primarily selling direct to customers, you would expect by now to have been inundated with requests to buy products from them — without being asked to join up. No, the sellers are the buyers, and the buyers are the sellers — generally to themselves and their immediate families.

<table>
<thead>
<tr>
<th>CHARACTERISTICS OF LEGITIMATE DIRECT SALES COMPANIES</th>
<th>LEGIT. DIRECT SALES</th>
<th>MLMs (that reward participants for recruiting large downlines, which is virtually all MLMs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The number of agents/sales persons recruited for a given area is somewhat limited to prevent market saturation and resulting dissatisfaction of existing sales persons or agents.</td>
<td>YES</td>
<td>NO — MLMs use an endless chain of recruiters recruiting still more recruiters, ad infinitum. And each participant must recruit others to make his/her investment profitable.</td>
</tr>
<tr>
<td>2. Advancement to various levels of sales management is by appointment.</td>
<td>YES</td>
<td>NO — Advancement in the sales hierarchy is achieved by recruiting a downline who purchase products</td>
</tr>
<tr>
<td>3. Little or no purchases are required to begin and to continue selling the program profitably. The company, rather than the sales person, assumes the burden of financing and stocking inventory. When I sold encyclopedias as a young man, it was not a requirement that I buy a set for myself or meet a certain quota in order to qualify for commissions. And as an insurance agent, I was not required to buy the insurance I was selling</td>
<td>YES</td>
<td>NO — Sizable initial and ongoing purchases are tied to qualification to get commissions and/or to advance through higher distributor payout levels. Thus, many participants stock up on inventory. The burden of inventory cost is thereby transferred from the company to the distributor — who finds that the easiest way to sell the products is to sell the “opportunity.” Most actual buyers are recruits.</td>
</tr>
<tr>
<td>4. A maximum of four levels of sales managers is sufficient— for example: branch manager, district manager, regional manager, &amp; national sales mgr.</td>
<td>YES</td>
<td>NO — An MLM downline may include 6, 8, 10, or even an infinite number of levels of distributors — which, of course, is absurd.</td>
</tr>
<tr>
<td>5. Commissions <strong>per sale</strong> paid by the company to the person selling products and services to end users are typically greater than the total override commissions for <strong>ALL those above him/her in sales management.</strong></td>
<td>YES</td>
<td>NO — A distributor several levels above the person selling the product may get as much or more commission <strong>per sale</strong> from the company as the person doing the selling.</td>
</tr>
<tr>
<td>6. The primary focus in compensation systems, at sales meetings, and in actual effort by sales persons is on selling products and services to legitimate customers, or “end users.”</td>
<td>YES</td>
<td>NO — Marking up and reselling products bought at high wholesale prices is unrealistic. The primary focus is on recruiting more participants, so persons are seldom approached to buy the products without considering the “business opportunity.” Top-level recruiters are often held up as examples for their huge pay checks.</td>
</tr>
<tr>
<td>7. Sales persons can make a reasonable income (in commissions and bonuses) from selling the products or services — without recruiting a downline.</td>
<td>YES</td>
<td>NO — Commissions paid by the company for direct sales pale in comparison with potential rewards for recruiting a downline. In MLMs, it is extremely rare for participants (except for those at or near the top of the pyramid), to report profits on their tax returns.</td>
</tr>
</tbody>
</table>

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66 Including insurance, real estate, investments, fire alarm systems, and other products and services that are sold person-to-person away from a fixed location (but without the first four of five CDCs of a product-based pyramid scheme)
7. Stockpiling of products is common, a fact seldom admitted by MLM participants. Many wind up making excessive purchases in order to advance up the hierarchy of participants, so they can reap large residual incomes off the efforts of others—which seldom happens. Most participants are left with unsold products, broken promises, and unrealized dreams. Return privileges for refunds are not used as much as one would expect for the reasons mentioned above.

Stockpiling is common in MLM

8. The regulatory process—essential in a democracy—is compromised when pyramid fraud is allowed by regulatory agencies. Victims of all types of pyramid or chain selling schemes rarely file complaints, fearing consequences from or to those they recruited (often relatives or friends) —and having been taught that failure is “their fault.” Lacking such complaints, law enforcement seldom acts against them. This complacency on the part of consumer protection officials creates, in effect, a “license to steal.”

8. MLM observers have noticed cultish and even compulsive behavior from MLM participation. Some MLMs adopt cultist patterns in recruitment and retention of members, becoming a rather closed society. Also, the devolution of “MLM junkies” has been observed, with traits of addiction similar to those with other addictions.

10. A perverse risk-reward relationship develops with MLMs. In legitimate businesses, the more time and money one invests in the business, the more likely it is that success will be achieved. But with MLMs (except for TOPPs), the more one invests, the more one loses. The luckiest participants are those who invest the least time and money. The most fortunate are usually prospects who refuse to join at all.

11. Extreme leverage results, meaning the majority of company payout goes to TOPPs. Cases of downline distributors receiving large commission checks are rare, but are held up as examples for all prospective recruits to see (without disclosing costs incurred). However, for the vast majority of MLM participants, actual profits are rare—and losses are the rule, not the exception. Again, study Exhibit 2g.

12. The program becomes a closed market system, in which products are sold primarily through (and to) a downline of participants (and sympathetic family members) and seldom to legitimate customers at retail prices. This alone should qualify it as an illegal pyramid scheme.

13. Personal losses can be substantial, including psychological, social, and spiritual harm—far outside of the norm for legitimate businesses. Some MLM participants lose more than money. We often hear of marriages and families broken up, credit cards maxed out, bankruptcies, long-term friendships ruined, religious and other groups stressed or broken up, even suicides—all from single-minded dedication to an MLM program. In fact, the more committed a person is to an MLM, the greater the likelihood that he/she will suffer at least some of these consequences.

Also, disturbing tendencies to move away from ethical and charitable motivations to a more materialistic and greedy persona often becomes apparent from MLM participation. These personality changes help explain why some see MLM as an unethical business model. 

67 For examples, go to feedback in ch. 9 Appendix.
Exhibit 2g: Legitimate direct selling vs. MLMs

Legitimate direct selling
Direct sales persons who sell directly to customers seldom lose money, since most supplies and training are provided by the company. And the sales persons do not have to buy the products in order to qualify for commissions. Most of the commissions are paid to the person doing the selling. With the growth of the Internet and discount stores, little direct selling is done any more.

MLMs, or product-based pyramid schemes
An extremely high loss rate explains MLM’s high attrition rates, churning of new recruits, and need to aggressively “re-pyramid” through new markets and/or with new products.

0.3% make money in the typical MLM
Only a few of the participants in a typical MLM earn significant profits – after purchases and operating expenses are subtracted. To correctly represent these persons would require a circle so small that it would be barely visible in this visual.

99.7% lose money in the typical MLM
It is very expensive to build a profitable MLM downline. Significant purchases are required to qualify for and to maintain “pin levels” (pay rank). And the cost of mounting a recruitment campaign effective enough to “succeed” in an MLM can be very high. For these reasons, the dropout rate is also extremely high. In any MLM, the first ones into a given market have a huge advantage. Those coming in later are buying a ticket on a flight that has already left the ground.

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69 See Chapter 7. Calculations are based on reports of average income of participants for 50 MLM companies that have released such data by 2013. See methodology and calculations in Chapter 7.
Considering all the harmful effects of MLM, it is easy to see why MLMs are far more harmful than no-product pyramid schemes. They have a higher loss rate, cause far greater losses in the aggregate, and affect far more victims. They also have a much lower payout ratio for distributors, since most of the proceeds go to products and infrastructure, and some to the founders.

Conversely, in no-product pyramid schemes, all the money goes to the person at the top, but the downline consists of only a few persons, who strive to move up to take their turn at the top.

See Exhibit 2h for a summary of some of the effects stemming from the CDCs (“red flags”) of MLMs, both individually and in combination.

### Exhibit 2h: Characteristics and effects of MLMs, or product-based pyramid schemes

<table>
<thead>
<tr>
<th>CHARACTERISTICS</th>
<th>EFFECTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Each person recruited is empowered &amp; given incentives to recruit other participants, who are empowered and motivated to recruit still other participants, etc. – in endless chains of empowered and motivated recruiters recruiting recruiters – without regard to market saturation.</td>
<td>Demonstrates primary income is from recruiting, especially with the features of unlimited recruitment and such powerful incentives to recruit – vs. meager profits from retailing over-priced products. Hyper growth inevitably leads to perceived saturation, which often is followed by expanding (“re-pyramiding”) to other markets – or to introducing new product divisions and cycling through the same markets.</td>
</tr>
<tr>
<td>2. Rank advancement in a hierarchy of multiple levels of “distributors” is achieved by recruitment, rather than by appointment.</td>
<td>Demonstrates primary income is from recruiting, since that is the only way to advance in the scheme and to realize major profits. In virtually any MLM, 99% of recruits are doomed to financial loss.</td>
</tr>
<tr>
<td>3. “Pay to play” requirements (to qualify for commissions and/or for rank advancement) are met by quotas of “incentivized purchases”.</td>
<td>Raises breakeven bar, assuring losses for 99% of participants. May technically place MLM in category of a franchise, security, business opportunity – or a de facto pyramid scheme. Encourages hyper-consumption of products by participants, who are the primary buyers.</td>
</tr>
<tr>
<td>4. Company payout per sale for the total of all upline participants equals or exceeds that for the person selling the product</td>
<td>Removes incentive to do direct selling, since recruiting is potentially many times more profitable.</td>
</tr>
<tr>
<td>5. (typical, but optional) The company pays commissions and bonuses on five or more “distributor” levels – more than are functionally justified; i.e., more than needed to manage the sales function.</td>
<td>Demonstrates primary income is from recruiting. Enhances leverage for top participants who profit hugely, while assuring high loss rate for lower levels. Virtually eliminates retail option, due to high wholesale prices (to pay commissions on many levels) that make direct sales with retail markup very difficult. Primary retail target is new recruits – which are making de facto pyramid investments.</td>
</tr>
<tr>
<td>1-5: Combining all (or at least the first four) of the above characteristics</td>
<td>Results in high loss rates (99.7% average) – much higher than for no-product pyramid schemes (87.5% to 93.3%). Strong emphasis on recruiting as the primary source of income, satisfying most statutory definitions of a pyramid scheme. Demonstrates extreme leverage, necessitating deceptive income promises to succeed at recruitment.</td>
</tr>
</tbody>
</table>
MLM’s unsavory reputation among the general public in the U.S.

Twenty years of feedback from all over the world confirms what most consumer advocates have observed – that the MLM industry generally has an unfavorable reputation among the general public. This has certainly been evident in consumer surveys.70

When I did an advanced (exact) Google search of the term “scam” (using quotation marks) with standard brands of nutritional supplements (such as Centrum, Bayer One-a-Day, etc.) sold in retail stores, I got 0 (zero) results. But in sharp contrast, when “scam” was paired with the names of leading MLM companies that sell supplements (Amway, Herbalife, Nu Skin, USANA, etc.), I got several hundred results for each of them!

The typical answer by promoters of specific MLMs to the unsavory reputation of MLM is that the reputation is deserved by most MLMs, but not their MLM. Their MLM is somehow different. This is another reason why defining and understanding the underlying MLM model is important.

MLM’s problem with legal identity

MLM promoters and defenders have a recurring problem whenever they have to present MLM as a class of business activity. This is because MLM is like a chameleon; it can – and often must – change colors to suit the situation. Consider the following examples:

- **Are MLM participants employees of the company?** MLM executives often try to exercise control of an employer, but don’t want to be classified as such because of the costs and legal liabilities. Yet, their contracts have been challenged as exercising too much control for participants to be considered independent contractors.71

For example, they may not be allowed to sell competitors’ products along with those of the particular MLM they signed with.

- **Are MLM promoters selling investment securities?** They talk to prospects about the “residual income,” or “passive income” potential of signing up in their MLM – as an investment that was not dependent so much on their own efforts as on the efforts of those in their downline. But they do not register as securities with the state or federal securities agencies.

- **Are MLMs franchises?** Though many promoters refer to their MLMs as “like a franchise,” as an “un-franchise,” or even as a “personal franchise,” the last thing MLM executives want is to have to comply with franchise disclosure requirements, including a franchise disclosure document that could be hundreds of pages long with financial data, background of founders, etc. The MLM industry spent $4 million lobbying for an exemption from the Business Opportunity Rule so they would not be required to provide even a one-page document disclosing information to help prospects make a wise decision about participation.

- **Are MLMs a form of gambling or a lottery?** Some promoters present MLM as an opportunity for the chance of unlimited income: “You never know how much money you will make if you sign up now,” or “You may get lucky and recruit someone in your downline who is a ‘business builder’ who will make you a lot of money,” etc. New MLMs will sell a “pre-launch” opportunity, implying that one could profit handsomely by being one of the lucky first ones in.

- **Are MLMs a form of direct selling?** Of course, the Direct Selling Association says it satisfies the criteria of person-to-person selling away from a fixed location, etc. The problem is that the DSA does not specify what legitimate direct selling is – endless chains of recruitment of participants as primary customers.72

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70 “Network Marketing Survey” Conducted in three Utah counties in 2004. Similar results were found in “Herbalife Online Fraud: A Web Analyst’s Perspective.” (Jonathan Brand’s Instablog at wwwSeekingAlpha.com)

71 For a thorough discussion of bad legislation (IRC § 3582) pushed by lobbyists in 1982 to reclassify employees as independent contractors to those contractors’ detriment, go to the following web site (“All you need to know about MLM) – http://www.armydiller.com/financial-scamlml.htm#dsalegislation

72 Again, See Exhibit 2f for a 7-point checklist for determining if MLM is a form of legitimate direct selling
• Are MLMs buyers’ clubs? Some MLM promoters present their programs as ways to buy from your own business rather than from others – like a buyers’ club. The problem is that products from MLMs are almost always far more expensive than those purchased from alternative outlets, so they can’t qualify as discount buyers’ clubs. It might be all right if an MLM was sold as a “pay more” buyers’ club, and not as a business opportunity.

• Are MLMs business opportunities? If so, they may need to register as such with the applicable state agencies, which may require disclosure of information they don’t want to disclose and other requirements with which they would not want to comply. So while MLM promoters often refer to their particular program as a “business opportunity” to prospects, they are careful to refer to it as “direct selling” to law enforcement officials.

• Are MLMs income opportunities? If they were, they should provide a good likelihood a person could earn a significant income from them. However, the opposite is true. As carefully demonstrated in Chapter 7, almost all participants in MLMs – approximately 99.7% of them (where data is available), lose money. And if you eliminate TOPPs (top-of-the-pyramid-promoters) from the calculation, the loss rate is about 99.9% for new recruits – with approximately zero chance of profiting. It would be more honest to call MLMs money traps that lead to almost certain loss, except for those at the top of the pyramid.

• And finally, are MLMs cleverly disguised pyramid schemes? If you are not already convinced, re-read this chapter and read the rest of the chapters in this book with an open mind and decide for yourself. But I can attest that after analyzing the compensation plans of over 600 MLM schemes, I feel more comfortable than ever labeling them recruitment-driven MLMs, or product-based pyramid schemes.

What is the difference between Ponzi schemes and (no-product or product-based) pyramid schemes?

