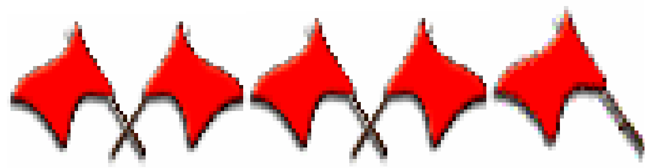

The 5 Red Flags

Five Causal and Defining Characteristics of Product-Based Pyramid Schemes, or Recruiting MLM's*

Report for Consumers, Regulators, and Legislators - 2006 Edition

Originally titled *"PRODUCT-BASED PYRAMID SCHEMES: When Should an MLM or Network Marketing* Program Be Considered an Illegal Pyramid Scheme?"*

Revised from text summarized in a white paper for the 2002 Economic Crime Summit Conference (sponsored by the National White Collar Crime Center and Coalition for the Prevention of Economic Crime) – and presented in a Power Point presentation at the Economic Crime Summit Conference in Dallas, August 17, 2004
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**a.k.a. "Multi-level Marketing," "Network Marketing," "Consumer Direct Marketing," etc. "MLM" is a generic acronym for any type of multi-level or endless chain product distribution program.*

CONTENTS

Report Abstract

As Ponzi, pyramid, and other endless chain selling schemes have grown in the U.S., confusion over definitions and measurable harm has clouded efforts to control it. The 1979 decision of a Federal Trade Commission (FTC) judge that Amway was not a pyramid scheme, provided that certain "retail rules" were followed, has had enormous worldwide consequences. Instead of moving towards resolution of issues related to enforcement, the multi-level marketing (MLM) industry has succeeded in weakening laws and enforcement efforts through a variety of legislative initiatives, court battles, and obfuscation of its methods and effects. (For a brief history of pyramid schemes and MLM, see Appendix A)

Through experiential testing, extensive interviews with top experts, surveys of consumers and MLM participants, and comparative analysis of features of compensation plans of normal and chain selling programs, five red flags of exploitive product-based pyramid schemes, or "recruiting MLM's," have been identified and tested. From at least four independent investigations, including tax returns of MLM participants and published reports of MLM companies, loss rates of over 99% have been found in MLM programs in which these 5 red flags are found in their compensation plans. The commonly held assumption that no-product schemes are worse than product-based programs has been found to be totally false, since the loss rate of no-product schemes is only about 90%.

Successful growth of these MLM's requires a whole set of misrepresentations, which are routinely used in MLM recruitment campaigns. Since nearly all recruits lose money, the income of recruiting MLM's could be considered theft by deception, or unjust enrichment of a few at the top of the pyramid and the MLM company itself – at the expense of a revolving door of new recruits, who buy over-priced products to "play the game."

Product-based pyramid schemes evolve into Ponzi schemes in order to survive and grow. So they typically move to other areas to recruit when market saturation makes successful recruitment difficult. Since little actual selling to non-participants takes place, such recruitment to new markets to pay earlier investors becomes essential.

Currently, MLM companies are duping officials in countries that are unprepared to cope with the defrauding of their citizens. The Direct Selling Association, through the World Federation of Direct Selling Associations, works tirelessly to modify existing laws against pyramid schemes to make them more MLM-friendly and to obstruct the passage of laws that would protect consumers from their member firms.

The FTC and most states have essentially capitulated to the MLM industry. Thus, consumers are left with little protection against some of the worst schemes. Consumers are left with the necessity of making decisions regarding MLM participation in the absence of true information about these programs. It is with the hope of correcting these deceptions that this report was prepared, based on extensive research – which is also posted on the web site – www.mlm-thetruth.com. Other web sites with valuable information sponsored by informed consumer advocates are also linked to the site.

Purpose of this report

In this paper I shall attempt to answer the following questions:

- How can product-based pyramid schemes be differentiated from fair and legitimate direct sales operations?
- What are the five causal and defining characteristics of product-based pyramid schemes, or recruiting MLM's – and how were they derived?
- Are nearly all multi-level marketing (MLM) programs merely exploitive product-based pyramid scheme, or recruiting MLM's?
- Which do the greatest harm – no-product pyramid schemes – or product-based pyramid schemes (recruiting MLM's)?
- Why have some of the worst schemes escaped prosecution as pyramid schemes?
- What recommendations can be given for legislation and for enforcement of laws and rules protecting consumers against product-based pyramid schemes?
- How can consumers protect themselves and recover any losses from MLM?

What shall we call these schemes?

This report uses the terms "Recruiting MLM" (implying an emphasis of recruitment over sales to non-participants) and "Product-based Pyramid Scheme" as interchangeable terms. These programs have also been called "Multi-level

Marketing," "Network Marketing," "Consumer Direct Marketing," etc. "MLM" is a generic acronym for any type of multi-level or endless chain product distribution program, and we will use it for brevity.

More negative sounding titles include "Chain Selling," "Pyramid Selling," etc. In this report, a "recruiting MLM" employs a compensation plan that rewards recruiting so much more than direct selling that there is little incentive to sell products.

Since many people mistakenly assume that if a multi-level or chain selling program includes the sale of legitimate products, it is not a pyramid scheme, I feel it is appropriate to refer to such MLM's as "product-based pyramid schemes" to underscore what recent research has shown – that product-based schemes are as virulent, harmful, and inherently fraudulent as no-product schemes. In fact, this paper will demonstrate that they are much more damaging.

My efforts to find the truth about MLM

In late 1994, having been aggressively recruited by associates who were active in MLM, I finally agreed to give it a one-year trial. After a year of diligent recruiting, I decided to call it quits when it began to dawn on me what was happening. Though in the top 1% in the hierarchy of participants, I was losing both money and friends. I knew from a broad base of business and sales experience that something was terribly wrong, and I knew it was not my lack of effort or skill. For my unique background and a more complete account of my experience with MLM, go to Appendix F.

In early efforts to unravel the "mystery of MLM," I decided to perform an informal telephone survey of persons who had experience with a wide spectrum of other MLM programs. These included a variety of compensation systems – breakaway, binary, matrix, unilevel, etc. But all were organized as a multi-level hierarchy of distributors.

After hundreds of phone calls, I learned that even modest success (say, a minimum wage for the time spent) was extremely rare. After expenses were subtracted, including product purchases that would not likely have occurred had they not been enrolled in the program, the vast majority lost money, and some a great deal of time. Generally, those who invested the most, lost the most.

