

*For enforcement agencies, consumer educators, journalists, and researchers*

# **When Should an MLM or Network Marketing\* Program Be Considered an Illegal Pyramid Scheme?**

- **History, effects, and defining characteristics of product-based pyramid schemes.**
- **Tools for identifying the most harmful of new product-based pyramid schemes as targets for proactive enforcement**
- **Recommendations for enforcement of laws and rules protecting consumers against product-based pyramid schemes—and suggestions for improved laws and rules**
- **Unmet challenge to network marketing (MLM) industry leaders**
- **Consumer awareness guidelines for distribution to consumers**

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

***\*a.k.a. Multi-level Marketing, Consumer Direct Marketing, Chain Distribution Scheme, (Multi-level) Purchasing Plan, Gifting Network, etc.***

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## REPORT ABSTRACT

*One of the most problematical of business models is multi-level or network marketing (MLM). Many MLM programs show all the effects and characteristics of a pyramid scheme, but the MLM industry has nonetheless been allowed to continue and flourish. Though considered benign by many, its insidious and corrupting influence and the financial and social harm suffered by participants is considerable. Unfortunately, victims of these programs seldom complain, blaming themselves for their failures.*

*This problem is compounded by limited resources available to enforcement agencies, faced with a profusion of both naked pyramid schemes (wherein no products are offered) and product-based pyramid schemes (PPS's), operating as MLM's. They are now appearing by the hundreds on the internet, and established MLM companies are expanding into overseas markets.*

*Due to inadequate definitions of what constitutes a pyramid scheme, insufficient resources, and/or lack of prosecutorial will in enforcement of existing statutes, enforcement agencies often wind up catching the minnows, but letting the sharks go free. The consequences are enormous—millions of consumers are being bilked out of billions of dollars each year.<sup>A1</sup>*

*A pyramid scheme, as currently defined by the FTC (and similarly in many state laws), are plans which (1) “concentrate on the commissions you could earn just for recruiting new distributors” and which (2) “generally ignore the marketing and selling of products and services.”<sup>A2</sup>*

*The above two criteria have proven to be inadequate for determining whether or not any given MLM program is a pyramid scheme. Interpretations based on qualified mathematical analyses of compensation systems could yield a wider application of the laws against pyramid schemes to PPS's. They would also allow for more proactive enforcement.*

*The key to predicting potential harm to victims of a PPS is to determine the degree of leverage of the compensation system. Once a highly leveraged PPS is identified by its compensation system, the prognosis is certain: inordinate emphasis on recruiting will follow, and only a few at the top of the pyramid will profit at the expense of the investments in product purchases by those in their downline—most of whom lose money. In other words, emphasis on recruiting is just one of the effects, not the cause, of the problems with PPS's.*

*Problems with interpreting the FTC definition of a pyramid scheme has been compounded by information releases from the FTC, state agencies, and the Better Business Bureau (BBB), in which MLM's are not only distinguished from pyramid schemes, but are exonerated as non-pyramids, when in fact they may be PPS's and actually more pyramidal in their effects over time than naked pyramid schemes.*

*Based on the FTC's definition of multi-level marketing, it is assumed that implementation of “rules” will keep MLM's out of the category of pyramid schemes. Such rules are ineffective unless they incorporate fundamental changes in the MLM compensation system so that it provides significantly greater rewards for retailing than for recruiting—in actual payout from the company, since MLM prices are generally too high for retail markup to non-distributors.*

*This paper provides legislators, enforcement agencies, educators, and others with three distinguishing characteristics that can be used as tools to determine proactively whether or not any given MLM program will lead to the harmful effects of a highly leveraged product-based pyramid scheme (PPS):*

*1. A chaining hierarchy of levels of distributors—more than is functionally justified—is recruited without area limits, which leads to extreme leverage and perceived saturation in the marketplace.*

*2. RVE-EHI. Relative vertical equality (RVE) in compensation systems leads to extreme horizontal inequality (EHI) in payout over the entire network of distributors—huge payouts to a tiny percentage of participants, while the vast majority wind up losing the money and effort they invested over a period of time.*

*3. Significant purchase or recruiting quotas are required (or incentives offered) to qualify for increasing bonus levels or purchasing discounts in an ascending hierarchy of payout levels (the “pay to play” feature).*

*Syndrome analysis, in which any program can be evaluated based on a set of pyramidal characteristics, can serve to corroborate the existence of a PPS.*

*Legislators, courts, and consumer protection agencies would serve consumers better if they improved their methods of determining whether or not an MLM business fits the definition of a pyramid scheme—or at the very least were more cautious in implying that an MLM program is not a pyramid scheme, when in fact it is more likely a PPS that has managed to escape corrective action. Genuinely helpful information should be supplied to consumers. (See Appendix C for a rigorous set of guidelines.)*

*It would be helpful if MLM companies were required in their recruiting to disclose average total payout from the company less purchases from the company by percentiles of distributors. The percentage of all distributors (past and present) who have achieved each payout level should also be disclosed. This would reveal extreme payout patterns typical of pyramid schemes.*

*The concepts and analytical framework for this paper are based on first-hand experience, a broad background in marketing and entrepreneurship, education and experience as a business analyst and behavioral researcher, extensive interviews with distributors from a variety of MLM programs, and a synthesis of the thinking of the best experts in the field.*

*The MLM industry has been challenged to refute many of the basic concepts for this report, but has so far responded with silence.*

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Dean VanDruff, author of the very popular articles "What's Wrong with Multi-level Marketing?" and "Frequently Asked Questions" on his web site (vandruff.com) provided conceptual input. Other valuable web sites are referenced in Appendix D.

My one-year test as a distributor for a popular MLM program, was vital in grasping the concept, motivation, dynamics, and effects of MLM's that were in reality product-based pyramid schemes. Top level distributors in this program provided valuable input.

In mentioning personal experience with MLM, there some who will say this is just a sour grapes response to my "failure." Let me respond by asserting that I was not a failure, but could see after a year that being in the top 1% was not profitable. One would have to be in the top 1/10 of 1% to begin to earn a significant profit—and then only at the expense of deceiving hundreds, even thousands of victims (each of whom would lose money) to get there. I later learned that this was true for many MLM programs.

Others will say, "No wonder you had a bad experience. You should have tried this MLM instead." But I sought input from hundreds of actual distributors and ex-distributors from a wide variety of MLM programs, using a variety of compensation systems. Industry representatives and authors I consulted, such as Richard Poe (*Wave 3: The New Era in Network Marketing*) and Leonard Clements (*Inside Network Marketing*), helped me to understand their viewpoints as well. I believe my analysis and conclusions are both fair and accurate.

## DEFINITIONS OF RELEVANT TERMS

What's in a definition? Plenty—even billions of dollars—as this paper will demonstrate. In order to lead the reader through difficult and subtle issues related to multi-level marketing (MLM or "network marketing"), some definitions are necessary—some from a standard dictionary, others unique to this analysis.

**Multi-level marketing program** (MLM for short, later referred to as "network marketing" or MLM), as defined by the FTC—

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.<sup>1</sup>

**Pyramid scheme** (as currently defined by the FTC and in some state legislation)—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."<sup>2</sup>

An example of definitions used by state regulators is the following:

"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.<sup>3</sup>

**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.

**Naked pyramid scheme** refers to 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 system.

**A product-based pyramid scheme (PPS)** is a pyramid scheme that in most respects resembles a naked pyramid scheme, except that products are purchased by distributors, primarily for resale (supposedly). Such product purchases, often combined with other incentives, qualifies distributors for commissions in ascending levels in the distributor hierarchy.

**Relative vertical equality (RVE)** in compensation—a characteristic common to both illegal pyramid schemes and most MLM programs, in which distributors far removed from consumers (the upline) receive as much or more total remuneration per sale from the company as does the distributor who actually sells the product to the consumer. The reward system creates greater incentive to recruit a downline of distributors than to sell products.

**Extreme horizontal inequality (EHI)** in payout to distributors—a characteristic common to both illegal pyramid schemes and most MLM programs, in which extreme inequality is created across the entire network of distributors, with relatively few distributors at the top of one or more pyramidal hierarchies receiving very large payouts from the MLM company, as opposed to the vast majority of distributors who receive little or no payout (usually losing money after expenses). In effect, the losses of the many finance the opulence of the few.

**Back end weighted system**—a MLM compensation system in which company remuneration is meager to front-line distributors (who actually sell the products to consumers) but generous to upline distributors with very large downlines, to the point that disproportionate incomes can be made by a handful of upline distributors on the “back end” of the compensation system. A strong RVE-EHI or pyramidal emphasis is seen in back end weighted systems.

**Front end weighted system**—a compensation system in which company remuneration to distributors is generous for front end (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. Deception and appeals to greed are minimized.

**Middle weighted system**—a system in which the payout per sale is larger for those distributors two to four levels up in the hierarchy than either for front line distributors or for those further upline.

**Pyramidal**—“of or like a pyramid”<sup>4</sup>

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

**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 his/her sales or purchases.

**Scheme**—“a plan or program of action, especially a crafty or secret one; . . . a systematic or organized framework; . . . design.”<sup>5</sup>

**Syndrome**—“a group of signs and symptoms that occur together and characterize a particular abnormality” and “a set of concurrent things (as emotions or actions) that usually form an identifiable pattern”<sup>6</sup>

## THE HISTORY OF PYRAMID SCHEMES AND MULTI-LEVEL (OR NETWORK) MARKETING (MLM)

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.<sup>7</sup>

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.”<sup>8</sup>

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.<sup>9</sup>

It is against this backdrop that we will look at the illegality of pyramid schemes and how they are often distinguished from “legitimate” MLM programs.

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.<sup>10</sup>

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 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 year<sup>A1</sup>—dwarfing illegal 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).**

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. But for now I will use the generally accepted "MLM" acronym.

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.**

**To be fair to responsible enforcement agencies and to those who draft laws relating to pyramid schemes, it is extremely difficult to define what is and what is not a pyramid scheme.** MLM, for example, is continually reinventing itself in new versions and complex compensation systems—partly to get around legislation against pyramid schemes. So it is not surprising that a simple definition of what constituted a pyramid scheme was adopted. How that definition is applied, however, is open to interpretation.

Consumers continue to be provided with misleading information (regarding what constitutes a pyramid scheme) 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) then expand upon and perpetuate these misconceptions.

## DESTRUCTIVE EFFECTS ON THE LIVES OF MLM PARTICIPANTS

The effects on the lives of participants is well described by Robert Fitzpatrick in excerpts from the web site of Pyramid Scheme Alert (Appendix D):

In recent decades, pyramid schemes have become an insidious, pervasive and corrupting influence in the marketplace and community, causing financial and social harm on a global scale.

Since 1980 a new form of sales and marketing, called multi-level marketing or network marketing, has spread worldwide and spawned an explosion of pyramid sales schemes involving tens of millions of consumers. The line between legal forms of network marketing and fraudulent pyramid programs is a point of controversy, confusion and inquiry in many countries.

### MLM Pyramid Schemes:

- The largest and most widespread of the pyramid schemes are those that disguise themselves as "Multi-level Marketing" (MLM) businesses.
- These schemes cause the greatest harm, affect the most people, and steal the largest amount of money.
- They can involve millions of people, swindle billions of dollars.
- Because they mask themselves as "sales and distribution businesses" they unfairly compete with legitimate business
- Because MLM pyramid schemes require high levels of recruiting, they entice people to defraud their own families and friends. Consequently, the social harm can be as greater or even greater than the financial damage.
- Because MLM pyramid schemes masquerade as "independent business" they play upon and distort important values such as independence, initiative, entrepreneurship, and personal freedom.
- Because MLM pyramid schemes make promises of extraordinary wealth to the participants, people can be induced to spend all their earnings, lose or quit their existing jobs, neglect their families and other relationships and take on great debt in the pursuit of the elusive "dream" they have been deceptively sold.
- MLM pyramids operate as private "networks" outside the mainstream of business and normal social life. They are strictly hierarchical with uplines, downlines and charismatic "leaders."
- They require loyalty and large commitments of time, and they persuade participants to avoid anyone ("negative") who questions or critiques MLM. Consequently, MLM pyramid schemes can gain the power of a cult over people's lives.

## HOW THIS RESEARCH CAME ABOUT

As a long-time critic of MLM programs, I was curious to know why so many otherwise intelligent and capable persons were involved. The growth of MLM amazed me, since it seemed obvious it was just a disguised pyramid scheme. Yet several persons whom I trusted and respected tried to recruit me into their downline. They convinced me that I may have misjudged the industry and that MLM may have a real future as a viable and ethical business model. By closing my mind to it I could be missing out on something really promising.

Finally, I decided to investigate MLM for myself—even to the point of seriously trying one highly rated program in an effort to prove for my self whether or not my original objections to MLM were valid. They were. A more detailed account of my participation and motivation for performing this research are included in Appendix A, along with my background and credentials.

On learning of my experience, many MLM enthusiasts from other companies suggested I try another company. But I felt my time and resources were too precious to waste. Besides, I was more interested in MLM as an issue for consumers generally than as a money-making vehicle for myself. If most MLM programs are merely cleverly disguised pyramid schemes with all the negative fallout of naked pyramid schemes, consumers need to be warned.

I decided to perform an informal telephone survey of persons who had 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.**<sup>12</sup>

One thing that my interviews revealed was a surprising number of maxed out credit cards, foreclosed homes, bankruptcies, and broken homes resulting from compulsive participation in MLM programs. A relative of a couple caught up in such a tragedy reported the following about one MLM addict:

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.<sup>13</sup>

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 participants there seems to be an addictive component to multi-level programs, whether it be MLM or illegal pyramid schemes—very much akin to an addiction to gambling.**

I began sharing my research and experience in speeches to groups, and 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 of the MLM distributors 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 or one in 1000 distributors ever earns a profit from MLM, that in itself would lean towards multi-level programs being classified as a bogus business opportunity—or as a pyramid scheme, depending on the definition—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.**

## **CHALLENGE TO THE INDUSTRY: “PROVE ME WRONG”**

As feedback began coming in, I began to see patterns displayed by MLM’s that were eerily similar to illegal pyramid schemes. One was a system of overrides in which upline persons would receive as much in commissions from sales as the front-line distributors making the sales. This appeared to result in extremely large payouts to top distributors, while those beneath them received little or no remuneration from the company. And retail prices were too high to sell at retail. So the emphasis was naturally on recruiting—if any money were to be made.

Taking a frontal approach, I wrote a letter to the presidents of 60 of the most prominent MLM companies and shared my conclusions in a report and request for information (Appendix B). I called it “*The Network Marketing Payout Distribution Study*.”<sup>14</sup>

The report began with a challenge to each president to prove me wrong by revealing the breakdown of payout by percentiles to distributors in his/her company that could be used for comparison—and to reveal (if such were present) the extreme horizontal inequality that would characterize a pyramid scheme. If they desired to prove my conclusions wrong they had an opportunity and a format for doing so.

I even gave these executives a choice between a simple and a more comprehensive report option, depending on how definitive they wanted to be. A data base consultant assured me that my request could be satisfied by a good programmer in only one or two days of effort, using the existing data base of most any modern MLM company.

While a few promised to cooperate, none of the presidents ever finally released the requested data, even with the promise that it be kept confidential. It seemed that **none were able or willing to demonstrate that they were not a pyramid scheme by revealing percentile breakdowns of payouts to distributors that could be used for comparison and analysis.**

I informed these MLM executives that if they were unwilling to supply the needed data, I would publish the information that I had, with the report’s conclusions asserted by default, since the companies themselves were the only ones who could furnish the data to adequately refute them.

I also issued the same challenge to MLM industry representatives and pro-industry “experts,” but none were able or willing to comply with my request.

At least I have obtained useful insights through the back door by asking questions about net income of people who handle the money of MLM distributors. While their recollections were revealing and probably correct, valid conclusions cannot be drawn from them exclusively.

It would be extremely helpful for consumers and researchers to secure release of valid data from MLM company executives on payout distribution. I can’t force compliance—though enforcement agencies could, and I believe should—considering the large amounts of money which are at stake for consumers.

