

**Title:**

Multilevel Marketing and Pyramid Schemes in the United States: An Historical Analysis

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**Disclaimer:**

The views expressed in this article are those of the authors and do not necessarily represent the views of the authors' respective organizations. A determination of whether a given MLM is a pyramid scheme is intensely fact-specific and beyond the scope of this paper. We focus on areas of concern that threaten to tar the reputation of even a legal MLM.

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## **Multilevel Marketing and Pyramid Schemes in the United States: An Historical Analysis**

### **Introduction and Overview**

Face-to-face retailing experienced two noticeable transitions during the 20<sup>th</sup> century. The first occurred when door-to-door selling, in an increasingly urban environment with rising household income, displaced the itinerant peddler. The second happened when a “business opportunity” via multilevel marketing (MLM) altered single-level, commission-based traditional direct selling.

The success of traditional direct selling pre-WWII caused concerned store retailers to seek legal remedies. Post-WWII, an increase in women salespeople and the “party plan” sustained growth. By the 1980s, with more women in the workforce and improved store retailing, direct selling growth stalled. Beginning in the 1940s, multilevel marketing offered an alternative business model, lowering fixed costs and adding a “business opportunity.” No longer commission-based selling, the MLM model operates on a dual premise of retailing products through a network of independent contractors also responsible for recruiting new distributors. When distributor income primarily derives from purchases undertaken by downline recruits, the MLM model creates an opportunity to operate an illegal pyramid scheme. By the 1970s, product-based MLM/pyramid schemes became a significant form of consumer fraud, creating millions of victims losing hundreds of millions of dollars.

This paper presents an historical analysis of the transition from an industry that began by retailing product to general consumers and evolved into an MLM model that is now apparently heavily reliant on selling to itself. We draw upon a wide range of primary and secondary source material, including: court decisions, company documents (e.g., annual reports), industry data, academic research in business and law, government documents, articles in the public press, and relevant books with an historic perspective. We structure the analysis in five sections. The first briefly examines the development of direct selling in the United States. The second looks at the transition from traditional direct selling to multilevel marketing. The third provides a detailed explanation of the multilevel compensation structure. The fourth highlights key legal decisions regarding the continuing problem of illegal pyramid schemes found to be operating under the guise of multilevel marketing. And the fifth examines MLM growth, stagnation and continuing concerns. We finish with conclusions and recommendations for future research.

### **The Direct Selling Model in the United States**

Early in the 20<sup>th</sup> century, direct selling bridged the selling tradition of the itinerant peddler into a new era. Where peddlers traveled great distances to sell primarily unbranded products to customers, direct selling salesmen went “door-to-door” and “house-to-house” selling regionally and nationally branded products in an increasingly urbanized environment (Friedman, 2004, p. 15). Over a relatively short period of time direct selling companies offered household consumers: brushes, groceries, radios, sewing machines, phonographs, musical instruments, vacuums, cosmetics, apparel, chinaware, cooking utensils, books, televisions, furniture – even automobiles.

Once viewed as a short-term approach to reduce excess inventory, direct selling established a firm foothold as a retail channel (Biggart, 1989, p. 27). Data on industry growth vary widely. In the mid-1920s estimates of the volume of annual direct selling ranged from \$300 - \$500 million (Curtis, 1925; Botsford, 1926). The Fuller Brush Company, founded in 1906, reported sales in 1923 of \$15M, that dropped to \$10.3M in 1929 in the face of increased competition (Friedman, 2004, p. 206). That same year the California Perfume Company (i.e., Avon), founded in 1886, generated \$2.5M in revenue (Friedman, 2004, p. 202).

Commissions of as much as 40 percent provided part- and full-time career options for the direct selling sales force. Exclusive selling territories created measurable areas of prospective customers, with expectations of a specific number of home demonstrations per day (Friedman, 2004, p. 204). Consistent with the then popular Taylorism method of scientific management, “specialty salesmen” – no longer simply peddlers – educated the American housewife on the “science” of new consumer products (Botsford, 1926). From 1919 to 1929 the percentage of U.S. households with a washing machine increased more than three-fold; vacuum cleaners more than four-fold, and radio ownership increased by a multiple of 400, in part due to direct selling (Friedman 2004, p. 195).

Direct selling firms sought salespeople for a variety of situations. College students were recruited as early as 1913 for summer selling and Fuller Brush recruited African-American male teachers from segregated high schools to sell in segregated markets (Friedman, 2004, p. 205). In the economically challenging 1930s, twenty-seven Eastern colleges - including Harvard, Dartmouth, Princeton, Yale, Williams, Brown, Columbia, and MIT - signed a statement discouraging “the practice of door-to-door salesmen trading upon their college connections to make sales,” a strategy also apparently adopted by some salesmen who did not attend college (*The New York Times*, 1932).

Branch managers recruited and trained new salespeople. Given the high turnover within the sales force, this was an ongoing responsibility. Companies worked hard to determine effective selling strategies and training programs, regularly communicating with the sales force. During the difficult years of the 1930s, top salespeople received prizes as managers tactically adjusted the product range, advertising strategies, and prices to sustain consumer interest (Friedman, 2004, p. 235).

Though for many decades a minority in direct selling, women tended to work the beauty category, an approach proven successful by Avon. Post-WWII, the percent of women in direct selling climbed until they became the majority of the sales force. Some companies welcomed women more readily than others. Fuller Brush took sixty years to hire its first “Fullerette” (Nuccio, 1966). Three years earlier Mary Kay Ash, an experienced door-to-door saleswoman, founded the new direct selling company Mary Kay (Nemy, 2001).

In the African-American market, women ownership started with Annie Turnbo Malone selling her hair treatments door-to-door as early as 1900 (Peiss, 1998). Madam C. J. Walker, one of Malone’s selling agents, adopted a similar approach to selling hair treatments and cosmetics to African-American women, a market segment largely ignored by store retailers and manufacturers. Their “agent-operator” earned commissions on

product sales and recruited and trained others to do the same. Those successful at recruiting received recognitions and compensation in the form of cash prizes, diamonds and low-cost mortgages (Peiss, 1998). Walker became the first woman and first African-American millionaire in the United States. Both Walker and Malone used their agent network and wealth to promote social issues.

The growth of direct selling brought with it some complaints – the Federal Trade Commission (FTC) recorded 17 of them in 1920 (*Nation's Business*, 1920). Problems also developed with the popular use of “collect on delivery” (COD), which required an initial payment to the salesmen with the balance due when the product was delivered (Layne, 1946). To allay concerns, the modern door-to-door salesman was characterized publicly as different from the peddler, “a shabby, furtive and seedy individual” (Botsford, 1926). Disreputable “door openers,” such as fake surveys and opinion polls, and the “box-top” approach - a bait and switch that substituted a lesser brand after opening with a known brand - caused the National Association of Direct Selling Companies, precursor to the Direct Selling Association (DSA), to work with the Better Business Bureau in 1949 on an industry code of conduct (*The New York Times*, 1949).

