

**UNITED STATES OF AMERICA
BEFORE THE FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580**

**IN RE: PETITION TO TAKE ENFORCEMENT
ACTION AND PROMULGATE TRADE
REGULATION RULE CONCERNING UNFAIR
AND DECEPTIVE ACTS AND PRACTICES IN
THE MULTI-LEVEL MARKETING INDUSTRY**

The undersigned are an *ad hoc* coalition of consumer advocates, entrepreneurs, economists, professionals and former participants in multi-level marketing (“MLM”) programs. None of us are receiving any compensation from any source for submitting this petition. We come from different backgrounds, experiences and political persuasions, but we share a concern that the MLM industry has become a substantial cause of injury to consumers. The MLM industry has proven incapable of regulating itself, is rife with fraudulent and deceptive earnings claims and has caused – and will continue to cause – untold financial harm and misery to the poorest and most vulnerable of the consumers whom the Commission was formed to protect.

For the reasons set forth in more detail below, we respectfully request that the Commission do the following:

1. Investigate the MLM industry for the purpose of determining whether owners, developers and promoters of MLM programs are using unfair or deceptive acts or practices, including but not limited to operating as pyramid schemes, making fraudulent or

deceptive earnings claims and product claims, and selling expensive and ineffective “lead generation systems” and other sales aids to MLM distributors.

2. Promulgate a trade regulation rule concerning the MLM industry which (a) requires pre-sale disclosure of important information to prospective MLM distributors including but not limited to data concerning earnings claims, business expenses, attrition rates, litigation history; (b) requires a “cooling off” period before participants in MLM programs make any material payments; (c) prohibits MLM compensation plans which promote recruitment of new distributors instead of retailing products or services and thereby tend to become pyramid schemes; and (d) prohibits unfair and deceptive practices in the marketing and sale of products and services related to MLM programs, including the sale of lead generation systems and other adjunct products and services to MLM distributors.

I. The MLM Industry Involves Millions of Participants Spending Billions of Dollars

Reliable data concerning the MLM industry is hard to come by, but it is undeniably a large industry affecting tens of millions of consumers who are induced to purchase billions of dollars worth of products and services, ostensibly to resell as MLM distributors. The Direct Selling Association (“DSA”), which is the primary MLM industry trade association and lobbying group, estimates that in 2012, total sales of the industry were \$31.63 billion, and the total number

of MLM distributors was 15.9 million.¹ The DSA currently has 171 member companies.² In 2001 an industry expert estimated that there were over 1,000 MLM firms in the United States.³ About a dozen MLM firms are publicly traded in the United States, with a combined market capitalization of over \$30 billion.⁴

II. Unfair and Deceptive Practices are Prevalent in the MLM Industry

In its seminal 1975 decision in In re Koscot Interplanetary, Inc. the Commission analyzed one of the largest MLM companies then in existence, found it to be a pyramid scheme, and noted that “[t]he record also reveals a staggering human toll – money borrowed, jobs quit, homes

¹ See <http://www.dsa.org/research/industry-statistics/> (retrieved 8/22/2013). The term “direct selling” refers to the sale of a consumer product or service, person-to-person, away from a fixed retail location. All MLM programs involve direct selling; however, not all direct selling companies utilize MLM compensation plans. The DSA reports that approximately 95% of its members utilize an MLM type of compensation plan. See <http://www.dsa.org/research/industry-statistics/11gofactsheet.pdf> (retrieved 8/22/2013).

² See <http://www.dsa.org/forms/CompanyFormPublicMembers/search?action=find> (retrieved 8/22/2013).

³ See Zig Ziglar; John P Hayes, PhD (2001), *Network Marketing for Dummies*. Another source lists over three thousand MLM firms, many of which are apparently defunct. See <http://www.financialindustryscam.com/mlm.htm>

