



The 5 Red Flags

Five Causal and Defining Characteristics of Product-Based Pyramid Schemes, or Recruiting MLM's*

Report for Consumers, Regulators, and Legislators - 2006 Edition

Originally titled "*PRODUCT-BASED PYRAMID SCHEMES: When Should an MLM or Network Marketing* Program Be Considered an Illegal Pyramid Scheme?*"

Revised from text summarized in a white paper for the 2002 Economic Crime Summit Conference (sponsored by the National White Collar Crime Center and Coalition for the Prevention of Economic Crime) – and presented in a Power Point presentation at the Economic Crime Summit Conference in Dallas, August 17, 2004
(Revised March 23, 2006)

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

**a.k.a. "Multi-level Marketing," "Network Marketing," "Consumer Direct Marketing," etc. "MLM" is a generic acronym for any type of multi-level or endless chain product distribution program.*

CONTENTS

	Page
Abstract	3
Purpose of this report	3
What shall we call these schemes?	3
Initial efforts to get at the truth about MLM	4
The twin challenges of defining product-based pyramid schemes, or recruiting MLM's – and understanding the harm to consumers	5
What is the difference between recruiting MLM's and (hypothetical) retail MLM's?	6
The five characteristics, or red flags, of product-based pyramid schemes, or recruiting MLM's, are causal, defining, and legally significant	7
THE FIVE RED FLAGS of product-based pyramid schemes, or recruiting MLM's	7
1. Recruiting of participants is unlimited in an endless chain of empowered and motivated recruiters recruiting recruiters.	7
2. Advancement in a hierarchy of multiple levels of "distributors" is achieved by recruitment, rather than by appointment.	9
3. Ongoing purchases (products, sales "tools," etc.) by "distributors" are encouraged in order for them to be eligible for commissions and to advance in the business ("pay to play").	10
4. The company pays commissions and/or bonuses to more than five levels of "distributors."	11
5. For each sale, company payout for each upline participant equals or exceeds that for the person actually selling the product, creating an inadequate incentive to sell products directly and an excessive incentive to recruit.	13
Recent research on the actual loss rates of recruiting MLM's	14
TAX RETURNS – further confirming evidence that most of the money goes to those at the top	14
Do MLM expenses qualify as tax write-offs?	15
Harmful effects of recruiting MLM's	15
<i>Table 1: The winners and the losers</i>	16
How do recruiting MLM's misrepresent earnings?	18
MLM and supplements – the perfect combination for scams.	18
Cognitive dissonance – a psychological explanation for MLM deceptions	18
Why are product-based pyramid schemes more harmful than (clearly illegal) no-product pyramid schemes?	18
<i>Table 2: Typical Misrepresentations Engaged in by Recruiting MLM's*</i>	19
The 8 R's of MLM durability – resulting in greater damage than no-product schemes	21
MLM companies as investments	21
<i>Table 3: Characteristics and effects of product-based pyramid schemes</i>	22
What would a fair MLM program look like?	22
DSA – the Direct Selling Association – or deceptive selling alliance?	22
What can consumers do to protect themselves against the worst scams?	23
Law enforcement considerations	24
Conclusions	28
References	30
Appendix A: The history of pyramid schemes and multi-level marketing	31
Appendix B: Explanations of compensation plans	33
Appendix C: Definitions of Other Relevant Terms	34
Appendix D: Does MLM (Multi-level or Network Marketing) Qualify as a Form of Direct Selling? — a 7-Point Checklist	36
Appendix E: Annotated list of recommended web sites on MLM	37
Appendix F: My unique background and experience with MLM	39

Report Abstract

As Ponzi, pyramid, and other endless chain selling schemes have grown in the U.S., confusion over definitions and measurable harm has clouded efforts to control it. The 1979 decision of a Federal Trade Commission (FTC) judge that Amway was not a pyramid scheme, provided that certain “retail rules” were followed, has had enormous worldwide consequences. Instead of moving towards resolution of issues related to enforcement, the multi-level marketing (MLM) industry has succeeded in weakening laws and enforcement efforts through a variety of legislative initiatives, court battles, and obfuscation of its methods and effects. (For a brief history of pyramid schemes and MLM, see Appendix A)

Through experiential testing, extensive interviews with top experts, surveys of consumers and MLM participants, and comparative analysis of features of compensation plans of normal and chain selling programs, five red flags of exploitive product-based pyramid schemes, or “recruiting MLM’s,” have been identified and tested. From at least four independent investigations, including tax returns of MLM participants and published reports of MLM companies, loss rates of over 99% have been found in MLM programs in which these 5 red flags are found in their compensation plans. The commonly held assumption that no-product schemes are worse than product-based programs has been found to be totally false, since the loss rate of no-product schemes is only about 90%.

Successful growth of these MLM’s requires a whole set of misrepresentations, which are routinely used in MLM recruitment campaigns. Since nearly all recruits lose money, the income of recruiting MLM’s could be considered theft by deception, or unjust enrichment of a few at the top of the pyramid and the MLM company itself – at the expense of a revolving door of new recruits, who buy over-priced products to “play the game.”

Product-based pyramid schemes evolve into Ponzi schemes in order to survive and grow. So they typically move to other areas to recruit when market saturation makes successful recruitment difficult. Since little actual selling to non-participants takes place, such recruitment to new markets to pay earlier investors becomes essential.

Currently, MLM companies are duping officials in countries that are unprepared to cope with the defrauding of their citizens. The Direct Selling Association, through the World Federation of Direct

Selling Associations, works tirelessly to modify existing laws against pyramid schemes to make them more MLM-friendly and to obstruct the passage of laws that would protect consumers from their member firms.

The FTC and most states have essentially capitulated to the MLM industry. Thus, consumers are left with little protection against some of the worst schemes. Consumers are left with the necessity of making decisions regarding MLM participation in the absence of true information about these programs. It is with the hope of correcting these deceptions that this report was prepared, based on extensive research – which is also posted on the web site – www.mlm-thetruth.com. Other web sites with valuable information sponsored by informed consumer advocates are also linked to the site.

Purpose of this report

In this paper I shall attempt to answer the following questions:

- How can product-based pyramid schemes be differentiated from fair and legitimate direct sales operations?
- What are the five causal and defining characteristics of product-based pyramid schemes, or recruiting MLM’s – and how were they derived?
- Are nearly all multi-level marketing (MLM) programs merely exploitive product-based pyramid scheme, or recruiting MLM’s?
- Which do the greatest harm – no-product pyramid schemes – or product-based pyramid schemes (recruiting MLM’s)?
- Why have some of the worst schemes escaped prosecution as pyramid schemes?
- What recommendations can be given for legislation and for enforcement of laws and rules protecting consumers against product-based pyramid schemes?
- How can consumers protect themselves and recover any losses from MLM?

What shall we call these schemes?

This report uses the terms “Recruiting MLM” (implying an emphasis of recruitment over sales to non-participants) and “Product-based Pyramid Scheme” as interchangeable terms. These programs have also been called “Multi-level

Marketing,” “Network Marketing,” “Consumer Direct Marketing,” etc. “MLM” is a generic acronym for any type of multi-level or endless chain product distribution program, and we will use it for brevity.

More negative sounding titles include “Chain Selling,” “Pyramid Selling,” etc. In this report, a “recruiting MLM” employs a compensation plan that rewards recruiting so much more than direct selling that there is little incentive to sell products.

Since many people mistakenly assume that if a multi-level or chain selling program includes the sale of legitimate products, it is not a pyramid scheme, I feel it is appropriate to refer to such MLM’s as “product-based pyramid schemes” to underscore what recent research has shown – that product-based schemes are as virulent, harmful, and inherently fraudulent as no-product schemes. In fact, this paper will demonstrate that they are much more damaging.

My efforts to find the truth about MLM

In late 1994, having been aggressively recruited by associates who were active in MLM, I finally agreed to give it a one-year trial. After a year of diligent recruiting, I decided to call it quits when it began to dawn on me what was happening. Though in the top 1% in the hierarchy of participants, I was losing both money and friends. I knew from a broad base of business and sales experience that something was terribly wrong, and I knew it was not my lack of effort or skill. For my unique background and a more complete account of my experience with MLM, go to Appendix F.

In early efforts to unravel the “mystery of MLM,” I decided to perform an informal telephone survey of persons who had experience with a wide spectrum of other MLM programs. These included a variety of compensation systems – breakaway, binary, matrix, unilevel, etc. But all were organized as a multi-level hierarchy of distributors.

After hundreds of phone calls, I learned that even modest success (say, a minimum wage for the time spent) was extremely rare. After expenses were subtracted, including product purchases that would not likely have occurred had they not been enrolled in the program, the vast majority lost money, and some a great deal of time. Generally, those who invested the most, lost the most.

Though legitimate products are offered and recruiting fees for participation are disguised or eliminated (thereby getting around laws forbidding pyramid schemes), it became apparent that MLM

generally is as pyramidal as any illegal pyramid scheme that could be conceived. As one MLM author admitted:

This “pyramid” effect reinforces the philosophy of many people in the MLM industry that the best way to make a substantial income with the least amount of actual selling is to recruit other people to do the work. Income is therefore generated through establishing the network, and not through the actual selling of products. Interviews with current MLM salespeople and distributors [from 11 different MLM companies] revealed a startling 100% that expressed this same philosophy.¹

My interviews revealed a surprising number of maxed out credit cards, foreclosed homes, bankruptcies, and broken homes resulting from compulsive participation in MLM programs. For example, a relative of a couple caught up in such a tragedy reported these developments in their lives:

He went bonkers with his latest MLM deal. He felt the necessity to buy a fancy sports car and the best suits to appear well heeled, then quit his job and mortgaged his home – without his wife’s permission. She was distraught when she found out, but he just responded with grandiose ideas and big promises.

Since she did not “catch the vision,” he felt his wife was holding him back. He continued to call the shots without consulting her. She lost all trust in him, and the family began to unravel. They lost their home and wound up in bankruptcy. She was embarrassed when they were forced to move in with her parents.

This couple finally divorced. Living in a trailer, he is still chasing his MLM dream. He doesn’t make alimony or child support payments. Why should he? Plenty of money is always just around the corner. Then he will catch up.²

MLM supporters are quick to point out that such irresponsible behavior had more to do with the person than with the program. But my interviews convinced me that such “multi-level junkies” are more common than is often acknowledged – certainly more common than in other types of businesses I have observed. For at least some who were recruited into an MLM program, there seems to be a compulsive component to more serious participation in multi-level programs, whether it be MLM or no-product pyramid schemes – very much akin to compulsive gambling.

After writing a book on the ethics of network marketing³, I began sharing my story and research in speeches to groups. The feedback was interesting. One tax accountant said he had worked

for H&R Block as one of the principals in northern Utah for many years, during which time his group had completed about 15,000 tax returns, several hundred of whom were MLM distributors. He said that in all that time he could remember only one MLM distributor who had reported a net profit on his return - and that person was bankrupt within a year!

This observation caught my attention. So I surveyed other tax accountants, financial planners, insurance agents, and other professionals who had access to people's financial records. Their responses were very similar - actual profits resulting from MLM participation were extremely rare. This heightened my suspicion that MLM was in fact a pyramid scheme - masked as a legitimate system for marketing products.

If in fact less than one in 100 distributors earns a significant profit from an MLM, that in itself would lean towards an MLM program being classified as a bogus business opportunity - or as a pyramid scheme - rather than as a legitimate business. This is especially true when such programs are touted by MLM promoters as "the opportunity of a lifetime," etc. At the very least, MLM's should be watched for violations of laws against deceptive sales practices, such as overstating potential earnings.

The twin challenges of defining product-based pyramid schemes, or recruiting MLM's – and understanding the harm to consumers

Pyramid schemes, in which no products are offered, 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 product-based pyramid scheme. Unfortunately, some of the most damaging programs manage to escape legal action.

After accumulating extensive data and analytical reports and posting them on a web site, I found myself interacting with the top experts on this topic. I formed the non-profit Consumer Awareness Institute and began offering research and training. Several of us also combined our resources to form Pyramid Scheme Alert, dedicated to exposing and preventing pyramid scheme fraud.

FTC rationale for considering pyramid schemes unlawful: 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 FTC does not specifically address pyramid schemes, such schemes have been deemed unlawful under the above clause in the Federal Trade Commission Act.⁴

Early evidence of the uneconomic nature of endless chain selling schemes, or MLM's: In a 1980 suit by the State of Wisconsin against Amway, the tax returns of the top 1% (about 200 out of 20,000) of Amway distributors were examined. Their average income was minus \$900!⁵

There may have been one or two that reported a significant net profit. As later research demonstrated, only a tiny number (at the top of a hierarchy of participants) profit in such programs.⁶ Later in this paper, recent evidence of the unprofitable nature of MLM for all except for a few at the top will be discussed.

The key to identifying the potential harm: Look for perverse elements in the compensation plan that create extremely high leverage for the top persons in the hierarchy of participants. *MLM "leverage"* refers to the concentration of payments (commissions, bonuses, etc.) from the company to top-level "distributors," who profit hugely from the efforts and purchases of a multitude of "downline" participants recruited beneath them. In highly leveraged MLM programs (which includes most MLM's), approximately 99.9% of recruits lose both time and money. *As a general rule, the greater the leverage for top participants in the distributor hierarchy, the higher the loss rate for their downline.*

I refer to highly leveraged MLM's, which recruit aggressively, as "recruiting MLM's," as opposed to "retail MLM's," which allow a person to earn a significant income from retailing products to end users. Understanding the difference is key to identifying the programs that do the most harm. However, harmless MLM's are extremely rare – probably less than 1% of all MLM's – out of hundreds of MLM's I have reviewed.

Confusing comparisons: MLM is often compared with legitimate alternative business models, such as franchising, direct sales, insurance agencies, and small business operations, such as product distributorships. This adds confusion in the minds of consumers and law enforcement officials.

However, my research suggests that clear differences can be seen.

One common strategy for MLM companies seeking to build credibility is to go to great lengths to be identified as a “direct sales” organization. But after rigorous comparisons of legitimate business models with features of highly leveraged MLM compensation plans, at least five clear distinctions can be made, as discussed below.

Interestingly, the five features, which 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 problem and define themselves as chain or pyramid selling schemes. Properly applied, they also identify programs that violate most federal and state laws against pyramid schemes.

Inadequate definitions: Most of the laws and statutes were crafted before the structure, dynamics, and effects of product-based pyramid schemes were understood, so the definitions within anti-pyramid statutes do not accurately reflect the root causes of the problems. 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 how complex is the compensation plan of the MLM in question.

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.

Why understanding the compensation plan is so important: Psychologists experimenting with both animals and people learned long ago that you get the behavior you reward. Since the compensation plan specifies how participants are rewarded, it reveals whether the primary emphasis is on recruiting or on retailing – and therefore, whether or not a given MLM is a disguised pyramid

scheme. (For terms used in describing MLM compensation plans, see Appendix B.)

MLM companies 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, or primarily from retailing to consumers outside of the MLM network of participants.*

The problem of evaluating MLM compensation plans is further complicated by an endless array of complex MLM payout formulas. 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 five characteristics discussed below – all of which are generic to exploitive product-based pyramid schemes.

What is the difference between recruiting MLM’s and (hypothetical) retail MLM’s?