Though legitimate products are offered and recruiting fees for participation are disguised or eliminated (thereby getting around laws forbidding pyramid schemes), it became apparent that MLM generally is as pyramidal as any illegal pyramid scheme that could be conceived. As one MLM author admitted:

> This "pyramid" effect reinforces the philosophy of many people in the MLM industry that the best way to make a substantial income with the least amount of actual selling is to recruit other people to do the work. Income is therefore generated through establishing the network, and not through the actual selling of products. Interviews with current MLM salespeople and distributors [from 11 different MLM companies] revealed a startling 100% that expressed this same philosophy.[1]

My interviews revealed a surprising number of maxed out credit cards, foreclosed homes, bankruptcies, and broken homes resulting from compulsive participation in MLM programs. For example, a relative of a couple caught up in such a tragedy reported these developments in their lives:

> He went bonkers with his latest MLM deal. He felt the necessity to buy a fancy sports car and the best suits to appear well heeled, then quit his job and mortgaged his home – without his wife's permission. She was distraught when she found out, but he just responded with grandiose ideas and big promises.
>
> Since she did not "catch the vision," he felt his wife was holding him back. He continued to call the shots without consulting her. She lost all trust in him, and the family began to unravel. They lost their home and wound up in bankruptcy. She was embarrassed when they were forced to move in with her parents.
>
> This couple finally divorced. Living in a trailer, he is still chasing his MLM dream. He doesn't make alimony or child support payments. Why should he? Plenty of money is always just around the corner. Then he will catch up.[2]

MLM supporters are quick to point out that such irresponsible behavior had more to do with the person than with the program. But my interviews convinced me that such "multi-level junkies" are more common than is often acknowledged - certainly more common than in other types of businesses I have observed. For at least some who were recruited into an MLM program, there seems to be a compulsive component to more serious participation in multi-level programs, whether it be MLM or no-product pyramid schemes – very much akin to compulsive gambling.

After writing a book on the ethics of network marketing[3], I began sharing my story and research in speeches to groups. The feedback was interesting. One tax accountant said he had worked for H&R Block as one of the principals in northern Utah for many years, during which time his group had completed about 15,000 tax returns, several hundred of whom were MLM distributors. He said that in all that time he could remember only one MLM distributor who had reported a net profit on his return - and that person was bankrupt within a year!

This observation caught my attention. So I surveyed other tax accountants, financial planners, insurance agents, and other professionals who had access to people's financial records. Their responses were very similar -actual profits resulting from MLM participation were extremely rare. This heightened my suspicion that MLM was in fact a pyramid scheme - masked as a legitimate system for marketing products.

If in fact less than one in 100 distributors earns a significant profit from an MLM, that in itself would lean towards an MLM program being classified as a bogus business opportunity - or as a pyramid scheme - rather than as a legitimate business. This is especially true when such programs are touted by MLM promoters as "the opportunity of a lifetime," etc. At the very least, MLM's should be watched for violations of laws against deceptive sales practices, such as overstating potential earnings.

The twin challenges of defining product-based pyramid schemes, or recruiting MLM's – and understanding the harm to consumers

Pyramid schemes, in which no products are offered, are fairly easy to identify, and they seldom last long without law enforcement shutting them down. But when products are offered, and when consumers are presented with an income "opportunity" with multiple levels of "distributors," it is not easy for some to decide whether or not it is in fact an exploitive product-based pyramid scheme. Unfortunately, some of the most damaging programs manage to escape legal action.

After accumulating extensive data and analytical reports and posting them on a web site, I found myself interacting with the top experts on this topic. I formed the non-profit Consumer Awareness Institute and began offering research and training. Several of us also combined our resources to form Pyramid Scheme Alert, dedicated to exposing and preventing pyramid scheme fraud.

FTC rationale for considering pyramid schemes unlawful: Section 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. 45(a)(1), states that "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful."

While the FTC does not specifically address pyramid schemes, such schemes have been deemed unlawful under the above clause in the Federal Trade Commission Act.[4]

Early evidence of the uneconomic nature of endless chain selling schemes, or MLM's: In a 1980 suit by the State of Wisconsin against Amway, the tax returns of the top 1% (about 200 out of 20,000) of Amway distributors were examined. Their average income was minus $900![5]

There may have been one or two that reported a significant net profit. As later research demonstrated, only a tiny number (at the top of a hierarchy of participants) profit in such programs.[6] Later in this paper, recent evidence of the unprofitable nature of MLM for all except for a few at the top will be discussed.

***The key to identifying the potential harm*:** Look for perverse elements in the compensation plan that create extremely high leverage for the top persons in the hierarchy of participants. *MLM "leverage"* refers to the concentration of payments (commissions, bonuses, etc.) from the company to top-level "distributors," who profit hugely from the efforts and purchases of a multitude of "downline" participants recruited beneath them. In highly leveraged MLM programs (which includes most MLM's), approximately 99.9% of recruits lose both time and money. *As a general rule, the greater the leverage for top participants in the distributor hierarchy, the higher the loss rate for their downline.*

I refer to highly leveraged MLM's, which recruit aggressively, as "recruiting MLM's," as opposed to "retail MLM's," which allow a person to earn a significant income from retailing products to end users. Understanding the difference is key to identifying the programs that do the most harm. However, harmless MLM's are extremely rare – probably less than 1% of all MLM's – out of hundreds of MLM's I have reviewed.

Confusing comparisons: MLM is often compared with legitimate alternative business models, such as franchising, direct sales, insurance agencies, and small business operations, such as product distributorships. This adds confusion in the minds of consumers and law enforcement officials.

However, my research suggests that clear differences can seen.

One common strategy for MLM companies seeking to build credibility is to go to great lengths to be identified as a “direct sales” organization. But after rigorous comparisons of legitimate business models with features of highly leveraged MLM compensation plans, at least five clear distinctions can be made, as discussed below.

Interestingly, the five features, which differentiate these programs from legitimate businesses, are the same features that cause an extremely high loss rate and other problems for participants. I call them “causal and defining characteristics of product-based pyramid schemes” because they both cause the problem and define themselves as chain or pyramid selling schemes. Properly applied, they also identify programs that violate most federal and state laws against pyramid schemes.

Inadequate definitions: Most of the laws and statutes were crafted before the structure, dynamics, and effects of product-based pyramid schemes were understood, so the definitions within anti-pyramid statutes do not accurately reflect the root causes of the problems. However, there is enough validity in the present legal definitions of pyramid schemes in most jurisdictions that enforcement against such schemes can be effective if the principles in this paper are understood and applied. This is true regardless of how complex is the compensation plan of the MLM in question.

FTC guidelines and most state statutes include a *key element in defining pyramid schemes* – the payment of money by the company in return for the right to recruit other participants into the scheme. If the *primary emphasis is compensation from recruiting,* rather than from the sale of products to end users, it is considered a pyramid scheme. How such primary emphasis is to be determined has until now been a formidable challenge for investigators.

Why understanding the compensation plan is so important: Psychologists experimenting with both animals and people learned long ago that you get the behavior you reward. Since the compensation plan specifies how participants are rewarded, it reveals whether the primary emphasis is on recruiting or on retailing – and therefore, whether or not a given MLM is a disguised pyramid scheme. (For terms used in describing MLM compensation plans, see Appendix B.)