## **NAKED PYRAMID SCHEME VS. PRODUCT-BASED PYRAMID SCHEME**

To distinguish between typical pyramid schemes and those masking as MLM’s, I will introduce two terms that should help clear up the confusion between the two, along with some features which they have in common.

A “naked pyramid scheme” refers to 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 system.

We may call them “participants,” rather than “distributors,” because no products are offered. Sometimes participants are referred to as “investors,” a misnomer because there is no title to property or legitimate securities.

A product-based pyramid scheme, or PPS, is exactly what the name implies. A PPS is similar to a pyramid scheme, except that products are purchased by distributors, primarily for resale—supposedly. Such product purchases, often combined with other incentives, qualifies distributors for commissions in ascending levels in the distributor hierarchy.

As this paper demonstrates, **the negative consequences of PPS’s are far more severe than the most blatant naked pyramid schemes because they are harder to detect and can grow to mammoth proportions before they are detected or transmigrated to new pyramids with new products—or moved on to new countries.** This is how some of the more durable MLM’s have survived. Some U.S.-based MLM’s expanded into vulnerable countries in Asia when regulatory agencies in this country began investigating them.

Some have considered any MLM program as exempt from laws against pyramid schemes, as long as the program offers legitimate products, which can be retailed through its distributor hierarchy. A moment’s reflection will reveal the fallacy behind this logic (though statutes in

some states, such as Utah, are weakened by this distinction).

As suggested above, **if such an exemption were allowed, a pyramid promoter could initiate a PPS distribution system that in all other respects was like a naked pyramid scheme and then introduce quality products to legitimize the pyramid scheme. All they would have to do is create the illusion that the emphasis is on retail sales, not recruiting** (which is inherently an illusion in most programs, due to RVE-EHI, discussed later). **This is precisely what many MLM companies have done in order to minimize regulatory scrutiny while they conduct pyramid distribution schemes.**

In trying to identify what PPS's have in common with chain letters and naked pyramid schemes, I found two major characteristics which the three of them have in common and which cause most of the problems inherent in all types of pyramid schemes. A third characteristic usually found in PPS's—significant purchase quotas and/or recruiting incentives—adds leverage and power to the scheme.

**In my opinion, the issue is not whether or not products are offered or whether the emphasis is on recruiting or retailing. The latter emphasis is merely the effect, not the cause, of the problem—which is the highly leveraged MLM compensation system.**

While this may seem confusing to some, I will sometimes use the acronym “PPS” to refer to the more generic practice of product-based pyramid schemes. “MLM” will be used in most cases, however, when referring to accepted MLM programs. If it were more widely accepted I would use PPS in every case, simply because the MLM designation has evolved into “network marketing,” “consumer direct marketing,” etc. I suspect new terms will arise, but they could all eventually fall under the generic umbrella of PPS.

## TYPES OF MLM COMPENSATION SYSTEMS

A frequent argument of MLM promoters is that while they may agree that there are problems in the MLM industry, each will claim they have solved the problems with their new brand of MLM compensation system, which is supposedly more fair, honest, generous, etc., than all the others. I believe the three defining elements discussed here will reveal the fallacy of these new, improved systems, so far as “correcting the problems” so common in the MLM industry.

Why are compensation systems 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 system IS our product.”

Some of the common compensation systems used by MLM companies are as follows:

**Unilevel systems**, which allow an unlimited number of recruits on the front line. However, there is a limit on the number of levels deep that can qualify for commissions or overrides. Unitary systems could be referred to as simple or broad-based pyramids.

**Matrix systems**, which are shaped in the form of blocks, or matrixes, which have limits on how many distributors can be recruited into one's front line. These could be referred to as blocked or flat pyramids.

**Binary systems**, in which recruiting is done in a downline of two legs, with incentives to maintain matching volume, or a balance, between the two legs. Binary systems are really matrix systems limited to two “profit centers” that may continue recruiting of downline distributors indefinitely. Binary systems could be considered split pyramids.

**Stairstep/Breakaway systems** allow distributors to ascend a stairstep of levels in a hierarchy of distributor breakaways. Each breakaway is a separate organization tied to one person who draws overrides from the entire breakaway organization. When tied to minimum requirements for breakaways on the front line, an extremely leveraged pyramid scheme results, in which enormous payout to top level distributors is financed partly by commissions from purchases of hundreds or even thousands of aspiring distributors beneath them—the vast majority of whom lose money.

Stairstep/breakaway systems are really nested pyramid schemes, with many pyramids (often polypyramids) nested within a master pyramid or megapyramid. The effects, in terms of losses to participants, far exceed those of naked pyramid schemes, which are considered illegal. In the author's opinion, **if any of the product-based pyramid schemes were found to be illegal, stairstep/breakaway compensation and marketing systems should be at the top of the list.**

Other MLM's or PPS's may exist and will continue to be developed, as creative pyramid promoters seek new ways to make a fortune and to circumvent legislation against pyramid schemes or to avoid arousing regulatory scrutiny. In many cases, before regulators figure out what is happening, the promoters have made their fortunes and moved on. Seldom is much or any of the money recovered for the victims of these scams.

## DEFINING CHARACTERISTICS OF A PRODUCT-BASED PYRAMID SCHEMES (PPS's)

All durable PPS's have certain features in common, and MLM's tend to display these features. When all three of the characteristics below exist in a PPS, the program will lead to all the effects of a naked pyramid scheme (often much worse in the long run) if not detected and stopped. The vast majority of participants lose whatever

time and money they have invested, while the company and a few upline distributors profit from their losses.

*Level 3:*  $125+30=155$  total distributors  
*Level 4:*  $625+155=780$  total distributors  
*Level 5:*  $3,125+780=3,905$  total distributors

**PPS DEFINING CHARACTERISTIC #1: A chaining hierarchy of levels of distributors—more than is functionally justified—is recruited without area limits, which leads to extreme leverage and perceived saturation in the marketplace.**

The MLM concept has great appeal to some people, especially marketers who find it tedious and expensive to go through standard distribution channels. The notion of “people telling people” or “word-of-mouth advertising” has wide acceptance. But problems occur when such direct marketing is tied to a chaining of distributors without appropriate market controls. When this happens, you often see the following:

**a. A multi-level hierarchy of several levels of distributors—more than is functionally justified for providing products and services in a given market area**

For even the largest of conventional distributor arrangements, the entire U.S. can be covered by a maximum of five levels in the distributor hierarchy; e.g., front line sales person, plus local and/or district, regional, and national sales managers. **More than that is superfluous and bloated, driving up product prices and making sales at a competitive retail markup unprofitable and unrealistic.**

When several levels are allowed in a multi-level hierarchy of distributors, there is seldom any functional justification for doing so other than to encourage recruiting and the illusion of very large potential incomes to more people than is mathematically possible—a hallmark of pyramid schemes. Also, **with an upline of many levels, all getting overrides from the sales of front line distributors, the top level distributors may be profiting to an extreme degree from the losses (including product purchases) of those beneath them.**

Such exorbitant incomes result from the reaping of huge overrides from the combined efforts of hundreds or even thousands of downline distributors. **MLM promoters refer to this as “residual income” or “leverage”—large payouts disproportionate to effort expended, resulting primarily from the purchases of downline distributors.**

Leverage can be illustrated by adding up a downline of MLM distributors that is extended to five levels—although many programs allow for many more levels. But for the purpose of illustration, assume that a distributor recruits five active distributors, each of whom recruits five more, and so on through five levels of distributors. The exponential growth of the pyramid becomes evident:

*Level 1:* 5 distributors  
*Level 2:*  $25+5=30$  total distributors

If each distributor were to buy enough products each month to yield an override of \$10 in commissions and bonuses to the original upline distributor, then with a four-level downline, the distributor gets \$7,800 per month, while with a complete five-level downline the same distributor gets \$39,050 per month. 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 example illustrates why so much emphasis is placed on recruiting as opposed to selling products to persons outside the pyramid. \$39,050 is much more appealing than \$50 that might be earned by a Level 1 distributor for selling the products (assuming \$10 total commissions from each of five customers). **When a distributor is rewarded over 781 times as much to recruit as to retail products, it does not require a survey to determine where the emphasis will be.**

**What is often not factored into projections made at opportunity meetings is the expenses of conducting the business.** If operating expenses plus products purchased from the company (which would not likely have been purchased if the person had not been a participant in the program) are subtracted from commissions, few are making any profits—except for those at the top levels in the distributor hierarchy. The vast majority are losing money, only to fatten the bank accounts of their respective uplines, from commissions on their product purchases.

From the above example we can see that limited leverage is seen in an MLM program (or PPS ) until several levels are included. The extent of aggregate investments—usually experienced as losses—of participating distributors to support upline gains would be much more limited with a small number of distributor levels. In fact, with less than five levels, the system would probably die out for lack of opportunity for ambitious participants to receive extremely large override checks from downline purchases. Blatant appeals to greed would be lessened. This is why most PPS’s allow for several levels of distributors.

**b. No territorial protection to prevent saturation**

Though not normal for MLM’s, if reasonable territorial protection is not offered to participants in a given area, the program will ultimately collapse from market saturation. Recruiters promote the illusion of an ever-expanding market and of the potential for large payouts for virtually all new recruits.

With unlimited recruiting in a given area, new distributors soon find it increasingly difficult to recruit more distributors. This is due to perceived market

saturation, wherein prospects perceive limited opportunity to profit from participation.

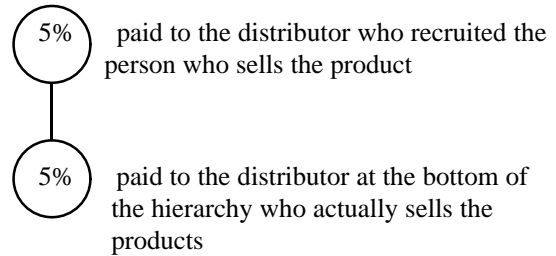
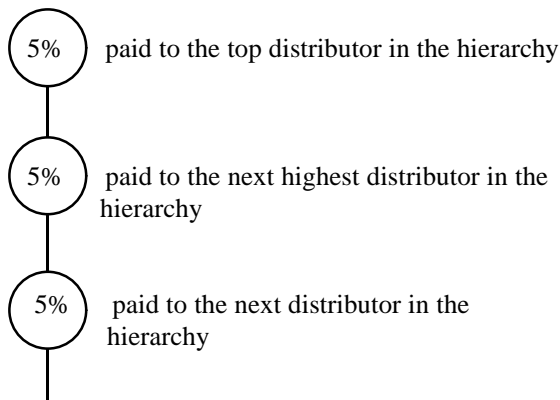
To illustrate an approach more in line with market realities, suppose the program were limited to one distributor for each 10,000 population in a given area or to one distributor in each one-mile radius—much like the territorial protection of a retail franchise. Then the problem of saturation would not be as significant. But limiting the amount of recruiting or the number of distributors in a given area is highly uncharacteristic of PPS's because that would lessen the illusion of the potential for very large payouts for new recruits. **Such limitations would render a PPS impotent.**

PPS company leaders, sensing perceived saturation and potential collapse, often develop new “divisions” or geographic “territories” (such as in vulnerable states or countries with weak anti-pyramid laws) to start new pyramids and thereby keep their top distributors happy.

**PPS DEFINING CHARACTERISTIC #2:  
Relative vertical equality (RVE) in distributor compensation leads to an emphasis on recruiting and to extreme horizontal inequality (EHI) over the entire network of distributors.**

While researching this subject, I often asked myself why MLM is so pyramidal in concept, motivation, and effects, and yet has been so successful in avoiding the label of “pyramid scheme.” After careful comparison of the compensation systems of MLM's with pyramid schemes, I found a striking similarity. I call it relative vertical equality (RVE) in commission structure. It works like this:

Let us suppose a person selling a MLM product gets paid a 5% commission from the MLM company. This is not much, but he/she is told that the product can be sold at a 30-40% markup to retail customers. However, since the product is priced so high to begin with, the distributor winds up selling it wholesale and hoping to make money recruiting and getting overrides from a downline. The distributor gets 5% from those he/she recruits, 5% from those they in turn recruit, and 5% from those below them—and so on until the maximum number of levels allowed in the program. Vertical equality looks like this:



Whenever I have shown this 5-5-5-5 vertical equality structure to a group of consumers, many of them responded, “What’s wrong with that? Everyone gets their fair share.” What they don’t recognize until it is pointed out to them is that **vertical equality is exactly how illegal pyramiding or chain letters work.** Incidentally, the 5-5-5-5 per cent structure is for illustration only. A wide variety of compensation patterns is used in MLM and the percentages and levels of payout vary greatly, but relative vertical equality in total compensation per unit of sale is common to nearly all MLM programs.

To further clarify that last point, strict vertical equality is not always evident in MLM programs, especially when the compensation systems include escalating commissions at higher levels in the distributor hierarchy and/or extensive and complicated bonuses and awards. But **after all aspects of compensation are factored in, when a distributor on the front line gets relatively the same total payout per sale from the MLM company as a hierarchy of distributors three or more levels above (the upline), you have what I call relative vertical equality (RVE). Nearly all MLM programs show this characteristic, as do all pyramid schemes.**

Each successive level theoretically increases geometrically the number of persons in a distributor’s downline until perhaps thousands eventually are each contributing 5% from their sales (or purchases). This is where the leverage and the real money is. I saw a photocopy of a monthly check to a founding distributor of a major MLM company in the amount of \$400,000. **That’s over \$5 million a year!\_This is also why so little emphasis is placed on selling the product. Selling the “opportunity” is where the money is. As psychologists learned decades ago, you get the behavior you reward.**

So what is the consequence of RVE in compensation systems? It leads inevitably to **extreme horizontal inequality (EHI)** in payout over the entire network of distributors. A relative handful of distributors receive huge paychecks, while over 90% (often over 99%) come away empty—actually losing money in most cases, after expenses are subtracted.

Table 1 shows the pattern of EHI in payout distribution in one prominent MLM company which is required by consent decree with the FTC to release average income figures by distributor levels. The

information contains some statistical inconsistencies, which are here corrected, using the best information available to me. While the leverage demonstrated in this example is highly extreme, most any MLM will demonstrate leverage beyond the norm for an acceptable business opportunity.

Based on the foregoing, I believe a similar pattern exists among distributors in most MLM companies. Such patterns could be verified by the release (by MLM company executives) of data on company payout to distributors by percentiles. Lacking that, I can only offer my estimate of what those patterns look like, based on extensive interviews and personal observations, including those of the company illustrated in Table 1.

Note that—**unlike other corporate and small business arrangements, most MLM distributors wind up losing money**—assuming all expenses and products purchased from the MLM company are taken into account.

In essence, RVE inevitably leads to EHI. EHI could easily be tested by requiring MLM companies to reveal payout to distributors by percentiles for all distributors—not just the “active” ones. (Again, see my “Network Marketing Payout Distribution Study,” Appendix B.)

If companies were required to disclose these statistics, I believe some startling information would come out. It would not surprise me to see many companies in which projections of very large incomes offered to recruits were in actuality achieved by far less than 1/10 of one percent of all distributors recruited into the network.

I believe the focus on pyramid schemes as programs which emphasize sales rights, rather than the sale of products and services, is inadequate. Other factors need to be factored into any attempts to determine what is a pyramid scheme.