Two decades earlier, door-to-door hosiery salesmen were labeled “a real menace,” not for misrepresenting themselves or pocketing deposits but rather for their success at selling. The rise of direct selling in the 1920s brought with it what later would be called “channel conflict,” taking “millions of dollars worth of hosiery business out of your [retail] store” (*The New York Times*, 1925). The consumer protection issue would be inevitably confounded by the loud complaints from store retailers.

Urbanization, the electrification of households, economic growth, and the corresponding development of a wide range of consumer products fueled the rise of direct selling in the early decades of the 20<sup>th</sup> century. The industry responded by opening new branch offices and developing a professional sales force. At the time, most women did not work outside the home, creating a viable home market for direct selling companies successful enough to create at least the perception of a threat to traditional store retailing.

In Florida store retailers produced full-page ads warning against “the Stranger Who Raps on Your Door” (Curtis, 1925). Chambers of Commerce found themselves in the uncomfortable position of established retail members now condemning new, direct selling members. With the support of store retailers, some communities adopted “Green River ordinances” that prevented direct sellers from making a home visit unless first invited to do so – a maneuver upheld by the U.S. Supreme Court. Store retailers felt sufficiently threatened as to help communities create legal defenses. Direct sellers felt differently, “If the retailers in a town where direct sellers are working feel that they have values which are superior, let them make it known fairly and squarely (Curtis, 1925).”

Though the 1930s brought lower household income and a large pool of available labor, it also brought government policies (e.g., Social Security) that formalized the employer/employee relationship. As a result, direct selling firms clarified the role of the salesperson to be that of an independent contractor (Williams, 1948). The degree of their

independence and extent of their responsibility to adhere to company policies would become a future issue.

Verifiable industry data is lacking but trends are apparent. Post-WWII estimates of direct selling sales varied greatly from “about 7 billion dollars a year – 5% of retail sales,” in 1950 to approximately \$1B in 1952, a number that reportedly held through 1953 and presumably moved to \$4B in 1955 or \$3B in 1963 (*Changing Times*, 1950; *The New York Times*, 1952; Zipser, 1953; *The New York Times*, 1955; Sloane, 1964). Industry data continued to vary – ranging from \$6B in 1974 to \$9B in 1980, \$7.5B in 1982 to \$8.5B in 1983-84 (*Changing Times*, 1975; Salmans, 1981; Goldstein, 1983; Purdum, 1985). Multiple sources report industry stagnation during much of the 1980s (*The New York Times*, 1985a; Hall 1988). The DSA now reports annual estimates of industry sales from 1991 forward, based on self-reported data from an industry overwhelmingly comprised of privately held companies, making the data unverifiable.

The environment that fostered the growth of direct selling would again change, this time in favor of store retailing. By the 1930s the growth of regional and national retail chains brought economies of scale in buying and marketing, standardizing product offerings and lower prices. Self-service, a temporary solution for Depression-era retailers, became permanent, as did the innovation of discount retailing. The percentage of women participating in the workforce also increased from 34 percent of women in 1950 to 58 percent in 2011, with 65 percent of women with children under 18 years of age employed outside the home in 2011 (BLS Reports, 2013; Toosi, 2002).

Direct selling growth from 1950 through 1980 relied on the increasing role of women in the sales force and on a new twist in the direct selling format – the party plan. Instead of going to the consumer, the consumer would come to a party sponsored by a salesperson. The approach successfully highlighted the social aspect of direct selling while efficiently providing product demonstrations to many potential buyers (Tompkins, 1957). Tupperware, PartyLite, Pampered Chef, Home Interiors, Longaberger Baskets, Stanley Home Products and other direct selling companies leveraged the party plan (Jones, 2011, p. 60). Women selling to women in someone’s home with food and drink became an industry staple. Parallel to the development of the party plan, the new multilevel marketing (MLM) business model also grew from the 1950s onward. The MLM business model will change the nature of direct selling by adding a “business opportunity” to the more traditional goal of offering consumers a viable alternative to store retail.

### **Development of Modern Multilevel Marketing**

Nutrilite, founded in 1934 as the California Vitamin company, adopted a multilevel marketing (MLM) business model in 1945 with characteristics similar to but different from traditional direct selling (Federal Security Agency, 1951). Both traditional direct selling, particularly the party plan, and the MLM model rely heavily on selling to friends, family, co-workers and neighbors (Grayson, 2007). Each approach provides the opportunity for product demonstrations, add-on sales, new product introductions, customized selling, and feedback from customer and potential customers.

The MLM model, however, differs in multiple ways. By shifting the recruiting, training, and supervising of new salespeople onto the sales force, the parent firm converts fixed costs to variable costs. Instead of a branch manager being responsible for the size and effectiveness of the sales force, now potentially everyone recruited can recruit others. Under the MLM model each “distributor” can potentially create his/her own business by recruiting new distributors, who also recruit new distributors, creating a “downline” of all direct and indirect recruits, purchasing products and potentially available for selling products and recruiting. Training can now be developed and sold by one distributor to another.

The MLM business model also introduced a new vocabulary, with terms such as: upline, downline, personal volume, and group volume. The vocabulary varies across MLMs with firms labeling their salespeople as “Distributors,” “Independent Representatives,” “Partners,” “Associates,” and “Independent Business Owners” (for simplicity we use “distributor”). Product points determine the amount of potential company compensation from purchases made by a distributor and his/her downline, and discounts from the suggested retail price may vary according to the purchase volume (see below: Multilevel Marketing Plans).

In traditional direct selling, sales to non-distributor customers generate commissions to the sales force, with branch managers rewarded for total sales volume. The MLM “business opportunity” ties together different themes of entrepreneurship: 1) selling products to non-distributors, 2) selling products to other distributors, and 3) earning company compensation based on personal purchases and the purchases of a distributor’s downline. The first two income sources come from margin created by the price negotiated with the buyer. Examples of MLM products sold to non-distributor customers can be found on websites such as eBay. One criticism of the MLM model is the inability to track and document these sources of income. All company compensation derives from purchases by a distributor and his/her downline that reach or exceed pre-specified targets for volume. Failure to achieve these levels means no or little company compensation for the distributor. The vast majority of distributors at two large public MLMs received no company compensation (Herbalife, 2013a; Nu Skin, 2013).

The exclusive territories of early direct selling companies prevented competition among salespeople and allowed some measure of market size and potential. Territory exclusivity began to blur with the development of the party plan and the movement of direct selling into the work environment, a natural outcome of more women working outside the home. In the MLM business model, success at recruiting new distributors reduces the probability of successful recruitment in that area in the future, while distributors face all-against-all competition with no verifiable information regarding the number of distributors in a given area at any given time.

The rapidly growing Nutrilite encountered a problem not uncommon in traditional direct selling – the tendency of some salespeople to over-sell by making false product claims. Concerned that such claims were more than isolated cases, in 1951 the Food and Drug Administration obtained an injunction “prohibiting 15,000 door-to-door salesmen from making ‘extravagant therapeutic claims’ for Nutrilite” (*The New York Times*, 1951). The



company agreed, “not to make certain therapeutic claims,” but did not admit fault or guilt (*Changing Times*, 1952). The issue persisted. In 1957 the FDA began “an educational campaign against door-to-door selling of various food additives and vitamin preparations” designed to counter “a violent campaign...designed to convince the American that he has some peculiar ‘deficiency’” (*The New York Times*, 1957).