⁴ Publicly traded MLM firms, and their approximate market capitalization as of the date of this Petition, include Avon (AVP, \$8.8 billion); Herbalife (HLF, \$6.5 billion); Nu Skin (NUS, \$5.1 billion); Tupperware (TUP, \$4.3 billion); Primerica (PRI, \$2.1 billion); Oriflame (ORFLY, \$1.7 billion); Usana (USNA, \$1.1 billion); Medifast(MED, \$357.5 million); Nature’s Sunshine (NATR, \$289.2 million); Lifevantage Corp. (LFVN, \$275.9 million); Blyth, Inc. (BTH, \$147.3 million); Mannatech (MTEX, \$54.9 million); Reliv’ Int’l (RELV, \$28.4 million); and Forever Green (FVRG, \$9 million). Of the companies on this list, at least two (MED and BTH) distribute through multiple channels including MLM, and one (ORFLY) does not distribute in the U.S. Prominent, privately held MLM firms include Amway, Mary Kay, Melaleuca, Monavie, ACN, Shaklee, Sunrider, Pre-Paid Legal, Neways, Market America, Advocare, Arbonne, Xango, Nikken, and Vemma Nutrition Company.

mortgaged, and personal bankruptcy for some who dared to be great.”⁵ Modern MLM plans may be more sophisticated than Koscot, but the human toll remains just as devastating.

The Commission has recognized that “fraud in the sale of business opportunities is not only prevalent but persistent.”⁶ In the rule-making proceedings during the 1970’s which led to the Franchise Rule, the Commission “found that franchise and business opportunity fraud was widespread, causing serious economic harm to consumers.”⁷ In the April 12, 2006 Notice of Proposed Rulemaking concerning the Business Opportunity Rule, the Commission noted that between 1997 and 2005 it had received 17,588 complaints concerning pyramid schemes, amounting to over \$46 million in aggregate losses. These losses grossly understate the total losses suffered by consumers since, in light of the Commission’s 2004 Consumer Survey, “consumers who had purchased a pyramid scheme were the least likely to complain” as compared with all other types of consumer fraud.⁸ The lack of reporting is even more profound when MLM firms target immigrant or minority communities, as Herbalife, Amway and other MLM firms do.⁹ As the Assistant Director, Marketing Practices has stated, “complaints filed with the FTC do not capture all of the problems that the most vulnerable communities face.”¹⁰

⁵ 86 F.T.C 1106, 1179 (1975).

⁶ <http://www.ftc.gov/os/fedreg/2010/october/101028businessopportunitiesstaffreport.pdf>

⁷ <http://www.ftc.gov/os/2006/04/R511993BusinessOpportunityRuleNoticeofProposedRulemaking.pdf>

⁸ See <http://www.ftc.gov/reports/consumerfraud/040805confraudrpt.pdf>, at 81.

⁹ See Letter dated June 5, 2013 from Congresswoman Linda T. Sanchez to Commissioner Edith Ramirez, <http://lindasanchez.house.gov/index.php/press-releases/820-linda-sanchez-calls-for-investigation-of-herbalife>; Letter dated August 29, 2012 from Alma Morales Rioja, President and CEO of MANA, http://www.hermana.org/sites/default/files/MANA_FTC_Herbalife.pdf ; Letter dated May 17, 2013 from Jose Calderon, President of the Hispanic Federation, <http://www.businessinsider.com/hispanic-fed-asks-ftc-to-probe-herbalife-2013-5>; Letter dated September 5, 2013 from Tito Jackson, Boston City Councillor,

As further evidence of the prevalence of unfair and deceptive acts and practices in the MLM industry, we submit the results of a petition posted on the Pyramid Scheme Alert web site (the "PSA Petition").¹¹ The PSA Petition was signed by over 1,000 people, many of whom added notes concerning their experiences in the MLM industry. The collected responses are submitted with this Petition as Exhibit A. The responses reference over 50 different MLM firms, including some of the largest firms in the industry. Most of the signers are from the United States, but there are signers from over 30 other countries, reflecting the fact that deception in the MLM industry is a worldwide problem, with many U.S.-based MLM firms exporting their

<http://www.valuewalk.com/2013/09/ftc-to-investigate-herbalife/> See also http://directsellingnews.com/index.php/view/the_new_american_heritage_tapping_the_hispanic_market_segment#.UkbLNUbD-0E (discussing various MLM firms' strategies for targeting the Hispanic market). According to the Commission's 2011 survey, African Americans and Hispanics are more likely to be victimized by "Income-Related Fraud" than non-Hispanic Whites. Consumer Fraud in the United States, 2011 Survey, at p. 52, <http://www.ftc.gov/os/2013/04/130419fraudsurvey.pdf>

¹⁰ Vaca, Monica and Carter, Thomas B., "How the Federal Trade Commission and Advocates Together Can Benefit Low Income Consumers," 45 Clearinghouse Review 457, 458 (March-April, 2012). The authors note that with scams targeted at immigrant communities, "locating injured consumers and persuading them to cooperate with federal authorities can be hard. To come forward, consumer-victims may have to overcome language barriers and unfamiliarity with U.S. laws and customs. Moreover, consumers whose legal status in this country is uncertain may be wary. Even consumers who have clear legal status may be apprehensive about participating in public court proceedings." *Id.* at 460.