MLM companies maneuver to divert authorities from examining how participants are rewarded. They speak of the validity of a company’s products, the integrity of its leaders, and the company’s solid financial condition. *It seems that the one thing MLM leaders do not want regulators to understand – the compensation plan – is the one thing investigators must grasp in order to answer the question of where the emphasis is* – on company payout resulting primarily from recruiting, or primarily from retailing to consumers outside of the MLM network of participants.

The problem of evaluating MLM compensation plans is further complicated by an endless array of complex MLM payout formulas**.** The problem of identifying emphasis on recruiting vs. retailing in a compensation plan, as well as consumer harm, can be greatly simplified by understanding the five characteristics discussed below – all of which are generic to exploitive product-based pyramid schemes.

What is the difference between recruiting MLM’s and (hypothetical) retail MLM’s?

Companies with all five of the following characteristics of a product-based pyramid scheme can be classified as *recruiting MLM’s,* as differentiated from the hypothetical *retail MLM’s,* which would primarily reward those who retail products. Recruiting MLM’s are essentially closed systems, which sell products at retail primarily to program participants and cooperating family members – seldom to the general public.

These product purchases could be considered disguised or laundered investments in a product-based pyramid scheme. Participants at the top (and the MLM company) are rewarded at the expense of a multitude of unwitting recruits.

How these defining characteristics were derived: Over ten years of research led to this edition of this paper, including a one-year experiential test, direct observations of numerous MLM opportunity meetings, interviews with hundreds of participants from a variety of MLM’s and with consumers as MLM prospects, consultations with top experts in the field, collection/processing of available data (including official company reports), analysis of all types of compensation plans, and surveys of tax professionals and ex-MLM distributors. MLM programs were compared with features of legitimate business models to which MLM is often compared, such as direct sales, franchises, distributorships, insurance agencies, etc.

The author was able to identify a list of characteristics that are common to MLM's. These were then compared to characteristics of no-product pyramid schemes – as well as to legitimate direct sales programs to which MLM is often compared. From this comparative analysis, a trained eye can see that when one focuses on the causes of the problems with more highly leveraged MLM's, which are compensation plans with perverse reward features (enriching a few at the top at the expense of a huge downline who lose money), certain characteristics, or "red flags," become obvious.

A detailed breakdown of the author's comparative analysis is found in the report entitled: "Comparative Analysis of Legitimate Distribution Models with No-Product Pyramid Schemes and Recruiting MLM's, or Product-based Pyramid Schemes."[7]

The five characteristics, or red flags, of product-based pyramid schemes, or recruiting MLM's, are causal, defining, and legally significant

The Five Red Flags. The set of five characteristics below – or red flags to watch for – were found to be exclusive to recruiting MLM's (which are almost all MLM's today). Based on careful analysis of available data, *MLM programs with these characteristics have a shocking loss rate – approximately 99.9% of participants lose money! – not a legitimate business by any reasonable measure.* In the light of these odds, typical promises made by MLM promoters of lucrative incomes are misleading, except for a few at the top of the pyramid who got in early.

Again, it is important to recognize that —

(1) These 5 characteristics are *causal* because they identify the cause of the harm or consumer losses.

(2) They are *defining* because they clearly separate what I call "recruiting MLM's" or product-based pyramid schemes from all other forms of commercial activity.

(3) And they are *legally significant* because they answer the question that law enforcement has not consistently answered in cases before; i.e., how the *primary emphasis on income from recruiting* (as opposed to selling direct to consumers at retail prices) can be determined from the reward system (compensation plan) – rather than from complaints, which simply are too unreliable in this field of activity.

It is the synergistic effects of these five features working together in an MLM that cause the extraordinary loss rates characteristic of these schemes. One should be wary of any MLM program that has even four out of five in their compensation and marketing plan.

It is interesting to note that most of the laws against MLM's as pyramid schemes are based on one of the *effects* (whether or not sales are made to end users, not just participants) and not the essential *causes* of the problems[2 (op cit)]. No wonder law enforcement has been so confused and inconsistent in this arena. Even so, using this analysis, law enforcement agencies can (and must) work within existing laws. Attempting to change the laws is risky, since the MLM lobby (Direct Selling Association) could then influence legislators to pass anti-pyramid laws favorable to MLM, as they have done in several states.

THE FIVE RED FLAGS of product-based pyramid schemes, or recruiting MLM's:

1. Each person recruited is empowered and given incentives to recruit other participants, who are empowered and motivated to recruit still other participants, etc. – in an endless chain of empowered and motivated recruiters recruiting recruiters – without regard to (de facto) market saturation.

When analyzing a program, ask: Is unlimited recruiting allowed, and are those who are recruited empowered and spurred on by incentives (such as

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overrides from downline purchases, advancement, etc.) to recruit additional participants, etc. – so that the effect is unlimited recruiting of empowered and motivated recruiters in an endless chain?

All pyramid schemes, chain letters, and MLM programs have this multi-level chaining characteristic in common. Had all forms of endless chain marketing schemes been declared illegal (as happened in Wisconsin in 1970 – but unfortunately was not enforced [8]), this confusion over definitions would be minimal. Aggregate losses likely totaling over $100 billion by tens of millions of unwitting victims would have been prevented. MLM in its present form would not have existed, and you would not be reading this paper.

The ill-fated Amway decision. In 1979 the FTC ruled that Amway was not a pyramid scheme, subject to "retail rules" – (1) distributors were to sell 70% of the products they purchased each month to non-distributors, (2) they must be able to prove a sale to each of ten customers each month, and (3) reasonable buy-back provisions be permitted. [93 F.T.C. 618, 716-17 (1979)]. These retail rules have been used as a benchmark in other MLM cases.

In practice, however, the first two of these rules are unenforceable and are generally ignored by MLM companies. Consumers recruited into MLM's worldwide will continue to pay heavy prices for that decision – unless federal and state enforcement agencies more rigorously apply existing laws as suggested in this paper. In spite of the confusion over definitions of what constitutes a pyramid scheme, much can still be accomplished within the present legal framework. This paper focuses on clarifying those definitions and on identifying the combination of features in the compensation plan that cause the greatest harm.

Is saturation inevitable? In 1979, Amway successfully argued to the federal judge that total market saturation, theoretically associated with a pyramid scheme, had never happened and was not possible[9] However, to a person experienced in market realities, this argument is absurd. Why, for example, would a town of 1,000 people need 1,000 distributors? Ten people (1%) may be more than enough to serve the market.

With unlimited recruiting, new recruits find it increasingly difficult to recruit more participants into the program. This could be termed *de facto saturation*, which is often reached very quickly.

So while total saturation is never reached, when enough people are brought into the scheme that prospects perceive little remaining opportunity to sell or recruit, *perceived* or *de facto market saturation* has taken place. De facto saturation would lead to collapse of the scheme, except that promoters typically expand to other geographical areas or set up new product divisions to survive and grow.