Nutrilite also encountered problems with the FTC for violating Section 3 of the Clayton Act and Section 5 of the Federal Trade Commission Act based on the exclusive dealing and non-compete sections of the distributor contract (*Mytinger & Casselberry, Inc., v. FTC*, 1962). Shifting the recruiting and training of new recruits to current distributors decentralized the sales force. Over time, the industry would see entire downlines of thousands of distributors move from one MLM company to another. Distributor actions that may or may not be legal, and may or may not comply with company policies, became part of the industry, as also suggested by this annual report quote: “As a result, there can be no assurance that our distributors will participate in our marketing strategies or plans, accept our introduction of new products, or comply with our distributor policies and procedures” (Herbalife, 2013b).

Tiring of the Nutrilite’s legal troubles, in 1959 two distributors, Jay Van Andel and Richard DeVos, created *The American Way Association* (i.e., Amway), a new MLM firm to sell household products –the company that would come to own Nutrilite and also become the largest MLM in the world (Biggart, 1989, p. 46). Three years earlier, Shaklee, a nutrition supplement company, adopted the MLM model (*The New York Times*, 1985b). For the next three decades, traditional direct selling and MLM companies would share the space of face-to-face retailing to consumers.

The MLM model created the possibility of compensation derived from an endless chain of recruitment to the extent that some were found by the courts to be pyramid schemes (*Changing Times*, 1971). Among other things, a pyramid scheme relies on continual recruitment as a mechanism for generating compensation for participants. Non-product based pyramid schemes are simply wealth transfer schemes similar to but distinguishable from Ponzi schemes. Unlike a Ponzi scheme, which relies on voluntary investments of new entrants to fund the investment returns paid to earlier entrants, a pyramid scheme compensates participants to recruit others (Securities and Exchange Commission, 2013). Product-based pyramid schemes rely on upfront fees and/or high margin products and services purchased by an ever-churning base of distributors to fund the compensation paid to participants, with sales to non-distributors playing a minor role (2004 FTC Advisory, further reviewed below).

In the 1970s, state and federal regulators identified numerous pyramid schemes posing as MLMs. Successful prosecutions included *Holiday Magic*, *Koscot Interplanetary*, and *Dare to be Great* (DeJute, Myers, and Wedding, 1973). By 1973 product-based pyramid schemes became “the number one consumer fraud in the [NYC] metropolitan area,” involving: additives, clothes, a wide range of household products, vitamins, buying clubs, cosmetics and hosiery, fire and burglar alarms, and motivational courses (Lichtenstein, 1973). The MLM model facilitated the growth of pyramid scheme fraud, creating victims rather than customers. The *Koscot* case (*FTC v. Koscot*, 1975), concluded in 1975,

provided pyramid scheme language that would have an enduring impact. That same year the FTC initiated a case against Amway (*FTC v. Amway*, 1979), one that would also have an enduring albeit different impact. The FTC agreed that Amway was not a pyramid scheme, in large part due to company policies designed to ensure retail sales (see below: MLMs and Pyramid Schemes).

The 1980s and 1990s brought new MLM companies, including: Sunrider (1982), Herbalife (1983), Advocare (1983), Nu Skin (1984), Melaleuca (1985), USANA (1992), Neways (1992), ACN (1993), Morinda (1994), and Mannatech (1994), among others. The growth of MLM companies in the 1980s was not matched among traditional direct selling companies, with the entire industry reporting essentially six years of flat revenues.

Perhaps no single event better represents the rise of the MLM model over traditional direct selling than when Amway, the largest MLM company, indicated an interest in buying Avon, the oldest and largest traditional direct selling company (Feder, 1989). Two weeks after announcing its intent, Amway withdrew the offer (Freitag, 1989). Eventually, single-level direct selling companies adopted an MLM model, allowing their sales force to receive commissions by recruiting and training others (e.g., Avon).

According to the Direct Selling Association, by 1997 multilevel marketing accounted for 72.4 percent of all direct selling sales in the United States. Despite the safeguards described by *Amway* in its successful defense and at least nominally adopted by virtually all MLMs, the FTC and Securities and Exchange Commission (SEC) have successfully prosecuted a number of MLM/pyramid schemes from 1996 through 2013.

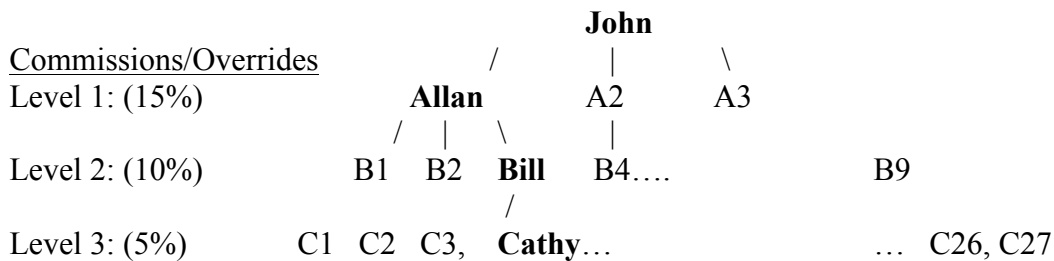
### **Multilevel Marketing Plans**

Multilevel marketing is a way of distributing products/services by which distributors earn income from their own sales and from the sales/purchases by those whom they directly or indirectly enroll. Most MLM firms use some form of progressive enrollment to propagate a business venture. To illustrate an MLM reward system under simple terms (Figure 1), assume each participant enrolls others (say 3), creating a *downline* of enrollment levels. Regardless of whether the participants generally enroll 3 others (and some slots remain open), the example is focused on certain sponsorships; i.e., John→Allan→Bill→Cathy:



Figure 1

Illustration of Multilevel Marketing “Downline”  
and Compensation Structure



*Terminology*

For the indicated sponsorships, Bill and Cathy are *indirect* sponsorships for John and Allan is a *direct* sponsorship, i.e., someone whom John has personally enrolled. The term *product volume* comprehends the purchase and/or sale of product and the participants generate product volume by buying/selling product.

*Reward system*

The firm pays two types of monetary rewards for generating product volume: (1) *direct commissions* for personal volume and (2) *override commissions*, which are additional commissions paid to the sponsors (direct or indirect) of any participant who generates volume. The featured MLM pays a direct commission of 25% on retail sales, with overrides as follows: 15% of volume generated by John’s direct enrollees (his level 1); then 10% of volume generated by his level 2 (indirect sponsorships of John); and 5% of volume generated by his level 3 (indirect sponsorships of John). To illustrate rewards, Cathy is at John’s level 3 and makes a \$100 sale (SRP). She receives a 25% retail commission (thus \$25), and the override commissions to her upline are: Cathy’s sponsor, Bill, obtains \$15 (since Cathy is a level 1 sponsorship for Bill); then Bill’s sponsor, Allan, receives \$10 (Cathy is a level 2 sponsorship for Allan); and Allan’s sponsor, who is John, receives \$5 (Cathy is at John’s level 3). For a retail sale of \$100 at level 3, the array of upline commissions comes to \$30. Adding the \$25 retail commission, each \$100 retail sale at level 3 has a selling expense of \$55 for this MLM. This array of rewards exemplifies MLM compensation: rewards are paid out via a series of percentages applied to downline volume. Equivalently stated, product volume generates an array of simultaneous upline rewards to all relevant sponsors, direct or indirect.