¹¹ The petition states as follows: "We, the People, call on Congress and the Obama Administration to end the neglect of consumer protection and the failure of law enforcement regarding pyramid scams and Ponzi operators. We respectfully request a Congressional Investigation of the FTC and SEC regarding enforcement of laws against Pyramid Selling Schemes, Multi-level Marketing Scams, Ponzi Investment Frauds, Bogus "Business Opportunity" and "Work from Home" Schemes." See <http://www.pyramidschemealert.org/ConsumerPetition.php>.

deceptive practices to foreign markets, in a never ending effort to find new sources of recruits to fill the ranks of distributors lost through attrition.¹²

Some sample, unedited comments from the PSA Petition are set forth below. The comments indicate that the harm caused by MLM is not only financial but includes damage to relationships with friends and family. A signer from Atlanta, Georgia wrote:

The victims of these scams wholeheartedly believe that if they work hard enough, they will make a living for themselves. These scams prey on a belief in the American Dream, on the entrepreneurial spirit, on the naive, the under-educated, those who are unemployed, those with low self esteem and poor support systems, and the poor. Please protect consumers (and the family members of victims who wind up having to support them) from these vultures.

A signer from Ottsville, Pennsylvania wrote:

My family has been victimized and almost saw a divorce over the scamming from a well known MLM that sucked my wife's bank accounts dry with their endless pulp mill of "necessary" sales aids, meetings, and other marketing scams. They are a cancer on our society with their appeal to greed and wondrous "opportunity" always just around the next corner [but never arriving] The DSA direct sales association is their lobby arm. BEWARE these wolves in sheep's clothing selling these de facto pyramid schemes. BAN THEM

A signer from Oregon City, Oregon wrote:

¹² In a 1998 seminar presented for the International Monetary Fund, the Commission's General Counsel stated that "[a]s we continue to pursue pyramid schemes, we would be delighted to coordinate our efforts with law enforcement in your countries. It is only too evident that the expansion of fraud across borders and on the World Wide Web means that no one agency or country can work effectively on its own. We must be collectively vigilant in order to protect the integrity of our marketplaces and the pocketbooks of our consumers." Prepared Statement of Debra A. Valentine, <http://www.ftc.gov/speeches/other/dvimf16.shtm>.

During desperate measures, my spouse had become disabled, and not able to work. While waiting for SSD (took 4 years) to be approved, we invested our last bit of savings, plus borrowed some from family to "become a wage earner from home". We spent over \$6,000 trying to build our base and it never ever happened. Constantly told not doing enough, needing to always put more money in, over an over. Finally cut my loss, the financial impact finally took a toll and had to file bankruptcy, which now doesn't help our US economy or financial bill. Anything I can do?

Eloquently explaining why we should care about the impact of U.S.-based MLM's doing business abroad, a signer from Australia wrote:

have recently resigned as a member of HERBALIFE AUSTRALIA PTY.LTD. 5 Butler Boulevard, Adelaide Air Port SA 5950 Australia. My own inquiries ,plus my daughter in Pretoria South Africa, sending me copies the High Court judgment in the EC Belgium, which condemned the operation of Herbalite in Europe, convinced me to sever my ties with them. Their so called marketing methods are extremely forcefull and unethical. All their products are made in the USA. Surely this monster must be dealt with from the base where IT is spawned the USA.

And a signer from Florida wrote:

Multi-level marketing scams damage relationships. Family, friends, neighbors, fellow church members and countless others are targeted as recruits, often causing or resulting in resentment and alienation, where otherwise healthy, harmonious relationships previously existed. The incessant mind control tactics used in these groups that are perceived by those enrolled as "encouraging," "inspiring," "life-changing," etc., serve only to enslave and deceive the masses. Those enrolled become "close friends" seemingly with only their fellow MLM enrollees & find a new "family" in them in which to dwell. Financial ruin coupled with previously cherished relationships in ruin is a much different picture than the one the MLM powers that be consistently paint to their "followers." Please put an end to these invasive, destructive scams.

