

## **How to tell the difference between a legitimate multilevel marketing/network marketing company and an illegal pyramid scheme**

Let me begin this discussion with an evaluation of the two entities with comparisons and contrasts as approached from the standpoint of a consumer and then follow it up with a discussion of how a company can prevent itself from falling into the pyramid scheme trap.

Telling the difference, as a consumer, between these two entities can at times be extremely difficult. Often an illegal pyramid scheme will be like a wolf in sheep's clothing and sucker many a good shepherd unwittingly into it's trap. On the other hand, it is estimated that over 10 million Americans make an income from a legitimate business opportunity. In 1988 the United States Department of Commerce estimated that independent salesmen and saleswomen contributed over \$9 billion to the economy of this country, and the numbers have steadily risen since than. By the same token, consumers lost untold millions of dollars at the same time in illegal schemes. The moral of this story is be careful, but do not be afraid. Learn to tell the difference between a scam and a good business opportunity; avoid the former and embrace the latter.

Let me begin by explaining how a typical illegal pyramid scheme<sup>1</sup> operates. To get into the program you may have to pay anywhere from a few hundred to a few thousand dollars. For your investment, you buy a position on the bottom level of the pyramid. Usually, half of the money which you invest goes to the person directly above you in the pyramid and the other half goes to the person at the very top of the pyramid. When the person at the top of the pyramid makes a profit of typically 16 times the initial investment<sup>2</sup> he or she is removed from the matrix and the next two people move up to the top(because the first level will have one person, the second level two people, the third level four people, the fourth level eight people, and so on and so on). At this point, for them to get their money and move off the matrix, 32 people would need to come into the program at the

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<sup>1</sup> The structure of the company does not dictate whether it is an illegal pyramid scheme or not. Do not be discouraged by people who tell you that the legitimate multi-level marketing program in which you are involved is a pyramid because the way it is set up to look. The United States Social Security program is a pyramid in structure, but is clearly not illegal, although younger Americans may wish it was.

<sup>2</sup> In this type of program, I am reluctant to use the term "investment" because an investment usually contains an element of calculated risk on the investments potential, in an illegal pyramid scheme there is no calculation required, merely a very real risk that you will lose your money.

level under you. They would then move out and the level of four would move in, this time needing 64 people to move the next level up. By the time it got to you at the level of 16 people, 512 people would have to be under you, of which 256 would be at the bottom and would have made nothing. If you are right at the top, you can see how these schemes are money makers. That is until the operators get caught and prosecuted. That's right, prosecuted, illegal pyramid schemes are a crime in all 50 states.

**[Illustrations 1 and 2]**

The reason this type of program is illegal should be obvious to all; by the very nature of its plan it must fail, it provides no marketable product or service and no function other than to bring in other people at the bottom. Without new people throwing their money in an illegal pyramid would fail. As the supply of people dwindles, the people at the lower levels of the pyramid who have invested their money are left holding the bag. An empty bag at that!

The Direct Selling Education Foundation in Washington D.C. in cooperation with the National District Attorneys Association Economic Crime Project, in 1991 put together a very handy little pamphlet entitled Pyramid Schemes: Not What They Seem. This pamphlet provides the best definition that I have seen for distinguishing legitimate business opportunities in multi-level marketing and illegal pyramid schemes.

The pamphlet defines and describes multi-level marketing as “a popular way of retailing in which consumer products are sold, not in stores by sales clerks, but by independent businessmen and women (distributors), usually in customer's homes. As a distributor you can set your own hours and earn money by selling consumer products supplied by an established company.

In a multi-level structure you can also build and manage your own salesforce by recruiting, motivating, supplying and training others to sell those products. Your compensation then includes a percentage of the sales of your entire sales group as well as earning on your own sales to retail customers.”

To distinguish; an illegal pyramid scheme which is disguised as a multi-level company may possess similar characteristics, however, there

never is much effort put into the actual marketing of the products. All or most of the money is made in the recruitment of new distributors, and new distributors are encouraged to purchase large quantities of inventory. Typically, the product purchased has little or no value, or is extremely overpriced. Many times the product itself is a fraud, such as numerous miracle cures, lotions and ointments; products that without the pyramid aspects of the company would truly serve no legitimate market, and these products generally find themselves in a garage somewhere with no actual use other than frontloading<sup>3</sup> individuals for financial gain at the top of the pyramid.**[Illustration 3]**

Pyramid scheme promoters are good! They know how to get you excited and make you think that if you do not act today the deal will be gone tomorrow. They know how to convince you to put up big bucks to make your fortune quick. Be careful, be very careful.

It may not be easy to differentiate a legitimate company from an illegal scam. The Federal Trade Commission suggests seven (7) tips to consider when considering joining a multi-level marketing plan to assist you in determining if it is legit or not. These tips are really broad and in some cases may deter you from joining a legitimate company, but the position of the FTC in offering these tips to the public is that it is much better to be safe than sorry. I add an eighth tip at the end that I feel is far more important than the other seven.

The FTC tips are as follows:

1. Avoid any program that includes commissions for the recruitment of others. If a plan offers such a commission, it is against the law in all states.
2. Avoid programs that pressure new distributors to purchase large quantities of inventory or small amounts of very expensive inventory.

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<sup>3</sup> Frontloading is a term used to describe inventory loading to new participants. Traditionally it is done as a high pressure sales pitch that by purchasing large quantities of inventory which you may not want you have a better chance of advancement and higher commissions. In reality what it does is enables the seller or sponsor to make greater commissions on your joining and leaves you with a garage full of shampoo or thigh cream.