Commissions need not be limited to 3 levels. An MLM’s ability to pay rewards for deeper levels is limited by the firm’s gross profit margin on product sales. Above, should the MLM enjoy (say) a 65% gross margin; i.e., 35% is the firm’s *cost of goods sold*, the above \$100 sale would yield a margin of \$65 to the company and this firm may well be able to afford \$55 in selling expenses. Gross margins as high as 80% are not unusual for

publicly traded MLMs. Depending on the margin, the company may decide to fund deeper levels of rewards.

Above, the firm pays retail and override commissions; however, an MLM may be set up differently. The firm may provide product to distributors with a Suggested Retail Price (SRP) and charge the distributor a wholesale price *W*. By retailing product, distributors obtain a retail commission via the distributor markup, rather than a commission paid by the MLM firm. Although a dollar calculation of rewards may come out the same when using a respective basis of SRP or *W*, the incentives are different [1]. If the firm pays commissions and overrides on consummated retail sales, it clearly incentivizes retail sales. If the firm pays rewards on distributor purchases, it incentivizes –first of all– distributor purchases. In the latter case, the firm needs additional safeguards to effectuate retail sales (*FTC v. Amway*, 1979)

Many MLMs characterize their pay plan as follows: upline rewards are paid for downline sales. The term “sales” typically refers to the firm’s sales to its distributors and equally to distributor sales further downline. The company could sell product directly to the public but this is often a small part, if any, of the firm’s total volume. The firm may have a non-compete clause with its distributors; in any event, the firm mostly provides product to the public via its distributors. The compensation plan is then accurately described as follows: upline rewards are based on downline distributor purchases –a compensation structure that can lead to a number of issues. For one, it can evoke *inventory loading*, i.e., purchases of inventory just to meet volume targets that grant multilevel rewards. In a related vein, the distributors may not be retailing any significant amount of product, perhaps pointing to an inability of selling the product at the SRP. In such a case it may also be that the MLM pays recruitment rewards that are unrelated to actual retail sales. These issues comprise the most frequent factors in distinguishing between legitimate MLMs and pyramid schemes.

### **MLMs and Pyramid Schemes**

There are two closely related descriptions of a pyramid scheme. The first is a general economic characterization in use for many years: a pyramid scheme is a perpetual recruitment chain in which the design of the scheme’s compensation plan dooms the vast majority of participants to financial failure [2]. The *Koscot test*–adopted by federal courts–applies this same meaning to ongoing recruitment in the context of multilevel marketing, focusing on an MLM that sells a product or service and pays recruitment rewards that are unrelated to the sale of product/service to people outside the MLM’s network. The *Koscot* analysis (reviewed below) moves from a general characterization of a pyramid scheme to a specific application in a multilevel marketing context.

In general economic terms, a pyramid scheme is an organization that hinges on the continual recruitment of new members, all of whom need to recruit others to recoup their own investment. The primary benefit –indeed, often the sole benefit– from ongoing recruitment is that the participants receive a certain portion of the monies paid by the set of subsequent recruits. The latter comprise a person’s “downline,” which refers to all direct and indirect recruits of a given person. In order for participants to recoup their own investment – and ostensibly much more, as expected by the participants – they all need to

generate further downline enrollment. The specific rules regarding recruitment and the related recoupment of money vary from one scheme to another but the common thread is: monetary returns are tied to an ongoing ability to recruit others into the same venture.

Thereby, a situation is created in which the desired recoupment will not, and *cannot*, come true for the vast majority of the participants. As recruitment continues, the number of people at or near the base of the recruitment structure grows very rapidly, often at an exponential rate for as long as a successful recruitment pattern is maintained. At whatever current enrollment level the program is considered (saturation or not), the most recent recruitment layers typically do not qualify for rewards because their own downlines are either empty or do not have the sufficient numbers required by the pay plan to secure rewards. In sum, a pyramid scheme is a money-transfer scheme in which the foreseen losses of the vast majority become winnings for a small minority at the top of the recruitment structure.

A pyramid scheme may seek to hide its real nature (essentially, a chain letter) by introducing a product or service to fool people into thinking that they are engaged in a business or income opportunity. The “*Koscot* test” (*FTC v. Koscot*, 1975) addresses this version of the scheme [3]. *Koscot*’s analysis assumes a multilevel marketing context in which people pay fees and buy product to participate in the venture. If all purchases/sales were internal to the MLM (no sales outside this network), ongoing recruitment would doom the vast majority of participants to inevitable losses because, as in the above analysis, monetary rewards would be critically tied to an ongoing ability to recruit others into the same venture; i.e., others who pay fees and buy product, who in turn recruit others who pay fees and buy product, indefinitely. In considering the impending losses that such a recruitment chain would create, *Koscot* looks to income that would not depend on recruitment but rather on product sales to people outside the venture. *Koscot* thus looks to retail sales and addresses certain factually based questions about the MLM’s program, namely whether there are any retail sales (product sales to people outside the MLM) and what relation exists, in practice, between such external sales and the rewards paid in connection with recruitment. If there is no relation between recruitment rewards and sales to the ultimate users outside the MLM’s network, the organization is just a perpetual recruitment chain; indeed, in *Koscot*’s words, “nothing more than an elaborate chain letter device.” Such an MLM dooms the vast majority of participants to financial failure; concomitantly, *Koscot* (1975) renders the same organization to be an unlawful pyramid scheme.

#### *FTC v. Amway (1975 - 1979)*

One of the most noted cases involving this nexus of issues was *FTC v. Amway* (1979). Under Amway’s plan, a recruit did not pay a large sum of money up-front and the initial sales kit purchase was largely refundable. In paradigm fashion, the upline distributors were rewarded for the volume of product purchased by new recruits – a reward system that held the prospect of significant rewards through the enrollment of others. As a defense against a pyramid allegation, Amway’s “70% rule” required that 70% of a distributor’s monthly purchases be resold at wholesale or retail, which sought to prevent inventory loading. And the “10 customer rule” required every distributor to make retail sales to at least 10 different customers each month. The administrative law judge found

that Amway sufficiently enforced these safeguards, which reassured the judge that the emphasis was on moving product through a wholesale and eventual retail network. A further salient feature was the refund policy, which offered a refund on initial purchases returned in saleable condition. Ultimately, a conclusion was reached in which Amway was prohibited from making false or misleading income claims, while specific company policies at the time rendered the company to be a legitimate MLM.