Why MLM's explosive growth? The recruitment feature of an MLM or product-based pyramid scheme is what accounts for its explosive growth – until it collapses or is shut down by authorities. Unlike chain letters or Internet report chains, very intensive person-to-person recruiting drives recruiting MLM's, with each new recruit under pressure to recruit numerous others to recover his/her costs of participation – let alone profit. Recruiting MLM's are like a fast-growing cancer.

Thus, each person brought into the program has a personal stake in advancing the scheme so that he or she may profit from an expanding downline. New recruits are taught to "be a product of the products" and to set the example of model recruiting and purchasing in suggested amounts so that others will duplicate their recruiting efforts and purchases, carrying them to success on the backs of downline participants.

Since the upline's income is dependent on the recruiting success of downline participants, the upline is motivated to encourage their recruiting success. Also, new recruits expect help with their recruiting in order to qualify for commissions and advancement in the scheme. At the same time, upline promoters may apply pressure on their downline to increase their own gains. This pressure from above and below can (at least initially) create explosive growth in recruitment and purchases by participants and sympathetic family members.

Are they buyers or sellers? Unlimited recruiting in MLM's also changes the marketing nature of the system from one of a network of "distributors" to a network of buyers. Any clear distinction between buyers and sellers evaporates. The sellers are the buyers, and the buyers are the sellers – to themselves and their families. Also, we see the fallacy of the claim of MLM promoters that they are removing the "middle man" in their marketing system. Actually, in an MLM, middlemen may be multiplied hundreds or thousands of times.

New MLM recruits buy products mainly to qualify for profits from recruiting others, rather than from any real need for the products or from any expectation of profit from retailing. And as people

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tire of being solicited, the perceived opportunity to find willing buyers eventually diminishes to a trickle. Since the retail market is a phantom one, in order to increase the base of recruiting prospects who will pay retail to "play the game," promoters must introduce new product divisions or open up new markets to recruit in other areas.

Recruiting MLM's become Ponzi schemes. When MLM promoters expand into other areas to make it possible for earlier investing participants to be paid off from newer investors, the MLM can be said to have evolved from a pyramid scheme into a Ponzi scheme – which is illegal in almost all jurisdictions**.** Ponzi schemes are programs in which new investors are repaid, not from the sales of products or fulfillment of services, but from the investments of new investors. Ultimate collapse is inevitable as new markets become less accessible, or when perceived saturation makes future prospects resistant to participation.

Some MLM proponents argue that continual dropouts justify replacement through ongoing recruitment, much as in other direct sales businesses. But this is a fallacy. Later recruits never have the same opportunity as earlier entrants due to facto saturation.

The more resourceful MLM's prevent market collapse by opening new markets in other states or countries and/or by starting new product divisions and repeating the cycle all over again. This is what Amway has done with Quixtar. Nu Skin has cycled through numerous countries and several product divisions, including Nu Skin, IDN, Big Planet, Pharmanex, and Photomax.

Why is recruiting emphasized over retailing? Unlimited recruiting of recruiters, combined with the other factors explained here, creates enormous leverage. Rewards for recruiting a large downline are so much greater than for retailing products that participants see no point in spending time and effort retailing, except for token sales (often fake sales to cooperating relatives) to satisfy "retail rules." Again, "you get the behavior you reward." The "primary emphasis on income from recruiting" test of a pyramid scheme is thus satisfied.

Not only are participants promised huge rewards for recruiting large downlines, but also the compensation plan penalizes them for not doing so. Participants might even be taunted for "leaving money on the table." The pay plan serves as a constant reminder that their income could be multiplied many times over by increasing the body count of recruits and by achieving volume triggers to move up through the various payout levels.

Does unlimited recruiting doom participants to failure? It is not the recruiting per se that creates the problems, as recruiting is essential in many businesses (e.g., sales and executive recruitment). But unlimited recruiting of participating recruiters, each of whom is empowered and given incentives to recruit other recruiters, who are empowered to recruit still other recruiters, etc., in an endless chain, inevitably dooms the majority of participants to failure and loss. This is not true of insurance agencies, direct sales, and other legitimate businesses – even recruiting businesses**.**

Any endless chain marketing scheme is an infinite recruiting program in a finite population of prospects – predetermined to failure and loss of investments, with the exception of a few at the top (or who got in at the beginning) of a pyramid of participants. Therefore, *making promises of rewards comparable to earlier entrants is misleading and becomes a primary device for defrauding recruits.*

Like territorial franchises, MLM companies could conceivably limit recruiting in a given area. But limiting the number of participants is uncharacteristic of MLM because it would dampen the illusion of the potential for huge incomes for new recruits. Such limitations would render any pyramid scheme impotent.

2. Advancement in a hierarchy of multiple levels of "distributors" is achieved by recruitment, rather than by appointment.

Ask: Does a participating "distributor" advance one's position (and potential income) in a hierarchy of multiple levels of participants by recruiting other "distributors" under him/her, who in turn advance by recruiting distributors under them, etc.?

In MLM programs, the position in the hierarchy is determined by time of entrance into the program and by success at recruiting, rather than by appointment. When consumers are recruited into such a program and then given incentives to buy products, they are being "leveraged" for the profit of those above them. They may think they are advancing, when in fact they are often being manipulated into buying more products and recruiting more people to benefit those above them.

Are MLM "distributors" really distributors? When the pay plan rewards recruits more for recruiting others than for retailing products or services, and when sales are "incentivized," or tied more to advancement in the scheme than to sales of products, it is a misnomer to refer to them as "distributors." This is why in this paper the term is often placed in quotation marks. It is more correct to refer to them as "investing participants." Correctly viewed, an accumulation of such incentivized purchases over a period of time constitutes a substantial investment in a pyramid scheme. (See #3 below)

For most MLM programs, it has become evident on close examination that *both advancement and income are dependent primarily on downline recruiting.* However, if participants must recruit to be successful, or if the pay plan's primary rewards are for building a downline, it should be considered a recruiting MLM, and hence an illegal pyramid scheme.

3. "Pay to play" requirements are met by ongoing "incentivized purchases," with participants the primary buyers.

Ask: Are "distributors" who are recruited presented with significant "pay to play" options; i.e., are they encouraged to make initial or ongoing investments in "incentivized purchases" in order to take advantage of the "business opportunity," and to continue qualifying for advancement in – or overrides and bonuses from – the MLM company?

What are "incentivized purchases?" (or "pay-to play purchases"? I coined the term "incentivized purchases" to refer to the practice of tying purchases of products from an MLM company with requirements to enter the "business opportunity" option and to advance in the hierarchy of "distributors" – who are in effect merely participants making pyramid scheme investments disguised (or laundered) as purchases. They could also be called "pay to play" purchases. (See "Definitions of Other Relevant Terms" in Appendix C.)