Based on our collective experience, as confirmed by the responses to the PSA Petition, MLM firms and promoters engage in a variety of unfair and deceptive acts and practices,¹³ including:

- Selling “business opportunities” to millions of consumers that are based upon the buyer reselling the same opportunity, *ad infinitum*, with the false promise that exponentially increasing rewards will flow to all participants in the recruiting chain.
- Making false and deceptive income claims concerning the MLM business opportunity through the use of charts and bogus hypotheticals.
- Permitting high level MLM distributors to make testimonial earning claims with perfunctory disclaimers and without disclosing unique or special circumstances that make the testimonials deceptive.
- Claiming that regardless of market saturation factors and population limitations, the income opportunity, based upon expansion of the sales chain, is unlimited and available to all forever.
- Failing to disclose failure rates, dropout rates, sources of income for those at the top of pyramid chain, and international income sources of high level US-based distributors.

¹³ We do not claim that all MLM firms engage in all of these practices, but that they are prevalent in the industry. We note that one large direct seller, Tupperware, recently left the DSA. Tupperware’s CEO told the Wall Street Journal “[w]e didn’t leave direct selling ... Direct selling left us, because the industry became dominated by buying clubs and what look like pyramid schemes.”
<http://online.wsj.com/article/SB10001424127887323689604578221430526328400.html>

- Failing to disclose the types and amounts of business expenses incurred by MLM distributors.¹⁴
- Presenting misleading and incomplete income “disclosures” that omit unprofitable participants, using skewed “mean” averages; factoring data for only one year or one month to conceal the annually compounding attrition, failure and/or dropout rates; and failing to disclose the number of existing or previous investors in the business opportunity in any geographic area.
- Presenting misleading and incomprehensible MLM compensation plans which cover up the reality that more commissions are transferred to those positioned at the top of the sales chain than to those who actually make the sale, and that between 50-80% of all commissions are transferred annually to the top 1% of the sales chain.
- Withholding information about the impact on the commission payouts for dropouts that “compress” or “roll up” payments to the distributors at the top of the chain.

¹⁴ These expenses can be substantial. Herbalife, in Item 7 of its 2011 Form 10-K, stated to its investors that “If a distributor wants to pursue the Herbalife business opportunity, the distributor is responsible for growing his or her business and personally pays for the sales activities related to attracting new customers and recruiting distributors by hosting events such as Herbalife Opportunity Meetings or Success Training Seminars; by advertising Herbalife's products; by purchasing and using promotional materials such as t-shirts, buttons and caps; by utilizing and paying for direct mail and print material such as brochures, flyers, catalogs, business cards, posters and banners and telephone book listings; by purchasing inventory for sale or use as samples; and by training, mentoring and following up (in person or via the phone or internet) with customers and recruits on how to use Herbalife products and/or pursue the Herbalife business opportunity.” Herbalife and other MLM firms have recently begun making generalized disclosures concerning business expenses. For instance, Herbalife currently advises prospective distributors that “[s]uch business expenses can vary widely. They might include advertising or promotional expenses, product samples, training, rent, travel, telephone and internet costs, and miscellaneous expenses.” <http://opportunity.herbalife.com/Content/en-US/pdf/business-opportunity/StatementAverageCompensation2011EN.pdf> This generic disclosure is utterly inadequate and incomplete and fails to provide the prospective distributor any means to estimate the amount of expenses they can expect to incur.

- Withholding or disguising the facts that high monthly purchases, specified recruitment quotas and other costs are effectively required in order to sustain “qualification” for the promised commission payments and that failure to meet any of those qualifications results in substantial or total loss of accrued rewards.
- Withholding data and facts regarding actual retail sales to end-users, which is information essential for determining whether the MLM is an illegal pyramid scheme.
- Making false and exaggerated health and medical claims about MLM “pills, potions and lotions” and food-related products.
- Permitting “independent” distributors to make deceptive health and medical claims, thus enabling the MLM firm to maintain “plausible deniability.”
- Charging inflated “wholesale” prices for the products purchased by MLM distributors, based on the false claim that the high prices are balanced by their high income potential or are unique, when typically they are generic, commodity type products manufactured by third party contractors who sell similar products under different brand names to other sellers.
- Using false claims of high income potential to entrap millions of consumers into making automatic monthly inventory purchases charged to their credit cards.
- Charging sales tax based on the suggested *retail* pricing level for wholesale purchases by the sales force that are known to be unsold.
- Charging excessive shipping and handling charges on inventory purchases by distributors that are unrelated to actual costs.