Companies with all five of the following characteristics of a product-based pyramid scheme can be classified as *recruiting MLM’s*, as differentiated from the hypothetical *retail MLM’s*, which would primarily reward those who retail products. Recruiting MLM’s 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. Participants at the top (and the MLM company) are rewarded at the expense of a multitude of unwitting recruits.

How these defining characteristics were derived:

Over ten years of research led to this edition of this paper, including a one-year experiential test, direct observations of numerous MLM opportunity meetings, interviews with hundreds of participants from a variety of MLM’s and with consumers as MLM prospects, consultations with top experts in the field, collection/processing of available data (including official company reports), analysis of all types of compensation plans, and surveys of tax

professionals and ex-MLM distributors. MLM programs were compared with features of legitimate business models to which MLM is often compared, such as direct sales, franchises, distributorships, insurance agencies, etc. The author was able to identify a list of characteristics that are common to MLM's. These were then compared to characteristics of no-product pyramid schemes – as well as to legitimate direct sales programs to which MLM is often compared. From this comparative analysis, a trained eye can see that when one focuses on the causes of the problems with more highly leveraged MLM's, 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 obvious.

A detailed breakdown of the author's comparative analysis is found in the report entitled: “Comparative Analysis of Legitimate Distribution Models with No-Product Pyramid Schemes and Recruiting MLM's, or Product-based Pyramid Schemes.”⁷

The five characteristics, or red flags, of product-based pyramid schemes, or recruiting MLM's, are causal, defining, and legally significant

The Five Red Flags. The set of five characteristics below – or red flags to watch for – were found to be exclusive to recruiting MLM's (which are almost all MLM's today). Based on careful analysis of available data, *MLM programs with these characteristics have a shocking loss rate – approximately 99.9% of participants lose money! – 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 —


- (1) These 5 characteristics are *causal* because they identify the cause of the harm or consumer losses.
- (2) They are *defining* because they clearly separate what I call “recruiting MLM's” or product-based pyramid schemes from all other forms of commercial activity.
- (3) And they are *legally significant* because they answer the question that law

enforcement has not consistently 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 unreliable in this field of activity.

It is the synergistic effects of these five features working together in an MLM that cause the extraordinary loss rates characteristic of these schemes. One should be wary of any MLM program that has even four out of five in their compensation and marketing plan.

It is interesting to note that most of the laws against MLM's as pyramid schemes are based on one of the *effects* (whether or not sales are made to end users, not just participants) and not the essential *causes* of the problems^{2 (op cit)}. No wonder law enforcement has been so confused and inconsistent in this arena. Even so, using this analysis, law enforcement agencies can (and must) work within existing laws. Attempting to change the laws is risky, since the MLM lobby (Direct Selling Association) could then influence legislators to pass anti-pyramid laws favorable to MLM, as they have done in several states.

THE FIVE RED FLAGS of product-based pyramid schemes, or recruiting MLM's:



1. Each person recruited is empowered and given incentives to recruit other participants, who are empowered and motivated to recruit still other participants, etc. – in an endless chain of empowered and motivated recruiters recruiting recruiters – without regard to (de facto) market saturation.

When analyzing a program, ask: Is unlimited recruiting allowed, and are those who are recruited empowered and spurred on by incentives (such as

overrides from downline purchases, advancement, etc.) to recruit additional participants, etc. – so that the effect is unlimited recruiting of empowered and motivated recruiters in an endless chain?

All pyramid schemes, chain letters, and MLM programs have this multi-level chaining characteristic in common. Had all forms of endless chain marketing schemes been declared illegal (as happened in Wisconsin in 1970 – but unfortunately was not enforced⁸), this confusion over definitions would be minimal. Aggregate losses likely totaling over \$100 billion by tens of millions of unwitting victims would have been prevented. MLM in its present form would not have existed, and you would not be reading this paper.

The ill-fated Amway decision. In 1979 the FTC ruled that Amway was not a pyramid scheme, subject to “retail rules” – (1) distributors were to sell 70% of the products they purchased each month to non-distributors, (2) they must be able to prove a sale to each of ten customers each month, and (3) reasonable buy-back provisions be permitted. [93 F.T.C. 618, 716-17 (1979)]. These retail rules have been used as a benchmark in other MLM cases.

In practice, however, the first two of these rules are unenforceable and are generally ignored by MLM companies. Consumers recruited into MLM’s worldwide will continue to pay heavy prices for that decision – unless federal and state enforcement agencies more rigorously apply existing laws as suggested in this paper. In spite of the confusion over definitions of what constitutes a pyramid scheme, much can still be accomplished within the present legal framework. This paper focuses on clarifying those definitions and on identifying the combination of features in the compensation plan that cause the greatest harm.

Is saturation inevitable? In 1979, Amway successfully argued to the federal judge that total market saturation, theoretically associated with a pyramid scheme, had never happened and was not possible.⁹ However, to a person experienced in market realities, this argument is absurd. Why, for example, would a town of 1,000 people need 1,000 distributors? Ten people (1%) may be more than enough to serve the market.

With unlimited recruiting, new recruits find it increasingly difficult to recruit more participants into the program. This could be termed *de facto saturation*, which is often reached very quickly.

So while total saturation is never reached, when enough people are brought into the scheme

that prospects perceive little remaining opportunity to sell or recruit, *perceived* or *de facto market saturation* has taken place. De facto saturation would lead to collapse of the scheme, except that promoters typically expand to other geographical areas or set up new product divisions to survive and grow.

Why MLM’s explosive growth? The recruitment feature of an MLM or product-based pyramid scheme is what accounts for its explosive growth – until it collapses or is shut down by authorities. Unlike chain letters or Internet report chains, very intensive person-to-person recruiting drives recruiting MLM’s, with each new recruit under pressure to recruit numerous others to recover his/her costs of participation – let alone profit. Recruiting MLM’s are like a fast-growing cancer.

Thus, each person brought into the program has a personal stake in advancing the scheme so that he or she may profit from an expanding downline. New recruits are taught to “be a product of the products” and to set the example of model recruiting and purchasing in suggested amounts so that others will duplicate their recruiting efforts and purchases, carrying them to success on the backs of downline participants.

Since the upline’s income is dependent on the recruiting success of downline participants, the upline is motivated to encourage their recruiting success. Also, new recruits expect help with their recruiting in order to qualify for commissions and advancement in the scheme. At the same time, upline promoters may apply pressure on their downline to increase their own gains. This pressure from above and below can (at least initially) create explosive growth in recruitment and purchases by participants and sympathetic family members.

Are they buyers or sellers? Unlimited recruiting in MLM’s also changes the marketing nature of the system from one of a network of “distributors” to a network of buyers. Any clear distinction between buyers and sellers evaporates. The sellers are the buyers, and the buyers are the sellers – to themselves and their families. Also, we see the fallacy of the claim of MLM promoters that they are removing the “middle man” in their marketing system. Actually, in an MLM, middlemen may be multiplied hundreds or thousands of times.

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,” promoters must introduce new product divisions or open up new markets to recruit in other areas.

Recruiting MLM’s become Ponzi schemes.

When MLM promoters expand into other areas to make it possible for earlier investing participants to be paid off from newer investors, the MLM can be said to have evolved from a pyramid scheme into a Ponzi scheme – which is illegal in almost all jurisdictions. Ponzi schemes are programs in which new investors are repaid, not from the sales of products or fulfillment of services, but from the investments of new investors. Ultimate collapse is inevitable as new markets become less accessible, or when perceived saturation makes future prospects resistant to participation.

Some MLM proponents argue that continual dropouts justify replacement through ongoing recruitment, much as in other direct sales businesses. But this is a fallacy. Later recruits never have the same opportunity as earlier entrants due to facto saturation.

The more resourceful MLM’s prevent market collapse by opening new markets in other states or countries and/or by starting new product divisions and repeating the cycle all over again. This is what Amway has done with Quixtar. Nu Skin has cycled through numerous countries and several product divisions, including Nu Skin, IDN, Big Planet, Pharmanex, and Photomax.

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 fake sales to cooperating relatives) 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.

Not only are participants promised huge rewards for recruiting large downlines, but also the compensation plan penalizes them for not doing so. Participants might even be taunted for “leaving money on the table.” The pay plan serves as a constant reminder that their income could be multiplied many times over by increasing the body

count of recruits and by achieving volume triggers to move up through the various payout levels.

Does unlimited recruiting doom participants to failure?

It is not the recruiting per se that creates the problems, as recruiting is essential in many businesses (e.g., sales and executive recruitment). But unlimited recruiting of participating recruiters, each of whom is empowered and given incentives to recruit other recruiters, who are empowered to recruit still other recruiters, etc., in an endless chain, inevitably dooms the majority of participants to failure and loss. This is not true of insurance agencies, direct sales, and other legitimate businesses – even recruiting businesses.

Any endless chain marketing scheme is an infinite recruiting program in a finite population of prospects – predetermined to failure and loss of investments, with the exception of a few at the top (or who got in at the beginning) of a pyramid of participants. Therefore, making promises of rewards comparable to earlier entrants is misleading and becomes a primary device for defrauding recruits.

Like territorial franchises, MLM companies could conceivably limit recruiting in a given area. But limiting the number of participants is uncharacteristic of MLM because it would dampen the illusion of the potential for huge incomes for new recruits. Such limitations would render any pyramid scheme impotent.



2. Advancement in a hierarchy of multiple levels of “distributors” is achieved by recruitment, rather than by appointment.

Ask: Does a participating “distributor” advance one’s position (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.?

In MLM programs, the position in the hierarchy is determined by time of entrance into the program and by success at recruiting, rather than by appointment. When consumers are recruited into such a program and then given incentives to buy products, they 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 more for recruiting others than for retailing products or services, and when sales are “incentivized,” or tied more to advancement in the scheme than to sales of products, it is a misnomer to refer to them as “distributors.” This is why in this paper the term is often placed in quotation marks. 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)

For most MLM programs, it has become evident on close examination that *both advancement and income are dependent primarily on downline recruiting*. However, if participants must recruit to be successful, or if the pay plan’s primary rewards are for building a downline, it should be considered a recruiting MLM, and hence an illegal pyramid scheme.

“pay to play” purchases. (See “Definitions of Other Relevant Terms” in Appendix C.)

How much is actually invested in the scheme?

MLM companies typically charge a nominal fee to be licensed as a distributor. This is usually less than \$100 to avoid raising the eyebrows of enforcement officials – and to escape subjecting the MLM program to more strict guidelines as a security or “business opportunity.” However, it is typical that initial registration or license fees are merely the beginning of the total investment for MLM participation. One must add incentivized ongoing purchases, which may total thousands of dollars a year. 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.


Escalating incentives to continue purchasing products to qualify for ever-higher levels in the hierarchy of participants often leads “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 participants would have purchased the products from another source anyway, and that these purchases should not be considered an expense of doing business, simply does not hold water.

So when participants are expected to make product investments to get into a program – and then to continue purchasing products, services, training, etc. (often by subscription), in order to progress in the organization, *they are paying pyramid investment fees to “play the game,” one of the earmarks of a product-based pyramid scheme.*

If participants subtracted the operating costs of recruiting and the cost of purchases from payments received from the MLM company, they would find the breakeven bar severely raised and rarely exceeded by revenues. In other words, almost all participants below those at the top of the pyramid lose money.

Why are incentivized MLM product purchases not recognized as pyramid investments?

Some MLM compensation plans offer escalating incentives for recruiting an increasing number of “distributors,” so many participants recruit “dummy distributors” from friends and relatives and buy products in their names. They come to believe this will qualify them for “the really big bucks.” Few among them realize that they – and their dummy distributors – have in effect paid a very large fee for participation in a pyramid scheme. Through a variety of misrepresentations about the “opportunity,”



3. “Pay to play” requirements are met by ongoing “incentivized purchases,” 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” 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”?) 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 and to advance in the hierarchy of “distributors” – who are in effect merely participants making pyramid scheme investments disguised (or laundered) as purchases. They could also be called

money is extorted from them in the form of incentivized purchases.

Such an amount paid at the start into a no-product pyramid scheme would immediately arouse suspicions of its constituting an illegal pyramid scheme. But since the money paid into an MLM program 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.

Many MLM products are sold at a premium so that commissions can be paid to many levels of distributors. If an MLM product were to be sold for \$20 more than a comparable one sold through other outlets, (or if \$20 were paid for products that would otherwise not have been purchased), 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 companies sell products at retail? MLM promoters have convinced many regulators and the public that MLM distributors sell a significant amount of products to consumers (as end users) not connected to participants in the scheme. In most MLM programs, 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. Only investors in the program can be induced into paying for overpriced “potions, and lotions” typically sold by MLM companies as a cover for pyramid investments.


In a randomized survey of households in Utah County, Utah, where many MLM’s are located, we found **four** MLM distributors for every **one** non-participating customer. For a list of criteria to clearly distinguish between MLM and direct selling, refer to Appendix D: “*Does Multi-level Marketing* Qualify as a Form of Direct Selling? — a 7-Point Checklist.*”

How recruiting MLM’s kill their own retail market. In many MLM’s, purchases at inflated retail prices are primarily made by new recruits as a form of entry fee – after which they pay wholesale for products. Promoters who recruit 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 MLM’s I have interviewed have said they cancelled automatic bank draft payments for monthly product shipments or sharply reduced purchases from the company following their leaving the program. This supports the conclusion that the retail market for the products is more contrived than real. “Pay to play” purchases practically cease upon termination.

What about the refund policy of MLM’s? Many MLM’s have a one-year return policy, which guarantees 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 participant/victims of the schemes. It is extremely rare for MLM victims to recognize the fraud in an MLM program without intensive de-programming by a knowledgeable consumer advocate. They have been conditioned to blame themselves – not the MLM program – for their “failure.” And many have opened their product packages to sample or share the contents.



4. The MLM company pays commissions and bonuses on more “distributor” levels than are functionally justified; i.e., more than five levels.

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

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

Why does more than five levels signal a recruiting MLM? There is seldom any functional justification for six or more levels in an MLM hierarchy of “distributors,” other than to encourage recruiting and the illusion of very large potential incomes to more participants than is mathematically possible – a hallmark of many pyramid schemes. When combined with the other factors herein, this feature hugely enriches those participants at the top of the pyramid at the expense of those beneath them. 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. (See Table 1.) This could be considered “unjust enrichment” – certainly an unfair trade practice.

This characteristic of excessive payout levels is a key feature separating recruiting MLM’s from 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 recruiting MLM’s 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. The pyramid grows exponentially as shown below:

Level 1: 5 distributors
 x \$5 in commissions & bonuses = \$25/month
 Level 2: (5x5=) 25 + 5 = 30 total distributors
 x \$5 “ ” “ ” = \$150/month
 Level 3: (25x5=) 125 + 30 = 155 total distributors
 x \$5 “ ” “ ” = \$775/month
 Level 4: (125x5=) 625 + 155 = 780 total distributors
 x \$5 “ ” “ ” = \$3,900/month
 Level 5: (625x5=) 3,125 + 780 = 3,905 total distributors
 x \$5 “ ” “ ” = \$19,525/month
 Level 6: (3,905x5=) 15,625 + 3,905 = 19,530 total distributors
 x 5 “ “ “ “ = \$97,650/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 these are the type of figures that are often presented to prospective new recruits at MLM opportunity meetings.

This illustrates why recruiting is emphasized, as opposed to selling products to persons outside the pyramid. An income of \$97,650 is much 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).

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.

