SALES GONE WILD:
WILL THE FTC'S PROPOSED RULE PUT AN END TO PYRAMID MARKETING SCHEMES?

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"Our company allows average people like you and me to get involved and do above-average things simply by plugging into a proven system. . . . [We have] put together something that is so simple that if you just plug in and follow our great team and our great system, there's no reason why you can't make it."[1]

"Now I know you may know some people that make six figures a year, but this is the kind of six figures where you could take a nap for one year straight – you could hibernate just like a bear and still earn six figures. . . . [I]n corporate America when you're earning six figures, the more you make the more your responsibilities go up . . . whereas in a business like this, you know what, you got six figures a year coming in, you can do whatever you want, it still comes in. . . ."[2]

INTRODUCTION

Americans who have seen "The Music Man"[3] may believe that they easily can spot a Harold Hill; that is, a traveling salesman intent on defrauding people to make his fortune. Yet day after day, many Americans, and others around the world,[4] fall prey to a similar type of

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[1] Web video: BOM – Business Opportunity Meeting, http://acnnv.com/Training.html (last visited Feb. 15, 2007) (videotaped copy on file with author). In this video, Andre Maronian, Senior Vice President, American Communications Network, Inc., ("ACN") attempts to recruit people to become ACN distributors. The quoted excerpt is found at minutes 2:41 through 3:02 of the video.

[2] *Id.* at minutes 9:05 through 9:31 of the video.

[3] MEREDITH WILLSON, THE MUSIC MAN (1957) (in this play, Harold Hill arrives in a small town and collects advance payments of money to help organize a musical band that he does not really plan to organize).

[4] The most renowned recent foreign scam is a 1994 Ponzi scheme, which was known as Caritas, in which approximately three million investors in Albania lost more than one billion dollars. *See* Cabot Christianson, *Bankruptcy Brief: You Can't Cheat an Honest Man: Everything You Want to Know About Ponzi Schemes*, 23 ALASKA B. RAG 23, 23 (1999). This was an astounding 43% of the country's gross domestic product. *Id.*

deception – supposed "opportunities"[5] in which 99.9 percent of investors lose their entire

[5] The terminology used in this article can be confusing because the perpetrators of scams are attempting to disguise what they are doing. In general, a sale of a "business opportunity" is a sale of the right to earn income. *See infra* note 194 and accompanying text. Typically, the seller of the business opportunity at least implies that the purchaser can make a certain amount of money or offers the purchaser assistance with the business after the purchase. *Id.* Many sales of business opportunities are completely legitimate. The term "business opportunity schemes" includes "work at home schemes" and "pyramid marketing schemes." *See infra* Sections I.A.1 and I.A.2. "Work-at-home schemes" are sales of business opportunity, other than pyramid marketing schemes, in which the seller of the opportunity makes false earnings claims or false offers of assistance with the business after purchase. *Id.* The term "pyramid marketing schemes" is used in this article to mean business opportunity sales in which the seller tells purchasers that they will make money both from their own sales and from sales of others they recruit to join the program; however, most of the money used to pay the purchaser is directly traceable to money paid by new recruits rather than from the sale of products or services to consumers. *See* FED. TRADE COMM'N, CONSUMER FRAUD IN THE UNITED STATES: AN FTC SURVEY 14 (2004), *available at* http://www.ftc.gov/reports/ consumerfraud/040805 confraudrpt.pdf (last visited Feb. 14, 2007). Pyramid marketing schemes are not necessarily illegal, which illustrates the need for more comprehensive federal anti-pyramid marketing scheme legislation. Like work-at-home schemes, pyramid marketing schemes often rely on false earnings claims and false offers of assistance to recruit people into the pyramid. The terms "product-based pyramid scheme" and "recruiting MLM" have the same meaning as "pyramid marketing scheme." "Multi-level marketing" ("MLM") is like pyramid marketing schemes in that the purchaser of the business makes money both from his or her own sales of products and from sales made by others he or she recruits into the program; however, the bulk of the money does not *necessarily* come from money paid by new recruits. *See* Peter J. Vander Nat and William W. Keep, "Marketing Fraud: An Approach for Differentiating Multilevel Marketing from Pyramid Schemes," 21 J. PUB. POL. & MARKETING 139 (2002). "Direct selling" is a broad term that applies to a form of selling in which individual sales people market the products that they sell and keep some percentage of the sales price. A direct selling business may or may not be a pyramid marketing scheme. This article is focused on pyramid marketing schemes; that is, companies in which the bulk of the money *(i.e.,* more than 50%) to be made by the purchaser of the business opportunity is derived from money paid by people that that purchaser recruits into the company. This article is not aimed at stopping legitimate direct selling companies; that is companies in which at least half of the money (*i.e.*, 50% or more) to be made by the purchaser is derived from people other than recruits into the company.

investment.[6] In the United States alone, over one and a half million people per year are victims