- Delaying or making it difficult for participants to stop charges to their credit cards for “auto-orders” and making return of goods contingent on quitting the business and losing accrued payments.
- Selling lead generation or promotional materials to MLM distributors which are expensive, ineffective and represent a substantial, undisclosed source of income to the high level MLM distributors who market them to their “downline” distributors, with the explicit or tacit support of the MLM firm.¹⁵
- Requiring MLM distributors to submit to onerous and unfair terms in their distributor agreements, including arbitration clauses, class action waivers, jury trial waivers, and provisions which permit the MLM company to make unilateral changes to the distributor agreement or compensation plan without the consent of the distributor.¹⁶

¹⁵ Many high level MLM distributors sell collections of promotional materials, sales leads and marketing techniques to other distributors. Herbalife refers to these materials as “lead generation systems.” The cost of purchasing leads and sales materials represents one of the many undisclosed expenses of operating an MLM distributorship. For many years Herbalife permitted and encouraged its high level distributors to sell lead generation systems to their downline distributors. Recently Herbalife has apparently restricted these activities. See <http://nypost.com/2013/08/17/death-of-a-dream-top-herbalife-pitchman-takes-his-own-life/> . The use and impact of similar systems in Amway, the largest MLM seller, has been documented in several books. See Carter, Ruth, Amway Motivational Organizations: Behind the Smoke and Mirrors (Backstreet Publishing, 1999); Scheibeler, Eric, Merchants of Deception, available at <http://archive.org/details/MerchantsOfDeception>. These writers demonstrate how high level Amway distributors made more money selling lead generation systems to their downlines than they made in the commissions paid by Amway.

¹⁶ Most MLM firms require distributors to sign a pre-printed agreement which is typically one or two pages long. The brevity of these agreements is deceptive, however, because they typically incorporate by reference a lengthy set of additional terms and conditions, often referred to as a policy and procedures manual. For instance, Herbalife utilizes a two page “Application for International Distributorship” which incorporates by reference “the Rules of Conduct and Distributor Policies, the Sales and Marketing Plan, Ordering Procedures and Sample Forms”, which collectively comprise 124 pages. The Herbalife agreement provides that it may change or add to these Rules at any time “in its sole and absolute discretion,” raising a question as to

- Utilizing deceptive Search Engine Optimization (SEO) tactics to manipulate search results so that web sites with negative or objective information concerning an MLM or the MLM industry are “buried.”
- Suing or threatening to sue bloggers and web site owners who attempt to post factual information concerning MLM business opportunities, or to provide a forum for MLM participants to discuss their experiences.

III. The Multi-Level Marketing Industry Causes Substantial Injury to Consumers

Several of the signers of this Petition have attempted to estimate the losses to consumers caused by the MLM industry.¹⁷ The task is made difficult by the fact that MLM firms do not release relevant data concerning the actual incomes of their distributors. In fact, few if any MLM firm even collect data concerning retail sales made by their distributors, or business expenses incurred by their distributors. Without such data it is not possible to know the actual rates of success or failure of MLM distributors. That the rate of failure is extremely high is not open to serious dispute, given the high attrition rates reported by MLM firms.¹⁸

whether it is an enforceable contract. *See Day v. Fortune Hi-Tech Marketing, Inc.*, Nos. 12-6305, 12-6305 (6th Cir., decision dated September 12, 2013) (holding arbitration clause in MLM distributor agreement unenforceable because agreement gave MLM company right to modify the agreement and policies and procedures at any time).