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, not of individual participants, but 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 in a breakaway system, 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 top participants.

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. MLM’s with breakaway compensation plans – though common – are the most extreme and exploitive type of pyramid scheme and therefore should be illegal.

Other MLM compensation plans have their own unique problems, primarily centered around obfuscating the fact that the programs are designed to enrich those at the top of a pyramidal hierarchy of participants at the expense of a multitude of downline participants.

“Australian two-up” and other schemes that limit the number of levels for payout but 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 necessarily negate the “endless chain” feature of the scheme. This could apply to Australian two-up compensation plans, in which 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.


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 factor, 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 jurisdiction because it shows a primary emphasis on compensation from recruitment rather than from sales to end users who are not participating in the scheme.*

Why is this feature one of the main problems with recruiting MLM’s? Compensation plans of recruiting MLM’s lead to extreme inequality in payout (money paid by the company) to participants. There are a few “winners” who got there at the expense of a multitude of “losers.” 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 system, which dooms approximately 99.9% to losses (after subtracting “pay to play” purchases and minimal operating expenses).

A failure rate in excess of 99% 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 without the abysmal odds of getting there.

In other sales settings, it is not unusual for a 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 in recruiting MLM programs, upline distributors several layers removed from the actual sale may receive as much or more in total payments per sale (including commissions and bonuses) 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 direct 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 limits the percentage of commissions to any participants selling products to actual customers. So the income of front line “distributors” is extremely limited,



5. Company payout (in commissions, bonuses, etc.) per sale for the total of all upline participants together equals or exceeds that for the person selling the product – resulting in inadequate incentive to retail and excessive incentive to recruit.

Ask: Would a “distributor” purchasing products for resale receive less in total payout (in commissions, bonuses, etc.) from the company as the total of all upline participants?

While the previous four 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 feature of recruiting MLM’s discourage retailing of products to end-users? Recruiting MLM’s offer small rewards to front line “distributors” for selling products, which are usually

forcing him or her to recruit a large downline to realize a significant income from commissions on their purchases. Powerful incentives may then be at work to recruit a downline of hundreds – or even thousands – of participants.

Can't low commissions to front-line distributors be offset by retailing products at marked up retail prices? MLM promoters claim “distributors” who buy products at wholesale prices from the company can then sell them at a higher retail price, such as happens in conventional retail outlets, which allow for a substantial retail profit margin. MLM companies then go to great lengths to assure recruits and regulators that they are legitimate direct sales operations and that participants are making money from selling products at profitable retail profit margins.

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 recruiting MLM's from retail MLM's? *This characteristic is primarily what would separate recruiting MLM's from retail MLM's.* The latter are MLM companies that make it possible for participants to make money from the sale of products with only a small downline of participants – by assigning the majority of commission payments to front-line distributors for actual sales. But out of hundreds of MLM programs with which I have become familiar, MLM companies programs that might be classified as retail MLM's could be counted on the fingers of one hand. A careful overview, using this analysis, would suggest that almost all MLM's should be classified as recruiting MLM's.

Recent research on the actual loss rates of recruiting MLM's

The lack of objective data on profitability of MLM “opportunities” demonstrated a need for better disclosure for the protection of consumers. I began my research on this aspect of MLM in 1999 by writing the presidents of 60 of the most prominent

MLM companies and asking for data on income distribution. They were supplied a simple form for breaking down the payout to distributors by percentiles for ascending payout amounts. While five company spokesmen responded that they would try to do so, none were finally able or willing to do so. I suspect that top management decided that the results would clearly show extreme differentiation between those at the top of their respective pyramids of distributors and all others, who would have shown a loss after subtracting expenses, including required product purchases.¹¹

Later, I was able to gather data from official company reports on top earnings and loss rates for ten MLM's, which could be classified as recruiting MLM's, since all of them have compensation plans with the five characteristics of recruiting MLM's, as identified in this paper. At least eight of them are still operating. This led to the remarkable finding that *the loss rate (percentage of participants who lost money after subtracting all expenses) in these recruiting MLM's was approximately 99.9%* (close to 100%) – with the remaining 1/10 of 1% who profited positioned at the top. (See Table 1.)

It should be noted that a true picture of success or loss rates can only be determined by removing the deceptions that seem to be common to typical reporting of distributor incomes and success rates by MLM companies. (See the section below: “How do recruiting MLM's misrepresent earnings?”)

Additional evidence came from Robert Fitzpatrick, of Pyramid Scheme Alert, who analyzed company reports of actual income of the various levels of participants in seven MLM programs. Without any attempt to debug their numbers, he found that actual income for 99% of participants was less than \$14 a week – which would have surely represented a loss after subtracting expenses and “incentivized” product purchases.¹³

TAX RETURNS – further confirming evidence that most of the money goes to those at the top

In a 2003 survey of tax professionals in Utah¹⁴, a clear distinction could be seen between MLM participants who could be described as “top of the pyramid promoters” (TOPP's) and downline participants. Prior surveys had shown that about 6% of Utah households participated at any given time in MLM. In three counties where no MLM companies were headquartered (Tooele, Uintah,

and Grand counties), one could assume that few if any TOPPS would reside.

Remarkably, *none* of the 33 tax preparers contacted in these three counties could recall *any* MLM participants reporting profits on tax returns for the year 2002 – out of approximately 14,400 total clients, including about 864 MLM participants, (based on a 6% MLM participation rate) In fact, these tax preparers could not recall any clients in their entire careers ever reporting significant or continuing profits from MLM.

In sharp contrast, in Utah County, with the highest concentration of MLM company headquarters in the U.S., a completely different picture emerges. A large number of TOPPS live in or near cities where their company headquarters are located. With 33 tax professionals surveyed (the same number as for the three counties mentioned above), 38 clients reported significant profits from MLM participation – from tens of thousands to as high as \$1 million a month! (This was from approximately 15,200 clients, including about 912 MLM participants – using the same 6% participation rate.)

So – as with no-product pyramid schemes, the compensation system rewards those at the top at the expense of participant-victims at the bottom. The other major beneficiaries of MLM fraud are founders and officials of the company, many of whom are paid huge salaries and profits or overrides from the same source.

It is noteworthy that in a survey of Utah County households, though 56% of households sampled had been recruited by an MLM “distributor” in the past year, less than 5% had joined. Less than 7% had been approached to buy the products without mention of the “opportunity,” and only 1% had actually bought. There were *at least four times as many distributors enrolled as there were customers who bought – evidence that very little direct selling was occurring. Almost all purchases were made by recruits in order to “do the business.” This is further evidence that these MLM’s meet the legal definition of a pyramid scheme in most jurisdictions.*

These results confirm what has been said earlier. With recruiting MLM’s, direct sales to end use customers seldom occur. The rewards go to those at the top of a large downline of “distributors” – almost all of whom lose money. Also, Utah County households don’t join the program or buy the products in significant numbers, so participants and promoters must go elsewhere to recover their

investment – making them Ponzi-like schemes as well as pyramid schemes.

Do MLM expenses qualify as tax write-offs?

In the aforementioned tax study, many tax return preparers noted that a lot of MLM participants attempt to write off expenses from MLM year after year. These expenses are often very significant. They have been allowed to deduct them for three of five years so as long as “a business intent” can be shown.

Since almost all MLM’s are merely product-based pyramid schemes, should expense write-offs be allowed (beyond offsetting revenues)? Gamblers and sponsors of racehorses have severe limits on expenses that can be written off. Since the odds for many games of chance have been found to be better than the odds of profiting from MLM, perhaps the same limitations should apply.

Billions in federal and state tax revenues are forfeited, to say nothing of the tens of billions of dollars lost each year by MLM participants. Perhaps if MLM’s expenses were disallowed by the IRS, fewer recruits would join up only to be defrauded.

Harmful effects of recruiting MLM’s

MLM compensation plans with all five characteristics inevitably lead to the following negative effects:

1. Loss rates are extremely high. (See preceding section) This is the harm that is most objectionable. Because of the extreme leverage in the compensation plan, some founders, early entrants into the program, and a few top distributors get huge gains – who are held up as examples for all prospects to see. However, for the vast majority of MLM participants, actual profits are rare.

In contrast, the loss rate for recent no-product pyramid schemes ranges from 87.5% to 93.3% (averaging about 90% – depending on whether or not re-investment is assumed by those profiting from each completed cycle), which is far less than product-based pyramid schemes – with about a 99.9% loss rate. So a person would have about 100 times the chance of profiting in a classic no-product pyramid scheme as in a recruiting MLM. We can conclude that recruiting MLM’s, or product-based pyramid schemes, are truly scams – far more harmful than classic no-product pyramid schemes.

Gambling and no-product schemes beat recruiting MLM's. It has been calculated that the odds of profiting from a no-product pyramid scheme are 111 times as great as profiting as a distributor

for one prominent recruiting MLM (after removing statistical misrepresentations from its reporting). The chance of profiting from a single spin of the roulette wheel at Caesar's Palace in Las Vegas is 48 times as great¹⁵.

Table 1: THE WINNERS AND THE LOSERS

Who gets the money paid out by typical recruiting MLM companies – and where does it come from?

	<u>Ave. income of top-Level distributors</u> ¹⁶	<u>Approximate % of participants who lose money</u> ¹⁷
Company A	\$137,000/year	99.99%
Company B	\$1,200,000/year (est.)	99.98%
Company C*	\$1,080,000/year	99.98%
Company D	N/A	99.96%
Company E	\$747,063/year	99.94%
Company F	N/A	99.94%
Company G	>\$2,720,382	99.92%
Company H	\$240,000/year	99.92%
Company I	\$18,189-158,128/year	99.90%
Company E	\$121,000/year	99.87%
Approximate Average Loss Rate		99.94%

*RTTP = Renaissance—the Tax People (shut down as an illegal pyramid scheme¹⁸)

Most of the others are prominent MLM's still operating.

2. Since the compensation and marketing system is weighted towards recruitment, instead of retailing of products, recruiting MLM's are technically illegal in many jurisdictions.

Recruiting MLM promoters go to great lengths to make it appear that their revenues come from direct selling of products, which is simply not the case. *This one effect is the basis of most statutes against pyramid schemes.*

The following provide evidence that recruiting MLM's do not engender any significant retail market:

- The compensation plan rewards the recruitment of a downline so well that there is little incentive to sell directly to consumers at retail prices.
- 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, in spite of what its promoters claim.

- Surveys of ex-distributors reveal that few continue buying the products after leaving the MLM. They recall that little if any direct selling occurred outside of the network of distributors and their immediate families. (Surveys of ex-distributors are more valid than those of current distributors, who may have contracted to sell at retail to keep their distributor license.)
- 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.
- Little if any direct selling continues in an area two or three years after an MLM finishes its recruitment blitz through the area.
- To counter dwindling sales due to a drop-off in recruiting, the MLM recruits in other areas or

shifts to new product divisions in the company. Promoters can then sell to new recruits.

- Signs of reporting inconsistencies can reveal a lack of direct sales in contradiction to what MLM officials are telling law enforcement investigators. 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.¹⁹
- Direct observation can be revealing. 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 Nu Skin's expensive supplements directly. She sold to a rich neighbors who were sympathetic.

3. Misrepresentations are rampant, since deception is essential for the MLM company to survive and grow. If the truth were told about the odds of success, few would join the program. Some MLM promoters also find it advantageous to make unjustified product claims to draw in new recruits. It has been my observation 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.

Table 2 lists 30 typical misrepresentations used in recruiting MLM's. With this many falsehoods used in MLM recruitment campaigns, it would not be exaggerating to consider the income thus generated as "theft by deception," and certainly ill gotten gain.

4. Recruiting MLM's evolve into Ponzi schemes, with promoters moving from one location to another, as each area is increasingly perceived by the public 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 are usually found in a losing position. MLM companies sometimes try to get around this by starting new divisions, introducing new products, or entering new geographic regions to start new pyramids, a process I call "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 position they gained. 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. Stockpiling of products is common, if only in secret. Many participants wind up making excessive purchases in their own name or in the name of downline "distributors" 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.

7. The regulatory process – essential in a democracy to protect consumers – is compromised when pyramid fraud is allowed by regulatory agencies, creating, in effect, a "license to steal."

8. MLM observers have noticed psychological, social, and spiritual harm far outside of the norm for legitimate businesses. Some MLM programs adopt cultist patterns in recruitment and retention of members, becoming a rather closed society. Marriages are terminated, and other important relationships are often disrupted by single-minded recruitment efforts. Also, the evolution of "MLM junkies" has been observed, with traits of addiction similar to those for other addictions. And disturbing tendencies to move away from ethical and charitable attitudes to more materialistic and greedy motivations often becomes apparent.²⁰

9. A perverse risk-reward relationship develops with recruiting MLM's. In legitimate businesses, it can be said that the more time and money one invests (risks) in the business, the more likely it is that success will be achieved. But with recruiting MLM's, with the exception of the first ones in and those at the top of the pyramid, the more one invests, the greater the losses. The most fortunate of the MLM participants are those who invested the least time and money. The luckiest of those approached are those who refused to join at all.

10. Extreme leverage results, meaning the majority of company payout goes to participants at the top of the hierarchy or pyramid. Cases of huge gains of some distributors are rare, but are held up as examples for all prospective recruits to

see. However, for the vast majority of MLM participants, actual profits are rare. (Table 1)

11. The program becomes a closed market system, in which products are sold primarily through 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.

See Table 3 for some of the effects stemming from the five features of product-based pyramid schemes, both individually and in combination.

How do recruiting MLM's misrepresent earnings?

To make participation appear profitable, recruiting MLM's typically use such tactics as these:

1. In figuring the odds of "success," the total number of persons who enroll as distributors are not counted, only those who are "active" during a given time period. These are then compared against a cumulative number of top distributors who have achieved certain levels over a long period.

2. Costs – especially incentivized or "pay to play" purchases – are not subtracted in figuring net earnings.

3. Assumptions are made that products purchased are sold at inflated retail prices, which seldom happens.

To learn how debunking of these deceptions leads to an awareness of the misrepresentations common to MLM income claims, see the author's analysis of the report of "Actual Average Incomes" of distributors for Nu Skin Enterprises.²¹

MLM and supplements – the perfect combination for scams.

Combine MLM misrepresentations regarding distributor earnings with the supplement boom, and you have a perfect recipe for consumer abuse – or legalized fraud, as some may call it. Since the passage of The Dietary Supplement Health and Education Act (DSHEA)²², which exempted companies that make supplements from seeking FDA approval before going to market, *TOPP's in MLM's have gotten away with extravagant claims to recruit "distributors" and sell products. We know who's getting the money in these MLM programs – and it's not the people that buy into the "opportunity."*

Cognitive dissonance – a psychological explanation for MLM deceptions

Many have asked how basically good people who get enmeshed in MLM seem to develop convoluted thinking patterns to the point that they will justify almost any deception to succeed in their recruiting efforts. As a person trained in the field of psychology, the answer seemed to be found in a principle discovered by Leon Festinger²³.

Festinger demonstrated that when we act contrary to our prevailing values and cannot say we were forced to do so, we experience dissonance. We reduce this by rationalizing until we come to believe that we have done is right. In other words, if our behavior is inconsistent with our beliefs, it is sometimes easier to change our beliefs to justify those actions – than to change the actions themselves. And money can be a powerful motivator to justify such self-serving rationalization!

Why are product-based pyramid schemes more harmful than (clearly illegal) no-product pyramid schemes?