Both pyramid schemes (whether or not product-based) and Ponzi schemes\(^3\) are money transfer schemes, meaning that they involve a transfer of money between participants, rather than offering either legitimate investments or the production or sale of actual goods or services to those outside of the participants themselves. In the case of Ponzi schemes, new investors are recruited to provide revenues, but little real investment occurs. Instead, earlier investors are paid dividends or “profits” from the investments of new investors. Of course, since the supply of new investors is limited, eventually the scheme collapses when new investors cannot be found, or the demand for refunds of original investment principal by earlier investors exceeds available funds. This is what happened to cause the collapse of the Bernie Madoff scheme in 2008 when the financial markets imploded.

Classic, no-product pyramid schemes offer no product, merely the transfer of investors’ money from those at the bottom to those at the top. In contrast, MLMs, or product-based pyramid schemes, deceive participants into thinking that they are legitimate businesses by offering consumable products. But few are sold outside the network of participants, so they wind up also being transfer schemes, at least indirectly – transferring money from product purchases of a continuing stream of new recruits to the company to pay for products, infrastructure costs, and distributors. Usually less than half the money from purchases of recruits is rebated back to the network of distributors, with a disproportionate amount going to founders and TOPPs.

Since MLMs are dependent on the recruitment of an endless chain of recruitment, recruiters soon find their local market saturated and must recruit elsewhere. As will be discussed in Chapter 3, this saturation of markets happens rather quickly.

\(^3\) The history of pyramid and Ponzi schemes will be discussed in Chapter 10.
so MLMs are extremely viral in spreading like a fast-growing cancer from state to state and eventually to vulnerable foreign markets to keep the chain of recruitment going. Both Ponzi and pyramid schemes are similar in that timing of entry into the program is critical. In Ponzi schemes, the person who initiates the scheme usually profits the most, failing to use the investors' money to fulfill his promises to them and instead chooses to pay them out of funds received from future investors. In pyramid schemes, the timing of entry affects rank position in the pyramid (and resultant level of pay) of participants, and each person recruited is incentivized to recruit others in an endless chain of recruitment.

Unlike Ponzi schemes and no-product pyramid schemes, some of the more successful MLMs are able to continue almost indefinitely, not only by expanding to other markets (often overseas), but by introducing new “product divisions” or name brands and starting the whole recruitment process all over again. And after enough years have gone by, a new generation of prospects can be targeted under a new name or focus, as Amway has done with Quixtar and Nu Skin has done with several product divisions. Again, this is a process I call “re-pyramiding.”

Are all MLMs pyramid schemes?

As the following chapters will demonstrate, MLMs are merely product-based pyramid schemes disguised as “direct selling companies.” But even when confronted with overwhelming evidence of this, MLM defenders – especially the Direct Selling Association – will likely protest: “Wait a minute. You’re not suggesting that all MLMs are (illegal) pyramid schemes, are you?”

As if all of the foregoing were not sufficient to answer that question, an appropriate response would be –

*If it looks like a duck, walks like a duck, swims like a duck, and quacks like a duck, then it’s probably a duck!*

Few would question the underlying flaws in chain letters where you pay ten dollars to everyone on a list, add your name at the bottom, and forward it to all your friends – and they to their friends, ad infinitum. Most consumers see the flaws in this concept, so that it requires little explaining. But when MLMs (built upon endless chains of recruitment) came along and introduced unique and exotic products with complicated pay plans, charismatic leaders, palatial home offices, and donations to charitable causes and influential political candidates; promoters were able to dupe regulators, legislators, and many in the media into believing they were legitimate.

The underlying motivations that seem to drive MLM development and recruitment are greed and the desire for easy money, even at the expense of a multitude of victims. Though not articulated by founders, they seem to understand that it is much easier to facilitate a scheme that promotes product purchases by selling a bogus opportunity than by selling the products without the attached opportunity.

In fact, as will be shown in later chapters, **MLM is the most harmful of the two classes of pyramid schemes (no-product and product-based), by any measure** – loss rates, aggregate losses, total number of victims, low payout percentage, and degree of leverage enjoyed by TOPPs (the degree to which they profit from the purchases of those beneath them). For an interesting analogy and explanation of the relative harm of no-product and product-based pyramid schemes, go to Appendix 2i: “Are all MLMs pyramid schemes”

Definitions and terms for pyramid schemes vary among the states. Those who expect to find uniform definitions of pyramid schemes across jurisdictions will be disappointed. Statutory definitions of what is and what is not a pyramid scheme vary from state to state, and many show lack of recognition of the fundamental flaws in all endless chain recruitment programs, including MLMs. This is not surprising, as many attorneys, legislators, academicians, and so-called experts are not clear on these issues.
As will be explained in Chapter 10, the structural difference between pyramid schemes and MLMs – aside from the existence of products for sale – may represent a distinction without a difference. (The only substantive difference is that one accepts cash – and the other payments for products (usually over time) as investments in the scheme.) Definitions and terms designating pyramid schemes used in state statutes are compiled in Appendix 2H. One can see from reviewing these that it is no wonder there is so much confusion over terminology.

Emphasis on “internal consumption” in labeling MLMs “pyramid schemes.” In recent MLM cases, efforts have been made to determine the percentage of sales that were made to participants versus non-participants. The former are considered internal to the system, or “internal consumption.” The latter are “external sales.” Unless it can be proven that the majority of sales were to end users outside the network, it may be considered a pyramid scheme. However, this data is not easy to obtain, as the companies are loathe to seek or to disclose such information. As explained in this chapter, this emphasis can more readily be discovered by analysis of the compensation plan.

The question of whether or not a given MLM is a pyramid scheme has become a red herring to mislead anyone investigating the company. Defining what is a pyramid scheme has become so obfuscated by the MLM industry that it swamps efforts to prosecute cases against MLMs. But one thing is certain – MLM is an unfair and deceptive practice – making it illegal under Section 5 of the FTC Act, and based on statutes in many states.

What about MLMs whose promoters claim they are “not MLM?”

Some MLM communicators claim that their program is “not MLM” – or “not like the others,” but a careful study of their compensation plan reveals the first four of the five CDCs listed above. They may have only three or four levels in their pay plan, but that is offset by greater commission percentages to the top levels – which accomplishes the same concentration of income to TOPPs. Or they may have a “play-to-pay” alternative to “pay to play,” as discussed above.

A more descriptive term for MLMs, or product-based pyramid schemes: “pancake schemes”

I owe this insight to a man whose loved one’s life was turned upside-down by MLM addiction. Others have calculated that in “doubling” 33 times with a simple binary MLM progression, you exceed the population of the earth. In plotting the positions on a graph, this man found that the downline organization looks more like a flat line or pancake with a bump in the middle than a triangular-shaped pyramid. This is illustrated in Appendix 2J.

Of course, if you have more than a doubling of recruits at each level, the line flattens out even more quickly. For example, with Nu Skin a person must be an “Executive” with five active distributors beneath him or her to qualify for “breakaway” commissions or for rank advancement. While a “Blue Diamond” may only be paid on six levels, the mathematical progression of endless chain recruitment continues. The progression (with the line of victims getting longer at each level) proceeds as follows:

\[ \begin{align*}
1 \times 5 &= 5 \\
X_5 &= 25 \\
X_5 &= 125 \\
X_5 &= 3,125 \text{ (a very long flat line of victims)} \\
X_5 &= 15,625 \\
X_5 &= 78,125 \\
X_5 &= 390,625 \\
X_5 &= 1,953,125, \text{ or } 1.9 \text{ million victims} \text{ (A line of that many persons standing next to each other could be 800 miles long!)}
\end{align*} \]

By only the 15th level, the progression approximates the population of the entire earth! (See Appendix 2J which shows that even a binary system is shaped more like pancake than a pyramid.)

In contrast, with a classic 1-2-4-8 pyramid scheme, the progression matures at the fourth level, with the person at the top cashing in from

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74 An article about claims of some MLMs to be “different” titled “What about this One?” by Robert FitzPatrick can be found at his web site – www.pyramidschemealert.org
the investments of those at the bottom. There are no product or infrastructure costs to recoup, so all the money goes to the person at the top. So one person wins at the expense of 14 who lose their investment—as opposed to a massive “flat line” MLM scheme in which thousands in a downline lose money to enrich a few at the top.

The point I am making is that the “flat line” downline is another way of illustrating that MLM is far more damaging than classic 1-2-4-8 no-product schemes by any measure—loss rate, aggregate losses, and number of victims.

Compensation plans designed to benefit the company and TOPPs, not downline participants

A recent statement75 by a leading designer of compensation plans reveals the real motivation behind the plans:

A critical component of your new MLM or party plan company is the compensation plan. This is one of their earliest concerns for many startup company entrepreneurs. Often the role and requirements or the compensation plan are widely misunderstood. Therefore on this page we’ll expose some misconceptions:

**Misconception #1:** The purpose of the compensation plan is to compensate distributors.

**Reality:** The purpose of the compensation plan is to motivate behaviors that will grow your company.

Here is another example of the unfairness of MLM. Newly recruited distributors are misled to believe that the compensation plan is designed to benefit them, when in fact, it benefits TOPPs (top-of-the-pyramid promoters), founders, and the sponsoring MLM company.

Then skip to misconception #7:

**Misconception #7:** I can buy an off-the-shelf plan for now and change it later.

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**Reality:** The plan you launch with will have enormous impact on your early success. Some refinements will be possible later, but a major change can destroy your business.

[NOTE: This latter reality explains why—once established, compensation plans are not altered, except for minor modifications.]

Some MLM players game the system.

Some “players” regularly “game the system.” They are extremely successful MLM recruiters who are continually on the lookout for new MLMs. Because of their reputation for aggressive recruiting, they are given entry positions at or near the top of a pyramid of distributors yet to be developed. They may bring hundreds of downline distributors with them from another MLM. This practice—called “cross recruiting”—has led to lawsuits. Some even work more than one MLM at a time.

These players often choose to work fast-paying binary compensation plans in which they can be earning tens of thousands of dollars a week before they move their downline to the next deal. This may happen when a new market is opened up in another country or when a new product division is introduced. We have learned of a top “player’s” position determined by nepotism, by a telephone call, or even by a toss of the dice. This is not fair to others in the MLM, but as this and subsequent chapters prove, MLM is fundamentally an unfair and deceptive practice.

What would a good MLM look like?

Many have asked if it is possible to have a fair and equitable “retail-focused MLM” program. In other words, what would a “good MLM” look like? Considering the inherent flaws in MLM as a business model, the established precedents, and the motivations that drive the industry, one might wonder if such an MLM is possible. Some insist that a “good MLM” is an oxymoron.

However, for anyone willing to try, here are some consumer protections that should mitigate some of the harm done by endless chain recruitment schemes. Assuming
honest execution, they could help to assure an MLM would be both legal and ethical.

1. Commissions or bonuses would be paid only for sales to non-participants – not for “internal consumption” (sales to participants). This would minimize losses from buying what is not needed and would put the emphasis squarely on selling to legitimate customers, as opposed to recruiting a downline and incentivizing them to buy and stockpile products.76

2. An MLM could reward selling of products more than recruiting by paying at least half of the total company payout of commissions to “front line distributors” actually selling products to end use consumers; i.e., persons not in the network of participants. So if a company’s total payout pf commissions to participants was 50% of total sales revenues, commissions (not retail markup) paid by the company to frontline distributors would be at least 25%. The other 25% would be split among the upline.

3. There would be limits to the number of participants allowed to recruit in any given area.

4. There would be no “pay-to-play” purchase requirements to qualify for commissions or rank advancement. Participants would not lose their status or their commissions if they have a bad month and fail to meet a monthly quota. This could minimize losses.

5. The number of levels in the pay plan would be no more than are functionally justified. Even sales programs of major corporations can cover the country with four levels of sales management – branch, division, regional, and national sales managers. Thus, if MLM is a legitimate direct sales program, it should be capped at a maximum of four levels of supervisors. (More than that serves only to enrich founders and TOPPs at the expense of their downlines). And by limiting the number of levels on which commissions are paid, prices could be more competitive – and distributors could profit from retailing products, not just from recruiting and selling to their downlines at inflated prices.

6. Ideally, no commission payments would be paid in perpetuity, except for sales by those on the first level (“front line”) in one’s downline of participants. For example, downline commissions might be paid for one or two years to give time for the upline to profit from training recruits until they are competent. This would minimize the mathematical absurdity of a program that expands endlessly not only in space (area-by-area market saturation), but also in time, and it would limit the motivation to build a downline for “residual income,” or the dream of sitting back and profiting forever from the efforts of others.

7. Breakaway compensation plans – essentially pyramids within mega-pyramids – would be banned, and other complex plans (matrix, binary, etc.), would be replaced with simpler unilevel plans. This would help to limit the obfuscation that hides misrepresentations and makes comparisons difficult. The irony of this is that such an MLM compensation plan would be fashioned after classic no-product pyramid schemes – which are illegal, though not usually as harmful as MLMs.

8. The MLM would disclose average NET payout to ALL participants at all levels in the pay plan, meaning money paid by the company to participants, less money paid in to the company by these same participants, including purchases, training, and “sales tools.”

9. In reports of average income of participants, ALL participants who joined would be included in these averages, not just those who are “active.” Attrition rates and total refunds (“buybacks”) as a percentage of total revenues would also be disclosed. Such transparency would discourage many typical MLM misrepresentations.

10. Prospects would have to be told that market saturation could inevitably occur, leading to a diminishing opportunity for new recruits. Such protections would remove the underlying “easy money” motivation (“residual income,” “time freedom,” etc.) and the complex maze of deceptions, upon which MLM is dependent.

11. Any major legal actions against the company would be disclosed, whether or not resolved successfully.

76 See Koscot and Omnitrition cases in Chapter 10.
12. And finally, a list of at least five names drawn randomly from the total population of participants in a given region who had been with the company for at least a year would be provided with telephone numbers as references, whether or not they are still active.

I have tried in vain to visualize an MLM program with such consumer protections succeeding. The driving force of huge incomes for TOPPs would be absent, and founders may find it more difficult to skim from revenues. In fact, I have run these suggestions by several persons who were interested in starting a “good MLM,” but they each decided on a more standard MLM compensation plan – probably because no one would make obscene profits with such strict protections against abuse.

Conclusions – definition and effects of multi-level marketing

An accurate, research-based, and consumer-friendly definition of multi-level marketing. Persons honestly seeking a good understanding of multi-level marketing (MLM) find that MLM does not yield itself to a short and simple definition. However, based on 20 years’ research and worldwide feedback on this topic, I can articulate what I believe to be the only accurate, research-based, and consumer-friendly definition of multi-level marketing. Although lengthy, it incorporates the four causal and defining factors of a recruitment-driven MLM, as discussed above. I am confident this definition is the most useful for analytical purposes, as it holds true for all of over 600 MLMs I have analyzed.

Unlike other definitions cited earlier, this definition recognizes the inherent flaws of any MLM, or product-based pyramid scheme; viz., an endless chain of recruitment and a pay plan that is recruitment-driven, top-weighted, and financed primarily by incentivized purchases of the participants. Also, it clearly separates MLM from all other income activities, which definitions articulated by others have not accomplished.

