October 2015

A Legislator's Guide to Pyramid Schemes

William W. Keep, PhD

The Federal Trade Commission (FTC) estimates that hundreds of thousands of Americans, and possibly a million+, are pyramid scheme victims each year[1]. Victim losses rise to hundreds of millions of dollars annually. A pyramid rule could clarify legal business practices, and reduce the cost and length of enforcement.

What is a pyramid scheme? [2,3,4,5,6,7,8]

- Recruits obtain the right to sell an "opportunity," often in conjunction with selling a product[*].
- The right to sell includes the right to earn rewards by recruiting others.
- Fees and/or product purchases sustain eligibility and are required for the prospect of any significant rewards.
- Rewards derive primarily from recruiting others, who typically buy products and/or pay fees for the sake of pursuing the opportunity, and not primarily from selling product to the public.
- Pyramid schemes have company policies, marketing material, and compensation plans that reinforce recruiting new participants into the opportunity rather than selling product to the public.

Product-based pyramid scheme symptoms necessarily include: deceptive earnings claims, a compensation plan that rewards recruitment unrelated to sales to the public, a convoluted set of policies and procedures, an inability to demonstrate consumer demand independent of recruitment, and ineffective anti-pyramid scheme safeguards. Unsupported product claims (i.e., product efficacy) may or may not be an issue and product margins considerably higher than competing products in the market are commonplace.

Product-based Pyramid Schemes v. Legal Multilevel Marketing:
Because product-based pyramid schemes intentionally emulate legal multilevel marketing, distinguishing between the two can be difficult. Through an administrative action in 1975 the FTC accused Amway, at the time the largest multilevel marketing company, of operating a pyramid scheme. Using language that distinguished sales to distributors (i.e., wholesale sales) from sales to the public (i.e., retail sales), Amway successfully defended its business model with three key anti-pyramid scheme safeguards: 1) each distributor must have 10 retail customers monthly, 2) before making a new purchase, each distributor mush sell 70% of last month's purchase at wholesale or retail, leaving 30% of each product purchase for self-consumption or inventory holdings, and 3) dissatisfied distributors could return unused products for a refund and leave the business. The FTC found Amway policies to be effective and enforced, and in 1979 declared the business model not to be a pyramid scheme[9].

Confusion and Grey Areas:
Deceptive selling practices have existed in a variety of formats for literally centuries. This is particularly true when the benefits of product usage are difficult to assess (e.g., the so-called "snake oil salesman"). While potentially illegal and surely unethical, such practices do not constitute pyramid scheme behavior. Nor does a viable product make a company immune to a pyramid scheme charge. As a result, prosecutors look for evidence of rewards derived from recruitment-driven fees and/or product purchases unrelated to the sale of product to the public, and an absence of effective, enforced anti-pyramid scheme safeguards. As pyramid scheme operators know of this focus, virtually every MLM company found to be a product-based pyramid scheme has claimed (a) to retail products to the public and (b) to have in place some version of effective anti-pyramid safeguards. Neither claim could be supported.[3,4,5,6,7,8]

[*]Product is defined as a physical product or service.
[1]FTC Fraud Surveys, [2]FTC v. Koscot; [3]Webster v. Omnitrition; [4]FTC v. BurnLounge; [5]FTC v. YTB; [6]United States v. Gold Unlimited, [7]FTC v. Vemma, [8]FTC v. Equinox, [9]FTC v. Amway