How much is actually invested in the scheme? MLM companies typically charge a nominal fee to be licensed as a distributor. This is usually less than $100 to avoid raising the eyebrows of enforcement officials – and to escape subjecting the MLM program to more strict guidelines as a security or "business opportunity." However, it is typical that initial registration or license fees are merely the beginning of the total investment for MLM participation. One must add incentivized ongoing purchases, which may total thousands of dollars a year. They constitute a substantial portion of the cost of participating in the "business opportunity." Whether they are used, sold, given away, or stored is irrelevant.

Escalating incentives to continue purchasing products to qualify for ever-higher levels in the hierarchy of participants often leads "distributors" to hyper-consume products or to give away a lot of samples. Many fill their garages with products they don't need. The argument that participants would have purchased the products from another source anyway, and that these purchases should not be considered an expense of doing business, simply does not hold water.

So when participants are expected to make product investments to get into a program – and then to continue purchasing products, services, training, etc. (often by subscription), in order to progress in the organization, *they are paying pyramid investment fees to "play the game," one of the earmarks of a product-based pyramid scheme.*

If participants subtracted the operating costs of recruiting and the cost of purchases from payments received from the MLM company, they would find the breakeven bar severely raised and rarely exceeded by revenues. In other words, almost all participants below those at the top of the pyramid lose money.

Why are incentivized MLM product purchases not recognized as pyramid investments? Some MLM compensation plans offer escalating incentives for recruiting an increasing number of "distributors," so many participants recruit "dummy distributors" from friends and relatives and buy products in their names. They come to believe this will qualify them for "the really big bucks." Few among them realize that they – and their dummy distributors – have in effect paid a very large fee for participation in a pyramid scheme. Through a variety of misrepresentations about the "opportunity,"

Why does more than five levels signal a recruiting MLM? There is seldom any functional justification for six or more levels in an MLM hierarchy of "distributors," other than to encourage recruiting and the illusion of very large potential incomes to more participants than is mathematically possible – a hallmark of many pyramid schemes. When combined with the other factors herein, this feature hugely enriches those participants at the top of the pyramid at the expense of those beneath them. Such exorbitant incomes result from the reaping of huge overrides from the combined product investments of as many as thousands of downline participants, which increase exponentially with each added level. (See Table 1.) This could be considered "unjust enrichment" – certainly an unfair trade practice.

This characteristic of excessive payout levels is a key feature separating recruiting MLM's from no-product pyramid schemes. The latter typically pay on only four or five levels before the person atop the pyramid collects and moves on to start a new pyramid. It also helps explain why the loss rate for recruiting MLM's is much higher than for classic, no-product pyramid schemes.

How does extreme leverage result from excessive payout levels? MLM promoters refer to such residuals as "leverage" – large company payouts, disproportionate to effort expended, to top-level participants. The effects of leverage can be illustrated in a downline of six levels of participants. For example, assume that a "distributor" recruits five "active distributors," each of whom recruits five more, and so on through six levels of distributors. The pyramid grows exponentially as shown below:

Level 1: 5 distributors
x $5 in commissions & bonuses = $25/month
Level 2: (5x5=) 25 + 5 = 30 total distributors
x $5 " " " " = $150/month
Level 3: (25x5=) 125 + 30 = 155 total distributors
x $5 " " " " = $775/month
Level 4: (125x5=) 625 + 155 = 780 total distributors
x$5 " " " " = $3,900/month
Level 5: (625x5=) 3,125 + 780 = 3,905 total distributors
x $5 " " " " = $19,525/month
Level 6: (3,905x5=) 15,625 + 3,905 = 19,530 total distributors x 5 " " " " = $97,650/month!

If each "distributor" were to buy enough products each month to yield an override of $5 in commissions and bonuses to the original upline distributor, then with a five-level downline, the upline distributor gets $19,525 per month, while with a six-level downline the same distributor can get $97,650 per month – five times as much as for five levels. The incentive to recruit to get to the sixth level becomes enormous. Of course, it seldom works out that way, but these are the type of figures that are often presented to prospective new recruits at MLM opportunity meetings.

This illustrates why recruiting is emphasized, as opposed to selling products to persons outside the pyramid. An income of $97,650 is much more appealing to a Level 1 participant than $100 that might be earned by selling the products at the full retail price (assuming $20 markup on products sold to each of five customers).

Compared to recruiting, selling products at full retail price becomes a waste of time in such a system. The incentive to recruit to move up a level becomes very great. Again, one can see that the legal requirement of "primary emphasis" on income from recruiting fees (in the form of downline purchases) is satisfied.

Exploitive breakaway compensation plans– legal or not? One category of compensation plans, the "breakaway" deserves mention, as it is so highly leveraged that the losses of participants are staggering.

In a breakaway system, the levels in the hierarchy are made up, not of individual participants, but of "breakaway organizations" (or pyramids) – groups of participants who have met requirements to "break away," allowing a small commission override from all participants in the breakaway unit. So in a breakaway system, a hierarchy of six levels is actually six levels of *groups* of participants, which makes it a constellation of pyramids within a giant mega-pyramid – with most of the payout going to top participants.

The extreme loss rate results from each profitable top-level "distributor" being supported by a downline of many groups of participants (often totaling thousands), almost all of them victims who lose money – after subtracting purchases and other expenses. MLM's with breakaway compensation plans – though common – are the most extreme and exploitive type of pyramid scheme and therefore should be illegal.