*FTC v. Koscot (1975) and Webster v. Omnitrition (1996)*

In connection with the *Amway* matter, a critical test for identifying an MLM firm as a pyramid scheme had been developed under *Koscot* (1975), i.e., if the firm pays “recruitment rewards that are unrelated to product sales to *ultimate users*.” Subsequently, *Webster v. Omnitrition* (1996) clarified that for purposes of pyramid scheme analysis, *ultimate users* (or *end-users*) are *non-participants* in the MLM’s business venture. A certain characterization emerged, namely an MLM is a pyramid scheme if it pays recruitment rewards unrelated to retail sales, which, in turn, led to a further consideration as to when the recruitment rewards are indeed unrelated to retail sales. Although Amway-type safeguards often play a role in this analysis, and many MLMs claim to have such safeguards, the *Omnitrition* court stated that these safeguards may not satisfy *Koscot*, noting that *Koscot* requires recruitment rewards to be tied to retail sales in an effective way. Specifically, the court states (in Part II, C): “That some amount of product was sold by each supervisor to only 10-customers each month does not insure that overrides [Royalty Overrides, the firm’s upline rewards] are being paid as a result of actual retail sales.” And regarding the 70% rule, the court states: “Importantly, the [70%] requirement can be satisfied by non-retail sales to a supervisor’s downline IMAs [Independent Marketing Associates]. This makes it less likely that the rule will effectively tie royalty overrides to sales to ultimate users, as *Koscot* requires.”

*Some Recent FTC Pyramid Cases*

Now continuing over many cases, FTC pyramid scheme analysis considers reward systems that pay: (a) commissions for product sales and (b) recruitment rewards. The recruitment rewards are generally of two types: (1) lump-sum payments for each new recruit, as in *FTC v. Fortune Hi-Tech Marketing* (2013) and (2) rewards based on volume purchased by recruits (cases below). When present, per-capita enrollment payments are, on their face, direct rewards for recruitment. In contrast, when the rewards related to recruitment are obtained as percentages of the product volume purchased by recruits, more analysis is indicated. The FTC has a record of action when it is evident from the combination of the firm’s pay plan, business presentations, and sales data that the product volume rewards (paid upline when new recruits buy product) are unrelated to retail sales; thus, a direct application of *Koscot* (e.g., *FTC v. Equinox*, 1999; *FTC v. Trek Alliance*, 2002). Some cases exhibit both per-capita recruitment bonuses and rewards for the product volume purchased by recruits. The record shows that when both types are encountered, the per-capita bonuses typically swamp all other rewards, making it manifestly evident that firm’s operation is critically tied to, and funded by, ongoing recruitment (e.g., *FTC v. Fortune Hi-Tech Marketing*, 2013).

The case record further shows that when the *Koscot* test is met (i.e., recruitment rewards unrelated to retail sales), the rewards for recruitment are typically displayed in a prominent

fashion, while retail sales play an incidental role. This incidental nature of retail sales is often supported by financial incentives that give substantially greater rewards for recruiting than for retailing. Participants thus naturally focus their efforts on recruiting others and engage in retailing to the extent that their compensation requires it; for example, as qualifiers for recruitment rewards. In FTC prosecutions of pyramid schemes: the *Koscot* test is shown to hold, as well significant income misrepresentations, high business failure rates for the participants, and substantial consumer injury. These factors are all underscored in the broader *Koscot* analysis; further, the general economic characterization of a pyramid scheme equally holds: the proposed opportunity is a money-transfer scheme in which the losses of the vast majority become winnings for a few at the top [4].

As the FTC strongly argued in *Koscot* (1975), ongoing recruitment cannot be maintained. However, the large-scale failure to obtain financial rewards in a pyramid scheme is *not* postponed until market saturation. Although the names of the most recent enrollees may quickly change as recruitment continues, the *percentage* of members comprising the most recent layers of recruits does not appreciably change for as long as a successful recruitment pattern is maintained, an activity that may be extended by entering international markets. At whatever enrollment level the program is considered, whether the total membership is large or small, saturation or not, the rules and implementation of the program ensure that the vast majority are not in a position to recoup their own investment. The losses are not accidental but are determined by the design of a compensation plan critically tying the financial rewards to a continual ability to recruit others into the same program—manifestly a false premise. Notably, the absolute number of people who lose money increases dramatically for as long as a successful recruitment pattern is maintained. As recruitment begins to falter and many at the bottom drop out, the scheme engages in more recruitment in an effort to replace the dropouts—a churning of the base. While a few fortunate people move up the ladder, the vast majority do not recoup their investment (e.g., *Equinox*, 1999; *Trek Alliance*, 2002; *BurnLounge*, 2008; *Fortune Hi-Tech Marketing*, 2013).

#### *Internal Consumption and the Historic Deconstruction of the 70% Rule*

In *Amway* (1979), the “70% rule” had a specific meaning, namely, on a monthly basis, 70% of a distributor’s purchase was to be resold at wholesale or retail. Primarily, the rule would help prevent inventory loading, while it could encourage some retail sales. After *Amway* prevailed against the government’s pyramid scheme allegation, many MLMs claimed to have adopted *Amway*-like safeguards. Specifically, on paper, each has its own version of a “70% rule” and a “customer retail sales rule.” But there was, and continues to be, no uniform meaning or verifiable enforcement for these company rules.

In a number of instances, the firm’s “70% rule” just requires that 70% of a distributor’s monthly purchase be consumed or sold (as in *Equinox*, 1999; *Trek Alliance*, 2002; *BurnLounge*, 2008; *Fortune Hi-Tech Marketing*, 2013). This formulation naturally raises two related questions: consumed by whom, sold to whom? Would a distributor’s own purchase of product be construed as a *product sale* to that same distributor and satisfy the firm’s 70% rule? Or, if distributors consumed (say) 100% of the product they purchased, would that too satisfy this rule? *Amway*’s current statement of its own 70% rule is this: “In order for an IBO to receive a Performance Bonus or recognition due on all the products purchased, an average of 70% of the IBO’s personal Business Volume (BV) per



month must come from products sold at a commercially reasonable price; if the IBO fails to meet this requirement, then such IBO may be paid that percentage of Performance Bonus measured by the amount of products that can be shown to have been actually sold, rather than the amount of products purchased, and recognized accordingly. For purposes of this Rule, a reasonable amount used for personal or family consumption or given out as samples can contribute to the 70% average” (Amway, 2014, p. D-14). The term *reasonable amount* is not defined and apparently left to distributor discretion. Over time MLM firms have formulated versions that, regardless of how a distributor uses or disposes of monthly purchases, their “70% rule” is deemed to be satisfied. Expressed in current vocabulary, all internal consumption satisfies this rule—a conclusion that appears to be generally shared by the MLM industry (Babener, 2013).