No-product pyramid schemes are fairly easy for regulators and consumers to spot. They seldom get very large, and they can be stopped by going after the perpetrators. No-product pyramid schemes normally require a one-time investment, progress and pay on only four or five levels, and pay the money directly to a person at the top of the pyramid before maturing and splitting to form new pyramids.

With product-based pyramid schemes, characteristics #1, #2, #3, and #5 (see pages 2-5) are usually the same as for no-product pyramid schemes, but the number of payout levels (#4) can be much larger. MLM companies usually pay on six or more levels, creating enormous leverage and therefore a higher loss rate and greater aggregate losses than is the case for no-product pyramid schemes. For recruiting MLM's, top participants are greatly enriched by this leverage.

Product-based pyramid schemes, or recruiting MLM's, do far more harm than no-product schemes because they tend to victimize far more people, have a higher loss rate, cause more aggregate damage, and endure much longer than no-product pyramid schemes – because of the 8 R's of MLM durability – as explained in the next section.

Table 2: Typical Misrepresentations Engaged in by Recruiting MLM's*

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

Typical MLM enticements, all of which are misrepresentations	The truth or actual realities about “recruiting MLM’s,”** or product-based pyramid schemes
Presented as a great “income opportunity,” with huge incomes reported for many.	Recruiting MLM's nearly always lead to certain loss for new recruits. A few are at the top of a pyramid of participants are enriched at the expense of a multitude of downline participants, at least 99% of whom lose money.
“Everyone can do this” – and earn a good income.	Holding up top earners as examples of what others can do is deceptive. It is unfair to sell tickets when – for nearly everyone – the ship has left the port.
Average earnings statements on official reports make MLM's appear highly profitable.	Reports of average incomes are full of deceptions - 20 on one page for Nu Skin's report of “Actual Average Incomes.” (See “Report of Violations” of the FTC Order for Nu Skin to cease misrepresenting earnings of distributors.)
Products can be resold at retail prices for a handsome profit	Products are high priced and sold primarily to recruits to “do the business,” rather than to persons outside the network of participants.
Presented as a legitimate business – “not a pyramid scheme”	Product-based pyramid schemes have been found to be the most extreme of all the types of pyramid schemes, with the highest loss rates (approximately 99.9%) – far worse than for no-product schemes, or even than most games of chance in casinos.
Work for only an hour or two a day, and build up a “residual income” that will allow you the “time freedom” to quit your job and spend more time with your family or do whatever you want.	To profit at a recruiting MLM, one must work long hours and be willing to continue to recruit to replace dropouts. One must also be willing to deceive large numbers of recruits into believing it is a legitimate income opportunity. Recruits are only fattening their upline's commissions. And is there anything immoral about hard work for honest rewards?
“The job market is not secure.” The stock market is even shakier. MLM offers a much more secure and permanent (residual) income.”	MLM is far more risky than either the stock market or the job market. It even makes gambling look like a safe investment by comparison. Residual income for almost all MLM recruits is a myth.
Standard jobs are not rewarded fairly. In MLM, you can set your own standard for earnings.	Fair? Most MLM compensation plans are weighted heavily towards those who got in early or scrambled to get to the top of a pyramid of participants.
“If not legal, the program would have been shut down long ago.” MLM's have survived legal challenges. The fact that they are still around tells you they are legitimate.	Consumer protection officials are reactive, not proactive. Since victims rarely file complaints, law enforcement rarely acts against even the worst schemes. Why don't victims complain? They blame themselves for their “failure” and they fear consequences from or to their upline or downline.
If you fail at this program, it is because you failed to properly “work the system.”	The system itself is inherently flawed – an endless chain recruitment of participants as primary customers. The vast majority will always lose money.
“In any businesses, one must invest time and money to be successful.” (Committed MLM participants may continue investing thousands, and even tens of thousands of dollars, over many years before running out of money or giving up.)	In recruiting MLM's, the more one invests in time, money and effort, the more he/she loses – unless willing to deceive enough people to rise to the top of a pyramid of victims. In legitimate companies, sales persons are not expected to stock up on inventory or subscribe to monthly product purchases. But in recruiting MLM's, incentivized purchases (purchases required to participate in commissions and/or advancement) are often merely disguised or laundered investments in a pyramid scheme.
“It takes time to build any business.” “This is not a get-rich-quick scheme, but a ‘get-rich-slow’ program.” “Don't expect instant success,” etc.	MLM promoters sell recruits on their programs as a business, but defend it to authorities as a “direct selling” opportunity. However, In legitimate direct sales programs, sales persons earn commissions right away and don't have to wait months or years for commissions to exceed expenses.
In MLM, no selling is required. Apply the principle of duplication (getting others to do what you do)	Selling is done by recruiting new recruits who make ongoing purchases to “play the game.” You are not only duplicating; you are deceiving others.
MLM is the “wave of the future.” In fact, “Our MLM is experiencing phenomenal world-wide growth,” etc. “So get in on the ground floor of this great growth opportunity.”	MLM'rs have been saying this for twenty years, but MLM still accounts for less than ½ of 1% of consumer purchases – in spite of the fact that the number of MLM companies has numbered in the thousands. MLM's come and go, as do new recruits, 99.9% of whom drop out. Long-term MLM growth is a myth.

* Recruiting MLM's are multi-level marketing programs that reward aggressive recruitment far more than direct sales of products to legitimate customers. This makes them technically illegal pyramid schemes.

CONCLUSION: The appeal in MLM promotions and the revenues reported on typical MLM financial statements have been obtained by misrepresentations and by deceptive sales practices. The degree of deception, if not the total amounts, exceed the deceptions reported in the Enron stock scandal – which later led to similar findings in the reporting by WorldCom and Global Crossing. In short, the typical MLM is a lie and engages in massive theft by deception. Exceptions to this are the extremely rare “retail MLM” like Avon, which does not expect their distributors to buy products, except to fill actual orders in hand – and offers greater rewards for selling than for recruiting.

Table 2: Generic Misrepresentations Engaged in by Recruiting MLM's, continued

Saturation never happens. Turnover, as in any business, is a reality that assures an ample supply of available prospects.	With few real customers, MLM products are sold by recruiting a revolving door of new "distributors" who buy products to "do the business." And since people perceive the opportunity as dwindling with each new "distributor," market saturation requires promoters to recruit elsewhere. So MLM's quickly evolve into Ponzi schemes, requiring the opening of new markets and/or new product divisions to repay earlier investors, as has happened with Amway (now Quixtar) and Nu Skin (which became IDN, then Big Planet and Pharmanex). It's not turnover, but continuous churning of new recruits to replace dropouts.
Take advantage of "momentum" and "windows of opportunity."	In any endless chain scheme, the momentum cannot continue indefinitely, leaving those who come in later in a loss position, which is at least 99% of recruits. Only by lying about this fact can recruiting be successful.
In this new (MLM) program, you can be the master of your destiny.	You will be a slave to the phone, to meeting the qualifications for commissions and bonuses, and to continual pressure to recruit new participants to replace those who drop out.
The demand for these MLM products are growing at a rapid rate. "They literally sell themselves."	The sale of products is distributor-driven, not market driven. Most products are sold to new participants to get in on this "ground floor opportunity."
Unlike franchises, business startups, or sales of existing businesses, you can start an MLM business with very little capital.	MLM's typically bleed new recruits of their funds by inducing them to buy products on a subscription basis, to pay for ongoing training, and otherwise draining them of their resources until they run out of money or give up.
The report of "Actual Income" of distributors states ".16% of active distributors have achieved the level of Blue Diamond," etc. This appears to be respectable odds of success. (See "How to Lie with Statistics")	When statistics are presented without deception, the "opportunity" is not so attractive. The ".16" should be preceded by a "0" (0.16% – or odds of 0.0016), and ALL who signed up should be factored in. So with 10% remaining after 5 or 10 years, the number should be reduced by 90%. This leaves odds of 0.00016 of becoming a "Blue Diamond." This looks far worse than ".16%"
Fear of loss (of potential income by not recruiting aggressively) is a great motivator.	If MLM participants understood what is happening to them, they would fear accumulating further losses by continuing to invest in the MLM.
You will belong to a great support team. In MLM, you have a whole network of people willing to help you succeed and be your friends.	Some MLM's operate like a cult with an "us vs. them" mentality. Watch how quickly the team ostracizes you when you quit or discover contrary information about the legitimacy of the program.
You will be offering people you care about the very best products available for promoting their health and well being.	No matter how high the quality of the products, investment in products for which you do not have orders in hand becomes a cleverly disguised means of laundering investments in a product-based pyramid scheme.
Our products are unique and consumable – perfect for repeat business.	MLM products are typically "potions and lotions." The secret formulas are a cover for the fact that they are priced too high to compete in standard markets.
Products are less expensive through MLM because you cut out the middleman.	MLM creates thousands of middlemen, with few real customers outside a bloated network of "distributors." And typically, they are not inexpensive.
Build your business by duplication. Buy five of these "business in a box" packages now, sell them to five people, and ask each to do the same, etc. Be a "product of the products" by signing up for monthly shipment of these items. Soon you will be reaping huge commission checks.	This is how recruiting MLM's earn fortunes for their top recruiters. Commissions from initial and ongoing purchases by new "distributors" (in hopes of profiting) is the life blood of their business. The promised rewards never come, except to those who recruit their way to the top of a pyramid of participants. Take away inducements for participant purchases, and these companies would fall like a house of cards.
Our "tools for success" are unbeatable. Sign up for our seminars and conferences, and buy our books and tapes to assure your success in this business.	In at least one major MLM, the "tools business" is a pyramid within a pyramid. Hardly anyone makes money selling products, so a lucrative source of income for those at the top is the sale of "success tools" to supposedly assure the success of their downline – who are in fact only further victimized when they buy these motivational items.
MLM is like insurance, investing, inventing, acting, and writing in that hard work at the outset yields residual income for the rest of your life. This is done by "leveraging" the efforts of your downline. So you can retire early, travel, etc.	MLM is more like gambling than legitimate residual income. It appeals to the "something for nothing" mentality. MLM addiction has been observed in some "true believers." The large residual incomes reported are more the result of time of entry and willingness to deceive prospective recruits than of payoff for hard work. To succeed in MLM, one must leverage one's deceptive recruiting through others who can be persuaded to do the same..
Very reputable people are involved in MLM.	This credibility argument has been the underpinning of many scams.
You will be helping your friends and family by recruiting them into your downline.	You are exploiting those you care about the most. In other words you are squandering your social capital.

The 8 R's of MLM durability – resulting in greater damage than no-product schemes:

(1) **Rewards.** The profitability for the MLM company and the payout to top distributors is so great that they will routinely misrepresent and will go to great lengths to keep the scheme going, including finding new divisions or areas in which to continue recruiting after a given area is saturated.

(2) **Ruse.** MLM's have been enormously successful in positioning themselves as direct sales programs that are exempt from laws against pyramid schemes. Even many regulators, the Better Business Bureau, educators, and writers will be quick to condemn a no-product pyramid scheme, but will exonerate a far more extreme and exploitive product-based pyramid scheme (MLM).

As this paper demonstrates, *a recruiting MLM company is actually an institutionalized pyramid scheme.* Recruits in the hierarchy of “distributors become unwitting agents in collecting pyramid investments (in the form of “incentivized purchases) that fund the company and enrich top “distributors.” Another ruse is the idea touted by MLM promoters that their program “gets around the middleman.” In fact, the MLM guarantees that their program will create a whole network of middlemen to be paid off.

(3) **Repeated investments** (“pay to play”). Although the cost of signing up as an MLM distributor is usually less than \$100, the cumulative investment, in strongly incentivized purchases to “stay in the game,” may amount to hundreds or even thousands of dollars over several months. Products are often sold on a subscription basis by automatic bank withdrawal to maintain cash flow and upline residuals. Often purchases are far beyond the needs of the buyers and are stockpiled or given away. Usually such purchases are discontinued when the person withdraws from the scheme.

(4) **Recruitment of revolving door of replacements.** MLM's are conducted as “body shops.” Those who drop out on the bottom levels are constantly being replaced with new recruits who believe the promises of wealth and time freedom – or a little additional income for persons who are struggling to make ends meet (which almost always sets them further behind financially).

(5) **Re-pyramiding.** When MLM company officers see that the “pyramid” is about to collapse, they start a new division, introduce new products, or enter a new region, all within the same corporate umbrella.

This makes possible a whole new “ground floor opportunity” to participate in the “hyper growth” of the company, or to “ride the wave of opportunity.” This Ponzi-like behavior is what Amway, Nu Skin, and other long-lasting MLM companies have done.

(6) **Rationalization and self-blame.** Self-deception is common in MLM's, making it the perfect con game. The very people who are being victimized are often its most ardent promoters – until they run out of resources and quit. They seldom complain to regulators, having been taught that any failure is their fault for not having tried hard enough, rather than the fault of the MLM. They may also fear retaliation from or to their upline or downline, which may include close friends or relatives.

(7) **Retail “rules.”** The trick for a recruiting MLM to evade regulatory scrutiny is to create the illusion that retailing is being done by establishing “rules” for minimum retailing with which distributors must comply – which are satisfied cosmetically so as not to arouse the attention of regulators. Compliance with these rules is not independently audited, nor are they reinforced by corresponding incentives in the compensation plan. MLM rule-making is ineffective without correcting problems in the compensation plan itself.

(8) **Recognition.** The MLM company may go to great lengths to enhance its legitimacy and its credibility. They may donate heavily to influential politicians and parties, to the Olympics, and to worthy, highly visible causes. Their support for these causes is given top billing at opportunity meetings and often given recognition by an unwitting press. Celebrities are hired to speak at MLM conventions. Top MLM officials and founders have been honored by university and civic groups.

MLM companies as investments

Several MLM companies have gone public and their stocks are publicly traded. When a stock analyst flew from New York to find out from me why the stock of an MLM company was rising dramatically, I showed him much of the information contained in this report. He was appalled at what he learned about MLM generally. This is a business that has no real customer base and that is totally dependent on a network of hundreds of thousands of distributors – over 99% of whom lose money! That's not a business, he remarked – it's a scam! Needless to say, he did not recommend the stock to his clients – except to possibly short the stock!

Table 3: Characteristics and effects of product-based pyramid schemes

CHARACTERISTICS	EFFECTS
1. Each person recruited is empowered & given incentives to recruit other participants, who are empowered and motivated to recruit still other participants, etc. – in an endless chain of empowered and motivated recruiters recruiting recruiters – without regard to market saturation.	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 a Ponzi move to other markets to repay early investors.
2. Advancement in a hierarchy of multiple levels of “distributors” is achieved by recruitment, rather than by appointment.	Demonstrates primary income is from recruiting, since that is the only way to advance in the scheme and to realize major profits. In recruiting MLM’s, most recruits are doomed to failure.
3. “Pay to play” requirements are met by “incentivized purchases”.	Raises breakeven bar, assuring losses for most participants. May place MLM in category of a security or business opportunity – or a de facto investment in a pyramid scheme. Encourages hyper-consumption of products by participants – who are the primary buyers.
4. The company pays commissions and bonuses on more “distributor” levels than are functionally justified.	Demonstrates primary income is from recruiting, not retailing. 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 that make direct sales with retail markup difficult. Primary retail target is new recruits – which are making de facto pyramid investments.
5. Company payout per sale for each upline participant equals or exceeds that for the person selling the product	Same effects as for #4, but greatly magnified when #4 and #5 are taken together. Removes incentive to do direct selling, since recruiting is potentially many times more profitable.
1-5: Combining all five characteristics	Results in high loss rates (close to 99.9%) – 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 fraud and misrepresentation in order to survive and grow.