**This issue may be both the heart and the Achilles heel of the MLM industry. RVE-EHI, combined with chaining more levels and recruiting more distributors than is functionally justified, is at the core of most PPS programs, and they are their most vulnerable features when understood.**

**TABLE 1: Which distributors get the money paid out by one highly leveraged MLM?**

Based on the company's official report: "1998 Actual Average Incomes"

Distributor levels	Number of distrib's*	Income**	
1. Blue Diamonds	102	\$480,404	*The total number of distributors who received no commissions is calculated at eight times the reported number of "actively participating distributors," including a minimum estimate of those who terminated or became inactive. This gives a more realistic view of the odds of success, which are extremely low, by any standard.
2. Diamond	57	\$154,582	
3. Emerald	51	\$53,422	
4. Ruby	121	\$27,071	
5. Lapis	419	\$12,409	
6. Gold	705	\$6,611	
7. Executive	1,690	\$4,622	
8. Qualifying Exec	292	\$2,989	
9. Distributor***	5,590	\$378	
10. Unpaid dist's***	508,160	\$311	

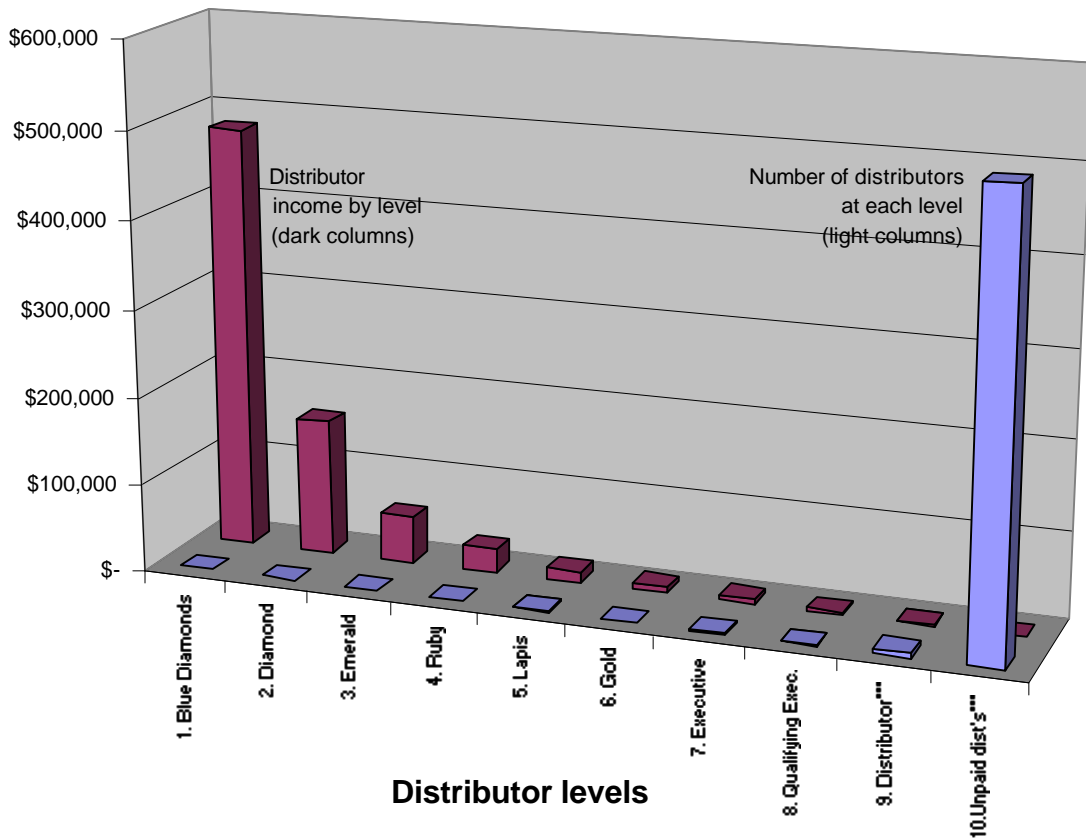
\*\*Note that most of the income goes to Blue Diamond distributors, with all but a few distributors receiving nothing from the company. In fact, the vast majority lose money, after subtracting operating expenses and product purchases.

\*\*\*The income figures shown include adjusted estimates of sales at retail prices, (after correcting for information based on a questionable survey)

Actual income for levels 9 & 10 (and most likely levels 3 to 8) would be shown as losses, after subtracting operating expenses and product purchases.

**Such extreme inequality (EHI) in payout to distributors is the direct result of relative vertical equality (RVE) in a product-based pyramid scheme.**

**Income by levels**





**PPS DEFINING CHARACTERISTIC #3: Significant purchase or recruiting quotas are required (or incentives offered) to qualify for increasing bonus levels or purchasing discounts in an ascending hierarchy of payout levels. This is referred to as the “pay to play” feature of a pyramid scheme.**

While this may not be a necessary feature of a PPS, it is a prominent feature in enduring PPS's. The “successful” (in terms of lasting more than a year or two) MLM's make it difficult for a distributor to be satisfied at any level of sales already accomplished. Higher bonus levels for recruiting more distributors or for moving more products keeps success-motivated participants on a continual treadmill. As a result, they often purchase more than they need for themselves or than they can realistically sell, especially at the excessive retail prices suggested for many MLM products.

As already discussed, if such product purchases—and other operating expenses—were subtracted from commission checks, very few would be showing an actual profit. Then, to add insult to injury, MLM companies or their distributors often strongly recommend attendance at seminars and convention events—for a fee—and purchase of training materials, and sales “tools,” all of which add to the cost of doing business.

A related problem occurs when a distributor buys enough products to achieve a certain level of payout qualification and has to continually buy a certain minimum quantity of products to maintain that level. When they find they can't sell them and finally quit, they are left with a garage or basement full of products. I and other observers have found this to be a common problem with MLM's, regardless of rules against stockpiling.

From the standpoint of the MLM company, such minimums and the sales of such sales aids help guarantee continued business and profitability. For its top distributors, override commission checks are much larger. The losers are the downline distributors who often are not fully aware of how much the business is costing them in time and money.

**Pyramid schemes masquerading as MLM's are often allowed to grow and flourish unchecked because they do not require a large up-front enrollment fee to sign up. Because recruiters often do not profit from the initial recruitment of a distributor, it is assumed the program is not a pyramid scheme.**

**In fact, nothing may be further from the truth.** As mentioned, MLM companies typically incorporate escalating incentives to purchase products (sometimes at initial signup, sometimes later) to qualify for ever-higher levels in the distributor hierarchy and/or for larger discounts on product purchases. Enforcement officials sometimes refer to this as the “pay to play” feature of a [product-based] pyramid scheme.

Also, because of a compensation system with rewards for recruiting a certain number of distributors (or escalating incentives to recruit more and more distributors), many of the more ambitious distributors will recruit “dummy distributors” from friends and family members and buy products in their names. It is not until they leave the system that the more astute among them realize that they have in effect paid a very large fee (in the form of product purchases) for participation in a pyramid scheme. Often this amounts to many thousands of dollars over a period of months.

Such an amount paid into a naked pyramid scheme would immediately arouse suspicions by the public and by enforcement agencies of its constituting an illegal pyramid scheme. But as already stated, since the money paid into an MLM program is paid for legitimate products and over a period of time, most participants (and many regulators) fail to see it as an investment in a pyramid scheme. However, **this “pay to play” feature of a product-based distribution system is often a clear indication it is in fact an illegal pyramid scheme.**

Many observers believe that MLM products are sold at a premium to support a large downline. If an MLM product were to be sold at a premium of \$20 more than competitive products sold through other outlets, the \$20 premium could be considered the pyramid premium portion of the price, which would flow to the top of the distributor hierarchy in typical pyramid fashion.

Also, as mentioned above, **powerful incentives may be built into the program for the distributor to buy much larger quantities of the product than he/she can realistically sell in order to qualify for ever larger payout (or discount) percentages. This is why incentives for purchases over a period of time need to be considered in calculating the cost of fully participating in the scheme.**

**THE KEY PROBLEM WITH THE FTC DEFINITION OF A MULTI-LEVEL MARKETING PROGRAM**

The Federal Trade Commission (FTC) defines a multi-level program as follows (problems are noted in italics)—

[multi-level marketing 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) *(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.*<sup>14(rep)</sup>

The major problem with the latter part of this definition is that "rules" are not sufficient to overcome the tendency to invest one's efforts and money where the greatest return is perceived to be, **unless such rules address the fundamental compensation systems that cause the problems with MLM's**. This is especially true where such incentives are literally hundreds (even thousands) of times greater than rewards for complying with the "rules"—such as recruiting a large downline versus selling products at retail to non-distributors.

Any dog owner knows that if you place a five pound package and a one ounce portion of hamburger in front of a dog—two feet apart—the animal will move first to the larger package before considering the smaller one. It would be very difficult to convince a dog with a rule or command that it would be to his advantage to forsake the large package for the tiny one.

This is why researchers such as myself have observed widespread ignoring or circumventing of such rules by MLM distributors. The same can be said for misrepresenting product effectiveness or income potential. **When the compensation system indirectly provides extreme rewards for stretching the truth,**

**while severely penalizing honesty, the result is predictable.**

However, even when actions are taken by the FTC and state agencies against MLM's, **it is sometimes difficult to validate and enforce those actions, especially since the larger MLM's have deep pockets and can often find ways around such rulings.** For an agency to enforce action against MLM's as PPS's requires the prosecutorial will and the resources to do so.

For example, according to research done at the office of the Attorney General of the state of Wisconsin, Amway blatantly ignores "the Amway rules" to avoid FTC action for conducting a pyramid scheme. These include:

(1) the "70% rule" (distributors must derive at least 70% of their income from retail sales to non-distributors) and

(2) the "10-customer rule" (an Amway representative had to prove that he/she has made at least 10 retail sales each month).<sup>15</sup>

In 1993, NuSkin International, Inc., was ordered by the FTC to provide information on average incomes for distributors, but using statistical sleight of hand was able to hide relevant information on the odds of success from prospects and from enforcement officials reviewing their program. Their annual report entitled "Actual Average Incomes," showing average incomes for each level of "actively participating distributors" is made available to anyone who requests it.

An uninformed prospect reading the report is led to believe that 100% of those who make an effort as new distributors in the NuSkin "business opportunity" earn a profit. But close inspection by an analyst who is familiar with their program revealed some fundamental flaws in their reporting.

The actual odds of success for **all** distributors who attempt the NuSkin program (after **all** expenses are subtracted, including product purchases) is probably less than 1/10 of 1%! It is astounding that NuSkin has been allowed to continue misleading consumers for so long, resulting in hundreds of thousands of persons investing in the NuSkin program—who probably would not have done so had they been furnished correct information.<sup>16</sup>

Apparently until now, the Enforcement Division of the FTC has considered NuSkin in compliance with its 1993 Order to cease and desist misrepresenting earnings. However, I understand NuSkin's compliance with the order is now under review, so hopefully this situation will change.

If a distributor tells prospective recruits that they have one chance in 10,000 of making a profit for their efforts, what are the chances he/she will be successful as a recruiter? Would a recruiter who gave out such

honest statistics be likely to rise to the level of a top distributor where the real money is to be made?

Or if the distributor tells prospects that his/her products are not as effective as its promoters claim or that a comparable product can be purchased for half the price elsewhere, what is the likelihood that enough sales will be made to advance to the next bonus level?

**Full and correct disclosure should be mandatory.**

**What are needed are not rules or artificial controls for MLM that are ineffective, but fundamental changes in compensation and marketing programs to correct the underlying problems of MLM's.** Of course, you would then not have MLM as it exists today. The extreme leverage would be eliminated. The resultant altered program would probably wind up being a more conventional marketing system that has proven the test of time.

In my opinion, **most MLM companies are PPS variants—fundamentally unsound and inherently fraudulent.** Distributors are doomed to failure, with the exception of a few at the top of the distributor hierarchy, as is true with any pyramid scheme.

#### **NEEDED: A MORE PROACTIVE APPROACH TO ENFORCEMENT OF LAWS AGAINST PYRAMID SCHEMES AS APPLIED TO MLM'S**

**One of the insidious features of many MLM's is that promoters often aggressively harvest the rewards from building their pyramids and disappear before enforcement agencies can catch up with them.** The more successful MLM's add products and divisions and grow to a size that makes enforcement very difficult.

The largest of the MLM's have very deep pockets and can endure regulatory actions through legal maneuvers, statistical reporting deceptions, public relations ploys, donations to political parties in power and to influential officials and groups, and lobbying against legislation which would make anti-PPS enforcement easier.

**Unfortunately, most enforcement against pyramid schemes masquerading as MLM (or network marketing) is reactive, not proactive. Victims of PPS's seldom complain,** having been tutored that anyone can succeed if they will only try hard enough to "work the system." When distributors quit, they usually leave quietly, too embarrassed to complain to anyone. Many will even apologize to their upline for having failed. **So agencies that enforce laws against pyramid schemes by acting on the basis of number of complaints will often be acting**

**after the fact. The damage is done before any action is taken, and victims are not likely to significantly recover their losses.**

So enforcement agencies are at a disadvantage when they wait until many complaints are filed to enforce laws against pyramid schemes. Investigations involving interviews of company representatives, surveys of participants, analysis of financial records, and other typical evidence gathering are time-consuming and often inconclusive.

The above characteristics, however, are easy to identify with a careful study of the compensation system and marketing structure of the company by investigators with expertise in principles of marketing and elementary statistics.

**It can be demonstrated that the prognosis for any company that incorporates these three features into their compensation and marketing plan is certain: an emphasis will be placed on recruiting over sales of products and services—regardless of "rules" or company policies to the contrary. Again, behavior that is powerfully rewarded is more likely to occur than weakly rewarded behavior.**

**An agency that uses these tools skillfully can identify PPS's at the first sign that such a company is starting up. Enforcement action could thus be timely and thereby prevent major losses.**

**The best scenario would be for legislation to be passed (or rulings by enforcement agencies) requiring submission of the compensation and marketing plan by any MLM company at startup. The application to do business could then be approved or rejected, based on carefully designed mathematical and/or defining criteria, such as the three explained above.** It is my sincere hope that this paper will encourage such a proactive approach.

It is my belief, however, that PPS's can be identified for enforcement action, using the tools provided herein to interpret and apply the FTC definition and most state statutes as they stand.

#### **SYNDROME ANALYSIS—A TOOL FOR CORROBORATING THE EXISTENCE OF A PYRAMID SCHEME**

I have researched this topic for five years and believe my facts and perspective on this issue to be accurate. Unlike investigators working at enforcement agencies, I have had first-hand experience myself as a distributor, as well as having gathered the experience of distributors from a wide variety of MLM programs.

Let us look at another approach for identifying PPS's. The very mention of the word "pyramid" in

MLM circles can elicit a torrent of rebuttals—many of which will hinge on the FTC’s original ruling that Amway was not an illegal pyramid scheme.

I maintain that just because some MLM programs do not meet a narrow interpretation of what is legally a pyramid scheme, they can still be pyramidal in concept, motivation, and effects. In fact, **over time most MLM programs are more pyramidal in their effects than naked pyramid schemes, simply because of the vastly greater volume** of income accruing to the company and to top distributors as time passes, stretching from months to years. This typically does not happen with naked pyramid schemes, which are usually discovered and shut down fairly quickly.

Sometimes it is useful to borrow definitions and concepts from a seemingly unrelated field of human activity in order to better define what may defy our current categorizations. For example, in the field of medicine, recent advances have led to the recognition of a whole class of diseases that defy ready explanation or diagnoses. These are often referred to as “syndromes.”

My dictionary suggests two definitions for the word “syndrome” that apply for the purposes of this discussion:

- 1: a group of signs and symptoms that occur together and characterize a particular abnormality and
- 2: a set of concurrent things (as emotions or actions) that usually form an identifiable pattern.”<sup>17</sup>

The syndrome method of classifying illness allows a physician to identify a disease or psychological disorder when several if not all of the symptoms are present. For example, if at least five out of ten symptoms characteristic of a disease are present, a doctor may say that a given person has that illness. Examples of syndromes would be fibromyalgia, Tourette’s syndrome, or attention deficit disorder (ADD).

While not an obvious pyramid scheme by the strict legal definition used by the FTC, I will demonstrate that the MLM model can be viewed as a pyramidal syndrome, with concept, motivation, and effects almost identical to any pyramid scheme. **This type of analysis may not be as useful as the defining characteristics discussed above for proactive identification of a pyramid scheme, but it could be useful in corroborating what they denote.**

In this paper, we shall use the convention of characterizing a syndrome with a multitude of symptoms, not all of which need be present to constitute the syndrome.