Table 2: Generic Misrepresentations Engaged in by Recruiting MLM's, continued

Saturation never happens. Turnover, as in any business, is a reality that assures an ample supply of available prospects.	With few real customers, MLM products are sold by recruiting a revolving door of new "distributors" who buy products to "do the business." And since people perceive the opportunity as dwindling with each new "distributor," market saturation requires promoters to recruit elsewhere. So MLM's quickly evolve into Ponzi schemes, requiring the opening of new markets and/or new product divisions to repay earlier investors, as has happened with Amway (now Quixtar) and Nu Skin (which became IDN, then Big Planet and Pharmanex). It's not turnover, but continuous churning of new recruits to replace dropouts.
Take advantage of "momentum" and "windows of opportunity."	In any endless chain scheme, the momentum cannot continue indefinitely, leaving those who come in later in a loss position, which is at least 99% of recruits. Only by lying about this fact can recruiting be successful.
In this new (MLM) program, you can be the master of your destiny.	You will be a slave to the phone, to meeting the qualifications for commissions and bonuses, and to continual pressure to recruit new participants to replace those who drop out.
The demand for these MLM products are growing at a rapid rate. "They literally sell themselves."	The sale of products is distributor-driven, not market driven. Most products are sold to new participants to get in on this "ground floor opportunity."
Unlike franchises, business startups, or sales of existing businesses, you can start an MLM business with very little capital.	MLM's typically bleed new recruits of their funds by inducing them to buy products on a subscription basis, to pay for ongoing training, and otherwise draining them of their resources until they run out of money or give up.
The report of "Actual Income" of distributors states " .16% of active distributors have achieved the level of Blue Diamond," etc. This appears to be respectable odds of success. *(See "How to Lie with Statistics")*	When statistics are presented without deception, the "opportunity" is not so attractive. The ".16" should be preceded by a "0" (0.16% – or odds of 0.0016), and ALL who signed up should be factored in. So with 10% remaining after 5 or 10 years, the number should be reduced by 90%. This leaves odds of 0.00016 of becoming a "Blue Diamond." This looks far worse that ".16%"
Fear of loss (of potential income by not recruiting aggressively) is a great motivator.	If MLM participants understood what is happening to them, they would fear accumulating further losses by continuing to invest in the MLM.
You will belong to a great support team. In MLM, you have a whole network of people willing to help you succeed and be your friends.	Some MLM's operate like a cult with an "us vs. them" mentality. Watch how quickly the team ostracizes you when you quit or discover contrary information about the legitimacy of the program.
You will be offering people you care about the very best products available for promoting their health and well being.	No matter how high the quality of the products, investment in products for which you do not have orders in hand becomes a cleverly disguised means of laundering investments in a product-based pyramid scheme.
Our products are unique and consumable – perfect for repeat business.	MLM products are typically "potions and lotions." The secret formulas are a cover for the fact that they are priced too high to compete in standard markets.
Products are less expensive through MLM because you cut out the middleman.	MLM creates thousands of middlemen, with few real customers outside a bloated network of "distributors." And typically, they are not inexpensive.
Build your business by duplication. Buy five of these "business in a box" packages now, sell them to five people, and ask each to do the same, etc. Be a "product of the products" by signing up for monthly shipment of these items. Soon you will be reaping huge commission checks.	This is how recruiting MLM's earn fortunes for their top recruiters. Commissions from initial and ongoing purchases by new "distributors" (in hopes of profiting) is the life blood of their business. The promised rewards never come, except to those who recruit their way to the top of a pyramid of participants. Take away inducements for participant purchases, and these companies would fall like a house of cards.
Our "tools for success" are unbeatable. Sign up for our seminars and conferences, and buy our books and tapes to assure your success in this business.	In at least one major MLM, the "tools business" is a pyramid within a pyramid. Hardly anyone makes money selling products, so a lucrative source of income for those at the top is the sale of "success tools" to supposedly assure the success of their downline – who are in fact only further victimized when they buy these motivational items.
MLM is like insurance, investing, inventing, acting, and writing in that hard work at the outset yields residual income for the rest of your life. This is done be "leveraging" the efforts of your downline. So you can retire early, travel, etc.	MLM is more like gambling than legitimate residual income. It appeals to the "something for nothing" mentality. MLM addiction has been observed in some "true believers." The large residual incomes reported are more the result of time of entry and willingness to deceive prospective recruits than of payoff for hard work. To succeed in MLM, one must leverage one's deceptive recruiting through others who can be persuaded to do the same..
Very reputable people are involved in MLM.	This credibility argument has been the underpinning of many scams.
You will be helping your friends and family by recruiting them into your downline.	You are exploiting those you care about the most. In other words you are squandering your social capital.

The 8 R's of MLM durability – resulting in greater damage than no-product schemes:

(1) ***Rewards.*** The profitability for the MLM company and the payout to top distributors is so great that they will routinely misrepresent and will go to great lengths to keep the scheme going, including finding new divisions or areas in which to continue recruiting after a given area is saturated.

(2**)** ***Ruse****.* MLM's have been enormously successful in positioning themselves as direct sales programs that are exempt from laws against pyramid schemes. Even many regulators, the Better Business Bureau, educators, and writers will be quick to condemn a no-product pyramid scheme, but will exonerate a far more extreme and exploitive product-based pyramid scheme (MLM).

As this paper demonstrates, *a recruiting MLM company is actually an institutionalized pyramid scheme.* Recruits in the hierarchy of "distributors become unwitting agents in collecting pyramid investments (in the form of "incentivized purchases) that fund the company and enrich top "distributors."
Another ruse is the idea touted by MLM promoters that their program "gets around the middleman." In fact, the MLM guarantees that their program will create a whole network of middlemen to be paid off.

(3) ***Repeated investments*** ("pay to play"). Although the cost of signing up as an MLM distributor is usually less than $100, the cumulative investment, in strongly incentivized purchases to "stay in the game," may amount to hundreds or even thousands of dollars over several months. Products are often sold on a subscription basis by automatic bank withdrawal to maintain cash flow and upline residuals. Often purchases are far beyond the needs of the buyers and are stockpiled or given away. Usually such purchases are discontinued when the person withdraws from the scheme.

(4) ***Recruitment of revolving door of replacements.*** MLM's are conducted as "body shops." Those who drop out on the bottom levels are constantly being replaced with new recruits who believe the promises of wealth and time freedom – or a little additional income for persons who are struggling to make ends meet (which almost always sets them further behind financially).

(5) ***Re-pyramiding***. When MLM company officers see that the "pyramid" is about to collapse, they start a new division, introduce new products, or enter a new region, all within the same corporate umbrella. This makes possible a whole new "ground floor opportunity" to participate in the "hyper growth" of the company, or to "ride the wave of opportunity." This Ponzi-like behavior is what Amway, Nu Skin, and other long-lasting MLM companies have done.

(6) ***Rationalization and self-blame.*** Self-deception is common in MLM's, making it the perfect con game. The very people who are being victimized are often its most ardent promoters – until they run out of resources and quit. They seldom complain to regulators, having been taught that any failure is their fault for not having tried hard enough, rather than the fault of the MLM. They may also fear retaliation from or to their upline or downline, which may include close friends or relatives.

(7) ***Retail "rules."*** The trick for a recruiting MLM to evade regulatory scrutiny is to create the illusion that retailing is being done by establishing "rules" for minimum retailing with which distributors must comply – which are satisfied cosmetically so as not to arouse the attention of regulators. Compliance with these rules is not independently audited, nor are they reinforced by corresponding incentives in the compensation plan. MLM rule-making is ineffective without correcting problems in the compensation plan itself.

(8) ***Recognition.*** The MLM company may go to great lengths to enhance its legitimacy and its credibility. They may donate heavily to influential politicians and parties, to the Olympics, and to worthy, highly visible causes. Their support for these causes is given top billing at opportunity meetings and often given recognition by an unwitting press. Celebrities are hired to speak at MLM conventions. Top MLM officials and founders have been honored by university and civic groups.

MLM companies as investments

Several MLM companies have gone public and their stocks are publicly traded. When a stock analyst flew from New York to find out from me why the stock of an MLM company was rising dramatically, I showed him much of the information contained in this report. He was appalled at what he learned about MLM generally. This is a business that has no real customer base and that is totally dependent on a network of hundreds of thousands of distributors – over 99% of whom lose money! That's not a business, he remarked – it's a scam! Needless to say, he did not recommend the stock to his clients – except to possibly short the stock!