So I conclude with what I believe to be the only accurate, research-based definition of the business model labeled “multi-level marketing”:

Multi-level marketing (MLM) is promoted as “direct selling”; but in fact, rewards are stacked in favor of recruitment, rather than sales to the public. MLM is characterized by all of the following:

1. Endless chains of participants are recruited into the bottom level of company-sponsored pyramids of participants,
2. Advancement up the levels in the pyramid is achieved by recruitment and/or purchases, not by appointment,
3. Minimum purchases are required to qualify for commissions and/or to attain or maintain ranks in the pyramid, and
4. The bulk of rewards are paid primarily those at the top of the pyramid.

NOTE: This set of four distinct characteristics is not found in any other type of business – except pyramid schemes. In fact, the fundamental structure of MLMs (MLM programs) is virtually identical to that of classic, no-product pyramid schemes, except that in lieu of cash exchanged directly between participants, products are purchased and commissions processed through an MLM company sponsor. Such commissions are drawn chiefly from purchases of their “downline” (those recruited beneath them). It is appropriate to refer to MLMs as “product-based pyramid schemes.”

This definition requires some explanation of its assumptions and effects, which have been identified through 20 years of research and worldwide feedback. Both the above definition and the effects described below provide a true and complete picture of multi-level marketing as a business model and as an industry, which again has been confirmed in analyses of over 600 MLMs:

As a business model incentivizing unlimited recruitment, MLMs (MLM programs) assume an infinite market, which does not exist in the real world. MLMs also assume virgin markets, which cannot exist for long. Since MLM compensation plans are heavily weighted towards recruitment, rather than retail sales, stable retail markets never
materialize. Consequently, MLMs must “re-pyramid” (expand) into new markets to compensate for saturation of existing markets. And with its high attrition rate, constant recruitment is necessary to replace dropouts. This re-pyramiding and constant churning of recruits is necessary to prevent total market saturation and collapse, as is true of any pyramid scheme.

In addition, some MLM recruiters sell books, lead generation systems, and other “sales tools” to assure success, but which wind up increasing costs and eventual losses. MLMs depend on a myriad of misrepresentations* to survive and grow and to defend against regulatory action. Exaggerated product and income claims are common in recruitment and in company communications. Prospects are typically lured into MLM with exaggerated product and income claims. Since approximately 99% of participants lose money, most eventually drop out, to be replaced by a continual stream of new recruits, who are likewise destined for loss and disappointment.

MLMs are therefore inherently flawed and have been proven to be the most unfair and deceptive of all purported business opportunities.** Technically, as extremely unfair and deceptive acts or practices UDAP), MLMs in the USA violate Section 5 of the FTC Act, as well as UDAP statutes in many states.

As recruitment-driven systems, MLMs can also be extremely viral and predatory. MLMs, or product-based pyramid schemes, do far more damage than classic, no-product pyramid schemes by any measure – loss rates, aggregate losses, and number of victims. Tens of millions of MLM victims suffer tens of billions of dollars in losses every year. MLM may be the most successful consumer fraud in history.

While financial losses can be significant, adverse effects can also sometimes be seen in bizarre or cultish behavior, divorces, loss of “social capital” or ruined relationships with family and friends, and even addiction to MLM’s empty promises. Some sacrifice careers or education to pursue MLM’s vaporous promises of easy wealth (“time freedom” or “residual income”) and a mystique of personal and spiritual fulfillment.

A testable hypothesis for the legitimacy of MLM

If the legitimacy of MLM were approached scientifically, the scientific method of proposing a testable hypothesis could be applied, at least in the examination of major effects of MLM on its participants. Some regulators made decisions on the theory (promulgated by MLM promoters) that if MLMs were pyramid schemes, they would be destined for saturation and collapse. Amway defenders used this theory while arguing that Amway had already been operating for many years without coming even close to saturation and collapse. Obviously the prosecutors did not understand the difference between total saturation and market saturation. As will be explained in Chapter 3, MLM promoters have found ways to overcome market saturation and to transfer losses to a revolving door of new recruits. So MLMs continue to survive and grow.

Because MLM is presented as an income opportunity, and income claims are what is most often challenged by critics, the bogus income claims issue is an excellent place to start. Given available data, the most relevant strategy for testing MLM as a business model would be to take a broad sample of MLM companies and analyze their compensation plans and resulting average income figures for participants. So a testable hypothesis might be framed like this:

Assuming MLM’s unlimited and incentivized recruitment of endless chains of participants, average income data for participants in a broad sample of MLMs will show that participation in MLM is profitable primarily for those at the top of the pyramid of participants. And given the costs of recruiting a downline, it would be rare for new participants to realize profits above expenses – meaning the vast majority lose money.

This hypothesis will be tested in upcoming chapters. In fact, in Chapter 7 I show that MLMs are the most harmful of the two classes of pyramid schemes (product and no-product), by any measure – loss rates, aggregate losses, payout ratios, and number of victims. So read on.
Appendix 2A

Definitions of Relevant Terms

**Compensation plan** – the method of compensating participants in a program, which can be very elaborate in MLMs. Often ignored by regulatory officials, it is the position of this author that analysis of compensation plans is essential in identifying the programs likely to cause the greatest consumer losses. See above for types of MLM compensation plans.

**De facto (market) saturation** – an area where recruiting opportunities are perceived to have diminished to the point that recruiting becomes unprofitable. (Same as “market saturation.”)

**Direct selling.** This is a term that MLM companies, with help from the Direct Selling Association, have worked hard to adopt for their business model. According to them direct selling is marketing and selling products, direct to consumers away from a fixed retail location. However, what the DSA/MLM lobby fails to recognize is what legitimate direct selling is not – an endless chain of recruitment of participants as primary customers.

**Downline** – all of the MLM distributors who are recruited under a given distributor and from whom are generated overrides on product sales.

**Incentivized (or “pay to play”) purchases** – the practice of tying purchases of products from an MLM company with requirements to enter the “business opportunity” option and to advance in the hierarchy of “distributors” – who are in effect merely participants making pyramid scheme investments disguised (or laundered) as purchases.

**Leverage** – a concept often used by MLM promoters to convey the idea that by drawing income from a large downline of distributors, a person can leverage his/her time and investment in the scheme by drawing on the time and resources of their downline. A related concept is “residual income,” a form of passive income often received by authors, artists, insurance agents, and others who have made a contribution and thereafter get royalties from work performed earlier. The ideal presented is that a successful MLM recruiter can work hard for a period of time and never have to work again, thanks to his/her downline.

**Market saturation** – an area where recruiting opportunities are perceived to have diminished to the point that recruiting becomes unprofitable. Promoters of an MLM program must then find other areas or create other product divisions in which to recruit. Market saturation is reached far sooner than actual saturation, a point often overlooked when MLM apologists defend their programs by saying that saturation has never actually happened, and that replacement is an ongoing process like many other businesses. Also called “de facto saturation”.

**Multi-level marketing (MLM)**, as defined by the Federal Trade Commission is “any marketing program in which participants pay money to the program promoter in return for which the participants obtain the right to –

1. recruit additional participants, or to have additional participants placed by the promoter or any other person into the program participant's downline, tree, cooperative, income center, or other similar program grouping;
2. sell goods or services; and
3. receive payment or other compensation; provided that:
   a. the payments received by each program participant are derived primarily from retail sales of goods or services, and not from recruiting additional participants nor having additional participants placed into the program participant’s downline, tree, cooperative, income center, or other similar program grouping, and
   b. the marketing program has instituted and enforces rules to ensure that it is not a plan in which participants earn profits primarily by the recruiting of additional participants rather than retail sales.” 36

As this book will make clear, this definition has some problems with it, most notably:

(1) Until this analysis, it has never been made clear how it was to be determined that payments to participants came primarily from the retail sales of goods or services and not from recruiting of additional participants. Hopefully, after reading this book, the question can be answered.

(2) the fact that the institution of “rules” [in (b) above], is insufficient to correct the problems with product-based pyramid schemes. The compensation plans must be addressed, along the lines of this analysis, if the problems with MLM are to be corrected.
The following definition, (explained in this chapter) is the only one based on extensive independent research:

**Multi-level marketing (MLM)** is a purported income opportunity, in which products are sold by recruitment of persons who are incentivized to buy products and to recruit others in endless chains of participants, who must buy products to qualify for commissions and to advance upward through multiple levels in company-sponsored pyramids of participants.

Further – With unlimited recruitment, MLM assumes both infinite and virgin markets, neither of which exists in the real world. MLM is therefore inherently flawed, unfair and deceptive. It can also be extremely viral and predatory.

Prospects are typically lured into MLM with exaggerated product and income claims. Rewards are stacked in favor of those at or near the top of the pyramid, who are often the first ones to join. Since approximately 99% of participants lose money, most of them eventually drop out, to be replaced by a continual stream of new recruits, who are likewise destined for loss and disappointment.

**Network marketing** – a term devised by MLM companies to get around the implications of “multi-level marketing” – which sounds too much like a chain distribution or pyramid form of marketing.

**No-product pyramid scheme** – a blatant pyramid scheme that is easy to detect because no products are offered, merely a participation fee or “investment.” Chain letters work on the same principle. A continuous chain of “participants” or “investors” is recruited, in which each pays a fee to participate and receives money by recruiting others into the program.

**“Pay to Play”** – a requirement common to all chain letters, no-product pyramid schemes, and product-based pyramid schemes, in which an investment – either in monies or in products purchased – is required in order to “play the game,” i.e., participate in and/or advance in the scheme. This need not be a substantial up-front fee to enroll in the MLM, but can be in the form of ongoing (usually monthly) volume purchase requirements for bonuses, advancement to “pin levels,” etc. These could be viewed as disguised or laundered investments in a product-based pyramid scheme. See “incentivized purchases.”

**Ponzi scheme** (in the final evolution of a MLM) – named after Charles Ponzi, an Italian-born swindler who cheated over 30,000 investors of over $15 million in 1919-1920. Since that time, a Ponzi scheme refers to any investment swindle in which some early investors are paid off with money put up by later ones. Since MLMs use compensation plans that pay much greater rewards for recruiting than for direct sales to end users, they cannot sustain themselves from direct sales only. So when recruiting leads to saturation in a given market, they must recruit elsewhere. They thus eventually become like Ponzi schemes, seeking new investing participants elsewhere (in the form of incentivized product purchases) to pay off earlier investors.

**Product-based pyramid scheme (MLMs)** – a pyramid scheme that in most respects resembles a no-product pyramid scheme, except that products are purchased by distributors, ostensibly for resale, but actually for qualification or advancement in the scheme. Such product purchases, often combined with other incentives, qualify distributors for commissions and advancement in ascending levels in the distributor hierarchy. Such payments could be considered investments in a pyramid scheme laundered through product purchases.

**Pyramid scheme** – According to the FTC, these are plans which “concentrate on the commissions you could earn just for recruiting new distributors” and which “generally ignore the marketing and selling of products and services.”

The latter feature, of course, ignores the realities of product-based pyramid schemes, which this paper demonstrates do more aggregate damage to consumers than no-product schemes. The FTC has also described the essential features of an illegal pyramid scheme as follows:

Such schemes are characterized by the payment by participants of money to the company in return for which they receive (1) the right to sell a product and (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of the product to ultimate users. . . As is apparent, the presence of this second element, recruitment with rewards unrelated to product sales, is nothing more than an elaborate chain letter device in which individuals who pay a valuable consideration with the expectation of recouping it to some degree via recruitment are bound to be disappointed.

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77 FTC Consumer Alert, December 1996
Recent court decisions have emphasized the need for the majority of sales to be to non-participants for an MLM program to avoid being classified as a pyramid scheme.

Unfortunately, the issue of whether or not a given MLM is a pyramid scheme has become a red herring to deflect attention away from its being determined to be an unfair and deceptive act or practice, which makes it clearly in violation of Section 5 of the FTC Act – and of many state statutes.

Recruitment-driven MLM (product-based pyramid schemes) – an MLM with a compensation plan that rewards primarily distributors who recruit huge downlines, and is therefore a product-based pyramid scheme. My research shows this applies to virtually all MLMs, or at least the 600 I have studied.

(hypothetical) Retail-focused MLM – an MLM which uses a compensation plan in which company remuneration to distributors is generous for front-line distributors who actually sell the products to consumers, but which does not allow huge and disproportionate fortunes to be made by upline distributors. Such companies may exist in theory, but I have not found any.

Saturation – the occurrence of reduced interest in an MLM as more and more people are recruited into the scheme. Note that although total saturation of a market may never be reached, saturation is perceived as a problem by new prospects as the percentage of prospects dwindles due to the perception of diminished opportunity. De facto or market saturation is the result.

Scheme – “a plan or program of action, especially a crafty or secret one; . . . a systematic or organized . . . design.”\(^79\)

Time freedom – another term bandied about by MLM promoters to appeal to those who want to be relieved from the requirement of having to spend their precious time to earn a living. They can live off the labor of others.

Unfair or deceptive act or practice – the very type of business activities that FTC was established to protect against.\(^80\) MLM is the epitome of such practices. Unfortunately, FTC officials have become sidetracked to determining whether or not an MLM is a pyramid scheme, using a definition that has been obfuscated to the point that MLM proponents are able to fend off efforts to stop such practices.

Upline – the direct line of distributors who are above a given distributor in the MLM distributor hierarchy or pyramid scheme and who receive overrides from sales or purchases. In a recruitment-driven MLM, top upline participants receive most of the payout in commissions and bonuses from the company and are the only ones to profit significantly.

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\(^79\) Merriam Webster’s Collegiate Dictionary, Tenth Edition, 1993
\(^80\) Section 5 of the FTC Act.
Appendix 2B
Explanations of Compensation Plans

MLM promoters frequently argue that while they know of problems in their industry, they have solved the problems with their new brand of MLM compensation plan, which is supposedly more fair, honest, generous, etc., than all the others.

Why are compensation plans so important to MLM promoters? Because they are at the heart of what MLM is about. As one promoter proudly stated in a meeting I attended, “Our compensation plan IS our product.”

Here are the basic MLM compensation plan options:

**Unilevel** – There is no limit to the number of distributors that can be recruited on the first level (who “retail” products to end users). However, there is usually a limit on the number of levels deep that can qualify for commissions or overrides. It could be considered a “flat pyramid” and is probably the most fair of the compensation plans – though few would get rich. It is also the structure typically used by no-product pyramid schemes of the past.

**Binary** – Binary plans promote recruiting in a downline of two legs of distributors (left and right “profit centers”), with incentives to maintain matching sales volume between the two legs, since commissions are based on the lesser producing leg. Commissions are paid only on “matching volume,” and this can sharply limit company payout. Seldom are high volume producers matched in the same leg of the downline. Binary plans could be considered “split pyramids.”

**Matrix** – A limit is placed on the number of distributors wide in the first and succeeding levels and on the number of levels deep. Additional recruits “spill over” into the next level. Growth is limited (for example, 4x12=48 total downline). Can be played like a lottery – lazy participants can win. Matrix plans could be viewed as “block pyramids.”

**Stairstep/breakaway** – A “distributor” ascends a staircase of groups of participants with escalating incentives to recruit more people to profit from more and more “pay to play” purchases. Commissions from one’s personal group are replaced with overrides for volume of qualifying breakaway groups (“organizations”) of “distributors.” Extremely high leverage rewards hugely those at the top at the expense of a multitude of downline distributors who invest in “pay to play” purchases – their loss, but their upline’s gain.

Each breakaway is a separate organization tied to one person who draws overrides from the entire breakaway organization, which may be one of many. It is important to recognize that six levels in a breakaway are not six levels of distributors, but of whole breakaway organizations of people.