Confronted with the charge of being a pyramid scheme, MLM apologists typically respond that a

pyramid structure is common in all large businesses and other organizations. You have a president at the top, vice presidents under the president, middle managers under them, front line supervisors, and finally the front-line work force.

I maintain that many significant features (symptoms) separate a “pyramid scheme” syndrome from normal business organizations. To suggest that “all organizations are really pyramid schemes” is naïve.

## **SYMPTOMS OF A PRODUCT-BASED PYRAMID SCHEME (PPS) SYNDROME**

I would suggest that a MLM program is a pyramid syndrome if perhaps twenty or more of the following 28 characteristics are in evidence:

### **PPS concept and structure common to all pyramids**

#### **1. A multi-level hierarchy of distributors is recruited under sponsoring distributors, allowing more levels in one's "downline" than is functionally justified to serve even a very large customer base.**

While all sizable organizations display a hierarchical structure in order to function efficiently, the MLM hierarchy is characterized by many levels, which spring primarily from recruiting and placement into successive levels for payout purposes. This is in sharp contrast to the normal pattern in more normal organizations, in which selection of persons for successive levels of responsibility is based on organizational need and managerial skills.

#### **2. In any given area, unlimited recruiting of distributors—each of whom may be encouraged to recruit—is permitted.**

With unlimited recruiting in a given area, new recruits soon find it increasingly difficult to recruit more participants into the system. This is due to perceived market saturation, wherein prospects perceive limited opportunity to profit from participation. The program will therefore eventually collapse from perceived, if not actual, market saturation. Franchises and legitimate distributorships generally get around this problem by offering some territorial protection.

#### **3. Total payout to distributors is characterized by relative vertical equality (RVE) in total compensation per sale to distributors by the company.**

**This means that the person actually selling the product earns little more in total payout per sale from the company than an upline distributor three or more levels up—who had little to do with the sale. This also necessitates recruitment in order to achieve any significant income, since company payout for the actual sale is not enough of an incentive to concentrate on the products themselves.**

While distributors can profit from selling the products at a marked up retail list price, the distributor's wholesale cost is usually too high for a markup to a competitive retail price, so products are

sold at wholesale or too far below list price to provide significant retail profit margin.

Some MLM programs have a complex compensation system of commissions, bonuses, and other incentives that make it very difficult to assess the extent of RVE that exists. However, RVE becomes manifest when extreme horizontal inequality (EHI) is displayed in compensation over an entire network of distributors. (See # 19 below.)

#### **4. The illusion of virtually unlimited financial growth opportunities masks the mathematical reality of limited advancement opportunities.**

Charts of compensations systems in MLM programs often show an almost limitless opportunity for financial growth by advancing geometrically through levels in the hierarchy of distributors to extraordinary incomes at the top levels. Recruiters imply that such income can be reached by anyone. Such promises of extreme financial opportunities often mask the reality that very few could actually make the top level.

### **Pyramidal concepts that apply primarily to MLM (PPS) programs**

#### **5. The MLM program displays a pattern of rapid growth, then a leveling off in sales, followed by a precipitous decline in volume.**

This pattern is common to all pyramid schemes due to a pattern of progression from phenomenal growth at the outset to actual or perceived saturation—perception by the public that the "opportunity" for successful recruiting has passed because too many people already know about it. Then the whole thing—like a house of cards—collapses. For this reason, few MLM startups last more than two or three years.

#### **6. The more durable MLM companies avoid collapse by initiating new pyramids, which they label "growth opportunities".**

The more resourceful MLM companies will periodically introduce new product lines or divisions or open up new countries or regions in which to operate. Experienced distributors, seeing the collapse of the pyramids in the areas in which they have been working—due to actual or perceived saturation—will then rush to establish new downlines in fresh areas that are opened up.

#### **7. Frequent mention is made by top distributors (of newer MLM companies or divisions of the same company) to potential recruits of "getting in on this ground floor opportunity."**

A rare or hitherto unseen opportunity with extraordinary income potential is discussed, even though the bulk of the income is locked in by the founding distributors in the pyramidal hierarchy. “Just get on board,” “ride the wave,” etc. are other typical appeals.

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

Distributors are taught that through effective recruiting and training one can replicate one’s own efforts through the efforts of one’s downline and that this process can continue almost ad infinitum until great leverage is achieved for one’s time and investment. New recruits are taught how to recruit from their “warm list” of friends and family first. What they are not told is that they are only fattening their upline’s override checks even after they eventually get disillusioned and quit the program.

**9. MLM recruiters in the organization promise or imply a substantial residual income (a.k.a. “permanent income”) can result from an initial investment of hard work for a short period of time. This supposedly leads to “time freedom”—freedom from having to work or trade time for pay. In actuality, it is pyramid income.**

These implied promises can vary from \$1,000 to \$100,000 or more a month. And some do actually receive checks of that amount, but only at the expense of those beneath them.

In one survey of MLM participants on expectations of success, 86 % expected a full-time income to result from their participation, and the average income cited to be sufficient for distributors to quit their jobs and do MLM instead was \$5,988 per month. But remarkably, 7% responded that the amount of MLM income which would meet their expectation of success would be \$86,000 per month!<sup>16</sup> By the way, that amounts to **over \$1 million a year.** **What do such expectations tell us about the more aggressive MLM promoters?**

The concept being promoted is “residual income” akin to that enjoyed by wealthy investors or successful authors, inventors, or actors who regularly get large royalty checks even though most of the actual work is behind them. This “time freedom” has great appeal to people who feel they are slaves to the clock and to their work. Even professional persons get involved, hoping to free themselves from the necessity of continuing to provide services; i.e., trading time for money.

**10. Pyramidal money-making concepts—the life-blood of the business—are discussed or implied at**

**opportunity meetings and in other recruiting events and devices, such as audio and video tapes.**

As mentioned in #8, distributors are encouraged to build their “organizations” (“pyramids” is a more accurate term) by duplication of their efforts. The implication is that a life of ease can be created, capitalizing on the efforts and product purchases of their downline.

Word pictures (if not actual videos or photos) of successful distributors lounging on the beach, driving an expensive car, living in an expensive home, and enjoying their family more fully than “those poor working types” is a common theme. Distributors are shown charts of potentially huge income resulting from the pyramiding of income from their recruiting efforts. These charts are as pyramidal as any seen for naked pyramid schemes.

**11. MLM distributors display an extreme sensitivity to their program being referred to as “just a pyramid scheme,” in frequent references by critics and consumers outside the program—who perceive it as such.**

Mention the word “pyramid scheme” in connection with their particular “opportunity,” and MLM promoters will go ballistic on you. Their reaction is reminiscent of a line from Shakespeare: “Me thinks the lady doth protest too much.”

MLM recruiters may pull out a pamphlet distributed by the BBB or the Direct Selling Association—made available by the Consumer Protection Division in some states—whose personnel may be unaware that the DSA is financed mainly by the MLM industry and uses the name “Direct Selling Education Foundation” as a front. These flyers distinguish illegal pyramid schemes from “legitimate business opportunities” like MLM.s. The MLM promoters will admit that other MLM companies may be “thinly veiled pyramids,” but not their company. They may loudly proclaim that the FTC and state agencies have looked at their company and given it a “clean bill of health.”

My surveys have demonstrated that consumers often label MLM programs as “just disguised pyramid schemes.” In this respect, the gut feelings of outside observers may be more valid than the narrow definitions of some statutes or the loud protests by MLM promoters of being so labeled.

**MLM (PPS) recruiting practices**

**12. Frequent (often weekly) opportunity meetings, three-way calls, or other recruiting devices are employed to tout promises or implications of great wealth and/or “time freedom,” to be attained**

**through patience, effort, and persistence in the particular program promoted.**

Such claims are not supported, except anecdotally or with average incomes of the top levels. Those who lose money—the vast majority of distributors—are not mentioned.

When the failure rate is brought up, the dropouts are denigrated for being lazy or not having applied themselves to the program. In actuality, many of the failures may have invested a great deal of time, money, and effort to make the program work—but their timing left them at or near the bottom of the pyramid.

**13. Recruiting can be characterized as a “body shop,” in which large numbers of distributors are continually recruited to replace an inordinate number of dropouts.**

Sometimes “opportunity meetings” will be attended by dozens or even hundreds of prospects who are given a pitch by top recruiters. Most of those who join eventually give up after wasting all their investment and efforts, only to further enrich upline recruiters—who must then find new recruits to replace the quitters.

“They didn’t try hard enough,” the MLM promoters say of the quitters. One almost has to have been involved in other sales situations or business startups to appreciate by comparison how extreme are the rate of dropouts for most MLM programs—well over 90% [probably per year], according to one researcher.<sup>19</sup> I would guess it ranges between 95% and 99% over a five year period.

**14. Emphasis when prospecting is on the “opportunity,” versus the value of the products themselves.**

In opportunity meetings and conversations between distributors, little emphasis is found on product sales. Recruiting is where the action is. Another term for the emphasis on recruiting is “top down prospecting”—as opposed to “bottom up prospecting,” in which persons are sold products and then encouraged to join the recruiter’s downline. In any case, it is made clear that the big money comes from recruiting a downline.

**15. The distinction between the consumer and the seller of the product becomes blurred in MLM programs.**

With MLM the consumer and the distributor often merge into one and the same person. Distributors are encouraged to buy products in order to set an example for their downline—to “be a product of the products;” and buyers of the products are often recruited to become distributors.

In a typical MLM, the sellers are the buyers, and the buyers are the sellers—to themselves. That is why the only way to significantly increase volume is to recruit more distributors.

**16. MLM companies encourage distributors to recruit family, friends, and others into its network of distributors as a way of moving its products.**

A major strength of MLM (PPS)—its potential to utilize the social capital of its participants—is also a facet of the business that offends the most people.<sup>18</sup>

People who are approached to do MLM often feel that their relationships are taken advantage of when their friends and family recruit them—placing their relationships “on the altar of money.”

**17. Demand is distributor-driven, not market-driven.**

In normal retail settings, sales are determined to a large degree by customer demand based on perceived needs. With PPS’s, the need for or quality of the product may be almost irrelevant—as long as it can be used for sales purposes to build a downline and to get around regulatory definitions of an illegal pyramid scheme. Truck tires could be sold to car owners if said car owners were vulnerable to PPS schemes.

**18. MLM companies charge for in-house seminars and sales materials—a source of revenue unique to the industry.**

I was amazed to find that MLM conferences on product information and recruiting techniques carried a charge even though all attendees were registered distributors. In alternative settings outside MLM, such conferences and sales materials for distributors selling a given company’s products normally are offered without charge. But for MLM companies, paid distributor conferences are an added source of revenue, since distributors are gullible enough to pay to attend. In many programs, distributors will pay willingly for flyers, order forms, and other sales materials used to promote the company’s products.

Compensation systems—the true villains in PPS’s

**19. As the direct result of relative vertical equality in MLM company compensation systems (#2, above), extreme horizontal inequality (EHI) is seen in payout to the entire network of distributors, with emphasis on the word extreme—as opposed to ordinary horizontal inequality in business generally.**

This translates into **huge incomes for the top distributors and little or no net income for the**

**bottom 99% of distributors** (with emphasis on net income after all expenses—usually losses after subtracting product purchases). **A few do get rich, but only at the expense of hundreds or even thousands who lose the time and money they have invested.**

The reason for this EHI is that upline distributors several levels up get about as much per sale as the seller of the products (due to RVE in commission structure), creating extraordinary leverage for the highest levels in the upline. It also means that distributors get so little income from actual sales that they must recruit a downline to make any money at all.

**20. Very small rewards are paid to distributors by the company for retailing the products.**

This is due to RVE, leading of necessity to an emphasis on recruiting in order to build volume and receive large overrides on the business of one's downline. After all, the pieces of a pie cannot exceed 100% of the pie. **If upline distributors each get a sizable chunk of the total price of the product, that limits the amount that can be allowed for the person selling the product. So the only way to make money with most MLM's is to get overrides from a very large group of downline distributors.**

Commissions paid by the company for selling its products are seldom enough to provide even a minimum wage for a distributor's efforts. And prices are usually too high to sell competitively at suggested retail prices.

Sometimes the rewards paid by the MLM company are as much as hundreds or even thousands of times greater for recruiting a downline as for retailing products. As a result, a common complaint of persons approached to do MLM is "She barely mentioned the product—it was only incidental to the 'opportunity' for which she was recruiting."

**21. Net profits from MLM participation are rarely sufficient to be reported by distributors to the IRS.**

**The acid test for success as a MLM distributor is whether or not significant profits remain after all expenses and product purchases from the company (which would not have been purchased had the person not been a distributor) were accounted for—enough to actually report a profit on their income taxes. Few do.**

While failure in other small businesses is common, the majority either quit the business if they don't achieve profits for their efforts and investment—or move on to something else. But in MLM, many continue losing money for years (supported by their "day job" or by savings or retirement), goaded on by their upline and promised they will soon realize their dream if they are patient and persistent.

Based on data furnished by the Nevada State Gaming Control Board<sup>19</sup>, I estimate that **the odds of winning at any of the gaming tables in Las Vegas is greater than the likelihood of profiting from most MLM programs—and without squandering time, effort, and relationships.**

**22. MLM distributors are led to believe that if they will only "be patient and work harder," they can all eventually succeed financially.**

Success motivation and training in salesmanship and recruitment techniques are often an important part of distributor conventions and retreats. This is often repeated, in spite of the reality that the vast majority will lose the time and money they have invested. The latter point is never mentioned—a big deception.

So when MLM distributors "fail", it is typical for them to conclude that it was their fault—no matter how hard they tried.

**23. The company's program is often touted as "the right vehicle for making money."**

Different types of MLM compensation systems (unilevel, binary, stairstep/breakaway, matrix, etc.) are manifested in different shapes of pyramids. Creative new MLM schemes are continually being developed, leaving a bewildering array of MLM programs to choose from— but all following a similar multi-level pyramid concept. And the effects discussed above seem to apply to all MLM's in varying degrees.

**"Legitimate products"—MLM promoters' justification before the regulators**

**24. Products are promoted through MLM that are unique, emotionally appealing, and consumable or renewable—to perpetuate the pyramid.**

MLM products have been characterized as "notions, potions, and lotions." For example, personal care and nutritional products have for years been the staples for MLM companies. More recently, MLM founders have promoted telecommunications (long distance), internet services, or other new technologies, which in the public mind represent almost unlimited—even magical—opportunities for growth.

"Intangibles," such as investments, buying clubs, and travel opportunities have also been promoted through MLM companies because they are renewable and allow for repeat business.

**25. Products are sold that are pricey and difficult to compare with alternative outlets, such as retail stores.**



Suppose a box of apples sells for \$15 at the supermarket. A MLM company sells comparable apples for \$35. The promotional line is that “These apples are bright red with green stripes, making them more valuable.” While some consumers may buy this “added value” argument, It could also be argued that the consumer is paying a premium of \$20 for these unusual apples. **The premium amount in excess of a competitive price could be considered the pyramid portion of the price, which accrues to the top of the hierarchy in typical pyramid fashion.** This allows the MLM company to conduct a pyramid scheme without arousing the suspicion of enforcement agencies—because “legitimate products” are offered.

The producer of vitamins for several MLM companies shared some interesting information with me. He was producing multiple vitamins at a cost of \$3 to \$4 a bottle, which were then sold through distributors under varying names by the MLM companies’ distributors. Each of the companies assigned a wholesale price to the product of about \$50 a bottle. This producer suggested to executives from the MLM companies that they offer a superior product with higher quality ingredients which he could produce for \$7 a bottle. None of the MLM companies were interested—not enough margin.

So in a PPS, the company pays the contribution to the pyramid for distributors out of product purchases—as opposed to a naked pyramid scheme in which participants make direct cash payments into the pyramid. One is as pyramidal as the other, but MLM companies cleverly—and very successfully—avoid regulatory action by playing the pyramid game by the definitional rules implied by statutes or as interpreted by enforcement agencies.