The FTC has described the essential features of an illegal pyramid scheme as follows:

> Such schemes are characterized by the payment by participants of money to the company in return for which they receive (1) the right to sell a product and (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of the product to ultimate users. . . As is apparent, the presence of this second element, recruitment with rewards unrelated to product sales, is nothing more than an elaborate chain letter device in which individuals who pay a valuable consideration with the expectation of recouping it to some degree via recruitment are bound to be disappointed.[33]

It appears that pyramid schemes are considered illegal when legitimate products are subordinated to the emphasis on sales rights and overrides from recruiting a network of participants, quite unrelated to sales of products themselves. Such programs lead to inflated and unrealistic promises and inevitable market saturation. So pyramid schemes allow a few opportunists to take advantage of the ignorance and vulnerability of an unwitting populace – who fail to see that mathematically only a few can succeed at the expense of failure and losses of the masses recruited into any given program.

But there is a pseudo-business model that is at least as pyramidal and powerful as any illegal pyramid scheme – and in my opinion more pernicious because of its more pervasive effects. It is a phenomenon that has for the most part escaped recognition as a pyramid scheme because legitimate products are offered and the money required for entry into the system is nominal, usually less than $100 for a kit of sales materials and samples. Yet it costs consumers billions of dollars every year[34] – dwarfing no-product pyramid schemes to a mere speck in comparison. The business phenomenon of which I speak is multi-level marketing (MLM), more recently referred to as network marketing (NWM). In the pages that follow, I will introduce new terminology that is perhaps more descriptive – "product-based pyramid schemes," or "recruiting MLM's (MLM companies that reward recruitment more than legitimate sales of products and services)."

One problem with using a generic term exclusively is that new schemes are being generated by the hundreds, many claiming to have solved the problems of MLM's. "Network marketing," for example, was a term coined to get around the onerous sound of "multi-level" marketing - which almost implied a pyramid scheme. Some companies use other designations to appear "different" so that they can say they are not MLM. But for now I will use the generally accepted "MLM" acronym for all these chain selling programs.

According to an FTC release on May 23, 1979, Amway - one of the earliest MLM companies - was ordered by the FTC "to stop fixing retail and wholesale prices and misrepresenting the profitability of Amway distributorships." Since that time Amway Corporation (as a company) has been more careful about making inflated promises to prospects. However, on a far more important issue, Amway and – by extension - an emerging industry triumphed. The complaint that Amway's sales plan was an illegal pyramid scheme was dismissed by the Commission - a major coup for Amway and for all MLM companies that followed.

It is this latter point that has given credence to MLM and led to enormous growth in an industry that in the past decade has cost consumers tens of billions of dollars and left tens of millions of participants holding the bag of broken promises—and in many cases—bro ken lives.

Consumers are often provided with misleading information (regarding what differentiates a pyramid scheme from an MLM) from government agencies and from the Better Business Bureau. Sources favorable to MLM, such as the Direct Selling Association (using the "Direct Selling Education Foundation" as a front), MLM industry sources (such as *Upline*), and business and "opportunity" publications (such as *Success* magazine) expand upon and perpetuate these misconceptions.

In this report, I introduce new terminology that is more descriptive and more precise in its features (the "5 Red Flags"). The terms are "product-based pyramid schemes," or "recruiting MLM's" – signifying companies that reward recruitment more than legitimate sales of products and services.

For more information on this fascinating history, read the treatise by Robert Fitzpatrick, President of Pyramid Scheme Alert, titled "Pyramid Nation – The Growth, Acceptance, and Legalization of Pyramid Schemes in America."[35] Early historical background on Ponzi schemes can be found in the book *Ponzi Schemes, Invaders from Mars, & More Extraordinary Popular Delusions and the Madness of Crowds,* by Joseph Bulgatz.[10 (op cit)]

Appendix B

Explanations of compensation plans

MLM promoters frequently argue that while they know of problems in their industry, they have solved the problems with their new brand of MLM compensation plan, which is supposedly more fair, honest, generous, etc., than all the others.

Why are compensation plans so important to MLM promoters? Because they are at the heart of what MLM is about. As one promoter admitted in a meeting I attended, "Our compensation plan IS our product."

Here are the basic MLM compensation plans:

Unilevel – There is no limit to the number of distributors that can be recruited on the first level (who "retail" products to end users). However, there is usually a limit on the number of levels deep that can qualify for commissions or overrides. It could be considered a "flat pyramid" and is probably the most fair of the compensation plans – though few would get rich.

Binary – Binary plans promote recruiting in a downline of two legs of distributors (left and right "profit centers"), with incentives to maintain matching sales volume between the two legs. Commissions are paid only on matching volume, and this can sharply limit company payout. Seldom are high volume producers matched in the same leg of the downline. Binary plans could be considered "split pyramids."

Matrix – A limit is placed on the number of distributors in the first level and on the number of levels deep. Additional recruits "spill over" into the next level. Growth is limited (for example, 4x12=48 total downline). Can be played like a lottery – lazy participants can win. Matrix plans could be viewed as a "block pyramids."

Stair step/breakaway – A "distributor" ascends a staircase of groups of participants with escalating incentives to recruit more people to profit from more and more "pay to play" purchases. Commissions from one's personal group are replaced with overrides for volume of qualifying breakaway groups ("organizations") of "distributors." Extremely high leverage rewards hugely those at the top at the expense of a multitude of downline distributors who invest in "pay to play" purchases – their loss, but their upline's gain.

Each breakaway is a separate organization tied to one person who draws overrides from the entire breakaway organization, which may be one of many. It is important to recognize that six levels in a breakaway is not six levels of distributors, but of whole breakaway organizations of people. Though breakaway plans are found in some of the most popular MLM's, those who understand breakaway plans agree that they are the most exploitive and extreme of all the pyramid schemes ever devised – and therefore have the greatest leverage and the highest loss rates. The author characterizes breakaways as "mega-pyramids" comprised of many nested "poly-pyramids."

Though these are the basic compensation plans that have been used by MLM companies in the past, it should be noted that new forms of compensation are being developed by a never-ending supply of MLM schemers. These include a trinary plan, modifications of matrix and binary plans, and creative combinations of the above. However, the five red flags discussed in this paper can be applied to all multi-level compensation plans.

Appendix D: Does MLM (Multi-level or Network Marketing) Qualify as a Form of Direct Selling? — a 7-Point Checklist

Much confusion exists on whether or not multi-level marketing (MLM) can qualify as direct selling. Since the MLM industry has much to gain by being classed as direct selling, MLM promoters and the industry's lobbying arm, the Direct Selling Association, work hard to convince legislators, regulators, and the public that they are direct selling companies. Since few officials have much experience in direct sales, they are often misled on this key point.

Based on several years of experience, observation and research related to both direct sales and MLM, I can safely conclude that **the typical MLM business model constitutes what I call a "product-based pyramid scheme" and NOT a form of legitimate direct selling.** They should be considered "recruiting MLM's"; i.e., MLM's that require aggressive recruiting of a large downline to earn a significant income. However, it is true that selling – mostly in the form of recruiting – is involved in building an MLM downline.