In January 2004, FTC staff issued an informal opinion on pyramid scheme analysis (Kohm, 2004). This Advisory letter has been widely circulated and often misread by industry advisors. The most referenced part is that the level of internal consumption does not determine whether the FTC will consider the MLM’s business plan to be a pyramid scheme. The Advisory continues by characterizing an MLM pyramid scheme as an organization whose primary purpose is recruitment and is funded by monthly product purchases that are qualifiers for recruitment rewards. This part of the Advisory is often ignored. Also ignored is the court’s warning in *Omnitrition*; i.e., the firm’s permission that its “70% rule” can be satisfied by a distributor’s purchase for personal use is certainly not a meaning consistent with *Koscot*. The court directly states: “Plaintiffs have produced evidence that the 70% rule can be satisfied by a distributor’s personal use of the products. If *Koscot* is to have any teeth, such a sale cannot satisfy the requirement that sales be to ultimate users” (*Omnitrition*, Part II C, 1996)

#### *Global Information Network—An MLM Based on 100% Internal Consumption*

In December 2013, the FTC alleged Global Information Network to be a pyramid scheme—rendered below as it is directly stated in further public filing re *FTC v. Trudeau* (2013). The program offers an educational and business opportunity. By enrolling others in the firm’s seminars on personal development, business acumen, and the like, participants obtain financial rewards. From the filing, there is (was) no sale of product/service to anyone outside GIN’s network; compensation is based solely on internal consumption. Financial rewards are obtained as certain percentages of the monies received from members enrolled in the seminars. Commissions & overrides (illustrated in Figure 1 but with different percentages) are paid over 7 levels of enrollment, adding a 4% override on as many levels as a person might accomplish. All recruitment rewards are tied to, and paid by, the continual enrollment of new members in GIN’s seminars. The *Koscot* test is applied. Since there is no sale of product/service outside this MLM’s network, neither can there be a relation between retail (external) sales of product/service and recruitment rewards. Upon employing the general characterization of a classic pyramid scheme (reviewed above) and the specific analysis under *Koscot*, the FTC maintains Global Information Network to be a pyramid scheme.

#### **MLM Evolution: Growth, Stagnation, and Continued Concerns**

Due to changes in households, lifestyles and retailing, the product range offered by contemporary MLM companies does not rival that of traditional direct sellers of the



1920s. Many, however, offer within product category depth (e.g., cosmetics), emphasizing innovation driven by research and development. According to the DSA, the majority of products sold using the MLM model fall into three categories: (a) Home, Family Care and Household Durables; (b) Wellness; and (c) Beauty. As with Nutrilite in the 1940s, some MLM companies have faced scrutiny regarding over-stated product claims (Federal Trade Commission, 1997). Concerns notwithstanding, new products and product improvements continue to be an industry theme.

Traditional direct selling firms began international expansions a century ago. Avon opened a Montreal office in 1914 and reported \$11.2M in 1960 from sales in markets other than the US and Canada (Avon Products, 2012; Avon Products, 1961). Growing MLM firms also quickly learned the potential of international markets. Amway began its international expansion by entering Australia in 1971; Herbalife, founded in 1980, began its international expansion by entering Canada in 1982; and Nu Skin, founded in 1984, entered Canada in 1990.

Amway, the world's largest MLM company and the 25<sup>th</sup> largest privately held firm in the U.S., operates in over 100 countries (DeVos, 2013). International expansion has meant both growth and change. China, Amway's largest single market, imposed challenging legal constraints on the MLM model. In response, Amway and other companies changed operations, altered compensation plans, and opened retail stores. The firm states the changes did not alter "the essence of the company" and some China-based changes were "exported" to other countries (DeVos, 2013). Amway does not attribute sales to individual countries or selling structures, leaving unclear the extent to which their revenues now rely primarily on the MLM model. The growth and profitability of the MLM model prompted some companies to go public. Reckoned in 2012 net revenues, the largest publicly traded MLM companies - Avon (\$10.7B), Herbalife (\$4.07B), Nu Skin (\$2.17B), Primerica (\$1.18B), and USANA (\$648.7M) - have a combined market capitalization of more than \$25B (sources: online company annual reports, shares and share prices accessed on 12/13/13). The potential risk to investors was recently highlighted when Pershing Square, a U.S. hedge fund, took a \$1B short position against Herbalife, accusing it of being a pyramid scheme (Delevingne, 2013).

Continuing FTC and SEC prosecutions of pyramid schemes posing as a legitimate MLM company raise questions about how these organizations can be distinguished from each other (e.g., *SEC v. CKB168*, 2013; *FTC v. Fortune Hi-Tech Marketing*, 2013; and *FTC v. Trudeau*, 2013). The president of the DSA expressed a similar concern when stating "there are a lot of pyramid schemes that like to disguise themselves as legitimate direct-selling companies. That creates an environment where there can be confusion" and "everybody has their own definition of multi-level marketing" (Greenberg, 2013a; Greenberg, 2013b). Tupperware, relabeled its model to be direct-to-consumer—neither direct selling nor MLM—to distance itself from an industry its CEO described as dominated by "buying clubs and what looked like pyramid schemes" (Greenberg, 2013a).

Academic researchers writing in the 1980s who made no mention of the MLM model with its accompanying business opportunity would soon recognize the new dominant approach (Peterson, Albaum, and Ridgway, 1989; Peterson and Watruba, 1996; Peterson

and Albaum, 2007; Albaum and Peterson, 2011). Researchers noted the characteristics similar to traditional direct selling—capitalizing on the benefits of face-to-face selling and the potential of “social linkages”—and recognized the impact of compensation structures on upline and downline distributor efforts, network growth, and distributor performance, though with little concern expressed regarding the growing list of successful MLM/pyramid scheme prosecutions (Peterson and Watruba, 1996; Coughlan and Grayson, 1998).

Other researchers studied non-financial motivations. An ethnographic study of Amway distributors led researchers to view Amway “as an organization that attempts to manage members’ identification by managing how they make sense of themselves (i.e., their identities), as well as their relationships with people within and outside of distribution.” The success or failure of these efforts followed from organizational “dream building” and “positive programming,” achieved through a combination of “sensebreaking” and “sensegiving” (Pratt, 2000). These observations are consistent with a comment made in an email sent to one of the authors, in which the sender describes the involvement of his family and friends: “Considering what they spend to attend Amway conferences and to market Amway’s ‘business,’ they have suffered financially as well as psychologically. And as for the psychological damage, it amounts to substituting probity with foolery, for which they pay a heavy price in considering that their personal lives become very disrupted” (Eidschun, 2014). The *People’s Daily*, a state newspaper in China, recently claimed Nu Skin “brainwashes its salespeople,” an accusation that would appear consistent with the notion of “positive programming” (Lawrence, 2014).

Some researchers questioned the ethics of the MLM model. In considering differences between the traditional direct selling model and the MLM model, one noted, “some really nasty human relations issues...a fundamentally problematic way of doing business” (Bloch, 1996). A survey of consumer perceptions of MLMs in Australia found, “suspicion of pyramiding, unfair commissions, uncomfortable atmosphere and aggressive salespeople” and Harvard publicly denied claims that it endorsed the MLM model (Kustin and Jones, 1995; Mehta, 1995). The risk of operating a pyramid scheme with an “endless chain” of recruits who quickly become inactive raised serious business ethics concerns (Koehn, 2001). Others sought to document the ethical awareness of MLM executives, finding awareness comparable to that in other industries (Chonko, Wotruba and Loe, 2002).