What would a fair MLM program look like?

An MLM could reward selling of products more than recruiting by paying at least half of the total company payout to those actually selling products to end use consumers. So if a company’s total payout to distributors was 50%, the commission paid by the company to frontline distributors would be at least 25%. And the number of levels in the payout structure should be capped at a maximum of four levels of individual participants.

In a hypothetical “retail MLM” that is both legal and ethical, products would be sold at competitive prices, so that distributors could succeed from retailing the products, not just from selling to their downlines at inflated prices. “Pay to play” requirements would be minimal or non-existent.

Breakaway compensation plans – essentially pyramids within mega-pyramids – would be banned, and other complex plans (matrix, binary, etc.),

seldom used effectively by participants or fully understood by regulators, could be replaced with simpler unilevel plans. This would remove the obfuscation that hides misrepresentations and makes comparisons difficult.

DSA – the Direct Selling Association – or deceptive selling alliance?

The MLM industry is now represented by the Direct Selling Association (DSA), which has been virtually taken over by the MLM industry and become its voice. The DSA actively promotes the interests of its MLM members, which – for recruiting MLM’s – are in direct conflict with the interests of consumers.

Legislators and regulators need to be vigilant, as the DSA periodically introduces state and federal legislation to legalize (exempt from prosecution as pyramid schemes) MLM’s that offer legitimate products – even though those MLM’s may be

recruiting MLM's, or product-based pyramid schemes.

While it may seem advisable to revise laws to better reflect the realities of product-based pyramid schemes (MLM's), it would be risky to do so.²⁴ Unless legislators are well informed on the issues (requiring extensive time and study), the DSA will likely enter the fray with powerful resources and influence the legislation in the direction of legalizing all MLM's which offer legitimate products. (See the author's analysis of DSA-initiated legislation in Utah and analysis by Robert Fitzpatrick of Pyramid Scheme Alert of DSA legislative initiatives.²⁵)

When DSA lobbying is successful and MLM-friendly legislation is passed, enforcement to protect consumers becomes difficult. Some states, such as Texas, Montana, Louisiana, Oklahoma, and New Mexico, South Dakota, Idaho – and most recently Utah – have been caught unawares and passed anti-pyramid legislation initiated by the DSA, which legalized the worst pyramid schemes of all – those that are product-based.

The DSA's definition of direct selling as “the sale of a consumer product or service, person-to-person, away from a fixed retail location” ignores what legitimate direct selling is NOT; namely, an endless chain of recruitment of “distributors,” who are its primary customers – as well as others of the “5 Red Flags” above. See Appendix D for a sharp distinction between the two.

The DSA engages in identity fraud to deflect honest inquirers from criticism of MLM member companies. When a group of us concerned consumers and ex-MLM participants who had been victimized by MLM banded together to form Pyramid Scheme Alert and expose pyramid scheme fraud, the DSA became concerned. Some of the many misrepresentations of its MLM member firms were being exposed on our web site, which is www.pyramidschemealert.org. We used the “.org” suffix because that is what we were directed to do as a non-profit organization. Later, when the constraints on suffixes was lifted, the DSA registered all related “pyramidschemealert” suffixes and directed them to the DSA web site.

So if (in the line) you type in any of the following web addresses:

www.pyramidschemealert.com

www.pyramidschemealert.net

www.pyramidschemealert.info

you will be directed to the DSA web site and its own definition of what is and is not a pyramid scheme,

which of course presents MLM's as legitimate businesses.

We could have fought this web version of identity theft, but as volunteers this would have required precious time and money. Besides, there is some benefit leaving it as is – as further evidence of what the DSA and its member firms are all about – deception.

What can consumers do to protect themselves against the worst scams? (The agencies mentioned will be different for countries outside the USA.)

1. Get Informed. You are off to a good start reading this report. Numerous other reports and information can be found from the list of recommended web sites in Appendix E. Most participants who lose money in MLM's drop out without knowing what went wrong. Many blame themselves for not “working the system.” Many may fear consequences to or from their upline or downline. So they don't file complaints. Also, they often believe that if the program were illegal, it would have been stopped by authorities – who simply don't have the resources to stop the abuses, and who won't act without a highly vocal group of complainants.

3. File a complaint with Your state's Consumer Protection Agency. Regulators in a few states have the resources and the will to take action, and typically don't act until a large number of complaints come in. Fraud inherent in a compensation plan seldom draws attention by itself. But by all means, file a complaint with your state's Consumer Protection Agency and/or Attorney General, even if only for the benefit of victims who are likely to be affected later. Feel free to use any of this information to help you in filing your complaint. Many state regulators are new or may lack fundamental information on the fraud inherent in the compensation plans of “recruiting MLM's.”

2. File a complaint with the FTC. If you want timely action, don't hold your breath waiting for the FTC to act. Part of the problem is the 1979 FTC ruling that Amway was not a pyramid scheme, conditioned on certain “rules” which are almost impossible to police and are generally disregarded. But if enough people place pressure on the agency to demand action, they may take some constructive steps, as they did in conjunction with eight states to shut down Equinox. But for every product-based

pyramid scheme the FTC has acted against, there are at least 50 that have escaped FTC attention. Other avenues are likely to be more effective.

4. File a complaint with the Better Business Bureau. Remember that many if not most MLM's are members of the BBB. Also, their bulletin on "multi-level marketing" reads as though it had been written by the DSA (Direct Selling Association, which has become the MLM industry's lobbying arm). But all companies who recruit aggressively are not going to be happy with a record of unresolved complaints against them. So at the very least add your complaint to their list of complaints against an MLM you feel has defrauded you.

5. Pursue a private class action lawsuit. This is a long process, but it sometimes gets better results in actions against MLM's than filing complaints with consumer protection agencies. You must find a law firm that is willing to underwrite the lawsuit for a percentage of the potential award.

6. File a Claim with the Small Claims Court in your area. I do not know of this having been tried with recruiting MLM's, but it could be effective in cases of blatant misrepresentation – which is common with all types of pyramid schemes, including product-based pyramid schemes. For this type of action, you do not need to hire a lawyer or go through a long and costly trial proceeding. Just state your case before the judge in your nearest Small Claims Court and include as much documentation as you can – promises made and broken, etc. You may be awarded up to \$7,500 to recoup losses you can prove. Feel free to use any of the reports on this site to help you make your case.

7. Support good legislation against product-based pyramid schemes – and speak out vigorously against any legislation in your area that the DSA (Direct Selling Association) is promoting. Statutes for most states are adequate as they stand, assuming they are understood and applied. Even when product-based pyramid schemes manage to avoid prosecution as pyramid schemes, they routinely engage in deceptive marketing practices, which may be easier to prosecute. In any event, you would be doing yourself and other consumers a favor by resisting any moves by unwitting legislators to sponsor DSA legislation to "improve" laws against pyramid schemes, which in any way exempt MLM's just because they have legitimate products to offer. Remember, product-based pyramid schemes have been found to have the highest loss rates and to do

the most aggregate damage of all the types of pyramid schemes.

8. Publish your experience and insights – in a book, in the media, and/or on the web. People have written articles or books about their experience with MLM, and some have gotten considerable attention in articles or on investigative TV news programs. Dozens of anti-MLM web sites are now available to the sincere seeker of truthful information to counter the deceptions in sites sponsored by MLM promoters. These anti-MLM sites, combined with the bad aftertaste of MLM participation by ex-distributors, may have had more effect on discouraging MLM abuse than has all of law enforcement put together. This is an excellent example of the benefits stemming from the free flow of information on the web.

9. Share this information with friends and family. Another way you can help prevent losses by friends and family members is to share information with them about this report and others on our web site and those of others on our list of recommended web sites – anyone who may at some time be confronted with a "once in a lifetime" MLM "opportunity." There are bulletins and answer cards on the "Actions" page of the web site for this purpose, and there is a brief version of this report as well as a one-page tri-fold flyer titled "12 Tests for Evaluating a Network Marketing 'Opportunity'" – which can be downloaded from the MLM Consumer Guides page.

Be sure to add your personal recommendation that they likewise pass it on to friends and family on their e-mail lists - and that they each in turn do the same. If you or your family are besieged with MLM offers, you might try posting a notice on your doorway and/or on your car's license plate holder, such as: "We don't do drugs, porn, or MLM."

Law enforcement considerations

Most of the leading MLM programs display all five of the characteristics of product-based pyramid schemes. But in 1979 an FTC judge ruled that Amway was not a pyramid scheme. Despite the ruling, recent evidence suggests that MLM programs biased towards recruiting (with these five characteristics), are the most extreme (highly leveraged) forms of pyramid schemes, based on loss rates (of participants who lose money) – which approximates 99.9% for companies for which data has become available. (See Table 1.)

As this paper demonstrates, the vast majority of sales recorded by recruiting MLM's are to new

recruits and sympathetic family members and not to ultimate consumers. Most purchases by these recruits are “pay to play” investments, made to qualify to participate and advance in the schemes.

Sale to non-participants in the MLM (ultimate users) is key to FTC definition of what is not a pyramid scheme. In the case of Equinox, which was shut down by the cooperative efforts of the FTC and eight states, FTC investigators made clear that “sale of products or services to ultimate users does not include sale to other participants or recruits in the multilevel marketing program or to participants’ own accounts.”

Since about 99.9% of participants in recruiting MLM’s lose money, then total sales revenues are a close approximation of the amount of aggregate losses suffered by those involved. Combining loss rates of close to 100% with estimated total sales volume for all recruiting MLM’s world-wide since the 1979 Amway decision, one could reasonably estimate that *well over 25 million victims have suffered total aggregate losses in excess of \$100 billion! This would place product-based pyramid schemes at or near the top of all consumer scams.* It could be considered a major category of white-collar crime, except that most of those doing the defrauding are not aware that it is a scam.

The 1979 Amway ruling was made on condition that certain “rules” would be adhered to that would separate Amway as a legitimate MLM from an illegal pyramid scheme:

- a “buy back rule” – Saleable unused merchandise can be returned for a refund - minus a restocking fee
- the “70% rule” – Distributors must derive at least 70% of their income from retail sales to non-participants
- “10 customer rule” – Each distributor must have ten retail customers).²⁶

While it is beyond the scope of this paper to review the company’s compliance with the “Amway rules,” it is generally recognized by informed analysts that, with the exception of the buy back rule, these rules are at best given token recognition by Amway and by the MLM industry and are not enforced consistently by regulators.

Actual statistics have confirmed this. According to research from the office of the Wisconsin Attorney General, Amway has blatantly ignored “the Amway rules” to avoid FTC action for conducting a pyramid scheme. An example is the “70% rule” – that at least 70% of distributor income must come from retail

sales to non-distributors – *when in fact it was found that such sales constituted no more than 19%!²⁷*

The “buy back rule” seldom works, as few participants are able to sort out the reasons for their “failure” in the year’s time that is typically allowed. Without expert consultation, most blame themselves and accept their losses without demanding a refund. Also, new recruits are encouraged to use or share the products they purchase and not stockpile them.

The fallacy underlying these rules is the assumption that they will have corrective effects without fundamental changes in the compensation plan. Without making the distributor pay plan more fair (by the company’s paying at least half of total payout to front-line distributors who retail products, pricing products competitively, restricting “pay to play” requirements and the number of payout levels to no more than five individuals) and thereby allowing those beneath top level participants to earn a profit, any number of “retail rules” will have negligible effects.

Needed – adequate disclosure by recruiting MLM’s and prosecution for misrepresentations or deceptive sales practices. Even if regulators do not wish to act on the legality of product-based pyramid schemes, it would be extremely helpful to consumers and to law enforcement to have true information on the odds of profiting for participants in all MLM’s. MLM companies should be required to release the following information:

1. Average company payout to all distributors at all levels, including those not considered “active”
2. The cost of participation (including all purchases from the company) at the various levels. Subtract this figure from the average company payout in #1.
3. The total number of participants recruited each year and the percentage of distributors who terminate or become inactive each year
4. The percentage of all participants who achieved the various levels in the payout hierarchy in a given time frame. These figures would then need to be carefully analyzed and debunked for typical deceptions, as noted in this report. As accurate data is accumulated on more and more MLM’s, stronger and stronger evidence would be available to confirm that programs with the five characteristics discussed in this paper are characterized by misrepresentations – promising riches but delivering extreme loss rates.

Also useful would be the disclosure of average payout (“unjust enrichment”) to the top 1/10 of 1% of distributors and the average for the 99% at the

bottom – minus average purchases that are in any way tied to advancement in the scheme. Likewise, it would be very revealing to know the average payout from the company for the founding distributors. This would expose extreme inequalities in the compensation system and discourage those who understand basic math from participating in the more exploitive MLM programs.

Enforcing such telling disclosures would have to be done with the aid of experts who know the pitfalls of such analysis, as MLM officials are extremely skilled at manipulating statistics and duping not only consumers, but law enforcement as well. (See author's report on Nu Skin's compliance with the 1994 FTC Order to stop misrepresenting earnings of distributors²⁸.) It is noteworthy that in Nu Skin's 1998 report of "Actual Average Incomes of Distributors," *20 misrepresentations were found on a single page!* And perhaps more remarkable is the fact that Nu Skin's report went unchallenged until the petition to the FTC to enforce its own Order was sponsored by Pyramid Scheme Alert.

Recruiting MLM's can and should be prosecuted for misrepresentation and/or deceptive sales practices. Also, consumers could be challenged with the question, "Do you really want to invest in a program in which over 99% of participants lose money?" Or perhaps it could be required that recruiting MLM's place a notice on all of their recruitment literature (similar to those on cigarette packages), stating:

WARNING –This program could be hazardous to your wealth!

Why so few complaints about MLM's?

Participants who have been misled and suffered losses from recruiting MLM's, or product-based pyramid schemes, seldom complain, having been conditioned to believe that anyone can succeed at it if they try hard enough. Instead of filing complaints, they blame themselves for their losses. Also, some fear repercussions from or to their upline (which could have been a close relative or friend) for registering complaints. And some may fear self-incrimination; i.e., legal sanctions for the recruiting they did.

Few victims of MLM schemes are sophisticated enough to see through the deceptions. As a result, much harm is done before any law enforcement action is taken. *Waiting for numerous complaints before taking action is ineffective in this arena.*

I spent several months working with 24 victims of one MLM company in debugging their misconceptions about their "failure" to apply the program to move from a loss position to a profitable one. Several who had lost tens of thousands of dollars feared the consequences of filing a claim and just accepted the loss. Of the victims who finally came to understand that the MLM was a scam that was profitable only for those at the top of the pyramid, only two of them mustered the courage to file a formal complaint with the State of Utah, where they resided.

A request we made for Utah's Division of Consumer Protection to enforce its laws against pyramid schemes and deceptive sales practices by a prominent MLM resulted in this response: "The number of complaints against [the company] has not risen, but instead has dropped in recent years." This response demonstrates this agency's lack of understanding of this unique enforcement issue.

Again, victims of MLM fraud seldom complain for the reasons mentioned above. And victims' resolve to complain decreases as time passes because of the assumption that "if the program were illegal, the FTC (or states) would have shut them down long ago." MLM promoters actually make this statement to prospects.