Though breakaway plans are found in some of the most popular MLMs, those who understand breakaway plans agree that they are the most exploitive and extreme of all the pyramid schemes ever devised – and therefore have the greatest leverage and the highest loss rates. The author characterizes breakaways as “mega-pyramids” comprised of many nested “poly-pyramids.”

**Creative new plans.** Though these are the basic compensation plans that have been used by MLM companies in the past, it should be noted that new forms of compensation are being developed by a never-ending supply of MLM schemers. These include a trinary plan, modifications of matrix and binary plans, and creative combinations of the above. Often, promoters of new MLMs claim they have come up with a revolutionary compensation plan that is superior to all others. However, I have found that the four (and usually five) causative and defining factors (“red flags”) discussed in this paper can be found in all multi-level compensation plans.
Appendix 2C

Sample MLM Compensation Plans

What follows are examples of compensation plans for two MLM companies with names starting with the letter Z. You can nearly always view the company’s compensation plan by doing an advanced Google search with the name of the company on one line and “compensation plan” on the other.

Note the creative nomenclature for these plans. This is typical in the MLM industry. In fact, analyses of “proprietary density” of MLM compensation plans reveals the use of many proprietary words unique to the specific MLMs – which is not typical in legitimate direct selling programs. All of this suggests a tendency on the part of founders and promoters of MLM programs to obfuscate the nature of their programs to prospects.81

81 For more on the myriad deceptions used to deceive prospects, see Chapter 8.
Zija Compensation Plan

You can really drink life in when you know you have the resources to do all the things you need to do, and a lot of the things you want to do. And let's face it, the most important resource is a pay plan that works for the average and the aggressive business builder. At Zija, you don't need a computer or a mathematical degree to understand the Zija plan — just five minutes worth of common sense.

Think you've heard all this before? Think again. Say hello to Zija's Compensation Plan, which includes FastStart Commissions with Builders' Bonus Pool, Customer Commissions, Unilevel payout to nine levels, and three Executive Director Bonus Pools.

**Zija FastStart Commissions**

We already know just how well the Zija beverage will jumpstart your lifestyle. Now let's talk about how the Zija FastStart Commissions can jumpstart your business. Because Zija is so easy to share, your friends and family will want to enjoy it like you do. Whenever someone becomes your customer, Zija will award up to 45% of their initial purchase made in the first month. You can even take advantage of the Builders' Bonus Pool, paid to the top new business builders every month from FastStart Commissions others left behind.

Click here for more details on just how fast Zija FastStart Commissions can move you.

**Zija Unilevel Commissions**
**FABULOUS WAYS TO MAKE MONEY WITH ZIJA**

**RETAIL COMMISSION - PAID WEEKLY**

Paid out when you sell Zija to other people who do not qualify for wholesale pricing. You'll either earn a $5 or $15 commission on each case of Zija you sell. Paid weekly.

**FASTSTART COMMISSION - PAID WEEKLY**

- **Each Initial Product Order Paid on TWO LEVELS**
  - Recruiter of New Member: 50 PSV at 20% / 100 PSV at 35%
  - First Upline Sponsor of Recruiter: 50 PSV at 5% / 100 PSV at 10%

**PAYS 45%**

**UNILEVEL COMMISSION - PAID MONTHLY**

- **Unilevel Commission** - This commission is earned by Active Distributors of any rank and is based on the sales volume of the first order made within 30 days by new Customers or Distributors. Paid weekly.
- **Unilevel Commission** - This commission is earned from the ongoing sales made by Customers and Distributors after the first FastStart purchase. The amount you are qualified to receive is based on your rank which dictates the number of levels for which you are paid. Paid monthly.
- **Rank Qualifications** - Refer to the Volume and Organization Requirements on the back of this sheet.

**BUILDERS' BONUS POOL - PAID MONTHLY**

- **Builders' Bonus Pool** - This pool is divided on a pro-rata basis amongst the top ten Active Distributors, based upon their personal FastStart sales volume generated during that month. The pool is funded by the FastStart Commissions that were not earned by other Zija Distributors. Paid monthly.

**RAPID GROWTH BONUS**

- **Earnings Rank**
  - Director: 3rd place / $2k
  - Senior Director: 5th place / $4k
  - Executive Director: 8th place / $8k
  - Executive Director 200: 12th place / $15k
  - Executive Director 400: 18th place / $25k

**Rapid Growth Bonus** - Rewards Active Distributors with bonus checks for meeting specific rank qualifications within set periods of time. It's paid in the 4th, 6th, 9th, 12th, and 19th months after enrollment to qualified Directors, Senior Directors, and Executives.

**LEADERSHIP BONUSES**

**Executive Director Bonus Pools - Paid Quarterly**

- Executive Director 100K (ED100) Bonus Pool / 100K GV / Pro Rata Share of 2% Gross Product Sales
- Executive Director 200K (ED200) Bonus Pool / 200K GV / Pro Rata Share of 1% Gross Product Sales
- Executive Director 400K (ED400) Bonus Pool / 400K GV / Pro Rata Share of 1% Gross Product Sales

**Executive Director Bonus Pools** - Three pools of money—ED100, ED200, and ED400—are funded with up to 4% of Zija's gross product sales. It's paid out in a pro-rata basis to qualified Executive Directors (ED). Paid quarterly.

**Unlimited Leadership Bonuses**

- **Unlimited FastStart Bonus (Paid weekly)**
- **Unlimited Unilevel Bonus (Paid monthly)**

For a more comprehensive explanation of the Zija Compensation Plan, go to drinklifein.com and review the Zija Policies & Procedures.
The “Zrii™ Prosperity Plan™” Explained

Fast Start Training Bonus (paid weekly)

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5% Fast Start Bonus Pool (paid monthly)

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Unilevel Royalty Bonus—dynamically compressed (paid monthly)

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Infinity Bonus (paid monthly)

- 3% of total commissionable sales paid to qualified 9-Star, 10-Star, and 11-Star Executives. 1% of the bonus is paid pro rata at each rank.

Matching Bonus (paid monthly)

- Must be an all 1 person on all 1-Star rank in order to earn the monthly Matching Bonus, through 9-Star Executive.

3% All Star Bonus (DCT quarterly)

- 3% of total commissionable sales paid to qualified 9-Star, 10-Star, and 11-Star Executives. 1% of the bonus is paid pro rata at each rank.

2% Founders Bonus (paid annually)

- One share of 2% of all new market commissionable sales will be paid as a royaly, to any Independent Executive who attains the rank of 7-Star Executive or above, within 1 year of enrolling in the program. 2% per year in the subsequent year. Bonus must be maintained 9 out of 12 months in a calendar year in order to continue to participate in the Founders Bonus.

BONUS DETAILS:

1. Fast Start Training Bonus: An Independent Executive whose autobiography is 25% or more will receive 10% of the product purchased by anyone they personally enroll during the first month of the new IE's enrollment. The sponsoring IE will receive 30% of month 1 and 20% in months 3 and 4. The bonus will continue as long as the sponsoring IE is at the minimum monthly OV of 240 PVP or above. A sponsor whose autobiography is under 240 PVP will receive 20%, 20%, and 10% in months 1, 2, and 3, respectively. Fast Start volume in excess of 1200 PVP in month one and 20% PVP in months two and three will be paid out through the un-level pay plan.

2. Minimum Monthly OV: Personal Volume (PV) requirements may be satisfied through personal autobiography (SAO) or retail customer orders.

3. Minimum Monthly OV: Organization Volume (OV) = PV + all other volume in your organization.

4. Rank Qualifications: A rank must be maintained for at least 90 days to qualify. Additionally, 8-Star must have at least 1 7-Star and at least 2 6-Star or above, 9-Star must have at least 1 8-Star and at least 2 7-Star or above, 10-Star must have at least 2 9-Star and at least 2 8-Star or above.

5. Infinity Bonus: Pay amount is determined by your lowest qualified commissionable level, until another IE in your organization achieves the same rank or higher.

Matching Bonus: An IE must personally enroll at least one IE or sponsored Customer each month in order to earn Matching Bonus. Once an IE attains the rank of 8-Star Executive, there is no longer a monthly personal enrollment requirement to receive Matching Bonus. Matching Bonus is now received on the individual share of personal volume.
Appendix 2D

Comparative Analysis of Direct Sales and other Legitimate Distribution Models with No-Product Pyramid Schemes (NPS) and Recruitment-driven MLMs*, or Product-based Pyramid Schemes (PPS)

Analysis by Jon M. Taylor, MBA, Ph.D., President, Consumer Awareness Institute, and Advisor, Pyramid Scheme Alert

What this analysis reveals

The table which follows shows that clear distinctions can be made between classic (1-2-4-8, etc.) no-product pyramid schemes, product-based MLMs (multi-level marketing) programs*, and all forms of legitimate businesses to which the latter are often compared. MLM programs are often referred to as “network marketing” (also “consumer direct marketing,” etc.) and can be separated into two categories:

1. Recruitment-driven MLMs use compensation systems that are so heavily weighted towards the top of the hierarchy of participants that it is necessary for participants to recruit aggressively to realize any significant profits. These are highly leveraged programs, enriching a few at the top of a pyramid of participants at the expense of the efforts and purchases of a multitude of downline distributors – whose contributions are “leveraged” for the benefit of those above them. In recruitment-driven MLMs, most of the payout in commissions and bonuses from the MLM go to top distributors and very little can be gained from efforts to sell products directly to consumers. Properly understood, such MLMs are illegal pyramid schemes. The vast majority of MLMs I have studied fall into this category.

2. Hypothetical retail-focused MLMs pay the bulk of their commissions to the person selling the products or services to end use consumers. In a retail MLM, there is enough incentive to sell directly to customers that it is not necessary to recruit a large downline to realize significant profits. In over 600 MLMs (to date), I could find no examples of true retail-focused MLMs. So I feel safe in concluding that retail-focused MLMs do not exist.

How these distinctions were derived

Fortunately, I was able to draw from an extremely broad background in home businesses to make these comparisons, having had direct experience or performed consultation services in almost all forms of business to which MLMs are often compared. In addition, I spent a full year in an intensive one-year test of a leading MLM as a full-fledged distributor, carefully noting everything that went on. I then conducted interviews with hundreds of present and former participants in a variety of MLMs before arriving at the conclusion that most MLMs are in fact cleverly disguised pyramid schemes.

I knew enough from my direct experience to know that the major problems with MLMs resulted from the compensation systems, or pay plans, of the various MLM companies. Decades ago, psychologists learned that “you get the behavior you reward.” Nowhere is this more evident than in multi-level marketing.

Combining the research and experience of myself and others, I itemized what characteristics in MLM and in no-product pyramid schemes are unique to them and clearly differentiate them from other types of business activity. Then I broke these down into those which were implicit within the compensation plan – which seemed to cause most of the problems – and those that could be considered merely effects growing out of the reward system. Items numbered 1 to 6 could be considered causal, while items numbered 7 to 17 could be considered effects. Number 6 applies to no-product pyramid schemes and is replaced by number 4 for product-based pyramid schemes.
Other useful findings:

What I found was strikingly clear. Five characteristics*** (especially the first four) clearly differentiated the MLMs, or product-based pyramid schemes from the rest. These factors were both defining and causal – defining the differences, as well as identifying the causes of the problems. No-product pyramid schemes have always been more easily recognized, both by law enforcement and by consumers. What this analysis shows is that traits can be singled out both to clarify differences and to predict high loss rates.

These same five “red flags” could have legal significance in court cases. In most jurisdictions, a key element is considered in defining pyramid schemes – the payment of money by the company in return for the right to recruit other participants into the scheme. If the primary emphasis is compensation from recruiting, rather than from the sale of products to end users, it is considered a pyramid scheme. How such primary emphasis is to be determined has until now been a formidable challenge for investigators. Hopefully, this challenge will be met with this analysis and my more complete analysis entitled “THE 5 RED FLAGS: Five Causal and Defining Characteristics of Product-Based Pyramid Schemes”***

In the spring of 1999, I mailed my conclusions to the presidents of 60 of the most prominent MLM companies and gave them a form to provide data to “prove me wrong.” At least five of them attempted to do so, but none were able or willing to do so. So I was left with the necessity of validating my conclusions using other resources. With the help of associates, careful research into public documents, and a lot of communications with key informants, I was finally able to locate the average incomes and percentages of “distributors” at various payout levels at 37 (by 2012) MLM companies. What I found was startling – far worse than expected. After eliminating typical deceptions in their reporting, the loss rate for the MLMs for which I was able to find average earnings data was approximately 99.7%. And if you eliminate TOPPs (top-of-the-pyramid-promoters) from the calculation, the loss rate is closer to 99.9% for new recruits.

That means that as few as one in 1,000 new recruits earn a profit – and only a tiny percentage of those earn the huge “residual income” promised them. No-product pyramid schemes, which are illegal because of the guarantee that the all of those on the bottom layers will lose money, have far better odds than that! Recent data shows that product-based pyramid schemes are far worse than no-product schemes by any measure – loss rate, aggregate losses, number of victims, etc.

The chart that follows is color-coded to help discern the differences between characteristics of the various business models. Defining and causal characteristics of -

No-product pyramid schemes are marked in medium gray.

Recruitment-driven MLMs are dark gray.

Retail-focused MLMs (if such were to exist) are light gray.

Significant effects that are not causal are marked in very light gray, the most important of which are listed first, as numbers 7 to 10.

* a.k.a. multi-level marketing, network marketing, consumer direct marketing, etc. Recruitment-driven MLMs can be distinguished from retail-focused MLMs, in which the company pays generously for retailing products without recruiting large downlines. For retail-focused MLMs, #5 (and preferably #4 as well) would be answered with a "NO."

** "Incentivized purchases" are purchases of goods and services from the MLM company that are tied to qualification to participate in commissions or to advance through ascending levels in the distributor hierarchy. If they constitute a required cost of participating in the “business opportunity,” then whether they are used, sold, given away, or stored is irrelevant – they should be considered a cost of doing business.