More than fifty years after Nutrilite, researchers would look at the relationship between successful pyramid scheme prosecutions and the underlying business model. Case law showed consistency in the regulatory emphasis and the courts’ concern for participant compensation primarily reliant on purchases made by non-distributor customers (Vander Nat and Keep, 2002). Claims that the resemblances between a legal MLM and an illegal pyramid scheme are “superficial” (Albaum and Peterson, 2011) ignore: the confusion between the two recognized by the president of the DSA (see above), four decades of case law, and public statements made by the FTC and SEC. In 2011 the FTC noted that “Identifying a pyramid scheme masquerading as an MLM requires a fact-intensive inquiry,” while the SEC recently warned investors against “Pyramid Schemes Posing as

Multi-Level Marketing Programs” (Benway, Greisman, and Vladeck, 2010; Securities and Exchange Commission, 2013).

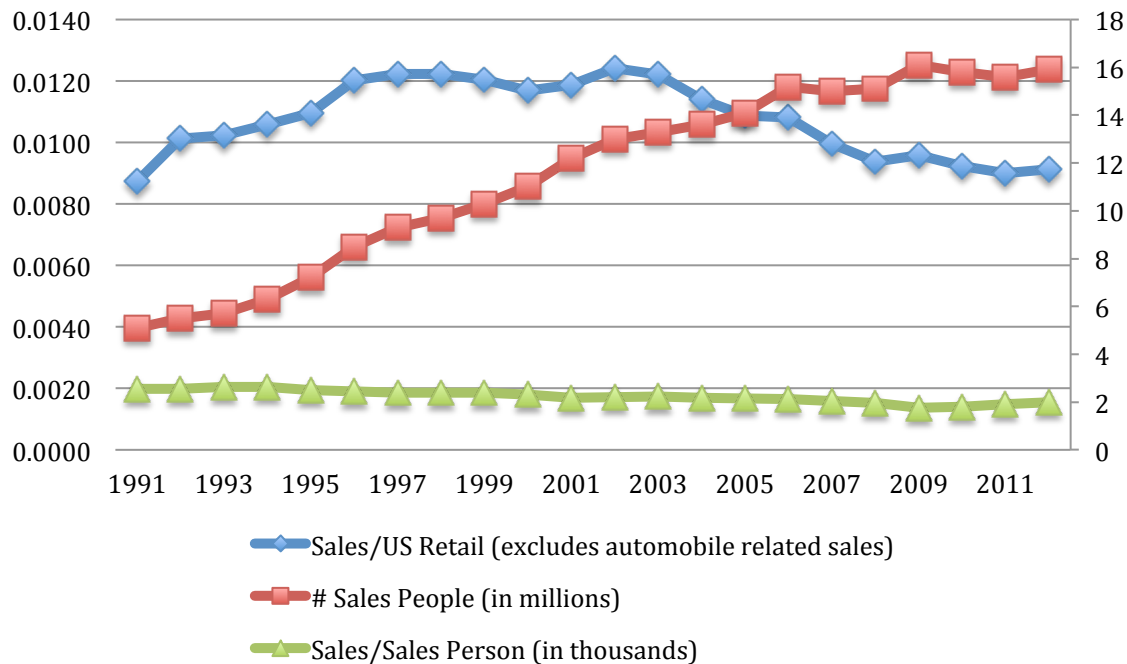
Distributor product purchases, relative to non-distributor purchases, have been alternatively described as ethical and just a variation of the MLM model (Peterson and Wotruba, 1996; Peterson and Albaum, 2007) versus an indicator of a possible pyramid scheme (Vander Nat and Keep, 2002) when being the primary source of compensation to the participants. A prescient 1997 article predicted that the distinctions between a legal MLM and a pyramid scheme would evolve on a “case-by-case” basis (Barkacs, 1997).

One recent article highlights the continuing problem of a lack of verifiable data, a problem that dates back decades. While criticizing the anecdotal evidence used by MLM critics, the authors based their conclusions on unverifiable, self-reported industry data (Albaum and Peterson, 2011). In a time when tracking the movement of products and services through the channel of distribution has become easier and more affordable, and delivering large databases of purchase behavior, no such capacity apparently exists in the MLM channel, despite numerous court decisions that focused on the lack of such data.

Unverifiable data makes understanding the health of the industry difficult. Many MLM companies report increasing sales, driven at least in part by international expansion. Growth within the U.S., however, has been less impressive. From 1974 to 2012, the U.S. direct selling industry grew at an annual rate of 1.45% while US GDP grew twice as fast, at an annual rate of 2.84%. The GDP grew approximately three-fold while the direct selling industry increased by approximately 1.7 times. As the number of people engaged in direct selling tripled from 1991 to 2011, direct sales as a percent of total retail sales at first increased and then declined (Figure 2).

Figure 2

U.S. Direct Selling Sales/Total Retail Sales;  
# Direct Selling Sales People;  
Direct Selling Sales/Sales Person



The MLM-dominated direct selling industry has not proven to be an increasingly important alternative to traditional store retailing. While the MLM model appears to have offset the stagnation of traditional direct selling in the 1980s, the self-reported sales per salesperson decreased over time. Recently three public MLMs relabeled the distributors who were apparently interested in purchasing the product at a distributor discount from SRP as “preferred customers,” making the actual number of direct selling salespersons uncertain (Conway, 2013; Stanford, 2013).

With no information regarding income from selling products to external customers and company compensation heavily skewed toward a small percentage of distributors, the prospective distributors’ ability to evaluate the opportunity remains a challenge. A comparison over time of average annual distributor earnings showed that the average Amway distributors in Wisconsin in 1980 earned \$744 in 2012 dollars (\$267 in 1980), while the average annual earning for all Herbalife and Nu Skin distributors in 2012 were \$749 and \$641, respectively (*State of Wisconsin v. Amway* 1982; Herbalife, 2013a; Nu Skin, 2013); thus little or no change.

The MLM model now apparently depends heavily upon selling to itself: “This is a critical

question, because at the core of the short seller accusation is the claim that a purchase for personal use by distributors (also known as internal consumption) cannot be considered a sale to an ultimate user. If this standard were to be adopted, it would cast a cloud over many well-established direct selling companies, particularly those that sell consumable products such as health, home and personal care” (Babener, 2013). Arguments that treat internal and external consumption the same blur the nature of the selling opportunity and ignore the potential for ongoing recruitment to be the primary source for compensating participants – a key characteristic of a pyramid scheme.

Internal consumption has been argued to be similar to a “buying club” that people join to receive a distributor discount, driving internal consumption above that of external consumption. The analogy is suspect, as an MLM company may lose eighty percent of its “internal customers” each year; in contrast, Costco, a well-known buying club, retains more than eighty percent of its customers each year (Forbes, 2013). The argument is also suspect since MLM firms ubiquitously promote a business opportunity by which people earn income – a set of facts that make a *failed* business venture a more cogent explanation for the noted annual dropout rates regarding general MLM participants.