#### **26. New MLM distributors are encouraged to buy more frequently and in larger volumes than would be seen as normal in other settings.**

In MLM meetings, distributors are taught to “be a product of the products,” to be an example to one’s downline, and (unspoken) to enrich the upline. So large purchases are often made for personal consumption, as well as for others in one’s downline and for gifts or samples—to reach volume quotas necessary to qualify for higher levels in the distributor hierarchy. It is a common practice for friends and relatives to be set up as “dummy distributors” to meet minimum qualifications for sales volume and number of distributors. As a result, purchases of products over a year’s time by serious distributors may total hundreds or even thousands of dollars.

One distributor who was held up as an example within an MLM company spoke at a distributor rally I attended. She boasted of spending over \$700 a month

on personal care products and nutritional supplements for her family—and encouraged all her downline to do the same.

These large purchases constitute a de facto entry fee, especially for products with an inherent pyramid premium built into their prices. **Though the stated entry fee for distributors may be minimal or non-existent, the aggregate total over a period of one or more years for the pyramid portion of product purchases typically far exceeds the entry fee for most illegal pyramid schemes. This is a factor often left out of the analyses of investigators from enforcement agencies.**

The promotion of repeat purchases to qualify for ever higher bonuses and levels in the hierarchy is also a powerful vehicle for moving overpriced products. Total purchases over a year or more often totals thousands of dollars, very little of which is actually sold at retail. It is another device for getting around anti-pyramid laws.

While many of these products are legitimate and even of excellent quality, distributors typically discontinue purchasing most of these products when they quit the system—or they find more reasonably priced products that are similar.

It is also not unusual for distributors who quit a given MLM program (which most do) to be left with a garage or basement full of unsold MLM inventory. Excessive stockpiling may be forbidden by a company or in decrees by enforcement agencies, but such rules are frequently ignored because rewards are paid for volume, not compliance.

#### **MLM negative lifestyle observations**

#### **27. MLM promoters engage in extensive deception and self-deception—probably more so than with any other distribution system.**

Much of the deception is unwitting self-deception. The true believers in MLM are convinced they are doing the right thing for themselves and those they recruit. Like the findings of the psychologist Leon Festinger on cognitive dissonance, they cannot allow themselves to see the disparity between the “exciting opportunity” they believe they are promoting and the reality of likely loss—sometimes significant losses—for the vast majority of those they recruit. So they resolve the dissonance by convincing themselves that the opportunity is legitimate.

**My observation is that to be successful in most MLM’s, a person must first be deceived, maintain his/her own self-deception, then deceive recruits and downline en masse. In the typical MLM company, greed and the desire for time freedom**

are primary motivators of serious participants; mystique, uniqueness, and consumability the necessary ingredients in the products; and deception and duplication the mechanism for growth of the pyramid.

**28. An addictive trait appears in some MLM distributors, much akin to compulsive gambling.**

Some distributors will pay tremendous prices for their MLM participation, resulting in loss of income, homes, and other assets; consumer debt (borrowing against homes and maxing out credit cards) and bankruptcy; broken homes; and ruined lives. (See the example of the MLM junkie on page 7.)

**Using the above criteria, one can see that most if not all MLM programs display a strong pyramid syndrome—certainly enough to be labeled a pyramid scheme, regardless of the legal definition. I am reminded of the old adage, “If it looks like a duck, quacks like a duck, and waddles like a duck, it’s a duck.”**

**CHARACTERISTICS OF MORE ACCEPTABLE NON-PPS MARKETING ORGANIZATIONS**

Now to help sharpen our discernment between inherently PPS and non-PPS organizations, let’s look at the characteristics of more acceptable sales opportunities and product distribution systems that do not display the symptoms of a pyramid syndrome:

**1. You seldom see more than four levels in the distribution hierarchy.**

If only for the sake of efficiency, successful sales organizations seldom have more levels than sales person, district manager, regional manager, and national sales manager or vice-president.

**2. Advancement through management levels—and corresponding pay—is limited, with no promise of unlimited opportunities for pay and advancement.**

Sales managers and higher executives are usually appointed, rather than automatically rising to new levels on the basis of recruiting success, as is the case with PPS’s.

**3. The portion of the retail price received by retail sellers is far greater than that received by wholesalers, manufacturer’s rep’s, or sales managers two or three levels above them. In direct sales organizations, the same holds true.**

**Horizontal equality or equity is actually achieved by vertical inequality in a fair breakdown of compensation (or in the case of the retail market—markup in prices) based on direct contribution to the sale,** with the person actually doing the selling receiving far greater remuneration per sale than the person one level (or even several levels) above him/her.

For example, in a typical retail setting such as a bookstore, the retailer may receive 40% of the price of the book (out of which also comes hired help, advertising, and store front costs), while the wholesaler may receive 15% (the lower commission offset by larger volume).

In a typical direct sales organization (selling cookware, encyclopedias, etc.), the sales person may get from 20-40%, while the district manager above him/her may get only 10 or 15%, the regional manager 5%, and the national manager perhaps a 1 or 2% bonus in addition to a salary. So the primary incentive of the person closest to the consumer is to sell, not recruit.

**4. Seldom are promises made for “residual” or “leveraged” income—or other magical money-making formula.**

Of course, there are exceptions, such as sales of insurance or investments. But the emphasis is not merely on passive money-making, in which income is generated by some magical pyramid-like money-making formula.

**5. When it occurs, growth is relatively persistent and steady and somewhat proportional to quality of the products and to marketing skill and effort.**

With the possible exception of some high-tech business startups, explosive pyramidal growth is seldom seen in a normal business setting.

**6. Not only do participants not see their business as a pyramid scheme, but also others outside the organization do not perceive it as such.**

Again, give the general public some credit. Ask a sample of consumers if the companies they routinely deal with are pyramid schemes, and the answer will almost always be “no.” Many in my telephone surveys answered quite differently when asked for their perceptions of MLM. “MLM is a pyramid scheme, regardless of what anyone says,” was a typical response.

**7. A clear distinction is made between the consumer and the person selling the product.**

Seldom is a buyer of books or furniture, for example, asked to become a seller of the same.

**8. Emphasis is on products and services, not recruiting.**

Products are sold for their intrinsic value, not as a vehicle to build a profitable downline. As mentioned earlier, recruiting is not even mentioned in most non-MLM sales situations.

**9. A respectable percentage of sales persons succeed (in most established non-PPS sales situations), with a probable dropout rate of well under 75% over a period of two years.**

**10. Mass recruiting or opportunity meetings are seldom needed.**

Hiring is done one-on-one or in small groups, with some emphasis on needs and qualifications of recruits—though some direct sales opportunities are an exception.

**11. Sales volume is built up by repeat business from satisfactory service, rather than being dependent on duplication of one's efforts through a multitude of distributors.**

**12. Generally, enduring demand is market-driven.**

Products are sold for every need—primarily based on customer demand. This is in sharp contrast to distributor-driven demand for MLM products—which require uniqueness, emotional appeal, and consumability, along with extensive margin to support a large network of distributors.

**13. An equitable payout system is characterized by relative horizontal equality in which total remuneration (including salary, commissions, and bonuses) is shared at least somewhat fairly among all participants, based on their value and contributions to the organization.**

Few if any lose money. And for paid workers in organizations, a minimum wage is guaranteed—at least in the U.S. Contrast this with typical PPS programs in which over 90% (over 99% in some cases) lose money, after subtracting all expenses and product purchases.

**14. It is possible for the person doing the selling to earn a comfortable living without having to do any recruiting.**

Prices are competitive enough to make retailing feasible, and the commissions sufficient to make retailing financially rewarding.

**15. Territorial protection is granted to prevent market saturation, especially in franchises.**

In normal business situations, even competitors usually spread themselves out to prevent saturation of a given market.

**16. Seldom are promises made for huge sums in monetary compensation, even for top distributors.**

Promises to newcomers of huge income potential (over \$50,000 a month, for example) in other settings would rouse suspicion of illegal dealings of some kind.

Another old adage applies here: “If it sounds too good to be true, it probably is.”

**17. Patience and hard work actually pay off for more than just a few persons.**

With the exception of illegal sweat shops, most income producing activities lead to some acceptable return for a person's time. Even small businesses owners can hold out profitless in the hope of future gain for only so long. The majority of business persons show at least a net profit within a reasonable period of time—or they will move on to something else.

**18. Sales persons and distributors for a given manufacturer are provided sales materials and training free of charge.**

Usually, the last thing a sales department of a major manufacturer wants is for those who sell the company's products to feel they have to pay to learn to sell their offerings. If a sales person must pay for a conference, it is usually industry wide or for specific needs of interest to many attendees.

**19. Products are competitively priced, and comparison shopping for competitive products is feasible.**

**20. Products are purchased as needed, not stockpiled to meet quotas to qualify for ever-higher commission levels.**

**21. While deception is found in many sales situations, success is not dependent on deception as an essential ingredient.**

Retailers in more standard settings are not rewarded for deceit to the extent that is the case for PPS's, where telling the truth will not get a distributor to the top levels—where the money is.

**22. There are little or no addictive attractions to the compensation system—at least not to the extremes found in MLM.**

The more normal expectation is for workers to be compensated for the work they do or for what they contribute to a business or other organization.

**By comparing the above characteristics with the foregoing characteristics of an MLM pyramid syndrome, the difference becomes obvious—even stark.**

## **HOW TO DEVELOP A PYRAMID SCHEME THAT IS VERY PROFITABLE FOR THE FOUNDERS—AND GET AWAY WITH IT**

Given the current regulatory environment, it is interesting to see what a person motivated to construct and profit from a pyramid scheme might do. One could very deliberately accomplish this and might even get away with it in most states by following these steps:

1. Decide on a compensation system (binary, breakaway, matrix, etc.) that would operate in pyramid fashion using products as a vehicle for getting people to pay into the pyramid. Offer a complex system of incentives for making it to higher and higher levels through intense leveraging, with a distributor four or five levels up getting as much or more per sale from the company as the person making the sale [*using the innocent appearing vertical equality model common to MLM's*]. Everyone will recruit like crazy to get to the top level. [*Beautiful!*]

2. Develop or hire someone to develop a product that has emotional or mystical appeal, is too unique to be compared with something that could be purchased at retail outlets, and is highly consumable.

For simplicity, hire a qualified nutritionist or herbalist to search the scientific journals for some newly-discovered substance that has been shown to help prevent cancer, minimize heart disease, slow aging, enhance sexual function, and/or stimulate energy and brain cells. It is best if this substance comes from some exotic rain forest or other remote location.

Then combine this exotic substance with some proven ingredients found to be effective for combating certain ills and arrange to have it manufactured by any of a number of companies that do this routinely. Make certain it is unique enough that it cannot be compared with existing off-the-shelf products.

3. Give your program a name that has a ring of success attached to it, such as “Wealth Plus.” Then give your product a magic sounding name—say “WP++.”

4. Price all of the variations of the product at a price that allows plenty of margin to support the distributor network that will sell it, with a nice margin for your firm. [*This margin would be large enough*

*that it could be considered the pyramid contribution to your pyramid scheme. But don't tell anybody.]*

Since the product cannot be compared exactly with any existing product, you may produce it for \$3 or \$4, for example, and list it for sale to consumers for \$75. Of course, your distributors would be able to buy it wholesale for about \$50.

*[What a great way to fool the regulators! Distributors may actually be paying \$25 a month from the pyramid portion of the price—or large multiples of that amount— into the pyramid, but because of the “legitimate product” disguise, this can be done over and over ad infinitum without detection and appear perfectly legal, except to the more astute enforcement agency officials.]*

5. Prepare literature touting your formulation as one of the greatest advances in nutrition, and offer it in conjunction with a compensation system that is “truly a revolutionary money-making program,” one destined to make those persons who “get in on the ground floor” an obscene amount of money—in a matter of weeks.

6. Set up your compensation plan so as to create the illusion for distributors that they can achieve success, though the bulk of the money will accrue to you and a few top distributors. Hire a statistician to hide the numbers so that new recruits and enforcement agencies will not realize that this “great opportunity” is will be profitable primarily to you and your founding distributors at the top of the pyramid.<sup>20 (rep)</sup>

7. Set up minimum purchase requirements and volume incentives to qualify for progression into ascending distributor payout levels. Make these volume requirements high enough that distributors will be on a continual treadmill trying to achieve that “next level.”

8. Put together a starter kit of sales materials, and enough products to get started. But check out local state laws regarding pyramid schemes to make certain the charge for the kit and products fall within what is legally acceptable.

*[This is not hard to do. The “legitimate product” rule and other restrictions are easy to get around. A good attorney will keep you out of hot water, while you conduct your pyramid scheme.]*

9. Begin selling this pre-launch “ground-floor opportunity” to MLM enthusiasts and through MLM publications, announcing a launch date when all who enter can expect to prosper beyond their wildest dreams. Set up a web page and promote it heavily to those seeking an inside track on a “pre-launch opportunity.”

10. Train the founding distributors in how to recruit, advertise, hold opportunity meetings, etc. Pump them up with promises of huge paychecks soon

to come. They will even pay to attend weekend retreats and “sales training” programs [*actually recruiting programs*—and for tapes, books, company T-shirts, web sites, and all the other programs and paraphernalia that will help them to be “successful.”

11. Build your infrastructure as you go, developing new products and geographical divisions as needed to continue the illusion of a “ground-floor opportunity.”

*[If the “first wave” is successful—you can take your money and run as soon as perceived saturation causes sales to level off. Spend your money or shelter it in offshore accounts so that if regulators catch up with you the fines you actually pay will be but a drop in the bucket compared to the take you have set aside.]*

12. Since the money will flow in bountifully, you may choose to stick around. If so, spend some of your abundant supply of money supporting the political party in power. Donate to the campaigns of all likely candidates for Attorney General, regardless of party.

13. Donate to university scholarship funds and popular local charities, making certain that timely press releases accompany all such giving. Support local athletic programs, with priority to highly visible scoreboards and other showy paraphernalia.

*[Enforcement agencies will not get popular support for going after an MLM that is doing so many good things, if your largesse is well-placed and very noticeable.]*

## **FRONT END OR MIDDLE WEIGHTED SYSTEMS—MORE EQUITABLE?**

Could an MLM be operated in a fashion that does not lead to the usual effects of a pyramid scheme (EHI and emphasis on recruiting)? Perhaps, but it is unlikely, since the changes necessary to make it a fair system would make it no longer recognizable as an MLM.

For example, with front end weighted systems, distributors are paid enough to sell the product that they do not need to recruit to be successful. In these cases, the program may be limited to 3 or 4 levels, and the vertical payout ratio is decreasing to, for example, 2:1 between each successive level, so that the persons selling the product gets 30% from the company, the person above him/her gets 15%, then 7½%, then 3-¾%, etc.

With such a compensation system, the distributor doing the selling may earn as much total income as a person three or four levels up— without recruiting. The sales managers or upline distributors make less per sale, but make money on volume with many

downline distributors. So it works out more equitably than a back end weighted system.

Of course, if there is little incentive to recruit, the network does not expand and will eventually die if only because of attrition. Also, no one makes an obscene amount of money with front end weighted systems, so avaricious and ambitious MLM persons are not attracted to them. Greed and deception are minimized in such a system, which tends to discourage participation by those with a pyramidal mentality. Consequently, front end weighted MLM systems have a tendency to quickly fade away and disappear.

Other MLM companies are experimenting with middle weighted plans in which the payout per sale is larger for those distributors two to four levels up in the hierarchy than for front line distributors or those further upline. Since there is just enough incentive to make it worthwhile to recruit one or two levels, the network can continue to grow. Therefore, these systems may have a greater likelihood of survival.<sup>21</sup> However, any program that requires recruiting in order for distributors to succeed could be considered a PPS. It would be better if we stick to the guideline that a person should not be required to recruit a single person to earn a good return for his or her time.