Also, the companies often move to other countries or start new divisions to recruit when de facto saturation has set in within a given area. *So complaints and inquiries drop from numerous complaints and inquiries at the outset of an MLM program to very few after several years – when, in fact, the number of victims may have increased substantially.*

The perfect con game. Product-based pyramid schemes represent the perfect con game – probably the most successful of all time. The very persons who are being victimized are ardent promoters of the scheme until they run out of money and drop out. And since they don't complain to authorities, the game goes on.

Failure to act is in itself a decision. It is important for officials at regulatory agencies, and others responsible for protecting consumers, to recognize that failure to act against product-based pyramid schemes is in itself a decision damaging to consumers. Consumers can assume that the worst offenders will be stopped or prosecuted. Hundreds of inquiries received by us and by Pyramid Scheme Alert include statements such as these:

“They (MLM promoters) said they were FTC approved.” (The FTC endorses no MLM programs.)

“If this company is promoting an illegal business practice, then why aren’t they stopped?”

“Neither the FTC nor our state AG has opposed MLM program, so it must be all right.”

While it may seem unrealistic to expect proactive enforcement in stopping illegal schemes, the consequences of not acting swiftly against the worst schemes should be considered. *Like a fast-growing cancer, they are characterized by a period of hyper-growth and a continual reaching out for new areas for exploitation. Victims of the initial wave of recruitment are not likely to recover their losses. So the sooner these scams are recognized and stopped, the better.* It is hoped that this paper will help officials more quickly discern the fraud and to be more proactive in heading off the rapid advance of such schemes.

Why consumers cannot be expected to “check it out carefully.” While consumers are encouraged to check out the background and details of any MLM program or to call their local Better Business Bureau, seldom are either of these measures effective. The BBB just registers complaints, and their representatives are poorly prepared to analyze the compensation plans in these programs. And with rare exceptions, *consumers and their advisors lack the sophistication to properly evaluate an MLM on their own.*

This author has a master’s degree in business, a Ph.D. with extensive training in research, over 30 years experience in marketing and initiating over 40 business startups, and direct experience with all the business models with which MLM’s are compared (direct sales, insurance, franchising, distributorships, etc.). It took all of that plus a one-year test of a leading MLM program, followed by several years of additional research, including hundreds of interviews with experienced MLM participants, to fully identify and decipher the fundamental deceptions inherent in these programs.

So consumers (and most lawyers and consumer advocates) should not be expected to have the expertise to properly evaluate the effects of MLM compensation and marketing programs. This is one area where competent law enforcement could make an important contribution to consumer protection.

In this paper, I have made a concerted effort to boil down the complexities and the obfuscation in MLM compensation plans to something that is

simple and straightforward. It is my hope that a thorough understanding of the principles in this paper will help law enforcement to be more effective in protecting consumers against recruiting MLM’s, or product-based pyramid schemes.

The key to cost-effective enforcement is to understanding the harm resulting from MLM compensation plans – and to take action proactively. These guidelines should help investigators to be more effective in recognizing and stopping the explosive growth of exploitive product-based pyramid schemes that are positioning themselves as legitimate direct sales companies. Ideally, this would be done proactively at the very inception of any multi-level program, without waiting for the effects to show up on thousands of participants, causing irretrievable loss. The compensation plan is the key.

Who is the villain in MLM fraud? It is an endless chain SYSTEM of recruiting that never should have been permitted in the first place. This is one of the trickiest issues confronted by researchers and by persons working in law enforcement. Researchers who have interviewed hundreds of promoters and participants in MLM programs of all kinds often come to the same conclusion. Most participants and even officers and founders of major MLM companies don’t see themselves as perpetrators of fraud or deceptive sales practices, and certainly not as white-collar criminals – even though the amount of deception and losses involved would certainly qualify as “white collar crime.”

The problem is that terms such as “fraud,” “scam,” “deception,” etc., usually imply intent to defraud or deceive on the part of the perpetrator. Interviews with top officials of several MLM companies convince me that most are not even aware of the losses experienced by the vast majority of participants. They interact primarily with the “successes,” or those at the top of their respective (pyramidal) “organizations,” and since they may be collecting handsome checks to manage the infrastructure, they often vigorously defend their companies. Some of these officials come to their companies with impressive resumes and are unwittingly kept as officers and board members to help maintain an air of legitimacy for what some might consider a questionable operation.

So MLM officers and promoters have rationalized to the point that most of them firmly

believe that their respective MLM's are operating under sound and ethical business practices. In this they are aided by aggressive promotion of the "DSA Code of Ethics," to which most major MLM's subscribe. Though some good principles are contained in this code, important points regarding disclosure and exploitive pyramidal features discussed in this paper are omitted.

I have finally concluded that though there may be a few MLM promoters who are aware of the fraud they are committing, most are in severe denial about the losses and other damage their programs are causing. In my communications with MLM company officers and promoters, they seem to have lost the ability to distinguish between truth from error when discussing their programs and comparing MLM with more honest business models.

I believe the primary villain in recruiting MLM's are the endless chain compensation and marketing systems that are inherently uneconomic. A new term is needed to describe the villain for the wrongs committed. We might call it "system fraud," implying that the fraud is not so much in the products (though many are questionable) or the people (though a few MLM founders have shady pasts), as it is in the compensation and marketing systems that perpetuate the respective MLM chains.

This does not suggest that regulators should not identify perpetrators of pyramid fraud in recruiting MLM's. Unfortunately, the laws are not written to prosecute *systems*, only *people*. So if any action is taken, some of the leaders of the most exploitive MLM's may have to be prosecuted – all the while kicking and screaming that they are innocent of any wrongdoing.

If laws could be passed and enforced similar to the Wisconsin statute ATCP 122 we would not even have this problem. ATCP 122 refers to "chain distributor schemes" which are synonymous with pyramids. According to Bruce Craig, formerly assistant to the Attorney General of Wisconsin, this rule has twice been upheld by appellate courts and has withstood challenges on vagueness, terminology and misapplication to innocent business activities.

ATCP 122 prohibits any sales device "whereby a person, upon a condition that the person make an investment (which can be in the form of money or product purchases – either up front or continuing as a requirement for qualification for commissions and overrides) is granted a license or right (by the company that runs the pyramid not the prior participant) to recruit for profit (i.e., overrides on the recruit's purchases) one or more additional persons

who are also granted such (i.e., the same and not a diminished) license or right (thus perpetuating the chain) upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition." (thus completing the "endless" aspect of the chain). The term "investment" includes any purchase and excludes sales kits sold at cost.¹²⁹

Unfortunately, the MLM industry is so well-entrenched in our society that effective laws for protecting consumers may be next to impossible without massive public support and clamor for change – which is not likely to happen. In fact, the opposite is more likely – participants in all types of pyramid schemes will fight to defend a scheme until they have had their opportunity to "cash out." In any event, let's not fool ourselves – most MLM programs are product-based pyramid schemes, which cause harm and loss for participants and billions of dollars in losses in the aggregate.

In summary, the blame should be placed on endless chain sales schemes that are inherently fraudulent systems, which enrich a few at the top at the expense of a multitude of downline participants, who wind up being victimized by the scheme. The best thing regulators can do is to limit harm by focusing on MLM compensation plans. It is hoped they will use the concepts in this paper to accomplish more cost-effective enforcement of existing laws for protecting consumers in a more proactive manner – and not wait for complaints to come trickling in. *At the very least, they could warn consumers against these types of programs – preferably against ALL MLM's, as the consumer cannot be expected to identify the extremely rare program that might be legitimate.*

Conclusions

If an MLM program is found to have all five (or even four) of the above characteristics, it is a recruiting MLM, or product-based pyramid scheme in concept, structure, and effects – regardless of quality of products offered, type of compensation plan (binary, breakaway, matrix, unilevel, etc.), company policy regarding recruiting, establishment of "rules," or other efforts by company officials to make its program appear to be legitimate. The primary emphasis will be on deriving income from recruiting, since the incentive to retail products or services will be comparatively slight.

The leverage in an MLM compensation plan, resulting from the foregoing factors, is a two-edged

sword. As a general rule, the better it is for the top “distributors,” the worse it is for those beneath them. This is particularly true when the compensation plan is focused not on selling to non-participating customers, but instead primarily on recruiting participants who buy large quantities of products to “do the business” – which is the case with nearly all of the MLM compensation plans I have studied. All their posturing about being direct selling programs is belied by their reward system.

While none of the five characteristics by itself constitutes a pyramid scheme, a combination of these five together suggests a harmful (and probably illegal) pyramid scheme, if properly understood. Conversely, if a company displayed only three of these characteristics, it is probably harmless. Four is questionable.

The effects of highly leveraged compensation plans can be measured by requiring MLM companies to release data on company payout to all participants (not just “active” ones) by percentiles after subtracting average purchases for gross income. Where MLM companies using such compensation plans have released honest data on income distribution, the results have been shocking. After all statistical manipulations of published data have been removed (which must be done by qualified and impartial analysts because MLM reports are typically full of deceptions), the results have proven that payout by the company has flowed inordinately to top “distributors.” This leaves those at the bottom – approximately 99.9%, or very close to 100% – in a loss position (after subtracting purchases and expenses). Of course, there are anecdotal exceptions – which are held up as examples for prospective recruits.

The loss rate for recruiting MLM's (about 99.9%) far exceeds that for no-product pyramid schemes (87.5-93.3%). By comparison, recruiting MLM's make no-product pyramid schemes appear extremely profitable.⁸ So the assumption that MLM's are not as bad as classic no-product pyramid schemes is patently false – the reverse is true.

In a recruiting MLM, the likelihood of a new recruit earning a significant income is so infinitesimally small – in spite of great effort – that it would be misleading to suggest otherwise. In fact, the opposite happens: Except for the top distributors and the first ones into the hierarchy, *the more time and money a person invests in a recruiting MLM, the more he/she loses. For a promoter to suggest that such a program will reward recruits with income proportional to honest effort can be grounds for*

charges of misrepresentation. In order to profit in a recruiting MLM, one must first be deceived, then maintain a high level of self-deception, and finally go on to aggressively deceive others.

Why do promoters of recruiting MLM's resort to such blatant misrepresentations?

Because to tell the truth would kill their recruiting efforts. Would any sensible person join if told that their chances of profiting were less than 1 in 1,000? So deception and misrepresentation become essential for the company to continue. Extreme incentives to recruit a downline often lead to many of the deceptions for which such programs are notorious – exaggerated product claims, overstated income potential, etc.

This also explains why many otherwise honest persons eventually mimic the deceptions of their upline and come to rationalize their own actions. Extensive interviews with participants and leaders in even the most highly leveraged MLM programs demonstrate a great deal of denial and ignorance of the deceptions inherent in their compensation and marketing plans and resultant effects on participants.

Based on available data and on voluminous feedback to consumer web sites, such as the following:

www.mlm-thetruth.com

www.pyramidschemealert.org

it appears that *most pyramid schemes today are product-based; i.e., are “recruiting MLM's”*—though few have been prosecuted as illegal pyramid schemes. Retail MLM's, as described here, are extremely rare.

Useful background information. For those who want more background on the history of pyramid schemes and MLM, go to Appendix A. You may also find my unique credentials as the author “Taylor-made” for the job of unmasking the deceptions in MLM! (See Appendix F)

In summary, here is the plain, unvarnished truth about recruiting MLM's, as my research suggests:

A “recruiting MLM” is a multi-level (or network) marketing system that depends upon recruitment of new distributors to replace a continuously collapsing base of new participants in a pyramid of recruits. As such, it constitutes an endless chain scheme of marketing by recruitment of participants as primary customers. It is a pseudo-business with no significant customer base and is dependent on a large network of distributors, approximately 99.9% of whom lose money from investing in products and

services (including “success tools”) offered by the sponsoring MLM company. The extremely high loss rate, aggregate losses, and number of victims make recruiting MLM’s, or product-based pyramid schemes, the most damaging of all types of pyramid schemes.

Thus, recruiting MLM’s are inherently flawed systems that promise ongoing residual income, but deliver very little except financial loss at the least, and loss of treasured relationships and values of honesty and integrity at the worst. They maintain themselves by continuous recruitment of new recruits, as investing participants give up or run out of funds and leave the system, seldom understanding what happened to them – even blaming themselves for their “failure.” Victims of MLM programs are seldom aware or resolved enough to overcome fear to file complaints with authorities. As a result, law enforcement rarely takes action.

To be successful in a recruiting MLM, one must first be deceived, then maintain a high level of self-deception, and finally go about aggressively deceiving others. It is theft by deception.

Additional research and resources Dr. Taylor has developed are posted on the author’s personal web site – www.mlm-thetruth.com Other helpful information on product-based pyramid schemes can be found on the web site for Pyramid Scheme Alert, which can be found at – www.pyramidschemealert.org

© 2004, 2005 Jon M. Taylor. This analysis may be reproduced in its entirety – including credits – for law enforcement or for consumer awareness, but may not be sold or packaged for sale without the author’s written permission. Contact the author: Dr. Jon Taylor, Consumer Awareness Institute. E-mail: jonmtaylor@juno.com.

References

1. Michael P. Harden, *Handbook of Multi-level Marketing* (Carrollton, Texas; Promontory Publishing: 1987), p. 29
2. Jon M. Taylor, *The Network Marketing Game: Gospel Perspectives in Network Marketing*. (Kaysville, Utah: King Alfred Press, 1997). p. 100
3. Ibid
4. In re Koscot Interplanetary, Inc., 86 F.T.C. 1106 (1975).
5. Tax Returns of the Top Amway Direct Distributors in Wisconsin, as reported by Bruce Craig, former Assistant Attorney General for the state of Wisconsin. From telephone discussions with Bruce Craig during March of 2000. Available from the author or on-line at – http://www.mlm-thetruth.com/wisconsintaxes_amway.htm
6. “No-product Pyramid Schemes vs. Gambling vs. Sample “Recruiting MLM” Programs: WHICH DOES THE GREATER HARM?” (2003) Available from the author.
7. The analytical breakdown entitled: “Comparative Analysis of Legitimate Distribution Models with No-Product Pyramid Schemes and Recruiting MLM’s, or Product-based Pyramid Schemes” can be found on the following web sites: www.mlm-thetruth.com.
8. Tax Returns of the Top Amway Direct Distributors in Wisconsin, Bruce Craig, op cit
9. Robert L. Fitzpatrick, *Pyramid Nation: The Growth, Acceptance and Legalization of Pyramid Schemes in America*, page 39.
10. *Ponzi Schemes, Invaders from Mars, & More Extraordinary Popular Delusions and the Madness of Crowds*, by Joseph Bulgatz, (New York: Harmony Books, 192), pages 11-45.