¹⁷ *See* Taylor, Jon M., [The Case Against Multi-Level Marketing as an Unfair or Deceptive Practice](http://mlm-thetruth.com/research/case4and-against-mlm/) (Chapter 7), available at <http://mlm-thetruth.com/research/case4and-against-mlm/>; Fitzpatrick, Robert L. “The Myth of ‘Income Opportunity’ in Multi-Level Marketing,” available at <http://pyramidschemealert.org/PSAMain/news/MythofIncomeReport.html>

¹⁸ For instance, in its 2005 Form 10K Herbalife reported that for the twelve month period ending in January 2005 “approximately 60 percent of our supervisors did not re-qualify and more than

As an example of the extent of financial losses incurred by participants in MLM schemes, we note the settlement in Jacobs v. Herbalife (C.D.Cal. No. CV-02-01431), a class action on behalf of Herbalife distributors who participated in a lead generation system known as “The Newest Way to Wealth” (“NWTW”). The claims were reviewed and evaluated by a professional claims administrator, whose report revealed that there were 7,779 class members who were entitled to submit claims for their economic losses.¹⁹ Of these, 2,481 or about 32%, submitted eligible claims. The aggregate economic losses of eligible claimants totaled \$19,731,186, indicating an average loss of \$7,953. Several individuals claimed - and proved to the satisfaction of the claims administrator - losses in excess of \$100,000. Based on our collective experience, including discussions with distributors in many different MLM plans, these types of losses are not limited to cases such as the NWTW case; they are distressingly common. If a relatively small group of claims by 2,500 MLM distributors can result in aggregate losses of close to \$20 million, the aggregate losses caused throughout the MLM industry are at minimum several billion dollars per year.

IV. Existing Laws and Regulations are Inadequate to Protect Consumers from Unfair and Deceptive MLM Schemes

There is a patchwork quilt of federal and state laws and regulations which affect the MLM industry. These laws and regulations are inadequate to protect consumers for the following reasons:

90% of our distributors that are not supervisors turned over.” Since 2005 Herbalife has not reported the attrition rates of its entry level distributors.

¹⁹ The claims administrator’s declaration is available at <http://www.ftc.gov/os/comments/businessopprule/522418-10572.pdf>

- There is substantial confusion concerning how to determine whether an MLM is operating as an illegal pyramid scheme.
- The determination that a particular MLM is operating as a pyramid scheme may not be made until the scheme has been running for years, with thousands of victims suffering millions of dollars in losses, most of which will prove to be unrecoverable.
- Whether or not they constitute pyramid schemes under any definition, MLM firms and their high level distributors continue to make deceptive earnings claims and engage in other unfair and deceptive practices, as described in this Petition.
- MLM firms have avoided the requirement for making pre-sale disclosures under the Franchise Rule by the simple expedient of keeping the initial fees under \$500.
- The MLM industry obtained an exemption from the Business Opportunity Rule and its pre-sale disclosure requirements, after extensive lobbying of the Commission and Congress.

A. Outline of Existing Laws and Regulations Affecting MLM

Both the FTC and the SEC have jurisdiction to bring enforcement actions against MLM firms which operate as pyramid schemes, because pyramid schemes are considered to be both unfair practices within the scope of Section 5 of the Federal Trade Commission Act and “investment contracts” subject to the Federal securities laws.²⁰ In addition, most states have laws prohibiting pyramid or endless chain schemes. All of these remedies suffer from the flaw

²⁰ See, e.g. Webster v. Omnitrition International, Inc., 79 F.3d 776 (9th Cir. 1996), *cert. den.* 519 U.S. 865 (1996) (adopting FTC pyramid scheme case law to define pyramid scheme in securities fraud action).

that they are only utilized after a fraudulent MLM has been up and running for a lengthy period of time. In addition, as discussed in more detail below, there are conflicting precedents and standards for determining what constitutes a “pyramid scheme,” which has generated significant confusion and misinformation for consumers, attorneys and regulators.

The Commission has broad authority to bring enforcement actions for other types of unfair and deceptive practices, such as making deceptive earnings or product claims, as do state enforcement authorities acting under the various state “little FTC” acts. These remedies suffer from the same flaw as pyramid scheme prosecutions in that they are enforced – if ever - only after a scheme has been operating for a period of time long enough to generate a volume of consumer complaints sufficient to attract regulatory attention.

The Commission has promulgated several rules which may affect certain aspects of MLM recruiting, including the Cooling Off Rule, 16 C.F.R. Part 429, and the Guides Concerning the Use of Endorsements and Testimonials in Advertising, 16 C.F.R. Part 255. The Cooling Off Rule is of limited benefit, since it likely applies only to a distributor’s initial purchase, if at all. Given the widespread use of deceptive testimonial earnings and product claims in the MLM industry, the utility of the Guides is limited by the failure to enforce them.