*** NOTE: In 2003, I settled on the 5 CDCs (or “5 red flags”) for analytical purposes. However, analysis of over 600 MLMs has led me to reduce the number to four, since #4 occasionally does not apply, [#4 and #5 were later reversed in subsequent reports so that the first four could be easily identified as universal and #5 as applied to most, but not all, of them.] However, when the number of levels in the pay plan has been limited to four or less, this has been compensated for by extreme jumps in income at the top levels. All are top-weighted, though increasing the number of levels can greatly enhance the effect.
<table>
<thead>
<tr>
<th></th>
<th>Pyramids</th>
<th>Distributor's sales</th>
<th>Insurance agency sales</th>
<th>Recruiting business</th>
<th>Legitimate Direct Selling</th>
<th>NPS (no product scheme)</th>
<th>PPS or recruitment-driven MLMs</th>
<th>Retail MLMs (hypothetical)</th>
<th>Comments – and Problems</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Recruiting of Participants is Unlimited in an Endless Chain of Empowered and Motivated Recruiters Recruiting Recruiters.</strong> Is unlimited recruiting allowed, and are those who are recruited empowered and spurred on by incentives (overrides, advancement, etc.) to recruit additional recruiters, who are also empowered and motivated to recruit still more recruiters, etc. – so that the effect is an endless chain of recruiters recruiting recruiters?</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>Income is dependent on downline recruiting, with the assumption of an unlimited market. Perceived or de facto saturation results in diminishing opportunity and guaranteed losses for participants at bottom levels. If all pyramid schemes were defined as illegal (and the laws were enforced) based on this one characteristic, we would not have the proliferation of schemes we see today.</td>
</tr>
<tr>
<td><strong>2. Advancement in a Hierarchy of Multiple Levels of “Distributors” is Achieved by Recruitment, Rather Than by Appointment.</strong> Does a participant advance in position (and potential income) in a hierarchy of multiple levels of “distributors,” by recruiting other distributors under him/her, who in turn advance by recruiting other distributors under them, etc.?</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>If a participant must recruit to advance to more profitable payout levels in the scheme, and if a program’s emphasis is on building a downline, it as a de facto pyramid scheme, whether or not it has been declared illegal by authorities. Also, for PPS’s, quality of products often becomes questionable when advancement and monetary incentives are tied to recruitment.</td>
</tr>
<tr>
<td><strong>3. “Pay to Play” Requirements are Satisfied by Ongoing “Incentivized Purchases”.</strong> Are new “distributors” given “pay to play” options? That is, are they encouraged to make sizable investments in “incentivized purchases” (purchases tied to qualification for commissions or advancement in the scheme”) in order to take advantage of the “business opportunity,” and later to continue qualifying for advancement and payments from the company?</td>
<td>NO – only initial investment</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>Such cost of participation assures huge gains for top-level participants, but guarantees losses for those who fail to ascend to higher levels in the hierarchy of participants. The amount of initial investment for PPS’s may be small, but total purchases over time can be very significant for those seeking promised rewards, such as advancement to higher “pin levels” or bonus categories.</td>
</tr>
<tr>
<td><strong>4. Top Weighted Pay Plan – Company Payout Per Sale for Each Upline Participant Equals or Exceeds That for the Person Selling the Product, Creating Inadequate Incentive to Retail and Excessive Incentive to Recruit – and an Extreme Concentration of Income at the Top.</strong> Would a “distributor” purchasing products “for resale” receive about the same total payout (in commissions, bonuses, etc.) from the MLM company as participants several levels above who had nothing to do with the sale? Those at the top of the hierarchy then profit hugely. <strong>NOTE:</strong> the program is still top-weighted if the total payout for all upline distributors exceeds that for the front-line person selling the product.</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>YES</td>
<td>NO</td>
<td>This results in extreme inequality in payout to distributors and a high loss rate. Only a few participants at the top of the pyramid get enough in commissions from sales to a large downline to achieve a significant income. Conversely, those on lower levels seldom get enough payment from the MLM to cover their expenses, including purchases from the company. Thus the emphasis is on recruiting, not retailing or direct selling. If distributors on the front line receive over half of an MLM company’s payout, the MLM would have more of a retail emphasis.</td>
</tr>
<tr>
<td><strong>5. Company Pays Commissions and/or Bonuses to More Than Five Levels of “Distributors.”</strong> Does the company pay commissions and bonuses to distributors in a hierarchy of more levels than are functionally justified; i.e., more than five levels?” Even in major corporations, the entire world marketplace can be covered in five levels of sales management – branch, district, regional, national, and international sales managers.</td>
<td>NO – not usually</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>4-level limit best</td>
<td>More than 4 levels in an MLM means huge payouts to top level participants, which come from overrides on purchases of a large downline. This more than compensates for the small payout per sale – vs. NPS’s, where the top person gets it all. Paying bonuses on more than five levels in an MLM enriches those at the top at the expense of those at the bottom.</td>
</tr>
<tr>
<td><strong>6. All the Money Goes to the Top.</strong> Would participants who recruit other participants into the scheme receive nothing until advancing to the top level in the hierarchy? <strong>NOTE:</strong> This applies to NPS only – PPSs (MLMs) are still top-weighted without all the money going to one person at the top, but more money goes to the upline than to the front-line person selling the product.</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>YES</td>
<td>NO</td>
<td>NO</td>
<td>With NPS’s, only participants at the top of the pyramid get paid. Those at the bottom levels will always be waiting to advance to the highest level to get paid. Approximately 90% end up losers when the pyramid collapses or is shut down.</td>
</tr>
</tbody>
</table>
### DEFINING AND CAUSAL CHARACTERISTICS in the compensation system that identify harmful pyramid schemes.

The features on this page both define a pyramid scheme and cause the harm (extreme loss rate).

<table>
<thead>
<tr>
<th>Franchise</th>
<th>Distributor-sales</th>
<th>Insurance-agency sales</th>
<th>Recruiting business</th>
<th>Legitimate Direct selling</th>
<th>NPS (no-product scheme)</th>
<th>PPS (or recruitment-driven MLM)</th>
<th>Retail MLMs (hypo-driven)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
<td>NO</td>
<td>NO</td>
</tr>
</tbody>
</table>

**COMMENTS** – and **PROBLEMS** resulting from these characteristics when applied to pyramid schemes (NPS and PPS)

7. Emphasis is on payments for the rights to recruit as the primary source of income, rather than the sale of products and services

8. Loss rate is so dismal enough to disqualify them as legitimate businesses. It is rare for participants to report a net profit to the IRS.

9. Misrepresentation and deceptive sales practices are commonplace, as they are essential for any pyramid scheme to survive and grow. If the truth were told about the abysmal odds of “success,” few would join the program, and it would soon collapse.

10. New pyramidal organizations are set up in other areas (or with new product divisions for PPS’s) to maintain downline networks until the pyramid collapses or the scheme is stopped by legal action. By having to recruit new participants to repay earlier investors, NPS’s and PPS’s evolve into Ponzi schemes.

11. The distinction between buyer and seller becomes blurred. With multi-level schemes, the seller, buyer, and recruiter (and his/her immediate family) may be the same entity.

12. The program displays a pattern of rapid growth, then a leveling off in sales, followed by a precipitous decline in volume, unless aggressive re-pyramiding occurs.

13. Duplication of one’s efforts and investment is encouraged in order to build one’s downline.

14. Continuous replacement of “losers” is supplied by continual recruiting of new participants.

15. Demand for the products is distributor-driven, not market-driven.

16. Promises are made of quick return on investment, huge residual (“permanent”) income, time freedom, and other easy money appeals.

17. Addiction to pyramid scheme appeals can be seen in some participants.

For more information, go to [www.mlm-thetruth.com](http://www.mlm-thetruth.com).
Appendix 2E: List of MLMs for which compensation plans have been analyzed by Jon M. Taylor, MBA, Ph.D.

As of January 11, 2016, a total of over 600 MLMs have been evaluated by Dr. Taylor (usually by request). When at least the first four of the five causal and defining factors82, or "red flags," identified by Dr. Taylor are found in an MLM, it can be considered a recruitment-driven MLM, or product-based pyramid scheme – and certainly an unfair and deceptive practice (UDAP). Such compensation plans have been found to result in loss rates of 99.1% to 99.9%, with an average loss rate of 99.7% in the 50 MLMs analyzed in Chapter 7.

When you eliminate TOPPs (top-of-the-pyramid promoters) from calculations of average incomes, the chances of new recruits profiting is approximately ZERO!

In addition to those listed below, Dr. Taylor also analyzed numerous MLM programs that are now defunct, shut down by authorities, or that did not provide sufficient detail in their compensation plans to do a complete evaluation. This was true of many party plans.

Those MLMs with the symbol ► by them have furnished average income statistics (See Appendix 7)

Disclaimer:: Since each person is encouraged to do their own 5-step “do-it-yourself evaluation” on our web site, we will not be responsible for the decision any reader chooses to make about participation.

---

82 See Chapter 2

**MLMs analyzed:**

<table>
<thead>
<tr>
<th>A</th>
<th>A. L. Williams (now Primerica)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Acai Plus</td>
</tr>
<tr>
<td>A</td>
<td>Achievers Unlimited</td>
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<tr>
<td>A</td>
<td>ACN</td>
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<tr>
<td>A</td>
<td>Adcall</td>
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<td>A</td>
<td>Advantage Marketing Systems</td>
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<tr>
<td>A</td>
<td>Advantage Neutraceuticals</td>
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<tr>
<td>A</td>
<td>Advocare</td>
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<td>A</td>
<td>Affordable Energy</td>
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<td>A</td>
<td>Agel</td>
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<tr>
<td>A</td>
<td>AllM</td>
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<tr>
<td>A</td>
<td>Allivemax</td>
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<tr>
<td>A</td>
<td>All-star Entrepreneur</td>
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<tr>
<td>A</td>
<td>AlpineV</td>
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<tr>
<td>A</td>
<td>Altairia</td>
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<tr>
<td>A</td>
<td>Amazon Herb</td>
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<tr>
<td>A</td>
<td>Ambit Energy</td>
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<tr>
<td>A</td>
<td>American Longevity</td>
</tr>
<tr>
<td>A</td>
<td>American Marketing Systems (AMS)</td>
</tr>
<tr>
<td>A</td>
<td>Ameriplan USA</td>
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<tr>
<td>A</td>
<td>Amway</td>
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<tr>
<td>A</td>
<td>APP - American Petroleum</td>
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<tr>
<td>A</td>
<td>Prom’s</td>
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<tr>
<td>A</td>
<td>Ameriplan USA</td>
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<tr>
<td>A</td>
<td>Amerisciences</td>
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<td>A</td>
<td>Amigo Health</td>
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<td>A</td>
<td>Amkey</td>
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<td>A</td>
<td>Amsoil</td>
</tr>
<tr>
<td>A</td>
<td>Amway (was Quixtar in USA for a few years)</td>
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<tr>
<td>A</td>
<td>Annasa</td>
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<tr>
<td>A</td>
<td>Apeus</td>
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<tr>
<td>A</td>
<td>Approval Warehouse</td>
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<td>A</td>
<td>Arbonne</td>
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<tr>
<td>A</td>
<td>Ardyss International</td>
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<td>A</td>
<td>Ariix</td>
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<td>A</td>
<td>Ascend Technologies</td>
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<td>A</td>
<td>Ascential Bioscience</td>
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<td>A</td>
<td>Asea</td>
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<tr>
<td>A</td>
<td>At Home America</td>
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<tr>
<td>A</td>
<td>Ava Anderson Non-toxic</td>
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<tr>
<td>A</td>
<td>Avallia – distributes Nutrimetrics</td>
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<tr>
<td>A</td>
<td>Aviance</td>
</tr>
<tr>
<td>A</td>
<td>Avon – now an MLM</td>
</tr>
<tr>
<td>A</td>
<td>Awareness Life</td>
</tr>
</tbody>
</table>

**B**

| B | Baby Crazy                    |
| B | Bamboo Park                   |
| B | Beach Body                    |
| B | BeautiControl Cosmetics       |
| B | Bel’Air                       |
| B | Bellamore                     |
| B | Better Universe               |
| B | Beyond Freedom Evolution      |
| B | bHIPGlobal                    |
| B | Big Planet (Nu Skin division)  |
| B | Boceutical                    |
| B | Biogen                        |
| B | Biometrics                    |
| B | Bioperformance                |
| B | BioPro                        |
| B | BioSolace (India)             |
| B | BodHD                         |
| B | Bodywise                      |
| B | Bookwise Books                |
| B | Boresha Int’l                 |
| B | Brain Abundance               |
| B | Brain Garden                  |
| B | Business in Motion            |
| B | Business Toolbox              |

**C**

| C | Cabi                          |
| C | Cajun Country Candies         |
| C | Celebrating Home              |
| C | Cell Tech                     |
| C | Cell Wireless                 |
| C | Ceres Living                  |
| C | Champion Communications       |
| C | Cie Aura                      |
| C | Citizenre                     |
| C | Cleur                         |
| C | Coastal Vacations             |
| C | Cognigen                      |
| C | Common Sense                  |
| C | Communications (Telex Free)   |
| C | Conklin                       |
| C | Consumer Choice Marketing     |
| C | Cookie Lee Jewelry            |
| C | cPRIME                        |
| C | CR Health & Beauty Systems    |
| C | Creative Memories             |
| C | Customer Advantage            |
| C | Cyberwize                     |

**D**

| D | Daisy Blue                    |
| D | DBN- Downline Builders Network |
| D | DCHL - Digital Crown Holdings Ltd. |
| D | De Marle at Home              |
| D | Destiny 2000                  |
| D | Direct from Vatican City      |
Discount Home Shoppers Club  
(now Global Income Partners)  
Do Terra Earth Essence  
Dove Chocolate Discoveries  
Drink ACT  
DS Domination  
DSX  
Dubli  
Dxn  
Dynapharm  
Dynasty of Diamonds  

E  
Easy Daily Cash  
E-bio (India)  
Ebiz.com  
►Ecoquest (now Vollara)  
eCosway  
eFoods Global  
eFusion (acai)  
Eiro  
Elite Marketing Alliance  
Elur  
Emgoldex  
Emerald Essentials  
Emerald Passport (Profit Masters)  
Emgoldex  
Empire Dreams  
►Empower Network  
Enagic  
Energetix  
Enfinita  
Eniva Gold Marketing  
Enliven  
Envision CC  
Envy Organics  
Epic Network  
Escape International  
Essante  
Essensa Naturale  
Essentially Yours  
Evolution International  
Evolv Health  
Excel Telecom's (acquired)  
eXfuse  
Extreme Research  
EZ Wealth by Design  
EZ-Biz

F  
Feeder Matrix  
Fern  
FFSI  
FGExpress  
Financial Education Services  
First Financial Security  
First Fitness International  
First Source Marketing Alliance  
Flexcom  
FM Group World  
For You  
Foru Int'l

G  
Gano Excel, Gano Life  
Gatosk  
GBG  
GDI - Global Domain Int'l  
Gem Lifestyle  
Gemcap  
Genesis Global Network  
Genesis Pure  
Gennewize Life Sciences  
Global Equity Lending  
Global Health Trax  
Global Income Partners  
GIFN- Global Information Network  
Globalinx  
Global Resorts Network  
Global Travel Trends (PRT)  
Travel  
Global Wealth Trade  
GNLD  
GOG (India)  
GoHFT  
Gold Canyon  
Gold Mine International  
Golden Neo-life Diamite  
GoldQuest  
Goldshield Elite  
Good Life International  
Goyin  
Great Life International  
Green Organics  
Green World  
GVO Team Elite

H  
Hand of Heaven  
Havnn Jus (formerly Jus Int'l)  
HBW Insurance & Financial  
Health 4 Wealth  
Healthy Coffee USA  
Healthy Habits Global  
►Herbalife  
Heritage Health Products  
Heritage Makers  
Home Tec  
Hsin Ten Enterprise USA (HTE)

I  
iBuzzPro  
ID Life  
IGlobalPro  
►Ignite/Stream Energy  
Igonet  
Ingreso Cyber  
►Immunotec  
Independence Energy Alliance  
►iNet Global  
Infinii  
Infinity Downline [That's no joke - “infinity” ~]  
Inner Light  
Inspired Living App  
Integris Global  
IDN (early Nu Skin division)  
Int’l Galleries, Inc. (IGI)  
►Isagenix  
It Works  
ITV Ventures  
IV-7 Direct  
iWowwe  
iZigg Mobile Marketing

J  
Jafra  
Jamberry  
Javita Coffee  
JD Premium  
Jeunesse Global  
Jewelry by Park Lane  
J Hilburn  
Jillian Chase  
JM Ocean Avenue  
Juice Plus (NSA)  
Jusuru Int’l