## CONCLUSIONS

When MLM programs are observed over long periods of time, pyramidal concepts, motivation, and effects become as evident as with any other pyramid scheme. But by using legitimate products to escape the definition of an illegal pyramid scheme, the major MLM companies have become far more pervasive and powerful in their effects than any illegal pyramid scheme ever was.

Though a MLM company may have little or no entry fee, the purchases of products over a year's time by a given distributor may total hundreds or even thousands of dollars, of which 20-40% may be a pyramid premium—dwarfing in the aggregate most participation fees for naked pyramid schemes. When the pyramid premium portion of these overpriced purchases are combined over an entire distribution network, the amount of contribution to the MLM company and its top distributors is huge.

Coupled with high priced products are compensation systems that are highly leveraged, as is true in any pyramid scheme. Three distinguishing characteristics are given for identifying PPS's:

**1. A chaining hierarchy of levels of distributors— more than is functionally justified—is recruited without area limits, which leads to extreme leverage and perceived saturation in the marketplace.**

**2. Relative vertical equality (RVE) in distributor compensation leads to an emphasis on recruiting and to extreme horizontal inequality (EHI) over the entire network of distributors.**

**3. Significant purchase or recruiting quotas are required (or incentives offered) to qualify for increasing bonus levels or purchasing discounts in an ascending hierarchy of payout levels. This is referred to as the “pay to play” feature.**

The cost to consumers nationwide of pyramid premiums built into PPS's could easily total billions of dollars annually<sup>41</sup>. I would not be surprised to learn that the aggregate losses to participants in PPS's (MLM schemes) greatly exceeds the sum total of all illegal pyramid schemes combined—by a factor of as much as 100 to one. And all over a definition.

**I maintain that PPS's constitute quadruple pyramids—schemes requiring continual investment of time, effort, money, and relationships, all of which work together in typical pyramid fashion.**

Naked pyramids in which a modest investment is required are much less costly to participants over time, because they are easily identified and quickly quashed by enforcement agencies.

**What is missing in interpretive guidelines used in enforcement of laws against pyramid schemes**

**are objective and proactive methods of distinguishing between emphasis on recruiting versus retailing of products and services.** The tools discussed here for accomplishing this could be validated using the following procedures:

1. Undercover observation (similar to what I have done) would help to understand subtle dynamics otherwise hard to discern.

2. **Interviews with ex-distributors** (which have been extremely helpful to me in my analyses) would yield more honest responses than current distributors for the reasons mentioned above.

3. **Requirements for MLM companies to reveal payout distribution by percentiles**, along with product purchases by the same groups of distributors by percentiles—which I can only **request**, but a government agency could **require**. (See Appendix B.) RVE-EHI, would become evident, especially when plotted graphically, as in Table 1.

4. **Mathematical analysis of the compensation system to reveal rewards emphasizing recruiting, as opposed to retailing.** (An analyst with a good math background would be crucial for this.) Payout from the company, not assumed retail markup, should be the determining factor. Even if products were priced competitively, when extraordinary rewards are offered for recruiting—often highly leveraged, the incentive to retail products may be insignificant in comparison.

5. **Syndrome analysis**, using symptoms such as those outlined in this report, would serve to confirm pyramidal behavior for MLM's that are in fact PPS's.

Personally, I have nothing against most of the people who are active in MLM's. In fact, some very respectable people get involved—as was the case with some of the early pyramid schemes.

Many of the executives and founding distributors of MLM companies are unaware of the pyramidal effects of their enterprises and claim to be persons of integrity who would never do anything to defraud or hurt anyone. But what few of them want to accept is the fact that if they are not deliberately deceiving others, they are deceiving themselves.

Also, the products are often of high quality. MLM programs are usually not set up to intentionally defraud, as is often the case with naked pyramid or Ponzi schemes. PPS's are much more subtle—even seductive—and sometimes widely accepted. But **feeding quality products through a multi-level network of distributors does not make an MLM program any less pyramidal in its effects than any other pyramid scheme, whether or not it is adjudged to be an illegal pyramid scheme.**

In my view, **the true villains in most MLM's are the pyramidal compensation systems, demonstrating the characteristics discussed above.**

It appears evident that most of the problems with MLM programs stem from these highly leveraged compensation systems. One prevalent effect of such (RVE) systems is the extreme payout to top distributors made possible by the investments of a large group of downline distributors, the vast majority of whom lose money after subtracting product purchases and operating expenses.

All of the MLM programs I have seen display a fairly obvious pyramid **syndrome**. But the word **scheme** is a word consumers understand, so I suggest that the PPS designation be used with all MLM companies which demonstrate a pyramid syndrome. So for classification purposes you would have **product-based pyramid schemes (PPS's)** and **naked pyramid schemes**. While it might be possible for an MLM to fall outside of either of these two categories, it would be rare if it were possible at all.

The situation today in the MLM industry is one of significant growth over the past decade. Numerous books are appearing on how to get rich via MLM. Discussion of MLM opportunities has become a respectable topic even in some of the business press, such as *Success Magazine* and other “opportunity” magazines. Even some business schools see MLM as a viable business model.

But one of the most disturbing aspects of the industry is its success in convincing enforcement agencies that they are not pyramid schemes and in communicating the same to the public. Many attempts to regulate the MLM industry through legislation have not been effective. Some state laws just create work for attorneys meeting cumbersome registration requirements—which, when satisfied, are then used by MLM promoters as an endorsement of their program as having “a clean bill of health.”

None of the states require adequate revelation of payout distribution by percentiles. Were MLM promoters required to make such statistics available in large print to people they recruit, consumers could at least have the information needed to make an informed decision regarding participation.

A more proactive approach to legislation and enforcement would be in the best interest of consumers. This could be accomplished by requiring submission of the compensation and marketing system of a new MLM for analysis before commencing operations. Using the tools discussed here, a determination could be made on whether or not it was a pyramid scheme (PPS). Many PPS programs could thereby be stopped even before they begin operations.

Front end weighted MLM's, in which distributors on the first level are rewarded enough in commissions that they do not need to recruit a downline to earn a good income, are a more equitable

system. However, few if any front end weighted programs survive, as examples cannot be found of upline distributors striking it rich—to act as a recruiting incentive.

**MLM is now the most common form of PPS's. Creative new versions will likely spring up as long as people are looking for an easy buck. Let us hope enforcement agencies and consumers are able to see through the deceptions that underlie every new pyramid scheme, whether naked or product-based.**

## RECOMMENDATIONS

What can be done to improve the oversight and regulation of the MLM industry? Well, I believe as in everything else, there is the ideal and the reality. An ideal program of action might include the following:

1. Limit the number of hierarchical levels in MLM compensation programs to about four levels.
2. Prohibit the RVE which characterizes most pyramid schemes, so that distributors several levels above the person selling the product do not profit as much per sale as the person actually doing the selling—unless they had something to do with the sale. (In some states the practice of upline overrides without direct contribution to sales is illegal, but seldom enforced.)
3. Require that all MLM companies make public a complete breakdown **by percentiles** of the payout distribution for **all** distributors in the network. The odds of winning a sweepstakes must be included in promotional mailings. Considering the slim odds of success in MLM, MLM programs should have a similar requirement. But I believe such a clear disclosure of meaningful statistics should be furnished to prospects in large, bold print on a sheet of paper by itself—not buried in a prospectus package.

Severe penalties should be exacted of both distributors and sponsoring MLM companies for not releasing such information to prospects in a clear and unmistakable format.

In some states, MLM recruiters are currently required to support income claims, but **statistical reporting methods that cleverly disguise the odds of success should not be allowed.**<sup>20 (rep)</sup>

Some agencies only act on complaints. Consumers seldom complain because MLM promoters drum into recruits the concept that failure is due to lack of effort or skill on the part of participants, and not the typical result of its compensation system. With more accurate information, consumers could be reassured that the failure may not have been their

fault, but in very many cases their “failure” contributes to the “success” of a system that was designed to benefit only a few.

Legislation should be passed which not only spells out to MLM companies what they **cannot** do, but what they **must** do—steps with which they must comply in every recruiting situation, or face sanctions for non-compliance. Examples would be notifying all recruits of the odds of success, based on commissions paid by the company to percentiles of all distributors.

Also, it would be wise to take a more proactive approach by requiring MLM’s to submit a copy of their compensation system in advance of commencing business. Highly leveraged systems that reward recruiting much more than retailing could be prohibited as pyramid schemes (PPS’s).

**4. Enforcement agencies should stop suggesting or implying that most MLM companies are not pyramid schemes simply because they are not naked pyramid schemes**—using some existing statutory criteria or precedents of weak regulatory action. Based on the foregoing analysis, a non-pyramidal MLM program would be extremely rare.

I am not saying all MLM programs are illegal and should be prosecuted as pyramid schemes. But judicious application of the tools explained here could help in identifying the most objectionable of PPS’s.

Realistically, I do not expect all of the above recommendations to be accepted or implemented. In some ways, the MLM industry is like the tobacco industry. Legislatures and regulators now recognize tobacco is harmful, but the industry and consumption habits of the American public are too ingrained to outlaw it. So the focus is now on truth in advertising and on removing the deception that tobacco is not harmful or addictive.

As with tobacco, enforcement agencies could at the very least avoid perpetuating commonly held deceptions regarding MLM; viz., that it is not a pyramid scheme simply because some MLM’s are not interpreted to fall within the definition of an illegal pyramid scheme. This should be reflected in all handouts from the FTC (as well as on the FTC Web site) and in information released by state consumer protection agencies. For example, “Think pyramids and multi-level marketing plans are the same? Think again.”<sup>22</sup> could be changed to “Virtually all MLM’s today, though not as yet adjudged as illegal pyramid schemes, are organized pyramid ally and may create similar effects.” Care should be exercised in suggesting that MLM programs are not pyramid schemes.

**Consumers could also be given better guidelines in what to look for if they want to pursue an MLM program.** For example, the author has

written a flyer entitled *Twelve Tests for Evaluating a Network Marketing (MLM) “Opportunity,”* which features a much more rigorous set of guidelines than those used by the FTC and the BBB. (Appendix C.)

## FINAL COMMENT

If you have found this report helpful in evaluating one of the most controversial of business practices—network marketing—you would be doing your associates a favor by sharing this information with at least five of them. Then ask each of them to share it with five more interested persons, and suggest they tell each of them to share it with five more . . .

## NOTES

### Abstract references and notes:

- A1. Will Marks, *Multi-level Marketing: the Definitive Guide to America’s Top MLM Companies* (Arlington, Texas: The Summit Publishing Group), p. 4. Also Leonard W. Clements, *Inside Network Marketing* (Rocklin, California: Prima Publishing), p. 4—and Richard Poe, *Wave 3: The New Era in Network Marketing* (Rocklin, California: Prima Publishing), p. xiii and xiv. In these and other references from sources familiar with the MLM industry, estimates of at least 5 to 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 founders would be hard to measure, but based on the analysis in this paper it most probably is quite substantial—at least in the billions of dollars.
- A2. *FTC Consumer Alert*, December 1996

### Text references:

1. *FTC vs. Future net, Inc.* Civil No. 98-1113 GHK (Bar)
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3. “Pyramid Schemes,” Div. of Consumer Protection, State of Utah—similar to definitions used in other states
4. *Merriam Webster’s Collegiate Dictionary, Tenth Edition*
5. & 6. *Ibid.*
7. Joseph Bullgatz, *Ponzi Schemes, Invaders from Mars, and More Extraordinary Popular Delusions* (New York: Harmony Books, 1992), p. 36.
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10. *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).
11. Published by Prima Publishing, Rocklin, CA, 1995
12. Michael P. Harden, Ph.D., *Handbook of Multi-level Marketing* (Carrollton, Texas: Promontory Publishing: 1987), p. 29.
13. Jon M. Taylor, Ph. D., *The Network Marketing Game* (Kaysville, Utah: King Alfred Press, 1997), p. 100.
14. Mailed in the spring of 1999.
15. Bruce Craig, Petition to Robert Pitofsky, Chairman of the FTC, for compliance analysis or enforcement review regarding Amway, 93 FTC 618 (1979), Docket 9023
16. Special report by Jon M. Taylor, *NuSkin’s Naughty Numbers*, Consumer Awareness Institute, August 7, 2000
17. *Merriam Webster’s Collegiate Dictionary, Tenth Edition*
18. Discussion with Leonard W. Clements, founder of *MarketWave*, July 13, 1999.
19. Michael P. Hardin, *Handbook of Multi-level Marketing*, p. 127.



18. Taylor, *The Network Marketing Game*, pp. 149-150 (Consumer Awareness Institute survey conducted of 100 persons approached to participate in MLM programs, 1997).

19. Nevada State Gaming Control Bd. statistics dated May 6, 1998

20. Special report by Jon M. Taylor, *NuSkin's Naughty Numbers*, Consumer Awareness Institute, August 7, 2000

21. Telephone conversation with Leonard W. Clements, founder of MarketWave, July 13, 1999.

22. *FTC Consumer Alert*, December 1996 (FTC web page).

**For recommended web sites, see Appendix D**

## Appendix A

### MY UNIQUE BACKGROUND AND EXPERIENCE WITH NETWORK MARKETING (MLM)

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. What follows is my relevant background and what I went through in researching this report for the benefit of consumers, legislators, and regulators.

First, my educational credentials include an MBA degree from Brigham Young University in 1965 and a Ph.D. in Applied Psychology from the University of Utah in 1986. An inveterate entrepreneur and communicator, I have over 30 years of sales, marketing, and entrepreneurial experience, having personally started or assisted in the creation of over 40 businesses.

I have worked on the administrative staff of and performed research for two universities and have taught adjunct college classes in business management, entrepreneurship, personal finance, communications, and business ethics. 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. Also, I have written and published on numerous consumer and business topics.

In the past, whenever asked to express my opinion on MLM, I openly shared my opinion that they were in fact pyramid schemes in which only a few made money at the expense of many who came away empty.

My outlook changed when in 1994 and 1995 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, which is 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, I have to say that I and 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 best-selling book *Wave 3: the New Era in Network Marketing*<sup>11</sup>. 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 knew and trusted, all of whom helped ease my concerns and even led me to see that there was 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 on board) 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, 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 many people I knew and sought any referrals I could get, advertised extensively (especially when personal recruiting became unproductive), attended all the training and opportunity meetings, used my best efforts to train and motivate my recruits, and drove my wife crazy with my single-minded dedication to MLM recruiting. 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.

Periodically, I reviewed my financial progress—a reality check of what was actually happening. At the end of the year I had financially fallen behind to a significant degree, 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.

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 when I would eventually write up my findings about MLM.

I was not alone in coming away empty from my participation. 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 conducting a business.

One major ethical problem was watching MLM promoters exploit the social capital of participants for gain—and the resulting contamination of treasured relationships that may have taken a lifetime to build.

I finally concluded that deception and greed are primary elements for the success of most MLM programs. The reasons for this finding are outlined in the foregoing report.

In fact, before I quit my program after about a year of concentrated effort, though I had achieved “executive” status, I could see clearly what I would have to do to earn sizable commissions (even the \$700,000 a year others had achieved). I decided it was simply not worth it. Why? Because I would have to recruit by deceiving hundreds, even thousands of downline distributors (like I had been deceived), into believing they too could achieve what I had achieved.

For me to receive that much money, thousands would have to lose their investment, since the money would have to come from somewhere. 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 and people were not merely recruited to pay for sales rights.

Upon learning of my dissatisfaction, many other MLM promoters tried to recruit me into their programs. 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 book and involvement in a consumer awareness movement focused on PPS’s.

Some critics of my analysis see my exposé on MLM resulting from a “sour grapes” attitude after failing at MLM. I can only 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. This is because 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 have chosen to focus so much of my energies and resources for a cause for which I will receive little or no gain. 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. This report is an effort to do so.

Also, **I believe that these insights could not have come about without a careful look from the inside of these organizations as a practicing distributor.** Had a 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.