Pre-sale disclosure of such facts as the attrition and failure rates of MLM distributors, the backgrounds of MLM promoters, the costs to operate as an MLM distributor, and the dismal earnings of most MLM distributors, might protect some consumers from the harm caused by MLM schemes. MLM firms have been able to avoid the disclosure requirements of the Franchise Rule by the simple expedient of setting the initial fees for joining the plan, such as the “starter kit,” below the \$500 threshold. This gap in coverage was set to be closed by the original

version of the Commission's Business Opportunity Rule. However, after intense lobbying by the DSA and many firms in the MLM industry, the Commission revised the new Business Opportunity Rule, 16 C.F.R. Part 437, to exempt most MLM firms from coverage.

Even if there were pre-sale disclosure requirements applicable to MLM, consumers would need more protection. Some MLM compensation plans are so extremely weighted to favor recruitment over retailing that they are "unsafe at any speed." As the Commission stated in Koscot, "[t]hat these schemes so often do not allow recovery of investments by means of retail sales ... merely points up that there is very little positive value to be lost by not allowing such schemes to get started in the first place."²¹

B. There is Substantial Confusion over what is a Pyramid Scheme

While there are some essential similarities among the various federal and state anti-pyramid laws, there are also some serious inconsistencies and contradictions. We are not attempting a full exposition of this issue in this Petition.²² To consider just one aspect of the problem, there is a great deal of confusion concerning the significance of retail sales to persons who are not participants in the plan. The Commissions' own precedents indicate that retail sales

²¹ 86 F.T.C. at 1181.

²² Several commentators have noted apparent inconsistencies and contradictions in various pyramid scheme definitions. See Craig, Bruce "An Investor's Guide to Identifying Pyramid Schemes," available at <http://seekingalpha.com/article/918831-an-investors-guide-to-identifying-pyramid-schemes>; Keep, William, "Publicly Available Lessons Regarding Pyramid Schemes: What Should We Think About Herbalife?," available at <http://seekingalpha.com/article/1244531-publicly-available-lessons-regarding-pyramid-schemes-what-should-we-think-about-herbalife>; Fitzpatrick, Robert "Recognizing Pyramids Without a Lawyer, an Economist or the FTC," available at <http://seekingalpha.com/article/1107821-recognizing-pyramids-without-a-lawyer-an-economist-or-the-ftc>; Taylor, Jon M. The Case Against Multi-Level Marketing as an Unfair and Deceptive Practice (Chapter 10), available at <http://mlm-thetruth.com/research/case4and-against-mlm>

– that is, sales to persons who are not participating in the MLM - are essential for distinguishing “legitimate” MLMs from pyramid schemes. For instance, the final order in In re Koscot Interplanetary, Inc. provided that an MLM firm could legitimately pay commissions only on “*actually consummated* sales of goods or services to persons who are not participants in the plan or program and who do not purchase such goods or services in order to resell them.”²³ The Commission explained that “by requiring that compensation for recruitment be based in all cases upon retail sales by those recruited, the order provides a readily monitored means to ensure that recruitment of distributors is based on market demand, which is the goal of any legitimate business enterprise.”²⁴ In Koscot the Commission also cautioned that “[i]ndeed, even where rewards are based upon sales to consumers, a scheme which represents indiscriminately to all comers that they can recoup their investments by virtue of the product sales of their *recruits* must end up disappointing those at the bottom who can find no recruits capable of making retail sales.”²⁵

The provision in the Koscot final order that commissions for recruiting be based on “actually consummated” retail sales was not followed in In re Amway, in which the Administrative Law Judge found that Amway was not a pyramid scheme because it had a buyback rule, a 70% resale rule and a 10 customer per month rule, all of which supposedly had the effect of encouraging retail sales to customers.²⁶ As a result, most sophisticated MLM’s

²³ 86 F.T.C. 1106, 1186 (1975) (emphasis supplied).

²⁴ 86 F.T.C. 1106, 1184 (1975).

²⁵ 86 F.T.C. 1106, 1180 (1975).