K  
Kaching Kaching  
Kaire  
Kangivity Global  
Kannaway  
Kanosis  
Karabars  
Karemore  
Kilante Coffee  
KIS  
Kleenze (UK)  
K-Link  
Klob International  
Kompond Strategies  
Kyani

L  
Learning Global USA  
Leaving Prints  
Legacy for Life  
Legacy Max  
Legal Shield (was Prepaid Legal)  
LEO  
Le-Vel  
Level One Network  
Level 9 Marketing  
Lexxus  
Lia Sophia  
Liberty International  
Liberty League Int’l (LLI)
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Company Name</th>
</tr>
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<tbody>
<tr>
<td>Life Force Int’l</td>
<td>Life Force International</td>
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<td>Life TEAM</td>
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<td>Longrich</td>
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<td>Loving Works</td>
<td></td>
</tr>
<tr>
<td>LR Health &amp; Beauty Systems</td>
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Simply You
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Skinny Body Care
Slender Now
Solavei
Soteria/ It Works Marketing
Southern Living at HOME
Sozo
SpeakAsiaOnline.com
Sportron
Spring Wellness
Stampin’ Up!
Stanley Home Prod’s/Fuller Brush
Stella and Dot
Stem Tech Health Sciences
STIFORP
Stimulife
Stream Energy (Ignite)
Strongbrook (real estate)
Success Life
Success University
Sunrider
Supralife
Sweet Living
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Talk Fusion
Tastefully Simple
Team Everest
Team Life Changes (Nutraburst)
Team National
Team Vinh University
Telecom Plus
TelexFree (Ponzi scheme promoted as MLM)
That Free Thing
The Green Polka Dot Box
The Limu Company
The Profit Masters
The Right Solution
The Traveling Vineyard
The Trump Network
Thirty One Gifts
Thoughts Transpired
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TLC - Total Life Changes
TMI - Transcend Marketing Int’l
Tom Danley’s Tape of the Month
Tomboy Tools
Top Line Creations
Traverus Travel
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Trio Global Company (Philippines)
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Trivita
Tupperware
TVC Matrix
TVI Express
Tyra

U
Ubifone
Ubox
UltraStore
Unicity
UniLife Health Care (India)
Univera Life Sciences
Unlimited Profits
UNO – Unlimited Network of Opportunities
Upper Crust Living
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USANA Health Sciences
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Visalus Health Sciences
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VM Direct (Helloworld)
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Wealth Masters Int’s
Wealth Pools International
WIN (Wellness Int’l Network)
Winalite
Woosh
World Financial Group
World GMN
World Group Securities
World Leadership Group
World Lending Group (recently Global Equity Lending)
WMA - World Marketing Alliance
World Ventures
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Appendix 2F

Petition from Bruce Craig, former assistant to the Wisconsin Attorney General, addressed to FTC Chairman Robert Pitofsky

February 25, 2000

Robert Pitofsky, Chairman,
Federal Trade Commission
600 Pennsylvania Avenue, N.W.
Washington, D.C. 20580

Re: Petition for compliance analysis or enforcement review regarding In re Amway, 93 FTC 618 (1979), Docket 9023

Dear Chairman Pitofsky:

I served as an Assistant Attorney General for the State of Wisconsin for 30 years, until retirement in 1997. During this period I litigated a significant number of pyramid cases - including extensive litigation against Amway in the early 1980s and cases against Koscot Interplanetary, Bestline, and Holiday Magic in the early 1970s. These actions were pursued with the direct cooperation of Commission staff. My most recent pyramid case, against Fortune In Motion, was successfully concluded in 1997. I recite this history only in the hope that it will lend credence to what follows.

I direct this letter to you because you drafted the Commission's Amway opinion in 1979. The opinion appears to hold that (a) "a pyramid distribution scheme should now be condemned even without the demonstration of its economic consequences. The Commission has studied the effects of such 'entrepreneurial chains' and seen the damage they do and a per se rule should be used." [ALJ finding at par 107] and (b) that Amway would have been one of those "chains" but for the existence, and enforcement, of the "buy back rule", the "70% rule" and the "10 customer" rule [93 F.T.C. 618, 716-17 (1979)].

These exculpatory rules have now become boilerplate in the hundreds of pyramid offerings that have surfaced since 1979. In my 1997 case, Fortune In Motion sought dismissal because it had incorporated the "Amway" rules into its marketing plan. In Webster v. Omnitrition, 79F.3d 776, 782-84 (9th Cir, 1996), the 9th Circuit reversed summary judgment in favor of the defendant, granted by the district court on the basis it used the "Amway" rules. The court, at p. 782, held "Our review of the record does not reveal sufficient evidence as a matter of law that Omnitrition's rules actually work."

Since investments in pyramid type offerings have resulted in billions of dollars in losses over the years, I believe it critical that the Commission, initially, determines whether in fact Amway currently enforces its rules to the extent that they produce the results the Commission anticipated in its decision.

The Commission may also want to consider, on a going forward basis, whether it is good policy to declare a practice per se illegal and then permit operation if certain exculpatory "rules" are incorporated into the business plan. The attractive, but illegal, aspects of a pyramid proposal will continue to permeate a promoter's offering and recruiting efforts notwithstanding the theoretical dampening effect of the "rules." The economic motivation of a company utilizing a pyramid concept is in direct conflict with the exculpatory "rules" it promulgates.

There also exists the question, from an enforcement standpoint, whether these exculpatory factors can be effectively evaluated in time to prevent losses to the consuming public. When a pyramid, or "multi-level", company begins business operations there is no direct evidence if its "rules" are enforced or not. The time period between startup
and detection is all some pyramids need. Fortune In Motion obtained over $4 million from Wisconsin residents during its short life and before we commenced litigation. The “buy back” rule was of no value since the company left the state and returned to its home offices in Canada. Does the enforcement agency bear the burden of proving that the "rules" are not enforced or is it an affirmative defense on the part of the pyramid company? Are all "multi-level" companies presumed to be pyramids until they prove their rules are effective in the manner contemplated by the Commission?

The contacts I have had with Amway, and other, distributors over the years indicates that the "rules" upon which the Commission based its decision are given, at best, token recognition and are not broadly implemented or enforced. I have attached some unedited Amway distributor statements to simply give a flavor of their views on these issues. One such statement comes from a high level "Emerald" distributor. Determining the actual practices of Amway and its distributors in this respect would seem to be uniquely within the domain of the Commission. To this end, I will be asking some ex-distributor organizations to contact their members for comment to the Commission on this point, pro or con.

I decided to submit this petition for enforcement review because it seems that most distributors, after failing in what they thought was a valid business enterprise, are not motivated to complain or seek redress. They have, in many instances, been conditioned to believe that any failure was their fault. Many such distributors have lost life savings, stable jobs, and their marriages. After having spent most of my career dealing with these companies from an enforcement standpoint, and witnessing the damage first-hand, I feel some obligation to these victims to make this effort on their behalf.

As indicated in Omnitrition, previously cited, and my Fortune In Motion case, the FTC Amway decision has created a good deal of uncertainty in respect to private and public legal efforts to deal with the abuses of pyramid plans. This will only increase with the onset of marketing over the Internet and the Globalization of this type of proposal.

I urge the Commission to make initial inquiry of Amway on the question of enforcement and enforceability of its rules. Documentation of compliance with the Commission’s decision, and of the beneficial effects it anticipated, should be readily available from Amway and its distributors. I also urge the Commission to re-evaluate, in general, the efficacy of its "rules" in preventing the abuses it has documented in connection with pyramid marketing. The premise of "multi-level vs. pyramid" marketing may well represent a distinction without a difference.

If I can be of further assistance in any efforts of the Commission, or in clarifying matters stated herein, please feel free to contact me. I appreciate your taking the time to review this matter.

Sincerely,

Bruce A. Craig – Assistant to the Attorney General (Department of Justice), State of Wisconsin (Retired). State Bar No. 1009068, of Counsel, Lawton & Cates, S.C.

1 This litigation was based on income misrepresentations. Documented evidence, from tax returns, disclosed that Wisconsin Amway Direct Distributors (the top 1%) had annual net incomes of minus $900.

2 Some language in the opinion, pp.716, 717, refers to the absence of inventory loading, "the purchase of a large amount of nonreturnable inventory" and the fact that an entry level Amway distributor makes no investment. However qualifying for the Direct distributor position does require mandatory monthly purchases, whether returnable or not depending on effective enforcement of the "buy-back" and other rules. The existence of the entry level distributor is not relevant to a pyramid analysis; the pyramid begins when the new distributor seeks to become a Direct. See Omnitrition par. 79 F.3d 776,782.

3 Wisconsin’s pyramid rule, Ch. ATCP 122, Wis. Adm. Code does not contain the exculpatory "rules". It has been upheld by the Wisconsin Supreme Court.
Appendix 2G

Letter to Dr. Peter Vander Nat, chief economist for the Federal Trade Commission

To: Peter J. Vander Nat, Ph.D.
Federal Trade Commission

From: Bruce A. Craig, Assistant Attorney General, Wisconsin (Retired)

RE: PYRAMID ANALYSIS

I have reviewed your declaration in the Equinox case. I would like to submit an alternative analysis of pyramids. Although many of the elements and concerns referenced in your declaration mirror mine, I believe our point of departure differs.

BACKGROUND

I have litigated against pyramids since the late 1960s. The significant economic losses they engendered raised the concerns of our office over and above standard fraudulent business offerings that relied on misstated earnings potentials and related deceptions. Wisconsin has a relatively unique regulatory status within the Department of Agriculture, Trade and Consumer Protection – whereby rules having the force and effect of law can be promulgated at the administrative level. One of those rules is ATCP 122, which can be found at the end of this memorandum. After extended public hearings, ATCP 122 declared illegal “chain distributor schemes.” The rule has withstood challenges in the Wisconsin Supreme Court and in Federal Court. Most recently, the rule was upheld, in 1997, by the Wisconsin Court of Appeals in State v. Fortune In Motion.

Perhaps of greater relevance to you is the fact that the then (c. 1972) Chairman of the Marketing Department of the Wisconsin School of Business, Howard Westing (now retired), was our primary witness in State v. H. M. Distributors and State v. Holiday Magic, the first significant legal challenges to ATCP 122.

Professor Westing’s testimony was forthcoming only after we spent several weeks discussing the elements of ATCP 122 and the pyramids it regulated. His initial reticence was based upon a natural inclination not to challenge what was then a novel means of marketing. Perhaps my interest at the time was based upon my undergraduate degree in marketing from Northwestern University and the stimulation provided by my mentor Stuart H. Britt.

The substance of Professor Westing’s testimony was that pyramids provided a form of “foreseeability” that enabled them to succeed notwithstanding non-competitive products, overlapping marketing areas, and saturated markets. In this context “foreseeability” was the element that let every new applicant see not only how he could recruit for profit but also that all those he recruited could similarly recruit, ad infinitum. In other words, there was no barrier within the terms of the pyramid plan to continued recruiting.

In essence, a pyramid is an endless chain in the guise of a business offering. This provides considerable leverage to pyramids because they could appeal to business success stories rather than the clearly gambling elements of a chain letter or lottery. Also they had the advantage of appearing, at first glance, as businesses to regulators and legislators – thus a foothold that has lasted until today.
Perhaps Wisconsin was fortunate in having a pyramid type endless chain reviewed, in 1907, by the Wisconsin Supreme Court in Twentieth Century Co. v. Quilling 130 Wis. 318, 319-20, 110 N.W. 174 (1907), the scheme involved the right to sell a “pole and thill coupling” to others:

"It was further agreed that each person to whom a sale was made should have the same right as the defendant to sell exclusive territorial rights in other counties, and the purchasers from him still the same rights, and so on without limits."

"We are unable to regard such a project as a legitimate business enterprise . . . . it will infallibly leave a greater or less crown of dupes at the end with no opportunity to recoup their losses because the bubble has at last burst. It contemplates an endless chain of purchasers, or, rather a series of constantly multiplying endless chains, with nothing but fading rainbows as the reward of those who are unfortunate enough to become purchasers the moment before the collapse of the scheme."

What Twentieth Century did was focus Wisconsin’s efforts towards the endless characteristics of a pyramid. This was reflected in ATCP 122.

**ANALYSIS**

The controlling element of every pyramid I have examined is that reflected in ATCP 122:

ATCP 122.02 Definition. (1) “Chain distributor scheme” is a sales device whereby a person, upon a condition that the person make an investment, is granted a license or right to recruit for profit one or more additional persons who also are granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. A limitation as to the number of persons who may participate, or the presence of additional conditions affecting eligibility for the above license or right to recruit or the receipt of profits therefrom, does not change the identity of the scheme as a chain distributor scheme. (emphasis supplied)

Once product sales and lower level introductory positions are stripped from the plan, the skeleton remaining is one where the recruit, for an investment (usually in the form of a minimum purchase or minimum monthly purchases), earns the right to recruit others in the same manner he was recruited.

The elements presented by this scenario are as follows:

1. The rules by which the pyramid operates are initiated, administered and enforced by the sponsoring company.
2. The recruit seeking to participate in the pyramidal elements of the offering must make a purchase or series of purchases i.e. an "investment". Usually this is a purchase from a recruiter who obtains his product from the sponsoring company at a discount from the amount paid by the recruit.
3. The required purchase generates profit to the recruiter and the sponsoring company from whom the product is purchased.
4. At the time the recruit makes his purchase investment he is fully aware that once reaching the distributive position for which the investment is made, he will be able to recruit others and profit in the manner described in Nos. 1, 2, and 3 above.
5. Furthermore, the recruit realizes that his chances for recruiting others in a manner which will generate to him the profits above discussed are significantly enhanced by his ability to offer, pursuant to the plan of the sponsoring company, those recruits the same right (or in terms of ATCP 122 – “such license”) as he obtained with his investment.
6. All future recruits within this narrative will have the identical rights as those of the first recruit, including the ability to offer to their recruits such rights, ad infinitum.
7. The plan does not diminish the right to recruit, upon investment, at any time along the chain (such as regional managers recruiting district managers who in turn recruit sales
agents). If it did, the element of “foreseeability” would deter the first recruit from joining, since his recruits would not enjoy the same recruiting rights as he does, and thus be much less likely to join.

8. It is the “endless” element of these proposals that distinguishes pyramids from other business offerings that do not contain that element.

DISCUSSION

A pyramid is much like a lottery, its mechanism is what makes it illegal – because the mechanism has no limit in its implementation. Many chain schemes are classified as lotteries, see for instance sec. 945.12 of the Wisconsin Statutes:

945.12 Endless sales chains. Whoever sets up, promotes or aids in the promotion of a plan by which motor vehicles are sold to a person for a consideration and upon the further consideration that the purchaser agrees to secure one or more persons to participate in the plan by respectively making a similar purchase and in turn agreeing to secure one or more persons likewise to join in said plan, each purchaser being given the right to secure money, credits, goods or something of value, depending upon the number of persons joining in the plan, shall be held to have set up and promoted a lottery and shall be punished as provided in –

http://folio.legis.state.wi.us/cgi-bin/om_isapi.dll?clientID=78254&infobase=stats.nfo&jump=945.02&softpage=Document-JUMPDEST_945.02s.945.02

The further prosecution of any such plan may be enjoined.

This analysis goes directly to the element of the plan that makes it a pyramid. Take away the right to offer future recruits the same rights to profit and recruiting held by the recruiter and the plan fails – or must exist on other legal or illegal marketing elements.