3. Avoid programs that boast that you do not personally need to make any retail sales to make money, merely that you will make your fortune through the work of your downline.
4. Watch out for miracle products. Look for substantiation of claims. Do not be afraid to ask questions. Don't forget the person on stage, or soliciting you may make tremendous claims of income potential and product performance, but just because he said it does not make it true.
5. Watch out for paid performers that will give you stories of their successes.<sup>4</sup>
6. Do not sign any contracts or give any money to the promoters at any business opportunity meeting or other high pressure meeting. Ask a friend or a lawyer if you are not sure. Do not rush into it. Make a list of questions you might have and get the answers before signing on the dotted line.
7. Check the company out. Ask around.

I consider suggestion number six to be the most important of all of the suggested tips of the FTC. Take your time. My philosophy is that if it is a good deal today, it will be a good deal tomorrow. And now for my eighth tip, which I consider to be of importance far above all the others and of importance in dealing with the other seven. Use common sense! There is no substitute for a little bit of old fashioned-look before you leap-common sense.

Take your time and find a deal that is suited for your needs and interests. Do not jump into a deal with promises of no work and great fortune. Remember the old adage, if it looks too good to be true, it probably is!

So what do you as a company do to keep yourself from obtaining the label "pyramid"?

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<sup>4</sup> Just last night, while I was up suffering from legal stress and unable to sleep, I flipped on the television to see the infomercials touting miracle products, real estate deals, and exercise products. You've all probably seen them. Even knowing what I know, I have to admit I was interested in hearing more; it all sounded so good, and for the first time in my life I stayed awake until the end. Then to my amazement a disclaimer came on the screen telling me that the participants in this particular infomercial were paid actors and not even participants in the program. Be careful!

First, do not pay any commissions for the recruitment of individuals into the program. It is acceptable to charge a one-time at cost distributorship fee, but it is not acceptable to pay any commission on this fee. This fee can be used for some type of packet explaining company procedures, sales aides, or other training materials. Generally, the lower this fee the less scrutiny which you will be under from regulatory officials.

Second, require that your distributors make retail sales in order to earn commissions. This is a key element used by regulators in distinguishing between a legitimate MLM and an illegal pyramid. Retail sales do not include items sold to others within the program or to others as a means of inciting them to participate in the program.

It is also arguable as to whether or not sales made for personal consumption may apply as qualifying sales. The case law seems split on this issue, with the recent trend towards stating that a small amount of personal consumption sales may apply, but anything beyond what the jurisdiction considers reasonable will not apply.

The rule established in the Amway litigation and with subsequent modifications since is that a distributor must do approximately five (5) separate retail sales monthly to persons outside of the distributor base in order to qualify for commissions or bonuses. Depending on the product and the cost there have been and will continue to be exceptions to this rule in the number of retail sales required, but there is little chance of ever surviving scrutiny with no retail sales. Remember that sales to existing distributors or sales made to persons becoming distributors at the time of purchase do not qualify for retail sales.

Next, establish a 70% rule, meaning that no distributor may purchase additional products unless they attest that they have sold at least 70% of all products previously purchased. This helps in several ways, it avoids refund requests from persons with garages full of products, and it shows regulators that retail sales are being made by the distributors and that the company is acting responsibly not to overload distributors with inventory.

It may be a good idea to voluntarily set up a program in which the company randomly verifies the information contained in the distributors 70% attestations. Perhaps a random sampling of 1% of all reorder forms

each month. This is a good idea because in case of any investigation, the company will be able to show the investigator that the company has indeed not only implemented programs to insure that distributors are not “stocking up” on products merely to obtain commissions, but also that the company has implemented procedures to insure that the information obtained from distributors is correct. This small step will go a long way towards keeping your company out of trouble. Many cases have been settled by either judgment or consent decree by the companies that have included a requirement that the 70% rule be followed and randomly verified by the company; take the initiative and make your company a good example by verifying information before you are forced too. It may prevent you from ever getting into a position of being forced to.

Finally, one important rule that many companies fail to follow that ends up being their Achilles heel. Do not disguise a recruitment fee as a product sale. What does this mean? It is really quite simple, do not have an overpriced useless item that you sell to a person and in turn they become a distributor of your products, and on the sale of that item commissions are paid to the upline distributor. **[Illustration 4]** This is nothing more than a scam to disguise a sham, you know it, I know it, and you had better believe that the Attorney Generals know it. A recruitment fee is a recruitment fee and attempts to hide it will only end up getting you in more trouble. If your company ideal can not survive on the strength of the products, and needs the extra boost from recruitment income, perhaps now would be a good time to rethink your entire plan.

In line with that theory is the idea that you should not have a required products purchase for personal consumption or otherwise for distributors. Recently the State of California filed suit against a company for the operation of a pyramid scheme. One of the allegations that seemed to cause great concern to both the government and the judge in the case was that distributors were required to make a purchase of products directly from the company at least once every thirteen weeks in order to qualify to receive commissions.<sup>5</sup>

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<sup>5</sup> Interestingly, this company was a binary marketing plan that sold multiple “business centers”, this represents a practice that appears to be the hot topic among regulators and I expect to see numerous additional lawsuits filed shortly against binary marketing plans that sell multiple “business centers”.

The key is *be real*: real products, sold by real distributors, to real consumers. Those three ingredients will keep you out of real trouble.