*Appendix B*

**Unmet Challenge to Network Marketing (MLM) Industry Leaders:  
Network Marketing Payout Distribution Study**

*The “Network Marketing Payout Distribution Study” includes:*

- (1) the letter to the presidents of 60 of the most prominent network marketing companies (below)*
  - (2) conclusions about network marketing (MLM) the company presidents were invited to disprove, at least for their companies*
  - (3) the forms which—if completed—would tend to prove or disprove such conclusions*
- 

**CONSUMER AWARENESS INSTITUTE**

Spring, 1999

ATTN: \_\_\_\_\_, President

Company

Address

Dear Mr./Ms. \_\_\_\_\_:

For the past two years I have researched the field of network marketing (MLM—a.k.a. “MLM”) and have interviewed hundreds of people who had been involved in a wide variety of programs. My research, while initially positive, uncovered more and more very unsettling problems with MLM.

When speaking on the subject of MLM to local groups I have received much feedback from participants and critics of MLM. One tax accountant who was a principal of H&R Block in northern Utah stated that over the years he and his staff had prepared thousands of tax returns, and of the several hundred of these who he knew had been involved in MLM, he could remember only one who had ever reported a net profit on his return.

Though I already knew that the actual success stories were far less than one would be led to believe from attending a typical MLM opportunity meeting, this tax man’s report was shocking to those of us who heard it. So I called tax accountants and preparers in other areas to see if their experience was the same. Each of them claimed similar experiences with their clients over the years. Others who work with peoples’ money, such as certified financial planners, insurance underwriters, and bankers, have relayed similar feedback.

I will soon be publishing this information for the benefit of consumers, educators, legislators, and regulatory agencies who have an interest in this topic. The page that follows presents the essence of my conclusions, which unfortunately are not favorable for the MLM industry. So I felt it only fair to allow for rebuttal from you and others who may have an interest in seeing a balanced treatment of the subject. So I am offering you that opportunity and the format for doing so.

Your assistance in gathering objective information will be greatly appreciated. I am not interested in anecdotal material, which may be no more valid than stories of persons who won a lottery or a sweepstakes. And vigorous arguments to the contrary will not help—I believe I’ve heard them all. What will carry weight is data which breaks down the distribution of payouts to your distributors, extracted from your data base of distributors. The information you provide must be verifiable by independent audit, as consumer protection agencies and legislators may choose to validate this material. Following this letter are instructions for providing the information.

You should be able to access this information readily from your database. However, if you prefer not to provide this information because it won’t reflect well on your program, I can certainly understand your reluctance. But such refusal will be interpreted to be an answer in itself. I shall be looking forward to your response.

Appreciatively,

Jon M. Taylor, Ph.D.

## NETWORK MARKETING PAYOUT DISTRIBUTION STUDY

By Jon M. Taylor, Ph.D.

### A. Network marketing has wide appeal.

Network marketing (MLM—a.k.a. MLM) offers the opportunity for an individual to conduct a business without having to bother with expensive resources such as physical plant or retail storefront, warehousing, employees, advertising, or other costs typically associated with running a business.

With MLM, large (leveraged) incomes can be produced by recruiting a downline (network) of multiple layers of distributors upon which a distributor can draw commissions and bonuses, the amount depending on the type of compensation plan and the size and character of one's "downline." Such an organization can be built from one's own home without the expenses and complications typically associated with other types of businesses.

MLM offers not only financial independence with minimal investment, but a level playing field in which anyone can participate, regardless of sex, age, education, or financial resources. Other advantages include the social benefits and recognition of building one's own organization and the backing of a MLM company which provides the products and infrastructure necessary for success.

### B. Network marketing poses problems for most participants, resulting from pyramidal concept, motivation, and effects.

When the Federal Trade Commission ruled in 1979 that Amway was not an illegal pyramid scheme—mainly because legitimate products were offered, the floodgates were opened and multi-level marketing programs began to proliferate. But what is often ignored is the fact that MLM programs are still pyramid schemes, modified by a variety of compensation systems that change the character of the pyramid, but not the essential pyramidal concept, motivation, and effects.

The pyramid concept in MLM is seen in multiple layers of distributors, with lower level distributors contributing income to an "upline" who may have little to do with a given sale. This is distinguished from the typical retail scenario in which a retailer may get two or three times the return per sale as the wholesaler, whereas with MLM the upline distributor may get as much or more of a return per sale (in commissions and bonuses paid by the company) as the front line distributor who actually sells the product.

Because MLM compensation systems reward front line distributors only a small commission (usually less than 10%) for selling product, recruiting to gain income from downline distributors is vital to earning a significant

income. This is distinguished from other direct sales programs, in which the person selling and servicing the product typically keeps from 20% to 50% of the sale—enough incentive to concentrate on the end user as a valued customer.

The motivation of most MLM is the opportunity to make large amounts of income for a minimal investment of time and money. One of the primary appeals of MLM is the concept (touted at MLM opportunity meetings) of "time freedom" or "leveraged income," which allows a person to gain an income flow from the efforts of others without having to work directly for one's own income. But because of MLM compensation systems, this requires success at recruiting a downline, more than on selling the products directly.

Critics complain that many MLM distributors place too much emphasis on the "opportunity" as opposed to the product, thus blurring the distinction between the product and the opportunity. As I mentioned, this can be accounted for by the reward structure of MLM compensation systems, which benefits primarily top upline distributors—who may receive extremely large commissions from their aggregate downline. An inordinate appeal to greed often becomes the primary motivation.

A most troubling aspect of MLM is its effects on people. Because the compensation systems are heavily weighted to reward upline distributors for their recruitment efforts and because of the pyramidal nature of these systems, extraordinary income differentials are created between upline and downline distributors. In fact, after deducting expenses for building and maintaining a network, only a tiny fraction of MLM distributors ever report a positive income on their income taxes. And if products purchased from the company (that likely would not have been purchased were they not participants in the program) are subtracted, perhaps less than one out of 100 distributors earns more than a minimum wage for their efforts. A high percentage of distributors lose money—much higher than most other legitimate business and income pursuits. Careful examination of most MLM programs reveals a pattern of exorbitant incomes accruing to relatively few top distributors at the expense of hundreds and even thousands of downline distributors who—even with diligent effort—come away empty-handed. In this respect MLM is akin to illegal pyramid schemes.

It is interesting to compare the odds of success of MLM schemes with legalized gambling in Nevada. It appears that on average one could do better at most any of

the gaming tables or slot machines in Las Vegas—without investing all that time and placing valued relationships at risk.

Some zealous MLM distributors will mortgage their homes or max out their credit cards (buying MLM products and other expenses) to finance their ambition to achieve top levels in their organization—which is seldom achieved. Others focus so much on recruiting to meet escalating volume requirements for higher distributor levels that they ignore the needs of spouse and family members.

Sometimes the recruiting practices of MLM distributors are deceptive and overbearing. Often MLM distributors will alienate friends and family members they endeavor to recruit for what seems to them a self-centered pursuit of a vaporous dream.

### **C. Summary and invitation for rebuttal**

In summary, with network marketing, what appears on the surface to be a fair and enabling marketing system for participants is in reality a legalized pyramid scheme with characteristics of concept, motivation, and effects similar to those of an illegal pyramid scheme.

You are invited to prove me wrong—at least for your company. This can best be done by providing full disclosure on payout distribution to your distributors on the attached form. For the purposes of this study, this information must be broken down by percentiles, not by distributor level.

Please note that I am not asking you to reveal sensitive information, such as individual distributor incomes or even your annual profits, which you may wish to keep confidential. It is average payout to distributors by percentiles (as indicated on the attached form) that will satisfy the objectives of this study for the benefit of consumers.

Please also note that I am offering two options for your response—an easy one (Option A) and a more comprehensive one (Option B). It is assumed that Option A could be competed quickly and easily from your existing accounting system.

Option B requires a more extensive breakdown, but would offer to those interested more conclusive evidence that your company does or does not base its compensation to distributors on a pyramidal structure, as discussed above. For the purposes of this study, Option B would be much preferred, if you can return such data to us within a month or so.

We are not making any assumptions about how much effort was put into any given MLM program or compensation system, as it relates to success or failure of any specific distributor or program. So it is important that all participants in your MLM program for the year be included, even those who only bought a distributor starter kit or set of samples—whether or not they have done anything with it.

Please mail completed form to:

MLM Payout Distribution Study  
Consumer Awareness Institute  
P.O. Box 488  
Kaysville, UT 84037

## OPTION A: Distribution of Payout to Distributors for the Most Recent Fiscal Year Beginning \_\_\_\_\_ and Ending \_\_\_\_\_

Company name \_\_\_\_\_ Contact person \_\_\_\_\_ Tel. no.(\_\_\_\_\_)\_\_\_\_\_

Address \_\_\_\_\_

City, state, zip \_\_\_\_\_

**Please check (✓) one:**

- a. We are willing to provide the information below and have it made available to the public.
- b. We are providing the information below with the understanding that it may be used for compiling industry statistics but not identified with our company in published reports.
- c. We are not willing to provide the information requested. We realize that in refusing to do so we may be tacitly conceding the conclusions drawn in the preliminary two-page report, entitled, "Network Marketing Payout Distribution Study."

If you are interested in receiving information on the completed report when it is done, please check here \_\_\_\_\_ (This research report is to be sold for a reasonable price—yet to be determined—to recover costs.)

**Important instructions:** For purposes of analysis, distributors are to be broken down by distributor payout percentiles, not company-established distributor levels. Also, it is important that every person who has enrolled as a distributor (i.e., purchased starter kit or samples, or signed a distributor agreement) be included in these statistics, including those who have not sold anything or quit, even after one day.

<b>Percentile break-down in payouts to distributors (by percentile, <u>not</u> distributor level)</b>	<b>Total number of <u>all of your distributors at this payout level</u></b>	<b>Ave. total payout per distributor (all <u>commissions and bonuses</u> paid by the company, but <u>excluding retail margins</u>)</b>	<b>Less: average total dollar amount per distributor of product purchases from your <u>company</u></b>	<b>Average net payout* per distributor (after deducting cost of <u>product purchases</u>)</b>
Top 1/10 of the top 1% of distributors	_____	\$ _____	\$ _____	\$ _____
Bottom 9/10 of the top 1% of distributors	_____	\$ _____	\$ _____	\$ _____
Next 9/10 of the top 10% of distributors (the 2nd to the 10th percentiles)	_____	\$ _____	\$ _____	\$ _____
Bottom 90% of distributors	_____	\$ _____	\$ _____	\$ _____

(Total 100%)

\*It is recognized that income reported here does not take into account costs to distributors for conducting their MLM business. Such costs may include, travel, postage and shipping, long distance and other telephone costs, advertising, rental of meeting rooms and/or office space, fees for company conferences or retreats, supplies, sales materials, and other expenses.

**THANK YOU FOR YOUR HELP!**

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**OPTION B: Distribution of Payout to Distributors for the Most Recent Fiscal Year  
Beginning \_\_\_\_\_ and Ending \_\_\_\_\_**

Company name \_\_\_\_\_ Contact person \_\_\_\_\_ Tel. no.(\_\_\_\_\_) \_\_\_\_\_

Address \_\_\_\_\_

City, state, zip \_\_\_\_\_

Please check (✓) one:

\_\_\_a. We are willing to provide the information below and have it made available to the public.

\_\_\_b. We are providing the information below with the understanding that it may be used for compiling industry statistics but not identified with our company in published reports.

\_\_\_c. We are not willing to provide the information requested. We realize that in refusing to do so we may be tacitly conceding the conclusions drawn in the preliminary two-page report: "Network Marketing Payout Distribution Study."

If you are interested in receiving information on the completed report when it is done, please check here \_\_\_\_\_ (This research report is to be sold for a reasonable price—yet to be determined—to recover costs.)

**Important instructions:** For purposes of analysis, distributors are to be broken down by distributor payout percentiles, not company-established distributor levels. Also, it is important that every person who has enrolled as a distributor (i.e., purchased starter kit or samples, or signed a distributor agreement) be included in these statistics, including those who have not sold anything or quit, even after one day.

<b>Percentile breakdown In payouts to distribu- tors (by percentile, not by distributor level)</b>	<b>Total no. of <u>all</u> distributors at this payout percentile</b>	<b>Ave. total payout per distributor (all commis- sions &amp; bonuses paid by the company, exclu- ding retail sales</b>	<b>Less: average total dollar amount per distributor of product purchases</b>	<b>Average net payout per distributor (after deducting cost of product purchases</b>
First 1/10 of the top 1% of distributors	_____	\$ _____	\$ _____	\$ _____
Second 1/10 of the top 1%	_____	\$ _____	\$ _____	\$ _____
Third 1/10 of the top 1%	_____	\$ _____	\$ _____	\$ _____
Fourth 1/10 of the top 1%	_____	\$ _____	\$ _____	\$ _____
Fifth 1/10 of the top 1%	_____	\$ _____	\$ _____	\$ _____
Sixth 1/10 of the top 1%	_____	\$ _____	\$ _____	\$ _____
Seventh 1/10 of the top 1%	_____	\$ _____	\$ _____	\$ _____
Eighth 1/10 of the top 1%	_____	\$ _____	\$ _____	\$ _____
Ninth 1/10 of the top 1%	_____	\$ _____	\$ _____	\$ _____
Bottom 1/10 of the top 1%	_____	\$ _____	\$ _____	\$ _____



**After breaking down average payout per distributor for the top 1% by tenths of a percent, please break down the next 9% by whole percentiles:**

<b>Percentile breakdown In payouts to distribu- tors (by percentile, not by distributor level)</b>	<b>Total no. of all distributors at this payout percentile</b>	<b>distributor (all commis- sions &amp; bonuses paid by the company, exclu- ding retail sales</b>	<b>Less: average total dollar amount per distributor of product purchases</b>	<b>Average net payout per distributor (after deducting cost of product purchases</b>
Second 1%	_____	\$ _____	\$ _____	\$ _____
Third 1%	_____	\$ _____	\$ _____	\$ _____
Fourth 1%	_____	\$ _____	\$ _____	
	\$ _____			
Fifth 1%	_____	\$ _____	\$ _____	\$ _____
Sixth 1%	_____	\$ _____	\$ _____	\$ _____
Seventh 1%	_____	\$ _____	\$ _____	\$ _____
Eighth 1%	_____	\$ _____	\$ _____	
	\$ _____			
Ninth 1%	_____	\$ _____	\$ _____	\$ _____
Tenth 1%	_____	\$ _____	\$ _____	\$ _____

**After breaking down average payout per distributor for the top 10% by whole percentiles, please break down the next 90% in groups of 10% each:**

<b>Percentile breakdown In payouts to distribu- tors (by percentile, not by distributor level)</b>	<b>Total no. of all distributors at this payout percentile</b>	<b>distributor (all commis- sions &amp; bonuses paid by the company, exclu- ding retail sales</b>	<b>Less: average total dollar amount per distributor of product purchases</b>	<b>Average net payout per distributor (after deducting cost of product purchases</b>
Second 10% (11-20%)	_____	\$ _____	\$ _____	\$ _____
Third 10% (21-30%)	_____	\$ _____	\$ _____	\$ _____
Fourth 10% (31-40%)	_____	\$ _____	\$ _____	\$ _____
Fifth 10% (41-50%)	_____	\$ _____	\$ _____	\$ _____
Sixth 10% (51-60%)	_____	\$ _____	\$ _____	\$ _____
Seventh 10% (61-70%)	_____	\$ _____	\$ _____	\$ _____
Eighth 10% (71-80%)	_____	\$ _____	\$ _____	\$ _____
Ninth 10% (81-90%)	_____	\$ _____	\$ _____	\$ _____
Bottom 10% (91-100%)	_____	\$ _____	\$ _____	\$ _____
	(Total 100%)			

\*It is recognized that income reported here does not take into account costs to distributors for conducting their MLM business. Such costs may include, travel, postage and shipping, long distance and other telephone costs, advertising, rental of meeting rooms and/or office space, fees for company conferences or retreats, supplies, sales materials, and other expenses.