11. “Network Marketing Payout Distribution Study.” Available from the author or from our web site at - <http://www.mlm-thetruth.com/NWMPayoutStudyScan.pdf>
12. “No-product Pyramid Schemes vs. Gambling vs. Sample “Recruiting MLM” Programs: WHICH DOES THE GREATER HARM?” (2003) Available from the author.
13. Robert Fitzpatrick, “The Myth of MLM Income Opportunity.” Go to his web site at - <http://www.falseprofits.com/MythofMLMIncome.doc.pdf>
14. *Who Profits from Multi-level Marketing? Preparers of Utah Tax Returns Have the Answer.* (February, 2004) Available from the author.
15. Ibid
16. The income of top level distributors is from “Network Marketing: Portrait of an industry and its Top Earners” by the Fielding Institute, November 1996, conducted by Dr. W. J. Burns of Iowa and Dr. C. Miller, American Graduate School of International Management, Thunderbird University. Company D (RTTP) was added by the author for further comparison.
17. “No-product Pyramid Schemes vs. Gambling vs. Sample “Recruiting MLM” Programs: WHICH DOES THE GREATER HARM?” (2003) Available from the author.
18. The Renaissance statistics were drawn from research I prepared for the state prosecution when the case was tried in Kansas.
19. *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. See latest update. Available from the author.
20. Jon M. Taylor, *The Network Marketing Game: Gospel Perspectives in Network Marketing*. (Kaysville, Utah: King Alfred Press, 1997).
21. *REPORT OF VIOLATIONS*, op cit
22. 13. Matthew Heller, *Healthy, Wealthy, But Wise?* How the dietary-supplement trade became Utah’s third-largest industry, and why that may not have been such a great idea. *L.A. Times*, Feb. 1, 2004, p. 1.10.
23. J. Cooper, J. and R. H. Fazio, “A New Look at Cognitive Dissonance Theory.” In L. Berkowitz (Ed.), *Advances in Experimental Psychology*, Vol. 17 (Orlando, Florida: Academic Press, 1984).
24. Based on author’s discussions with Kristine Lanning, assistant to North Carolina’s Attorney General, and director of a pyramid working group for the NAAG (National Association of Attorneys General), November 6, 2002.
25. Reports by Jon M. Taylor on DSA-influenced legislation in Utah on web site – www.mlm-thetruth.com. See also analysis by Robert L. Fitzpatrick, on web site – www.pyramidschemealert.org Go to “Action Alert” tab and pull up reports on DSA legislation.
26. *FTC vs. Amway*, 93 FTC 618 (1979), Docket 9023
27. Bruce Craig, Petition to Robert Pitofsky, Chairman of the FTC, for compliance analysis or enforcement review regarding Amway, 93 FTC 618 (1979), Docket 9023
28. *REPORT OF VIOLATIONS*, op cit
29. Wisconsin statute supplied by Bruce Craig, former assistant Attorney General of Wisconsin

Endnotes and references for appendices:

30. Joseph Bulgatz, *Ponzi Schemes, Invaders from Mars, and More Extraordinary Popular Delusions* (New York: Harmony Books, 1992), p. 36.
- 31 & 32. Ibid, p. 42-3
33. In re Koscot Interplanetary, Inc., 86 F.T.C. 1106, 1180 (1975), gaff’s mem, sub nom. Turner v. FTC 580 F.2d 701 (D.C. Cir. 1978).
34. Will Marks, *Multi-level Marketing: the Definitive Guide to America’s Top MLM Companies* (Arlington, TX: The Summit Publ. Group), p. 4; Leonard W. Clements, *Inside Network Marketing* (Rocklin, CA: Prima Publ.), p. 4; and Richard Poe, *Wave 3: The New Era in Network Marketing* (Rocklin, CA: Prima Publ.), p. xiii+. Based on these sources, estimates of 5-7 million distributors selling at least \$12-15 billion annually in MLM products seems a safe estimate of the size of the industry. The portion of that amount that is siphoned off each year from unwitting participants to top upline distributors and company coffers would be hard to measure, but based on the analysis in this paper it is several billion dollars.
35. Robert Fitzpatrick, “Pyramid Nation – The Growth, Acceptance, and Legalization of Pyramid Schemes in America.” Go to his web site at - <http://www.falseprofits.com>
36. *FTC vs. Future net, Inc.* Civil No. 98-1113 GHK (Bar)
37. *FTC Consumer Alert*, December 1996
38. In re Koscot Interplanetary, Inc., 86 F.T.C. 1106, 1180 (1975), gaff’s mem, sub nom. Turner v. FTC 580 F.2d 701 (D.C. Cir. 1978).
39. “Pyramid Schemes,” Div. of Consumer Protection, State of Utah – similar to definitions used in other states
40. *Merriam Webster’s Collegiate Dictionary*, Tenth Edition, 1993
41. Richard Poe, *Wave Three: The New Era In Network Marketing*. (Rocklin, California: Prima Publishing, 1995)
42. Jon M. Taylor, *The network Marketing Game*, op cit.

Appendix A: The history of pyramid schemes and multi-level marketing

The history of pyramid schemes in this country is fascinating, but I will include merely a brief sketch here. When Charles Ponzi organized the Securities Exchange Company in Boston in 1919 and issued promissory notes payable in 90 days with 50 percent interest, he kicked off a storm of investment frenzy which duped just about everyone, including politicians, law enforcement officers, and reporters. He tricked speculators by using the money of new investors to pay old investors huge ‘profits.’

Ponzi took in over \$15 million from this and other schemes before his house of cards collapsed, causing losses for thousands and leading to jail time and his eventual deportation to Italy in 1934. Incidentally, there were similar schemes prior to Ponzi (for example, John Law’s “Mississippi Bubble” scheme in France in 1719 and William Franklin Miller’s Franklin Syndicate in 1899—a.k.a. “520 percent Miller”), but the Ponzi name stuck for this type of phenomena.

Some consider Ponzi schemes as separate and distinct from pyramid schemes, but as one writer observed,

Ponzi and pyramid schemes do have similarities. Both are fraudulent arrangements for the receipt and redistribution of money with early participants winning and those who enter later losing. In each case it is essential to continue the game with new infusions of money, for if the play ends and there is an accounting, there must be a deficit and cries of pain. But where Ponzi promised a definite return on one’s investment—albeit a huge one—the possibilities in a pyramid were almost limitless as new subscribers feed those who joined before.

Furthermore, the machinery of the pyramid is always explained and is, in fact, one of its alluring features, whereas Ponzi plans invariably refer obscurely to exotic investments that are really irrelevant and usually nonexistent. In some cases the pyramid seems almost acceptable socially, as in the cases of chain letters or distributorship plans, but there has never been any question about the vice of Ponzi schemes.³⁰

Later came chain letters, beginning with the “send-a-dime” letter widely appearing in Denver in 1935, which bore the heading “Prosperity Club” and the slogan “In God We Trust” This led to the \$1 chain letter in Omaha, chain letter agencies or “factories, and the “Circle of Gold” which spread from California throughout the country in the late 1970’s – all of which used the postal system.

Many of these chain letters went underground because of aggressive enforcement of federal mail fraud statutes. Still other variations, such as chart and airplane games, emerged later.

“Chain selling” or “chain distribution” systems, the basis of multi-level marketing, was an eventual offshoot from chain letters. With chain selling, the selling of products was made through multiple levels of distributors, each of whom received some type of compensation for the sales of those recruited at lower levels, or one’s “downline.”

In 1967 Glenn W. Turner began an incredible distribution scheme in Orlando, Florida.

His line purported to be cosmetics, featuring mink oil as a special ingredient, but in reality he sold distributorships. A participant paid a fee and became a distributor, entitling him to sell the cosmetic products, but more important, entitling him to sell other distributorships. Little selling of the cosmetics actually took place, for the real money was to be made in the sale of distributorships. Those transactions were essentially the same as in the chain letter, or the airplane or chart games, in that the new participant paid one fee to the party who brought him in, another to the party at the top, and then assumed a position at the bottom of the pyramid.

Over five years, Turner “parlayed \$10,000 . . . into a conglomerate that generated a cash flow of \$200 million, and in which as many as 100,000 people may have invested. . . . Two main business organizations were developed to carry out his activities: Koscot (‘Kosmetics Company of Tomorrow’) Interplanetary, Inc., the sales arm, and Dare to Be Great, Inc., the training body.”³¹

I cannot leave the Turner case without quoting the following, which sounds like many typical MLM opportunity meetings today:

Would-be [Dare to Be Great] participants were brought to staged gatherings in places like hotel ballrooms where clean-cut young men, each with a rhinestone pin of a flag . . . attached to his lapel, subjected them to the rigors of high-pressure salesmanship. . . .” These gatherings, called “Adventure Meetings” or “Golden Opportunity Meetings,” were described by one judge as being like an old-time revival meeting but directed toward the joys of making easy money rather than salvation. Their purpose is to convince prospective purchasers, or ‘prospects,’ that Dare is a sure route to great riches.

At the meetings are employees, officers, and speakers from Dare, as well as purchasers (now ‘salesmen’) and their prospects. The Dare people, not the purchaser-‘salesmen,’ run the meetings and do the selling. They exude great enthusiasm, cheering and chanting; there is exuberant handshaking . . . The Dare people dress in expensive, modern clothes. . . . they drive new and expensive automobiles, which are conspicuously parked in large numbers outside the meeting place.

Dare speakers describe, usually in a frenzied manner, the wealth that awaits the prospects if they will purchase one of the plans. Films are shown usually involving the ‘rags-to-riches’ story of Dare founder Glenn W. Turner. The goal of all of this is to persuade the prospect to purchase a plan . . . and thus grow wealthy as part of the Dare organization.³²

The FTC has 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.³³

It appears that pyramid schemes are considered illegal when legitimate products are subordinated to the emphasis on sales rights and overrides from recruiting a network of participants, quite unrelated to sales of products themselves. Such programs lead to inflated and unrealistic promises and inevitable market saturation. So pyramid schemes allow a few opportunists to take advantage of the ignorance and vulnerability of an unwitting populace – who fail to see that mathematically only a few can succeed at the expense of failure and losses of the masses recruited into any given program.

But there is a pseudo-business model that is at least as pyramidal and powerful as any illegal pyramid scheme – and in my opinion more pernicious because of its more pervasive effects. It is a phenomenon that has for the most part escaped recognition as a pyramid scheme because legitimate products are offered and the money required for entry into the system is nominal, usually less than \$100 for a kit of sales materials and samples. Yet it costs consumers billions of dollars every year³⁴ – dwarfing no-product pyramid schemes to a mere speck in comparison. The business phenomenon of which I speak is multi-level marketing (MLM), more recently referred to as network marketing (NWM). In the pages that follow, I will introduce new terminology that is perhaps more descriptive – “product-based pyramid schemes,” or “recruiting MLM’s (MLM companies that reward recruitment more than legitimate sales of products and services).”

One problem with using a generic term exclusively is that new schemes are being generated by the hundreds, many claiming to have solved the problems of MLM’s. “Network marketing,” for example, was a term coined to get around the onerous sound of “multi-level” marketing - which almost implied a pyramid scheme. Some companies use other designations to appear

“different” so that they can say they are not MLM. But for now I will use the generally accepted “MLM” acronym for all these chain selling programs.

According to an FTC release on May 23, 1979, Amway - one of the earliest MLM companies - was ordered by the FTC “to stop fixing retail and wholesale prices and misrepresenting the profitability of Amway distributorships.” Since that time Amway Corporation (as a company) has been more careful about making inflated promises to prospects. However, on a far more important issue, Amway and – by extension - an emerging industry triumphed. The complaint that Amway’s sales plan was an illegal pyramid scheme was dismissed by the Commission - a major coup for Amway and for all MLM companies that followed.

It is this latter point that has given credence to MLM and led to enormous growth in an industry that in the past decade has cost consumers tens of billions of dollars and left tens of millions of participants holding the bag of broken promises—and in many cases—broken lives.

Consumers are often provided with misleading information (regarding what differentiates a pyramid scheme from an MLM) from government agencies and from the Better Business Bureau. Sources favorable to MLM, such as the Direct Selling Association (using the “Direct Selling Education Foundation” as a front), MLM industry sources (such as *Upline*), and business and “opportunity” publications (such as *Success* magazine) expand upon and perpetuate these misconceptions.

In this report, I introduce new terminology that is more descriptive and more precise in its features (the “5 Red Flags”). The terms are “product-based pyramid schemes,” or “recruiting MLM’s” – signifying companies that reward recruitment more than legitimate sales of products and services.

For more information on this fascinating history, read the treatise by Robert Fitzpatrick, President of Pyramid Scheme Alert, titled “Pyramid Nation – The Growth, Acceptance, and Legalization of Pyramid Schemes in America.”³⁵ Early historical background on Ponzi schemes can be found in the book *Ponzi Schemes, Invaders from Mars, & More Extraordinary Popular Delusions and the Madness of Crowds*, by Joseph Bulgatz.^{10 (op cit)}

Appendix B

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 admitted in a meeting I attended, “Our compensation plan IS our product.”

Here are the basic MLM compensation plans:

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.

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. 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 in the first level and on the number of levels deep. Additional recruits “spill over” into the next level. Growth is limited (for example, $4 \times 12 = 48$ total downline). Can be played like a lottery – lazy participants can win. Matrix plans could be viewed as a “block pyramids.”

Stair step/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 is not six levels of distributors, but of whole breakaway organizations of people. Though breakaway plans are found in some of the most popular MLM’s, 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.”

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. However, the five red flags discussed in this paper can be applied to all multi-level compensation plans.

Appendix C

Definitions of Other Relevant Terms

Compensation plan – the method of compensating participants in a program, which can be very elaborate in recruiting MLM's. 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 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. De facto 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.

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. 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.

Multi-level marketing program (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 report 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 report, 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.

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 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 recruiting 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 recruiting MLM’s 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 de facto saturation in a given market, they must recruit elsewhere. They thus eventually become Ponzi schemes, seeking new investing participants elsewhere (in the form of incentivized product purchases) to pay off earlier investors.

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.”³⁷ 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.³⁸

Here is an example of the definition in a state statute:

“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.”³⁹

While this definition is used extensively for legal purposes, it does not address the issue of harm to participants, which is the primary focus in this paper.

Product-based pyramid scheme – 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, qualifies distributors for commissions in ascending levels in the distributor hierarchy.

Recruiting MLM – an MLM with a compensation plan that rewards primarily distributors who recruit huge downlines, and is therefore a product-based pyramid scheme.

Retail 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.

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 saturation is the result.

Scheme “a plan or program of action, especially a crafty or secret one; . . . a systematic or organized . . . design.”⁴⁰

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.

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 recruiting MLM, top upline participants receive most of the payout in commissions and bonuses from the company and are the only ones to profit significantly.

Appendix D: Does MLM (Multi-level or Network Marketing) Qualify as a Form of Direct Selling? — a 7-Point Checklist

Much confusion exists on whether or not multi-level marketing (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 “recruiting MLM's”; i.e., MLM's 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 Avon 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. **For MLM companies with 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.

CARACTERISTICS OF LEGITIMATE DIRECT SALES COMPANIES	DIRECT SALES (Avon, etc. – also life & health insurance)	RECRUITING MLM's (that reward participants for recruiting large downlines – Melaleuca, Nu Skin, USANA, Amway/Quixtar, Nikken, etc.)
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.	YES	NO – MLM's use an endless chain of recruiters recruiting still more recruiters, ad infinitum. And each participant must recruit others to make his/her investment profitable.
2. Advancement to various levels of sales management is by appointment.	YES	NO – Advancement in the sales hierarchy is achieved by recruiting a downline.
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.	YES	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 idle 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.
4. A maximum of four levels of sales managers is sufficient– for example: branch manager, district manager, regional manager, national sales manager	YES	NO – An MLM downline may include 6, 8, 10, or even an infinite number of levels of distributors.
5. Commissions <u>per sale</u> paid by the company to the person selling products and services to end users are typically greater than the total override commissions for ALL those above him/her in sales management.	YES	NO – A distributor several levels above the person selling the product may get about as much commission <u>per sale</u> from the company as the person doing the selling – or the person who recruited him/her. And reselling at a profit products bought at already high wholesale prices is unrealistic.
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.”	YES	NO – The primary focus is on recruiting more MLM 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.
7. Sales persons can make a reasonable income (in commissions and bonuses) from selling the products or services – without recruiting a downline.	YES	NO – Commissions paid by the company for direct sales pale in comparison with potential rewards for recruiting a downline. In recruiting MLM's, it is rare for participants (except for those at the top of the pyramid), to report profits on their tax returns.