Communications about the MLM opportunity can be multifaceted and difficult to unravel. For example, for 2012 Herbalife reports an average annual gross earnings for 86,913 “eligible” distributors and sales leaders of \$4,358 before expenses, though there exists no independent way to determine the percentage of the other 406,949 distributors who tried but failed to become eligible (Herbalife, 2013a). In a recent court document Herbalife states “Bostick knew that he was not guaranteed success as an Herbalife Distributor and that most of even Herbalife’s most successful leaders made only modest amounts of commission income” (emphasis added), further describing most participants as discount buyers. That said, its website features success stories highlighting “financial freedom” and “being my own boss” (*Dana Bostick v. Herbalife*, 2013; Herbalife, 2013c). But in 2012 less than 2.7% of eligible distributors and sales leaders (.47% of all distributors) earned more than \$25,000 in annual compensation (Herbalife, 2013a). Selling and recruiting methods that led to the success of others – beyond statements about hard work – are opaque, as is the number of distributors selling in a given area at any time. Untangling the incentives for distributor discounts from a venture promoted to provide business income makes a proper assessment of individual MLMs difficult.

The failure of MLM companies to track sales outside the distributor network exacerbates this problem. Competing explanations of internal consumption, i.e., distributors enjoying a discount on products for personal use coupled with intangible benefits of social connections, versus distributor recruitment incentivized to achieve company-specified volumes (repeated annually with new recruits), all happen simultaneously. The lack of transparency hinders consumers, investors, and regulators from accurately assessing the general MLM business model, as well as individual MLMs.

The ability of high volume distributors to generate and sell business support materials at a profit to downline distributors further obscures the path to financial success. High annual distributor turnover creates a ready market for fee-based training programs offered by upline distributors. While MLM companies typically offer some instructions on selling,

the cost and effective of sales training falls on distributors, an approach different from the company sponsored “scientific” selling training offered to the sales force at no charge in traditional direct selling. Instead, MLM distributor-generated training can deliver profits to the upline distributor regardless of the training effectiveness.

The 2004 FTC Fraud Survey points out the extent of the overall problem of pyramid schemes (Federal Trade Commission Staff Report, 2004). Of the ten most prevalent types of consumer complaints received by the FTC, purchasing a membership in a pyramid schemes ranked seventh, with an estimated 2.55 million incidents and 1.55 million individual victims in the preceding year (the 95 percent interval ranged from .8 to 2.3 million individual victims, effecting between .4 percent and 1.1 percent of the US adult population). The amount lost per individual ranked pyramid schemes second among the ten fraud types. Most notably, pyramid scheme victims were the “least likely to complain,” despite recognizing that they had been victims of consumer fraud.

### **Conclusions and Future Research**

This analysis contributes to the marketing literature by providing a long-term perspective on a specific and continually evolving area of retailing. Through the lens of history we identify forces of change and highlighting the impact of marketing actions. For traditional direct selling, MLMs, and pyramid schemes, the impact has varied from bringing a wide range of products literally to the doors of consumers, to struggling to maintain consumer connections in the face of changing lifestyles, to a restructuring of the business model, to triggering a series of ongoing regulatory actions in the face of consumer fraud. Unlike contemporaneous studies, which document and test theories against current actions, historical studies provide sufficient context to compare the actions and motivations in one time period to those in another.

As noted throughout, the MLM model operates on the dual premise of retailing through a network of distributors and recruiting new distributors to do the same. Federal regulators and courts have consistently focused on the “retail question” – the existence and extent of sales to consumers external to the distributor network (Vander Nat and Keep, 2002). The inability to track sales other than to distributors themselves conflates the dual premise, obscuring the basic role of providing a retail channel. Without a significant external customer base, internal consumption by an ever-churning base of participants resembles neither employee purchases nor a buying club. The MLM industry now appears to be heavily reliant on selling to itself – raising *the retail question* to ever greater urgency.

Academic research and articles in the popular press regularly demonstrate the ability for businesses to add value and make social contributions, and also to do social harm. Our analysis of multilevel marketing and pyramid schemes in the U.S. makes explicit the potential of the MLM business model to have this dual impact on society. This duality motivates further public policy consideration in an effort to protect consumer welfare while providing market-based benefits.

Opportunities for future academic research abound. Little systematic research has been done comparing the variety of compensations structures and company policies across MLM firms, including those found to be pyramid schemes. Studies using experimental



design could tease out the relative value of tangible and intangible rewards associated with becoming an MLM distributor. Studies of current and former distributors could lend understanding to the evident process of being first active, then inactive. And the low level of complaint behavior by victims of pyramid scheme fraud requires additional study. Unlike motivations associated with traditional direct selling, the MLM industry continues to present a less understood and at times illegal business model.

And research is surely warranted to determine the nature/extent of discounts: (a) from an SRP that perhaps no one except uninformed consumers would pay, and (b) with respect to similar products available via non-MLM channels. Further, if deemed plausible to a researcher (though at first sounding like a satire), undertake a genuine study of how new MLM entrants establish a business, earning profit on products available at discounts to people joining as internal customers. This would render a statistical estimate of the number of *uninformed customers*, likely not to be statistically different from zero, who would form the *business entrants'* customer base: customers who do not (yet) know they could avoid paying a mark-up by becoming internal customers. Regrettably, a study that documents such foreseen outcomes is apparently needed for an industry now moving down a very dubious path: i.e., continually replacing retail sales with proposed internal consumption that, if taken seriously, would demand fundamental changes to the current MLM model, or failing that, would render a proposal that is economically infeasible.

1. If the MLM offers commissions on a \$100 sale (SRP), the *level-1 override* may be expressed as 15% of SRP, e.g., \$15 via a \$100 sale. Or, if the firm pays rewards on distributor purchases, the level-1 override can be expressed as 20% of W; e.g., 20% x \$75 = \$15. One obtains the same \$15 reward for level-1 volume, but the incentives are different depending on whether the underlying volume represents retail sales or distributor purchases.

2. For example, see Lichtenstein G. (1973) "Pyramid Sales Are Now Chief Consumer Fraud Here," *The New York Times*, 3, April.

3. In *Koscot*, the FTC articulates its test for a pyramid scheme. The ruling notes that the absence or paucity of retail sales dooms the MLM to be an endless chain that is "nothing more than an elaborate chain letter device...". Re *Koscot Interplanetary, Inc.*, 86 F.T.C. 1180 (1975). The FTC further held that a pyramid scheme is an organization in which the participants pay the company money 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 (1180). Federal courts have adopted, and elaborate upon, the *Koscot* test, notably in *Webster v. Omnitrition* (1996); *United States v. Gold Unlimited* (1999); *FTC v. Five Star* (2000); and *FTC v. BurnLounge* (2011). All of these court rulings concur that for purposes of pyramid scheme analysis under *Koscot*, "ultimate users" are people who are not participants in the proposed venture, i.e., are consumers outside the MLM's network.

4. See full text of Opinion and Final Order, re *Koscot Interplanetary, Inc.* 86 F.T.C. 1106-1192 (1975). At times, readers focus narrowly on *Koscot's* "two prongs"; i.e., a payment

of money that grants the right to: (a) sell the firm's product and (b) obtain recruitment rewards which are unrelated to sale of the product to ultimate users. For the historical record, Koscot's analysis identifies *ultimate users* as consumers outside the MLM's network and it affirms the economic characterization of pyramid scheme as an organization based on the false premise of continual recruitment, dooming the vast majority of participants to financial failure.

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