²⁶ 93 F.T.C. 618, 646, 667-68 (1979).

have purported to adopt these “Amway rules” in their distributor agreements; we are not aware of any currently operating MLM which limits the payment of commissions to “actually consummated” retail sales. In effect, the Amway rules tacitly approve the concept of an “advance commission,” that is, the payment of a commission based on a retail sale that has not yet taken place but presumably will take place in the future. In our view, this was a serious mistake which has allowed the MLM industry to flourish while causing increasing harm to consumers.

The Ninth Circuit in Omnitrition emphasized that it is not enough to pay lip service to the Amway rules; the rules must be actually enforced and effective in ensuring retail sales.²⁷ The Ninth Circuit also commented that a distributor’s personal use of the products could not satisfy the requirement that commissions be based on sales to “ultimate users” of the product. The DSA and other MLM proponents argue that this language is “dicta” and that “internal sales” may be used to generate commissions.

More recently, the amended final order in Burnlounge adopted the Omnitrition view that a distributor’s personal use does not constitute retail sales.²⁸ However, the Burnlounge order did not adopt the “actually consummated” requirement from Koscot.

To add to the confusion, a Staff Advisory Opinion dated January 14, 2004 stated that “the amount of internal consumption in any multi-level compensation business does not determine

²⁷ 79 F.3d 776, 783 (9th Cir. 1996).

²⁸ Federal Trade Commission v. Burnlounge, Inc., Case No. CV 07-3654-GW (C.D. Cal., Western Division, Amended Final Order dated February 29, 2012) (appeal pending).

whether the FTC will consider the plan a pyramid scheme.”²⁹ This language has been used by the DSA and others to support the proposition that sales to MLM participants for their “personal use” do satisfy the retail sales requirement, notwithstanding Omnitrition. The DSA has successfully lobbied several state legislatures to modify their anti-pyramid laws to legitimize the payment of commissions on such “internal sales,” thereby legalizing what would otherwise be considered to be pyramid schemes.

Accordingly, there is considerable confusion concerning what constitutes a pyramid scheme. Consumers who are recruited to join an MLM program cannot readily determine whether the program is an illegal pyramid scheme. If the existence of substantial retail sales is to be the touchstone of whether an MLM is a pyramid scheme, the determination cannot be made until the scheme has been operating for a substantial period of time and only after an extensive investigation. The Commission needs to address and clarify this situation. In our view, any MLM program which permits unlimited recruiting and rewards distributors with commissions paid on the purchases of other distributors should be deemed to be a pyramid scheme without the need for further analysis. Such a bright line rule will provide essential guidance to consumers, regulators, investors and the MLM industry.

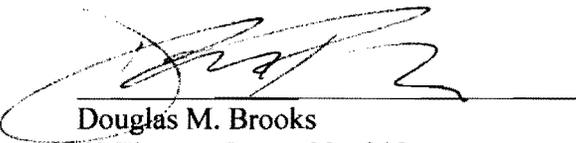
V. Conclusion

The MLM industry has taken advantage of the confusion over what constitutes a pyramid scheme, and the lack of any pre-sale disclosure requirement, to become a multi-billion dollar behemoth in which the vast majority of participants lose their investments and eventually drop out, while a tiny percentage of distributors at the top of the chain become very wealthy. In its

²⁹ See <http://www.mlmlaw.com/FTCinternalconsumptionletterkohm.pdf>

1975 Koscot decision the Commission stated that “[i]t is regrettably clear that responsible authorities, including this Commission, have acted far too slowly to protect consumers from the manipulations of respondents and others like them. ... The necessity to prove that a marketing plan, deceptive on its face, has in fact resulted in injury to numerous consumers, is a lengthy process.”³⁰ The problems recognized by the Commission in Koscot have continued to fester, as MLM firms have modified their practices in response to cases such as Koscot, Amway and Omnitrition, but have failed to change the fundamental flaws of the entrepreneurial chain. We urge the Commission to act now both to investigate the MLM industry and bring enforcement actions against those firms and individuals which are committing unfair and deceptive acts and practices, and to promulgate a trade regulation rule to prevent further harm.

We appreciate the opportunity to address the Commission on this important issue, which will affect millions of consumers in the United States who have suffered and will suffer many billions of dollars of injury from their participation in the MLM industry.



Douglas M. Brooks
60 Thoreau Street, No. 219
Concord, MA 01742
(781) 424-6737
dmbrooks@brooks-law.net
Attorney for *Ad Hoc* Coalition

³⁰ 86 F.T.C. 1106, 1181-82.