Based on this analysis, below is a comparison of two marketing models – direct sales, as represented by traditional Avon sales persons (or any non-MLM direct sales company, including life insurance) – with prominent MLM programs, such as Amway and Nu Skin.

CONCLUSION: The typical MLM company is no more a direct sales company than a pig is a horse. **For MLM companies with highly leveraged compensation systems (rewarding top distributors at the expense of a large downline of recruits who invest in products to "play the game" – almost all of whom lose money), its participants are primarily recruiting to build downlines, not to sell products directly to end users.**

When was the last time you were approached by an Amway or Nu Skin "distributor" to buy products without some mention of the "business opportunity"? With millions of "distributors" recruited over the last twenty years, **if they were primarily selling direct to customers, you would expect by now to have been inundated with requests to buy products from them – without being asked to join up. No, the sellers are the buyers, and the buyers are the sellers** – generally to themselves and their immediate families.

CARACTERISTICS OF LEGITIMATE DIRECT SALES COMPANIES	**DIRECT SALES** (Avon, etc. – also life & health insurance)	**RECRUITING MLM's** (that reward participants for recruiting large downlines – Melaleuca, Nu Skin, USANA, Amway/Quixtar, Nikken, etc.)
1. The number of agents/sales persons recruited for a given area is somewhat limited to prevent market saturation and resulting dissatisfaction of existing sales persons or agents.	**YES**	**NO** – MLM's use an endless chain of recruiters recruiting still more recruiters, ad infinitum. And each participant must recruit others to make his/her investment profitable.
2. Advancement to various levels of sales management is by appointment.	**YES**	**NO** – Advancement in the sales hierarchy is achieved by recruiting a downline.
3. Little or no purchases are required to begin and to continue selling the program profitably. The company, rather than the sales person, assumes the burden of financing and stocking inventory.	**YES**	**NO** – Sizable initial and ongoing purchases are tied to qualification to get commissions and/or to advance through higher distributor payout levels. Thus, many participants stock up on idle inventory. The burden of inventory cost is thereby transferred from the company to the distributor – who finds that the easiest way to sell the products is to sell the "opportunity." Most actual buyers are recruits.
4. A maximum of four levels of sales managers is sufficient– for example: branch manager, district manager, regional manager, national sales manager	**YES**	**NO** – An MLM downline may include 6, 8, 10, or even an infinite number of levels of distributors.
5. Commissions <u>per sale</u> paid by the company to the person selling products and services to end users are typically greater than the total override commissions for ALL those above him/her in sales management.	**YES**	**NO** – A distributor several levels above the person selling the product may get about as much commission <u>per sale</u> from the company as the person doing the selling – or the person who recruited him/her. And reselling at a profit products bought at already high wholesale prices is unrealistic.
6. The primary focus in compensation systems, at sales meetings, and in actual effort by sales persons is on selling products and services to legitimate customers, or "end users."	**YES**	**NO** – The primary focus is on recruiting more MLM participants, so persons are seldom approached to buy the products without considering the "business opportunity." Top-level recruiters are often held up as examples for their huge pay checks.
7. Sales persons can make a reasonable income (in commissions and bonuses) from selling the products or services – without recruiting a downline.	**YES**	**NO** – Commissions paid by the company for direct sales pale in comparison with potential rewards for recruiting a downline. In recruiting MLM's, it is rare for participants (except for those at the top of the pyramid), to report profits on their tax returns.

I attended training and opportunity meetings, worked hard to train and motivate my recruits, and drove my wife crazy with my single-minded dedication to MLM. But my upline was pleased.

My wife began asking questions after a few months of no income. She did not like the changes that were occurring in me as a person – neglecting the family and seeing everyone as a prospect, even our most treasured friends and family members. Fortunately, as a researcher I had kept detailed notes of my experiences and observations with MLM and was still in an investigative mode.

At the end of a year I was in the top 1% in the hierarchy of distributors and could see my way to the top. That handsome payoff seemed doable. However, I had fallen behind financially, partly because of all the products I had purchased to maintain artificial qualifying standards (quotas) for ever-higher commission and bonus levels, partly because of all the other expenses of running the operation, and also because of my not having any alternative income during that time. Though in the top 1%, I was spending about $1,500 a month and bringing in only $250 a month.

MLM promoters encouraged this dedication, but on seeing my setbacks, my upline changed their tune and told me that I should have kept my other work going. The problem was that I could see from the outset that to be successful, such total dedication was required. Also, I wanted to be in a position to speak from personal experience should I eventually write up my findings about MLM.

I was not alone in coming away empty. Others who joined the program when I did also lost whatever time and money they had invested – including an attorney and persons with solid records of sales and marketing success in other settings.

Another facet of MLM fascinated me even more than the money. I discovered a whole range of ethical conflicts that for me – as a former teacher of ethics and one who considers himself to be an honest person – made MLM an unacceptable way of doing business. Exploiting friends and family for personal gain conflicted with my most basic values. I witnessed MLM participants sacrificing their social capital, contaminating treasured relationships that may have taken a lifetime to build.

I finally concluded that deception and greed are primary elements for success in MLM. In fact, before quitting the program, though I had achieved "executive" status, I could see clearly what I would have to do to earn the $700,000 a year others had achieved. I decided it was simply not worth it. Why? Because I would have to deceive hundreds, even thousands of downline distributors (like I had been deceived), into believing "anyone can do it." It was truly a bogus business opportunity.

Also, I would have to continue to insist that MLM programs were not pyramid schemes (after all, the FTC and the BBB had implied in their information pieces that they were not) – as long as legitimate products and services were sold.

Upon learning of my dissatisfaction, other MLM promoters tried to recruit me into their programs – which were somehow "better." But I felt my time and resources were too valuable to learn everything by experience. My primary interest by this time was in presenting a good overview of the generic problems of MLM's, which led to extensive telephone surveys and other research about the pros and cons of this unique business model. Out of all this research came this and other analytical papers, a book[42], and involvement in a consumer awareness movement focused on problems with chain selling schemes.

Some critics of my analyses see my exposés on MLM resulting from a "sour grapes" attitude after failing at MLM. I respond that (1) I was not a "failure" since I rose to the top 1% of all distributors who had tried this program, and (2) consumers may be fortunate that (unlike millions of others who quit MLM with feelings of failure) I had the determination to tell the truth and to publish what I have learned. I was fulfilling my initial pledge to myself to make public whatever I learned from my research and experiences with MLM.

Others have asked why I focus so much of my energies and resources for a cause for which I will receive little reward. My answer is that when I gain unique insights on an inequity or injustice in society, I feel a moral imperative to share what I know.

I believe that the insights expressed in this paper could not have come about without a varied background in sales, marketing, entrepreneurship, and research – and a careful look from the inside of these organizations as a practicing distributor. Had a capable government investigator with my unique background gone undercover as a MLM distributor for a year or more, he/she would probably have come up with similar conclusions.

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