**THANK YOU FOR YOUR HELP!**

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## Appendix C

# Twelve Tests for Evaluating a Network Marketing (MLM) “Opportunity”

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

Network marketing (a.k.a. multi-level marketing or MLM, consumer direct marketing, purchasing or gifting network, etc.) developed from pyramidal concepts, which initially led to pyramid schemes, chain letters, and chain selling. While pyramid schemes are illegal, many MLM programs have managed to circumvent Federal Trade Commission (FTC) rulings and applicable state laws.

Legislation and court cases have defined pyramid schemes as plans which concentrate on commissions earned for recruiting new distributors and which generally ignore the marketing and selling of products and services. However, many MLM promoters, even with good products, emphasize recruiting simply because of a compensation system that rewards recruiting much more than retailing.

**An MLM program that some enforcement agencies may not classify as an illegal pyramid scheme may for all practical purposes still be a product-based pyramid scheme (PPS). Strong pyramidal elements remain for most MLM programs, leaving participants with little chance of financial success (usually resulting in losses), except for a tiny percentage at the top of a hierarchy of distributors.**

The following tests should help you avoid programs in which you will only be wasting your money, time, and effort.

### ✓THE OPPORTUNITY TEST

**Were you approached primarily on the basis of the actual value and need for the products—or for the “opportunity?”** If the latter, the program may be actually a pyramid device for enriching the company and a small group of upline distributors.

Another red flag to look for is promoters who talk of “getting in on the ground floor” or “riding the wave” of opportunity. Usually, the bulk of the income in these cases is already locked in by the founding distributors in the pyramidal hierarchy.

### ✓THE MARKET REALITY TEST

May MLM recruiters point to the huge growth potential of their programs without considering the normal dynamics of supply and demand. Without adequate controls, saturation in any given market may soon be reached—at least in peoples’ minds.

**Are numerous levels of distributors allowed—more than is needed to get the products out to customers? Also, ask if the company allows unlimited recruiting of distributors in an area—with no territorial protection or**

**other provisions for preventing market saturation?** If so, you may be buying a ticket for a flight that has already departed. You could be left holding a bag of empty promises and a worthless ticket.

### ✓THE PRODUCT TEST

Review the products offered and ask yourself:

**Is it likely the products could be sold successfully on their own merits without going through a MLM distribution system?** If nothing comparable is on the market, find out why.

**Does the MLM company focus on legitimate products of value to consumers, or does it emphasize fleeting trends and timing, and exotic or secret formulas?**

Are products of consistently high quality, and do they carry a buy-back guarantee? Can all product claims (such as health claims) be backed up by reliable research? Are orders filled and shipped promptly? And are manufacturing and expiration dates printed on consumable products?

### ✓THE COMPENSATION TEST

**Can you as a distributor make a good income for the time you spend selling the products—without recruiting a single person?** Or is the commission paid by the company for selling the products so low that you have to recruit a downline in order to earn a significant income?

**Would distributors several levels above you—who had nothing to do with the sale—receive as much or more total payout per sale (including commissions and bonuses) from the company as you would get for selling the product or providing the service?**

**If the latter is the case, the emphasis is on income from a downline of distributors (that you would have to recruit), not on the sale of products. Even though such a MLM program may have escaped prosecution as a pyramid scheme, it may still be a de facto pyramid scheme (or PPS).**

Your odds of success in such a program will not be favorable. While a few distributors at the top of the pyramid will be rewarded handsomely, as many as 99% (over 99.9% in some programs) of distributors beneath them will come away empty—**most actually losing money, after subtracting expenses and product purchases.** Also, in some programs,

your quitting merely enhances the income of your upline—because income from your downline “rolls up” to those above you.

**Don’t fall for the line that it takes months or even years for most businesses to show a profit and that if you just “work hard and hang in there” you will make lots of money in this MLM program.** Be aware that in other comparable settings, sales distributors usually show a respectable income within a couple of months, or they turn to something else.

Ask distributors who have been with the company for two or three months if they are turning a respectable profit—after operating expenses and product purchases are subtracted. If not, they are only fattening the pockets of their upline.

#### ✓THE INCOME DISCLOSURE TEST

If an MLM recruiter touts huge income figures of top distributors, request that the company disclose average payout to distributors by percentiles (highest 1%, second highest 1%, and so on to the lowest 1%), so that you can determine your chances of success. Ask for **net payout (after subtracting product purchases) for all distributors who ever signed up**, including those not now active. If they fail to furnish such data, they are not providing the balanced information you need to make an informed decision.

Estimate the operating expenses for building your distribution network. For anyone serious about building an MLM business, a significant amount will be spent on telephone costs, travel, samples, sales materials, office supplies, mailing costs, printing and duplication, and (when friends and family don’t respond) some advertising. **Most distributors wind up spending far more money on products and operating expenses than they bring in. The best source for expense information is ex-distributors, not current distributors who are in denial about how much they are actually spending.**

**If less than 1% of all distributors earn the equivalent of a minimum wage for their time** (after subtracting all expenses and MLM products purchased), **you might want to consider a more profitable use of your money, time, and energy.** (Some researchers estimate that for most MLM programs, less than 1% of distributors ever turn a profit.)

Another acid test of the profitability of an MLM distributorship is to **ask the person recruiting you to show you his/her last year’s tax return.** It has been found that it is extremely rare for network marketing participants to show a profit for their networking efforts on their annual tax returns.

#### ✓THE “PAY TO PLAY” TEST

**Find out how high the expectation is for you to purchase products, services, training, etc., over a period of time, in order to be a serious participant.** In other words, what will it cost you to “play the game?” Don’t be fooled by a simple request for a small sign-up fee, soon to be followed by endless invitations for specials on purchases of samples or

inventory, accelerating bonus levels for higher sales plateaus, paid seminars, and training sessions or retreats.

This requirement (or strong suggestion) that you make large purchases of products over a period of time to qualify for increasing bonus levels or purchasing discounts is one sign of a product-based pyramid scheme. After months or years of fruitless effort and a garage full of products, some participants come to realize they have merely been paying into a pyramid scheme in the form of payments for unneeded products.

#### ✓THE PRICE TEST

**Are the company’s wholesale prices low enough to allow a respectable profit when marking up for resale—at a retail price that is still competitive with comparable products through other sources? Or are retail prices so high that they must be sold at wholesale to achieve any volume?**

**If products are priced at a premium to support a large network of distributors, then the premium portion of the price could be considered the pyramid portion.** So if a MLM product sells for \$40 and a comparable product would sell for \$20 at a typical retail outlet, the \$20 premium may be deemed the pyramid portion of the price and would flow to top distributors in typical pyramid fashion.

#### ✓THE GOLDEN RULE TEST

How did you feel about the way you were recruited to do the business, and how do you feel about approaching your family and friends in the same way? **How important are your relationships to you?** Are you offended when they attempt to exploit your connection with them for monetary gain? **Would you want to do the exploiting?**

#### ✓THE TIME FREEDOM TEST

The perennial dream of those with a pyramidal mentality is to be successful at recruiting a downline that will bring in enough money to support them so they won’t have to work themselves—thus giving them “time freedom.” They can then “leverage” their time by living off the efforts of others.

If a recruiter promises that by working hard for a brief time period you will never have to work again, **ask what percent of their top distributors are no longer actively involved with the company—and never attend opportunity meetings.**

Ask veteran distributors when they last took an extended vacation. Were they able to do so without significant losses for not tending their downlines? And did any of them quit or scale down without experiencing major financial losses?

**Better yet, ask for a copy of the recruiter’s downline and upline. Contact distributors at several different levels to see if any have achieved “time freedom.”** And if you know the spouse of any of the distributors, you might ask what problems the family has experienced due to MLM participation (intrusive phone calls, untimely visits to the home, and neglect of family and other duties by the distributor).

### ✓THE HONESTY TEST

**Has the recruiter been devious or up front in his or her inviting attempts?** And can the products and “opportunity” be sold without making exaggerated product and income claims? Ask for validation of each of the claims made.

**If you find the truth frequently distorted, powerful and escalating incentives may be driving the recruitment. If normally honest persons feel the need to exaggerate claims to sell the products and the program, you may find yourself having to do the same.**

### ✓THE CREDIBILITY TEST

MLM promoters who don’t command respect themselves may lean heavily on the “credentials” or “character” of others involved in the “opportunity.” **If such references are used to excess, watch out. Such credibility links can be deceptive.** Why? Because the ethics of MLM are so tricky to sort out that respectable and high level people have been drawn into the most problematical of programs.

### ✓THE SUPPORT TEST

Does the company offer an adequate support infrastructure to handle a temporary burst of volume?

Will your upline be there when you need them, or do they have a history of jumping ship when the next hot MLM deal comes along?

**Are conferences and training programs, audio and video tapes, etc., free of charge** (as is the case elsewhere for company sponsored programs), **or are you expected to pay for them—as another revenue source for the company and upline?**

### A FINAL WORD

If you have found this flyer helpful in deciding about participation in MLM, you could be doing your friends and family a favor by sharing this information with at least five of them. Then ask each of them to share it with five more persons, and suggest they tell each of them to share it with five more, and . . . .

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For more information on problems with network marketing and possible solutions, visit our web site—**[www.whatisgood.com/NWM](http://www.whatisgood.com/NWM)**. Or write:

The Consumer Awareness Institute  
P.O. Box 488  
Kaysville, UT 84037

*NOTE: A reproducible version is available free of charge from the author for printing on 8½x11” paper to be folded in a tri-fold format, which can be copied and folded for a handy pocket-size handout.*

## Appendix D

### Web Sites that Offer a Critical Review of MLM/Network Marketing

By Jon M. Taylor, Ph.D.

A new and very promising non-profit organization— Pyramid Scheme Alert—has been formed for combating all forms of pyramid schemes. Information and resources that can be extremely valuable for enforcement agencies, consumer advocates, educators, researchers, writers and journalists, consumers, and other interested parties will be posted on the web site at <http://www.pyramidschemealert.org>

There are hundreds of pro-MLM sites on the web, and blatant pyramid schemes are continually being promoted. Nearly all of these sites are selling a program of some kind. In the past little solid information countering their claims has been available. However, this is rapidly changing. In my research I have come upon some excellent sites for those who want to be informed on the problems of MLM/NWM:

Ruth Carter (a pseudonym to protect herself from an avenging upline) has offered some great services to consumers by posting (at her own expense):

- court cases and petitions against MLM's
- an MLM survivor's home page
- relevant media articles

- instructions on what to do if you've been deceived
- how to take legal action against MLM's, etc.

Ms. Carter has also written a very helpful book about Amway Motivational Organizations (AMO's) and the whole Amway scene entitled "*Behind the Smoke and Mirrors.*" Check it all out at: [www.mlmsurvivor.com](http://www.mlmsurvivor.com)

Robert Fitzpatrick is the author of the provocative book (with a great title) *False Profits*. An example of the fine quality of his writings and observations, see his insightful article entitled "Is MLM legal?":

<http://www.falseprofits.com/FSLegalityPg.html>

Also click on "70% Rule," "Amway's Rule of 10" and "FTC Warning." Mr. Fitzpatrick is becoming an important figure in the fight against illegal (or what should be illegal) pyramidism in all its forms.

Also on Fitzpatrick's site is an excellent analysis entitled: "The Dark Side of MLMs" by Ravi Dykema (Publisher/Editor in Chief, NEXUS, Colorado's Holistic Journal - Reprinted with permission by NEXUS from the January/February, 1999 Edition) <http://www.falseprofits.com/NexusEditorial.html>

One of the most cogent of articles on MLM/network marketing is written by Dean VanDruff and is entitled "What's Wrong with Multi-level Marketing?" It can be found at:

<http://www.vandruff.com/mlm.html>

His "Frequently Asked Questions" is a great retort to all those who say, "Yes, those criticisms about MLM are all true about all those OTHER MLM's, except (of course) THIS one. Is it not truly different from all the rest?" Check out VanDruff's cut-to-the-chase answer at:

[http://www.vandruff.com/mlm\\_FAQ.html](http://www.vandruff.com/mlm_FAQ.html)

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>

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://dcn.davis.ca.us/~btcarrol/skeptic/mlm.html>

For this one, I'll quote the introduction to this myth-exploding site:

"Welcome, fellow 'Truth Seeker'. This site takes a good look at MLM and network marketing from the perspective of someone (me) who once built a sizeable downline. I've been there, and I have a perspective that took me years to acquire. This involves you. I'm not talking about 'them' here, this isn't someone else's problem...this is YOU. If you're smugly defending the myths of network marketing, ask yourself these questions:" [And then prepare for some very challenging questions. It is hard to imagine anyone choosing any MLM-type business after reading this and the follow-up information with an open mind!]

<http://members.aol.com/multisense/home.htm>

"*Is Your Church a Marketplace?*" A disturbing book by Kim S. Mather reveals the destructive influence of MLM/network marketing on religious communities.

<http://www.newwave.net/~poohbear/chaching/index.html>

"Quackwatch - Your Guide to Health Fraud, Quackery, and Intelligent Decisions" sponsors a site loaded with myth-debunking information about health and related scams, including MLM/network marketing companies that promote health products through amateur distributors. Its commentary about MLM's is well worth reading. For example: "MLM Watch - A Skeptical Guide to Multilevel Marketing" Operated by Stephen Barrett, M.D.

“Accurate information about multilevel marketing is not easy to get. Few publishers, editors, and broadcasters are willing to examine this topic in depth. Most reports reaching the public express what the companies and individual distributors would like people to believe. Nearly all MLM companies selling health-related products exaggerate their value, and the vast majority of people who become distributors do not make significant income.” Dr. Barrett has a site with several pages dedicated to MLM consumer watchdog information. It can be found at <http://www.MLMwatch.org> The site even has an invitation for plaintiffs in class action lawsuits against MLM’s.

See also “The Mirage of Multilevel Marketing,” an excellent analysis also by Stephen Barrett, M.D., a dedicated foe of MLM’s offering health-related products (and exaggerating health benefits)

<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/mlmrsch.html>

Quatloos! Features useful stuff about scams and financial frauds. Read its scathing “Guide to Multi-Level Marketing (MLM)”

<http://www.quatloos.com/mlm/mlm.htm>

This site for the World Wide Scam Network includes a motley collection of complaints, exposés, analyses, legal actions and defenses, and resources pertaining to current MLM’s and pyramid schemes under investigation.

<http://www.worldwidescam.com/index.htm>

Scott Larsen does a very creditable job of exposing myths about Amway/Quixtar in “The Amway/Quixtar Distributor's ‘Little White Lies,’” where he blasts the notion that ‘If you have a dream the facts just don't matter.’

<http://www.awod.com/gallery/rwav/slarsen/amway.html>

Then you analytical types must read: “Amway: A Negative Sum game?”

[http://www.awod.com/gallery/rwav/slarsen/Amway\\_zerosum.html](http://www.awod.com/gallery/rwav/slarsen/Amway_zerosum.html)

The Cagey Consumer offers a report on multi-level marketing packed with sub-articles, references, and links.

<http://www.geocities.com/WallStreet/5395/mlminfo.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. Check out the cultish aspects of Amway and Quixtar in the article “Amway Motivational Organizations at:

[http://www.freedomofmind.com/groups/amway/amo\\_qmo.htm](http://www.freedomofmind.com/groups/amway/amo_qmo.htm)

In addition, see the article entitled “Multi-level Marketing Plans,” produced in cooperation with the North American Securities Administrators Association November 1996, which

can also be found at:

<http://www.ftc.gov/bcp/online/pubs/invest/mlm.htm>

“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):

“Network Marketing - Networking - Multi-Level Marketing- MLM - NWM - Pyramid Selling.” <http://mlm.4mg.com/>

Here is 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 (being self-funded), 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>

Please check out my web site at <http://Whatisgood.com/nwm>

In this site you will find information on my 5 years of research on network marketing (NWM, a.k.a. MLM). In addition to the information contained in this report, you will find information on a book directed to members of the Church of Jesus Christ of Latter-day Saints entitled “*The Network Marketing Game*.” It was directed to this specific group because so many members have been drawn into the NWM web. Information on the book can be found at:

<http://whatisgood.com/nwm/nwmls.htm>