The FTC in the Amway decision appeared to recognize this critical factor, and then ignored it by concluding that retail sales and buy back provisions in the plan somehow changed it into a legal enterprise.

A lottery is not made legal by adding requirements to participation or requiring acts, which would, in theory, mitigate the impact of the lottery. An illegal lottery is rendered legal by eliminating one of the elements of prize, chance and consideration.

A pyramid is rendered legal by eliminating either the investment or the unbridled right to pass on recruiting rights identical to those held by the recruiter. In the case of a pyramid, neither of these elements is critical to a bona fide business.

While requirements of bona fide retail sales and buy backs would undoubtedly mitigate the impact of a pyramid, they would also destroy the pyramid if truly enforced – just as the theatre referenced in footnote 3 would go broke if it truly let any meaningful number of persons participate in its lottery without buying a ticket to the movie.

As previously discussed in my petition to the Chairman of the Commission, from an enforcement standpoint, it would be impossible to monitor the efficacy of a retail sales or buy back rule at the time a pyramid started up and likely impossible to validate at the time when the pyramid collapsed and the company disappears. The other scenario, much more dangerous, is that the company continues in business and has the economic and political resources to deter the Commission from even determining whether the retail sales and buy back rules are in fact enforced. It is for these reasons that I contend that the only way to prevent a pyramid from operation is to prohibit it, like a lottery, and require the company to eliminate one of the pyramidal elements before operating.

In theory, a buy back rule could result in the conclusion that no “investment” was made since the money could be returned if requested. If this were the case, it would be the legal obligation of the defendant to prove that the buyback is readily and universally
available to the extent that no “investment” was made. Here, it would be the legal burden of
the defendant, not the government, to prove the plan was not a pyramid.

CONCLUSION

I have no doubt that you are fully aware of the damage that a pyramid can cause. My
recollection is that pyramids virtually destroyed the government infrastructure of
Romania and areas of Russia. They clearly have taken billions from the thousands of
participants over the years, not to speak of the diversion of funds from legitimate business
enterprises.

I recognize the difficulty the Commission has in undoing the Amway decision. However, if there was ever a time to reverse this trend it has to be now. I strongly urge you
to focus your marketing and economic talents toward the “foreseeability” element
referenced by Professor Westing and less towards traditional marketing analysis of
products and markets. As I previously indicated, I believe the MLM – Pyramid distinction
to be illusory. Proof of emphasis on retail sales and other distinctions that may mask the
“investment” element neither go to the heart of the pyramid analysis nor escape the
enforcement problems discussed above concerning the retail sales and buy back rule.

I wish I had copies of Prof. Westing’s testimony, but it was 30 years ago. If you
would like other information or documentation I would be pleased to supply it.

I sincerely ask for your comments on this memorandum, including areas where you
think my legal or marketing analysis is flawed. I am not working on commission in respect
to these matters.

I ask that this document, sent by e-mail, be currently treated as confidential, or at
least not published, until we have had a further chance to discuss it. Be advised that I am
sending copies of this correspondence to Prof. Keep, Ms. Perkins, and Taylor and
Fitzpatrick. Attached to the e-mail is a copy of the Fortune In Motion opinion. Please note
ATCP 122 set forth below.

Thank you for your time and consideration.

Bruce Craig

NOTE: In the Wisconsin law Chain Distributor Schemes are considered an unfair trade
practice (The FTC should take note.):

ATCP 122.01 Unfair trade practice. The promotional use of a chain distributor scheme in connection
with the solicitation of business investments from members of the public is an unfair trade practice
under s. 100.20, Stats. When so used the scheme serves as a lure to improvident and un-
economical investment. Many small investors lack commercial expertise and anticipate unrealistic
profits through use of the chance to further perpetuate a chain of distributors, without regard to actual
market conditions affecting further distribution and sale of the property purchased by them or its
market acceptance by final users or consumers. Substantial economic losses to participating
distributors have occurred and will inevitably occur by reason of their reliance on perpetuation of the
chain distributor scheme as a source of profit. (emphasis by author)
Appendix 2H
Definitions of – or related to – illegal pyramid schemes in state statutes

[Notes by JMT: Most of the states fail to specify the endless chain of recruitment in pyramid schemes, which would help to separate them from legitimate recruiting businesses. Also, in several states where a chain selling or recruitment program is exempt from being classified as a pyramid scheme if sales are made to anyone (not just to non-participants), or where buyback provisions are offered, the Direct selling Association has likely influenced the legislation – especially if modifications were recent. Except where otherwise noted, the text for each state is a direct quote of that state’s definition. For a compilation of MLM laws in the 50 states, go to the web site for The Advocate Group at – www.theadvocategroup.net.]

Alabama
As used herein, “pyramid sales structure” includes any plan or operation for the sale or distribution of goods, services, or other property wherein a person for consideration acquires the opportunity to receive a pecuniary benefit, which is based primarily upon the inducement of additional persons by that person, and others, regardless of number, to participate in the same plan or operation, and is not primarily contingent on the volume or quantity of goods, services, or other property sold or distributed. [Ala. § Code 8-19-15 (19)]

Alaska
“Chain distributor scheme” means a sales device whereby a person, upon condition that the person make an investment is granted a license or right to solicit or recruit for profit one or more additional persons who are also granted a license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted a license or right upon the condition of investment. [Alaska Consumer Protection Act. AS § 45.50.561 (See definitions a.3)]

Arizona
“Pyramid promotional scheme” means any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from any person’s introduction of other persons into participation in the plan or operation rather than from the sale of goods, services or intangible property by the participant or other persons introduced into the plan or operation. (Ariz. Rev. Stat. § 44-1731. Modified 3-5-2010)

Arkansas
A pyramiding device shall mean any scheme whereby a participant pays valuable consideration for the chance to receive compensation primarily from introducing one (1) or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant. (Ark. Code Ann. § 4-88-109)

California
An “endless chain” means any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant. Compensation, as used in this section, does not mean or include payment based upon sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme. (Cal. Penal § 327)

Colorado
“Pyramid promotional scheme” means any program utilizing a pyramid or chain process by which a participant in the program gives a valuable consideration in excess of fifty dollars for the opportunity or right to receive compensation or other things of value in return for inducing other persons to become participants for the purpose of gaining new participants in the program. (Colo. Rev. Stat. Ann. § 6-1-102)

Connecticut
The advertisement for sale, lease or rent, or the actual sale, lease or rental of any merchandise, service or rights or privileges at a price or with a rebate or payment or other consideration to the purchaser which is contingent upon the procurement of prospective customers procured by the purchaser, or the procurement of sales, leases or rentals of merchandise, services, rights or privileges, to other persons procured by the purchaser, is declared to be an unlawful practice rendering any obligation incurred by the buyer in connection therewith, completely void and a nullity. The rights and obligations of any contract relating to such contingent price, rebate or payment shall be interdependent and inerseverable from the rights and obligations relating to the sale, lease or rental. (Conn. Gen. Stat. Ann. 42-105)

Also – from State v. Bull Inv. Group, Inc. (1974) 351 A.2d 879, 32 Conn.Supp. 279] Pyramid fraud law prohibits sale of rights or privileges where payment made or consideration given to purchaser is contingent on his procurement of prospective customers; since both vertical and horizontal pyramiding involve rebate or payment to purchaser which is contingent upon procurement of prospective customers procured by purchase, both forms of pyramiding are prohibited by this section.

Delaware
“Pyramid or chain distribution scheme” means a sales device whereby a person, upon a condition that the person part with money, property or any other thing of value, is granted a franchise license, distributorship or other right which person may further perpetuate the
pyramid or chain of persons who are granted such franchise, license, distributorship or right upon such condition. (Del. Code Ann. § 2561)

Florida

A "pyramid sales scheme," which is any sales or marketing plan or operation whereby a person pays a consideration of any kind, or makes an investment of any kind, in excess of $100 and acquires the opportunity to receive a benefit or thing of value which is not primarily contingent on the volume or quantity of goods, services or other property sold in bona fide sales to consumers, and which is related to the inducement of additional persons, by himself or herself or others, regardless of number, to participate in the same sales or marketing plan or operation, is hereby declared to be a lottery, and whoever shall participate in any such lottery by becoming a member of or affiliating with, any such group or organization or who shall solicit any person for membership or affiliation in any such group or organization commits a misdemeanor of the first degree, punishable as provided in s. 775.082 or s. 775.083. For purposes of this subsection, the term "consideration" and the term "investment" do not include the purchase of goods or services furnished at cost for use in making sales, but not for resale, or time and effort spent in the pursuit of sales or recruiting activities. (Fla. Stat. Ann. § 849.091)

Georgia

"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 into the plan or operation rather than from the sale of goods, services, or intangible property to participants or by participants to others. (Georgia Code § 16-12-38 (8))

Hawaii

A person engages in an unfair method of competition and an unfair or deceptive act or practice within the meaning of section 480-2 when, in the conduct of any trade or commerce, the person contrives, prepares, sets up, proposes, or operates any endless chain scheme. As used in this section, an endless chain scheme means any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme, or for the chance to receive compensation when a person introduced by the participant introduces a new participant. Compensation, as used in this section, does not mean or include payments based upon sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme. [L. 1970, c 28, §1; gen ch 1985] (Hawaii Rev. Stat. § 480-3.3)

Idaho

"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. (Idaho Code Ann. § 18-3101)

Illinois

The term "pyramid sales scheme" includes any plan or operation whereby a person in exchange for money or other thing of value acquires the opportunity to receive a benefit or thing of value, which is primarily based upon the inducement of additional persons, by himself or others, regardless of number, to participate in the same plan or operation and is not primarily contingent on the volume or quantity of goods, services, or other property sold or distributed or to be sold or distributed to persons for purposes of resale to consumers. (815 Illinois Comp. Stat. 505/1)

Indiana

"Pyramid promotional scheme" means any program utilizing a pyramid or chain process by which a participant in the program gives a valuable consideration exceeding one hundred dollars ($100) for the opportunity or right to receive compensation or other things of value in return for inducing other persons to become participants for the purpose of gaining new participants in the program. (Ind. Code Ann. 24-5-0.5-2)

Iowa

The advertisement for sale, lease or rent, or the actual sale, lease or rental of any merchandise at a price or with a rebate or payment or other consideration to the purchaser which is contingent upon the procurement of prospective customers provided by the purchaser, or the procurement of sales, leases or rentals to persons suggested by the purchaser, is declared to be an unlawful practice rendering any obligation incurred by the buyer in connection therewith, completely void and a nullity. The rights and obligations of any contract relating to such contingent price, rebate or payment shall be interdependent and inseverable from the rights and obligations relating to the sale, lease or rental. (Iowa Code Ann. 714.16)

Kansas

"Pyramid promotional scheme" means any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from any person’s introduction of other persons into participation in the plan or operation rather than from the sale of goods, services or intangible property by the participant or other persons introduced into the plan or operation. (Kan. Stat. Ann. § 21-3762)

Kentucky

"Pyramid distribution plan" means any plan, program, device, scheme, or other process by which a participant gives consideration for the opportunity to receive compensation or things of value in return for inducing other persons to become participants in the program. (Ky. Rev. Stat. Ann. § 361)

Louisiana

"Pyramid promotional scheme" means any plan or operation by which a participant gives consideration for
the opportunity to receive compensation which is derived primarily from the person's introduction of other persons into a plan or operation rather than from the sale of goods, services, or intangible property by the participant or other persons introduced into the plan or operation. (La. Rev. Stat. Ann. § 361)

Maine
The organization of any multi-level distributor-ship arrangement, pyramid club or other group, organized or brought together under any plan or device whereby fees or dues or anything of material value to be paid or given by members thereof are to be paid or given to any other member thereof who has been required to pay or give anything of material value for the right to receive such sums, with the exception of payments based exclusively on sales of goods or services to persons who are not participants in the plan and who are not purchasing in order to participate in the plan, which plan or device includes any provision for the increase in such membership through a chain process of new members securing other new members and thereby advancing themselves in the group to a position where such members in turn receive fees, dues or things of material value from other members, is declared to be a lottery, and whoever shall organize or participate in any such lottery by organizing or inducing membership in any such group or organization shall be guilty of a misdemeanor, and upon conviction thereof shall be punished by a fine of not more than $5,000 or by imprisonment for not more than 11 months, or by both. (Me. Rev. Stat. Ann. Title 17, § 2305)

Maryland
"Pyramid promotional scheme" means any plan or operation by which a participant gives consideration for the opportunity to receive compensation to be derived primarily from any person's introductions of other persons into participation in the plan or operation rather than from the sale of goods, services, or other intangible property by the participant or other persons introduced into the plan or operation. [Md. Title 8: 4: 8-404 § (a) (5)]

Massachusetts
[Note by JMT: While the applicable Massachusetts statute does not define pyramid schemes as such, it defines multi-level marketing and has some unique and very salient restrictions regarding MLM, particularly Ch. 93:69 (a), (d), and (e)]

Section 69. (a) As used in this section the term "multi-level distribution company" shall mean any person, firm, corporation or other business entity which distributes for a valuable consideration, goods or services through independent agents, contractors or distributors, at different levels, wherein participants in the marketing program may recruit other participants, and wherein commissions, cross-commissions, bonuses, refunds, discounts, dividends or other considerations in the marketing program are or may be paid as a result of the sale of such goods and services or the recruitment, actions or performances of additional participants.

(d) No multi-level distribution company or participant in its marketing program shall: (1) operate or, directly or indirectly, participate in the operation of any multi-level marketing program wherein the financial gains to the participants are primarily dependent upon the continued, successive recruitment of other participants and where retail sales are not required as a condition precedent to realization of such financial gains; (2) offer to pay, pay or authorize the payment of any finder's fee, bonus, refund, override, commission, cross-commission, dividend or other consideration to any participants in a multi-level marketing program solely for the solicitation or recruitment of other participants therein; (3) offer to pay, pay or authorize the payment of any finder's fee, bonus, refund, override, commission, cross-commission, dividend or other consideration to any participants in a multi-level marketing program in connection with the sale of any product or service unless such participant performs a bona fide and essential supervisory, distributive, selling or soliciting function in the sale or delivery of such product or services to the ultimate consumer; or (4) offer to pay, pay or authorize the payment of any finder's fee, bonus, refund, override, commission, cross-commission, dividend or other consideration which the participant may receive, or where the participant is without that degree of control over the operation of such plan as to enable him substantially to affect the amount of finder's fee, bonus, refund, override, commission, cross-commission, dividend or other consideration which the participants in turn receive from other members, is declared to be a lottery, and upon conviction thereof shall be punished by a fine of not more than $5,000 or by imprisonment for not more than 11 months, or by both. (Mass. § 93:69)

Michigan
A pyramid or chain promotion is any plan or scheme or device by which (a) a participant gives a valuable consideration for the opportunity to receive compensation or things of value in return for inducing other persons to become participants in the program or (b) a participant is to receive compensation when a person introduced by the participant introduces one or more additional persons into participation in the plan, each of whom receives the same or similar right, privilege, license, chance, or opportunity. (Mich. Comp. Laws Ann. § 445.1528)

Minnesota
It shall be illegal for any seller or lessor to operate or attempt to operate any plans or operations for the
disposal or distribution of property or franchise or both whereby a participant gives or agrees to give a valuable consideration for the chance to receive something of value for inducing one or more additional persons to give a valuable consideration in order to participate in the plan or operation, or for the chance to receive something of value when a person induced by the participant induces a new participant to give such valuable consideration including such plans known as chain referrals, pyramid sales, or multilevel sales distributorships. (Minn. Stat. Ann. § 325F.69)

Mississippi
The term “pyramid sales scheme” includes any plan or operation for the sale or distribution of goods, services, or other property wherein a person for a consideration acquires the opportunity to receive a pecuniary benefit, which is not primarily contingent on the volume or quantity of goods, services, or other property sold or distributed to be sold or distributed to persons for purposes of resale to consumers, and is based upon the inducement of additional persons, by himself or others, regardless of number, to participate in the same plan or operation. (Miss. Code Ann. § 75-24-51)

Missouri
The term “pyramid sales scheme” includes any plan or operation for the sale or distribution of goods, services, or other property wherein a person for a consideration acquires the opportunity to receive a pecuniary benefit, which is not primarily contingent on the volume or quantity of goods, services, or other property sold or distributed to be sold or distributed to persons for purposes of resale to consumers, and is based upon the inducement of additional persons, by himself or others, regardless of number, to participate in the same plan or operation. (Mo. Ann. Stat. § 407.400)

Montana
(a) "Pyramid promotional scheme" means a sales plan or operation in which a participant gives consideration for the opportunity to receive compensation derived primarily from obtaining the participation of other persons in the sales plan or operation rather than from the sale of goods or services by the participant or the other persons induced to participate in the sales plan or operation by the participant.