Appendix E

Annotated list of recommended web sites on MLM/network marketing

Without qualification I can say that the best information to guide consumers on these issues are found on the World Wide Web. If you want to be well-informed, you will want to read some of the independent research studies on the effects of MLM compensation plans, profitability and legality of MLM's, guides to protect consumers from losses, and the humor associated with MLM. Go to <http://www.mlm-thetruth.com>.

Below are links to other sites I recommend:

<http://pyramidschemealert.org> – sponsored by Pyramid Scheme Alert, a non-profit corporation established to expose and prevent pyramid scheme fraud world wide. Robert Fitzpatrick is founder and president and is assisted by a team of top experts from a variety of disciplines contributing their expertise and writings. Fitzpatrick has appeared on several local and national TV programs exposing pyramid scheme abuse and has served as an expert in several public and private court cases involving MLM companies. This site offers resources for consumers, enforcement agencies, legislators, educators, journalists, and consumers.

www.mlmsurvivor.com – news, announcements, and resources for persons inquiring about MLM's – or recovering from experience with an MLM. Particularly thorough on Amway/Quixtar, but covers other MLM's as well. One of the most popular consumer advocacy sites on the entire web.

For a fascinating insider's look at "the world wide conspiracy of lies that is Amway/Quixtar and their motivational organization," go to <http://www.merchantsofdeception.com>. Eric Scheibeler, a former federal auditor, rose in the ranks of Amway to the top 1/25 of 1% of distributors. What he discovered disturbed him so much that he decided to leave Amway and go public. Due to death threats, the FBI was called in, and eventually Dateline ran a story showing the deceptions inherent in the company's recruiting and "opportunity meetings." You can download his book *Merchants of Deception* free of charge if you hurry. The author expects that Amway will not take this lightly and will take legal action to stop him, as they have with others who have published information against them.

<http://www.falseprofits.com> – insightful reports and books about both product-based and no-product pyramid schemes. Sponsored by sales distribution expert Robert Fitzpatrick, who also sponsors Pyramid Scheme Alert.(above) Mr. Fitzpatrick has posted some very

insightful new articles on his site, including: "The Myth of MLM Income Opportunity," "The American Scam," "The Meaning of Pyramid Schemes," "A Disguised Pyramid Scheme: The Non-Retail "Direct Selling" Company," among others. I highly recommend these for informative and entertaining reading.

One of the most important sites on the web for those considering becoming Mary Kay consultants – and for those recovering from having lost time and money with Mary Kay is THE PINKING SHEARS web site. On the site , you will find a feast of information and feedback from those who have "been there, done that." Go to www.thepinkingshears.org. You'll be glad you did.

Stephen Barrett, M.D., is one of the most prolific independent investigators of health quackery and related fraud on the web. He has several useful sites, including one on MLM's which offer questionable health products and questionable income opportunities – <http://www.mlmsurvivor.com> The site even has an invitation for plaintiffs in class action lawsuits against MLM's. See also "The Mirage of Multilevel Marketing," at – <http://www.quackwatch.com/01QuackeryRelatedTopics/mlm.html>

And for reporting quackery sponsored by MLM/network marketing companies, you are invited to participate in the "Multilevel Marketing Project" at – <http://www.quackwatch.com/06ResearchProjects/mlmrsc h.html>

<http://www.vandruff.com/mlm> – A classic article on MLM/network marketing, "What's Wrong with Multi-level Marketing?" is written by Dean VanDruff. His "Frequently Asked Questions" is also excellent – http://www.vandruff.com/mlm_FAQ

Quoting VanDruff about another valuable resource: "Ami Chen Mills 'Shaking the Money Tree' is fascinating journalism that captures the 'stink' of MLM pathology and culture most vividly. Hold your nose, and dive into major deja-vu" at – <http://www.metroactive.com/papers/metro/10.03.96/cover/multilevel-9640.html>

Cult expert, founder of "Resource Center for Freedom of Mind," counselor and author Steven Hassan looks at MLM/network marketing as exhibiting many of the destructive traits of a cult. (The site also posts "10 Tests for Evaluating a Network Marketing Company." - mentioned above). Check out the cultish aspects of

Amway and Quixtar in the article "Amway Motivational Organizations at–
<http://www.freedomofmind.com/resourcecenter/groups/a/amway/index.htm>

For some more revealing information on Amway/Quixtar, go to the excellent pages offered by Scott A. Larson at
<http://www.amquix.info/amway.html>

Quatloos! Features useful stuff about scams and financial frauds. Read Scott Larsen's scathing "Guide to Multi-Level Marketing (MLM)" –
<http://www.quatloos.com/mlm/mlm.htm>

The Cagey Consumer offers reports on multi-level marketing packed with sub-articles, references, and links –
<http://www.geocities.com/WallStreet/5395/mlminfo.html>

Want to read some painfully true stuff from a confirmed cynic, Professor Robert T. Carroll, who specializes in exposing all sorts of popular myths and scams? Check out the MLM section of "The Skeptic's Dictionary."
<http://skeptdic.com/mlm.html>

"Amway world wide dream builders and the things they will say to profit from your dreams." Potential Amway recruits will be inoculated against their program after reading "the things they will say." –
<http://www.angelfire.com/or/amwaydreamers/index.html>

Here is a site by someone angry enough to write about MLM abuses and willing to link with other sites, but preferring to remain anonymous (probably fearing retaliation). His title descriptors: "Network Marketing - Networking - Multi-Level Marketing- MLM - NWM - Pyramid Selling." – <http://mlm.4mg.com/>

Here's a site loaded with information damaging to Amway/Quixtar: [Quoting from the introduction] "Welcome to Amway: The Continuing Story" WARNING! This site presents facts, opinions, and other information that is critical of the Amway business. There are things on this site that the Amway Corporation, its distributors, and Quixtar (its "sister company") would prefer you not know. If you are easily offended by such information (or your upline would not allow you to view it), please click your browser's 'back' button now so you do not expose yourself to this critical information. Otherwise, please continue... " [But don't miss what is loaded on this site.]
<http://www.cocs.com/jhoagland/>

Unfortunately, this and other web sites are constantly under attack by Amway, using expensive legal maneuvers that place a great burden on those trying to speak out against the deceptions they foster. It's a David and Goliath type of struggle, to be sure. Hopefully, Goliath won't win in the long run. For information on this

continuing saga, check out: "Welcome to The Anti-MLM and Anti-Amway Webring Home Page" at:
<http://www.cocs.com/jhoagland/webhq.html>

The Anti-MLM and Anti-Amway Webring features some sites by angry ex-MLM distributors who feel they and millions of others are being routinely ripped off by MLM/network marketing companies. Some of the sites are less than professional, but they are very revealing of how mad some people are about this deceptive business practice. <http://www.webring.org/cgi-bin/webring?ring=amaaaw:list>

Rick Ross has compiled an impressive array of resources on the topic of pyramid schemes and MLM's, which have a very fine line [if any] between them. Here are two examples:
<http://www.rickross.com/reference/general/general519.html>

<http://www.rickross.com/reference/general/general546.html>

<http://www.usps.com/postalinspectors/fraud/pyramid.htm>
 – Information provided by the U.S. Postal Services to protect consumers from chain letters and MLM's that are thinly disguised pyramid schemes.

The FTC published an article entitled "Multi-level Marketing Plans," in cooperation with the North American Securities Administrators Association November 1996, which can also be found at the following web address. (FTC headlines comes up if you click on it. You must paste in this exact URL in the address line to get it)
<http://www.ftc.gov/bcp/online/pubs/invest/mlm.htm>

The Attorney General of New Mexico put out an insightful web site to help protect consumers against MLM and pyramid scheme fraud –
http://www.ago.state.nm.us/divs/pros/pros_pyramid.htm

Appendix F: My unique background and experience with MLM

By Jon M. Taylor, Ph.D., Consumer Awareness Institute, and Advisor, Pyramid Scheme Alert

Anyone reading this report might see this as a rather brash expose against an established industry and relevant regulators. My motives and my credentials which qualify me to make such claims deserve scrutiny.

My education includes an MBA degree from Brigham Young University in 1965 and a Ph.D. in Applied Psychology from the University of Utah in 1986. I have over 30 years of sales, marketing, and entrepreneurial experience, having started or assisted in the creation of over 40 businesses.

I worked on the administrative staff and performed or evaluated research for two universities – and have taught college classes in management, entrepreneurship, personal finance, business ethics, and communications. I have also traveled the country teaching business-related seminars and have sponsored income opportunity events, as well as educational programs for businesses and consumers. I have written and published on numerous consumer and business topics.

In the past, I openly shared my opinion that MLM's were in fact pyramid schemes in which only a few made money at the expense of many who came away empty. But my outlook changed when in 1994 I was approached by influential friends who insisted I was wrong and should take a more objective look at the MLM industry. They provided me with much information for my review.

Being both an entrepreneur by nature and a researcher by training and experience, I was curious and considered proving for myself once and for all whether or not MLM was a legitimate business – by trying it myself. I would test MLM in the crucible of personal experience. Then I would tell the world the truth, whatever I discovered – positive or negative.

As a first step, I went straight to Utah's Division of Consumer Protection and was furnished a pamphlet published by the Direct Selling Education Foundation (which I have since learned was a cover for the Direct Selling Association – financed primarily by the MLM industry and represented heavily in its membership) entitled "*Pyramid Schemes: Not What They Seem!*" It made the case for multi-level marketing programs as legitimate income opportunities. I was reassured when I noticed it was "prepared in cooperation with the Federal Trade Commission, Washington, D.C."

Then, like a good investigating consumer, I checked with the Better Business Bureau. They supplied me with a BBB flyer entitled "*Tips on . . . Multi-level Marketing (How to Tell a Legitimate Opportunity from a Pyramid Scheme.)*" Again, the message was similar – reputable MLM's were distinguished from illegal pyramid schemes, pretty much following the information released by the FTC. Guidelines and checklists were given, but most any MLM program could pass, as long as products and services were offered – in lieu of recruiting people to pay fees for the right to sell products.

[In retrospect, no doubt many others were let down by the very agencies that should have been protecting our interests as consumers. One of the reasons I am donating my time researching and writing on this topic is that I felt compelled to ask: "If one with my background and thoroughness in seeking information was so misled, what could be expected of someone without such background?"]

Next, I read Richard Poe's book *Wave 3: the New Era in Network Marketing*⁴¹. Having served on the editorial staff of *Success Magazine*, he seemed credible. I met him personally and learned that he had never been a MLM distributor, but considered himself an objective reporter of the MLM phenomenon – and conveyed a favorable outlook for the industry. That impressed me.

I then read numerous articles on MLM and spoke with several MLM participants I trusted, all of whom helped ease my concerns and even led me to believe that there could be a tremendous future in this industry and that I should get on board.

I jumped in with both feet, dropping my other business interests and dedicating more than full time to the enterprise. I carefully selected a company with a sterling reputation (and several "millionaire" distributors in their program) and excellent products. According to published income figures, the top level of distributors averaged over \$700,000 a year. I figured that with my training, sales experience, contacts, and determination, I could succeed if anyone could.

I did everything my company and upline recommended – subscribed to and tried all the products, recruited people I knew and sought any referrals I could get. I even advertised with classified ads and flyers when I'd exhausted my personal contacts.

I attended training and opportunity meetings, worked hard to train and motivate my recruits, and drove my wife crazy with my single-minded dedication to MLM. But my upline was pleased.

My wife began asking questions after a few months of no income. She did not like the changes that were occurring in me as a person – neglecting the family and seeing everyone as a prospect, even our most treasured friends and family members. Fortunately, as a researcher I had kept detailed notes of my experiences and observations with MLM and was still in an investigative mode.

At the end of a year I was in the top 1% in the hierarchy of distributors and could see my way to the top. That handsome payoff seemed doable. However, I had fallen behind financially, partly because of all the products I had purchased to maintain artificial qualifying standards (quotas) for ever-higher commission and bonus levels, partly because of all the other expenses of running the operation, and also because of my not having any alternative income during that time. Though in the top 1%, I was spending about \$1,500 a month and bringing in only \$250 a month.

MLM promoters encouraged this dedication, but on seeing my setbacks, my upline changed their tune and told me that I should have kept my other work going. The problem was that I could see from the outset that to be successful, such total dedication was required. Also, I wanted to be in a position to speak from personal experience should I eventually write up my findings about MLM.

I was not alone in coming away empty. Others who joined the program when I did also lost whatever time and money they had invested – including an attorney and persons with solid records of sales and marketing success in other settings.

Another facet of MLM fascinated me even more than the money. I discovered a whole range of ethical conflicts that for me – as a former teacher of ethics and one who considers himself to be an honest person – made MLM an unacceptable way of doing business. Exploiting friends and family for personal gain conflicted with my most basic values. I witnessed MLM participants sacrificing their social capital, contaminating treasured relationships that may have taken a lifetime to build.

I finally concluded that deception and greed are primary elements for success in MLM. In fact, before quitting the program, though I had achieved “executive” status, I could see clearly what I would have to do to earn the \$700,000 a year others had achieved. I decided it was simply not worth it. Why?

Because I would have to deceive hundreds, even thousands of downline distributors (like I had been deceived), into believing “anyone can do it.” It was truly a bogus business opportunity.

Also, I would have to continue to insist that MLM programs were not pyramid schemes (after all, the FTC and the BBB had implied in their information pieces that they were not) – as long as legitimate products and services were sold.

Upon learning of my dissatisfaction, other MLM promoters tried to recruit me into their programs – which were somehow “better.” But I felt my time and resources were too valuable to learn everything by experience. My primary interest by this time was in presenting a good overview of the generic problems of MLM’s, which led to extensive telephone surveys and other research about the pros and cons of this unique business model. Out of all this research came this and other analytical papers, a book⁴², and involvement in a consumer awareness movement focused on problems with chain selling schemes.

Some critics of my analyses see my exposés on MLM resulting from a “sour grapes” attitude after failing at MLM. I respond that (1) I was not a “failure” since I rose to the top 1% of all distributors who had tried this program, and (2) consumers may be fortunate that (unlike millions of others who quit MLM with feelings of failure) I had the determination to tell the truth and to publish what I have learned. I was fulfilling my initial pledge to myself to make public whatever I learned from my research and experiences with MLM.

Others have asked why I focus so much of my energies and resources for a cause for which I will receive little reward. My answer is that when I gain unique insights on an inequity or injustice in society, I feel a moral imperative to share what I know.

I believe that the insights expressed in this paper could not have come about without a varied background in sales, marketing, entrepreneurship, and research – and a careful look from the inside of these organizations as a practicing distributor. Had a capable government investigator with my unique background gone undercover as a MLM distributor for a year or more, he/she would probably have come up with similar conclusions.