(b) A pyramid promotional scheme includes a Ponzi scheme, in which a person makes payments to investors from money obtained from later investors, rather than from any profits or other income of any underlying or purported underlying business venture.

(c) A pyramid promotional scheme does not include a sales plan or operation that:

(i) subject to the provisions of subsection (6)(b)(v)

(v) (A) provides for, upon the request of a participant deciding to terminate participation in the sales plan or operation, the repurchase, at not less than 90% of the amount paid by the participant, of any currently marketable goods or services sold to the participant within 12 months of the request that have not been resold or consumed by the participant; and

(B) if disclosed to the participant at the time of purchase, provides that goods or services are not considered currently marketable if the goods have been consumed or the services rendered or if the goods or services are seasonal, discontinued, or special promotional items. Sales plan or operation promotional materials, sales aids, and sales kits are subject to the provisions of this subsection (6)(b)(v) if they are a required purchase for the participant or if the participant has received or may receive a financial benefit from their purchase. (Mont. Code Ann. § 30-10-324)

Nebraska
Chain distributor scheme also known as pyramid sales shall mean a sales device whereby a person, upon a condition that he or she make an investment, is granted a license or right to recruit for profit one or more additional persons who also are granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. (Neb. Rev. Stat. § 87-301)

Nevada
A “pyramid promotional scheme” means any program or plan for the disposal or distribution of property and merchandise or property or merchandise by which a participant gives or pays a valuable consideration for the opportunity or chance to receive any compensation or thing of value in return for procuring or obtaining one or more additional persons to participate in the program, or for the opportunity to receive compensation of any kind when a person introduced to the program or plan by the participant procures or obtains a new participant in such a program. (Nev. Rev. Stat. Ann. § 598.100)

New Hampshire
“Chain distributor scheme” means a sales device whereby a person, upon condition that he make an investment, is granted a license or right to solicit or recruit for profit or economic gain one or more additional persons who are also granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. (N.H. Rev. Stat. Ann. § 358-B:1)

New Jersey
[Note by JMT: New Jersey was the only state for which I could not find anything resembling a statute defining or restricting pyramid or chain selling schemes, but I found this excerpt from an informative article by Eric Wolit in the Law Review of Seton Hall University School of Law:]

Who would not like to make a 700% return on an investment in a relatively short period of time? Although this offer is obviously too good to be true, over the last sixty years countless people have fallen victim to this allure. In fact, fraudulent pyramid investment schemes recur regularly. To address this problem, New Jersey's Legislature considered a bill which would have prohibited pyramid scams, but ultimately declined to enact any new legislation. Although the state may bring civil actions against a
promoter under the Consumer Fraud Act and the Uniform Securities Law and criminally prosecute under the theft statute and the Uniform Securities Law, case law, including the appellate division decision State of New Jersey v. Frederica Bey and the New Jersey Supreme Court decision State v. DeLuzio, raises the question of whether New Jersey, like Delaware and Michigan, should adopt legislation prohibiting pyramid promotion scams.

The defendant, in Bey, was acquitted of theft by deception. On appeal, the New Jersey Superior Court, Appellate Division, overturned the defendant's conviction for promoting an illegal lottery after concluding that pyramid schemes do not fall within the statute which prohibits illegal lotteries. This decision, however, is more significant for the fact that it reveals a conflict in two lines of cases: one construing pyramid investments as merchandise under the Consumer Fraud Act and the other holding pyramid investments as securities under the Uniform Securities Law.

(Article on New Jersey Law: “Selling The Right to Sell the Same Right to Sell: Applying the Consumer Fraud Act, the Uniform Securities Law and the Criminal Code to Pyramid Schemes” 1996, 26 Seton Hall L. Rev. 1635)

New Mexico
“pyramid promotional scheme” means any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from any person's introduction of other persons into participation in the plan or operation rather than from the sale of goods, services, or intangible property by the participant or other persons introduced into the plan or operation. (N. M. Stat. § 57-13-2)

New York
As used herein a “chain distributor scheme” is a sales device whereby a person, upon condition that he make an investment, is granted a license or right to solicit or recruit for profit or economic gain one or more additional persons who are also granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. . . It does not include sales demonstration equipment and materials furnished at cost for use in making sales and not for resale. (N. Y. Gen. Bus. Law § 359-ff)

North Carolina
“Pyramid distribution plan” means any program utilizing a pyramid or chain process by which a participant gives a valuable consideration for the opportunity to receive compensation or things of value in return for inducing other persons to become participants in the program; and “Compensation” does not mean payment based on sales of goods or services to persons who are not participants in the scheme, and who are not purchasing in order to participate in the scheme. [N. C. Gen. Stat. Ann. § 14-291.2 (b)]

North Dakota
“Pyramid promotional scheme” means any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from any person’s introduction of other persons into participation in the plan or operation rather than from the sale of goods, services, or intangible property by the participant or other persons introduced into the plan or operation. (N.D. Cent. Code § 51-16.1-01)

Ohio
“Pyramid sales plan or program” means any scheme, whether or not for the disposal or distribution of property, whereby a person pays a consideration for the chance or opportunity to receive compensation, regardless of whether he also receives other rights or property, under either of the following circumstances: (1) For introducing one or more persons into participation in the plan or program; (2) When another participant has introduced a person into participation in the plan or program. (Ohio Rev. Code Ann. § 1333.91)

Oklahoma
“Pyramid promotional scheme” means any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from the person's introduction of other persons into the plan or operation rather than from the sale of goods, services or intangible property by the participant or other persons introduced into the plan or operation. (Okla. Rev. Stat. § 21-1071)

Oregon
“Pyramid club” means a sales device whereby a person, upon condition that the person make an investment, is granted a license or right to solicit or recruit for economic gain one or more additional persons who are also granted such license or right upon condition of making an investment and who may further perpetuate the chain of persons who are granted such license or right upon such condition. “Pyramid club” also includes any such sales device which does not involve the sale or distribution of any real estate, goods, or services, including but not limited to a chain letter scheme. (Or. Rev. Stat. Ann. § 646.609)

Pennsylvania
The terms “Chain-Letter Plan” or “Pyramid Club” mean any scheme for the disposal or distribution of property, services or anything of value whereby a participant pays valuable consideration, in whole or in part, for an opportunity to receive compensation for introducing or attempting to introduce one or more additional persons to participate in the scheme or for the opportunity to receive compensation when a person introduced by the participant introduces a new participant. (73 Pa. Stat. Ann. § 201-2)

South Carolina
Any contract or agreement between an individual and any pyramid club, or other group organized or brought together under any plan or device whereby fees or dues or anything of material value to be paid or given by
members thereof are to be paid or given to any other member thereof, which plan or device includes any provision for the increase in such membership through a chain process of new members securing other new members and thereby advancing themselves in the group to a position where such members in turn receive fees, dues or things of material value from other members, is hereby declared to be an unfair trade practice pursuant to § 39-5-20 (a) of the South Carolina Unfair Trade Practices Act of 1971.

South Dakota

“Pyramid promotional scheme” defined. For the purposes of 37-33-1 to 37-33-11, inclusive, the term, pyramid promotional scheme, means any plan or operation by which a person gives consideration for the opportunity to receive compensation that is derived primarily from the introduction of other persons into the plan or operation rather than from the sale and consumption of goods, services, or intangible property by a participant or other persons introduced into the plan or operation. The term includes any plan or operation under which the number of persons who may participate is limited either expressly or by the application of conditions affecting the eligibility of a person to receive compensation under the plan or operation, or any plan or operation under which a person, on giving any consideration, obtains any goods, services, or intangible property in addition to the right to receive compensation. (S. D. Cod. Laws § 37-33-1)

Tennessee

A “pyramid distributorship” means any sales plan or operation for the sale or distribution of goods, services or other property wherein a person for a consideration acquires the opportunity to receive a pecuniary benefit, which is not primarily contingent on the volume or quantity of goods, services or other property sold or delivered to consumers, and is based upon the inducement of additional persons, by such person or others, regardless of number, to participate in the same plan or operation. (Tenn. Code Ann. § 47-18-104)

Texas

“Pyramid promotional scheme” means a plan or operation by which a person gives consideration for the opportunity to receive compensation that is derived primarily from a person’s introduction of other persons to participate in the plan or operation rather than from the sale of a product by a person introduced into the plan or operation. (Texas Bus. & Com. Code Ann. § 17.461)

Utah

(b) “Compensation” does not include payment based on the sale of goods or services to anyone purchasing the goods or services for actual personal use or consumption.

[Note by JMT: I personally testified against the SB182 amendment to the statute in 2006 which allowed for compensation for personal use. The DSA used deception and trickery to get it passed, with the support of Utah’s Attorney General, whose main political donors were MLM companies. Similar tactics have been used by the DSA in other states.]

(2) “Consideration” does not include payment for sales demonstration equipment and materials furnished at cost for use in making sales and not for resale, or time or effort spent in selling or recruiting activities.

(4) “Pyramid scheme” means any sales device or plan under which a person gives consideration to another person in exchange for compensation or the right to receive compensation which is derived primarily from the introduction of other persons into the sales device or plan rather than from the sale of goods, services, or other property. (Utah Code § 76-6a-2)

Vermont

“Chain distributor scheme” is a sales device whereby a person, upon a condition that he make an investment, is granted a license or right to solicit or recruit for profit or economic gain one or more additional persons who also are granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. ((06-031-002 Vt. Code R. §CF 101)

Virginia

“Pyramid promotional scheme” means any plan or operation by which a person gives consideration for the opportunity to receive compensation a majority of which is derived from the introduction of other persons into the plan or operation rather than from the sale or consumption of goods, services, or intangible property by a participant or other persons introduced into the plan or operation. (Va. Code Ann. § 18-2.239)

Washington

“Pyramid schemes” means any plan or operation in which a person gives consideration for the right or opportunity to receive compensation that is derived primarily from the recruitment of other persons as participants in the plan or operation, rather than from the bona fide sale of goods, services, or intangible property to a person or by persons to others. (Wash. Rev. Code Ann. § 19.275.020)

West Virginia

“Pyramid promotional scheme” shall mean the organization of any chain letter club, pyramid club, or other group organized or brought together under any plan or device whereby fees or dues or anything of material value to be paid or given by members thereof are to be paid or given to any other member thereof, which plan or device includes any provision for the increase in such membership through a chain process of any members securing other new members and thereby advancing themselves in the group to a position where such members in turn receive fees, dues or things of material value from other members.
Appendix 2I: Are All MLMs Pyramid Schemes?

Asking if an MLM is a pyramid scheme is like asking if an SUV is a car. The SUV may hold more people, but it is still a car. MLMs, or what I prefer to call “product-based pyramid schemes” (PPSs), are structured exactly the same as classic, “no-product pyramid schemes” (NPSs). With unlimited endless-chains of recruitment, they both assume an infinite market, which does not exist in the real world. For both, the only way to advance in rank to where profits are possible is to recruit a "downline." Both have a 'pay-to-play" feature, with the purchases more ongoing and substantial over time for PPSs than for NPSs. And commission structures for both are top-weighted, meaning the bulk of the rewards go to those at the top of the pyramid of participants; almost everyone else loses money.

The primary difference between the two classes of pyramid schemes is that to participate in an NPS, investments are made in cash, whereas in a PPS (MLM), the investments are in the form of purchases of products through an MLM company. Therefore, after covering costs of products and company infrastructure, a lower percentage of revenues is rebated back to the network of participants. Also, the downline networks for PPSs are far more elaborate. Classic 1-2-4-8 pyramid schemes (NPSs) have 15 participants with 100% of the money going to the person at the top, But with PPSs (MLMs), after covering product and company costs, generally less than 50% goes back to the participants – most of it to those at or near the top of their respective pyramids, which may include thousands of participants.

With less money shared by far more participants, and most of the commissions going to those at the top of the pyramid, the loss rate for PPS schemes (approx. 99.7%) is far greater than it is for NPSs (approx. 90%). So a person has over ten times as much chance of profiting from an NPS as from a PPS (MLM). PPSs are far worse than NPSs by any measure – loss rate, aggregate losses, and number of victims.

The Direct Selling Association and other industry defenders, have endeavored to confuse the issue by focusing on behavior of participants in defining what is a pyramid scheme, rather than the fundamental structure. They have also rebranded MLM as “direct selling.” But in legitimate direct selling, those doing the selling are paid the bulk of the commissions, whereas MLMs incentivize recruiting with compensation plans that provide huge upline rewards for recruiting a large downline. MLMs also require ongoing purchases to qualify for commissions and rank advancement to where profits are possible.
MLM programs can be considered *flat line or pancake schemes*

MLM programs are shaped more like a flat-line with a bump in the middle than like a triangle or pyramid. MLMs are far worse than no-product pyramid schemes by any measure – loss rates suffered by participants, aggregate losses, and numbers of victims.

A classic 1-2-4-8 no-product pyramid scheme, which is shaped like a pyramid:

```
O
O O
O O O O
O O O O O O O O
```

Binary MLM programs – displayed in 6-point type. The next line would be longer than a page.

```
O
O O
O O O O
O O O O O O O O
```

Binary MLM programs – displayed in 2-point type – which looks more like a line with a bump in the middle: The next line would be two pages long.

```
O
O O
O O O O
O O O O O O O O
```

Nu Skin’s highly leveraged breakaway compensation plan – an even flatter line:

Each distributor must have 5 Executives under him/her to qualify for breakaway commissions – and for rank advancement. The top person is a Blue Diamond – who receives over half of the commissions paid to a mega-pyramid of participants. By the 16th level, the number of distributors exceeds the adult population of the earth!

Using 6-point type. The next line would exceed the width of the page.

```
O
O O O
O O O O O O
```

Using 4-point type: it looks more like a flat line – or a pancake – than a pyramid. The next line would be about five pages long, and it would definitely look like a flat line – with a bump in the middle.