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[6] *See* Letter from Jon M. Taylor, President, Consumer Awareness Institute, to Federal Trade Commission (June 30, 2006), *available at* http://www.mlmwatch.org/06FTC/business_opportunity/taylor.html (last visited Feb. 15, 2007) ("[W]herever I could get the earnings reports of participants in [pyramid marketing schemes] . . . , *approximately 99.9% of ALL participants (including dropouts) lost money, after subtracting ALL expenses*. . .). *See also* JON M. TAYLOR, THE 5 RED FLAGS: FIVE CAUSAL AND DEFINING CHARACTERISTICS OF PRODUCT-BASED PYRAMID SCHEMES, OR RECRUITING MLM'S 5, *available at* http://www.mlm-thetruth.com/5RedFlags2column40 pages2Color3-6.pdf (last visited Feb. 15, 2007); ROBERT L. FITZPATRICK, THE MYTH OF "INCOME OPPORTUNITY" IN MULTI-LEVEL MARKETING 3, *available at* http://www.falseprofits.com/MythofMLMIncome.doc.pdf (last visited Feb. 15, 2007). Mr. FitzPatrick's report in particular provides extensive details regarding his methodology. Note that the Direct Selling Association (the "DSA") disputes these claims and, in its comments to the FTC, states the following:

> Although this claim is made repeatedly throughout several comments (each citing the other as corroboration in an echo chamber of misinformation), it remains both unsubstantiated and *unverifiable*. None of the comments making this claim provide any information as to how this percentage was calculated. While at least one commentator provides an anecdotal description of the information he reportedly considered or consulted in making the claim, one will look in vain for precise and verifiable information as to exactly how the purported calculation was made and what numbers were included in it. For example, the comments provide no data regarding the types of salesperson revenues (including profits on retail sales) that went into the purported calculation, the overall amount of those revenues, the types of expenses that were included, the overall amount of those expenses, the number of distributors considered in the calculation, how that number was derived and what it represents, the period covered by the calculation, how that number was derived and what it represents, the period covered by the calculation, or any other numbers critical to the calculation.

Letter from Christine A. Varney, Attorney for the DSA, to the Federal Trade Commission, 3 (Sept. 29, 2006) (emphasis added), *available at* http://www.ftc.gov/os/comments/ businessopprule/rebuttal/522418-13253.pdf (last visited Feb. 15, 2007). Contrary to Ms. Varney's assertions, Mr. FitzPatrick's report is relatively comprehensive when one considers that the very industry that accuses him of not including enough information in his report is the industry with access to that information and it is the industry that is aggressively trying to keep that information hidden. If the industry would allow complete disclosure and transparency, then the actual results could be verified.

of these pyramid marketing schemes.[7] Although little data is available concerning total losses experienced by victims of these schemes, a recent class action settlement against Herbalife[8] revealed an average loss of $7,953 per claimant in connection with the scheme at issue in that case.[9] Furthermore, these schemes consistently rank in the top ten list of fraud complaints received by the Federal Trade Commission (the "FTC") and state consumer protection divisions.[10] Unlike the sale of stock, bonds, and franchises, the sale of these "opportunities" is unregulated and occurs with virtually no government oversight.[11]

Perhaps the most famous deceptive business opportunity scheme in the United States is the one begun by Carlo Ponzi in 1919.[12] Carlo's initial business idea was to take advantage of coupons issued by the International Postal Union that could be traded for postage stamps in

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[7] *See* FED. TRADE COMM'N, *supra* note 5, at 29 (demonstrating that 1.55 million people were victims of pyramid marketing schemes and .45 million people were victims of work-at-home schemes during the last seven months of 2002 and the first five months of 2003). While it is impossible to tell exactly the total number of people who have been hurt and how much money has been lost as a result of these schemes, it is helpful to note that the DSA estimates that there were over 14.1 million direct sellers and over $30.47 billion of direct sales in the United States in 2005 alone. *See infra* notes 26 and 27 and accompanying text.

[8] The lawsuit was brought in the U.S. District Court for the Central District of California as Jacobs v. Herbalife International, Inc., No. CV-02-01431 SJO (D.C.D. Cal. filed Feb. 19, 2002).

[9] *See* Letter from Douglas M. Brooks, Martland & Brooks, LLP, to Federal Trade Commission, 9 (July 16, 2006), *available at* http://www.ftc.gov/os/comments/businessopprule/522418-10570.pdf (last visited Feb. 15, 2007).

[10] *See* Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,058 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437) [hereinafter Proposed Rule].

[11] *See infra* note 103 and accompanying text.

[12] *See* Christianson, *supra* note 4, at 23.

various countries around the world.[13] According to Carlo's calculations, he could take advantage of post-World War I fluctuations in currency rates by trading and redeeming these coupons in different countries to make a profit of up to four hundred percent.[14] Although the basic idea worked in theory, it did not work in practice because the administrative cost of handling a large volume of coupons wiped out any potential profit.[15]

Carlo's real skill lay in convincing others that the idea worked, even though he knew that it did not. Carlo formed the *Security Exchange Company*, and, beginning in December of 1919, he began to tell his family and friends about his business opportunity so that they too could "invest" in it—specifically, he guaranteed them fifty percent interest on their investment in ninety days.[16] He promptly paid the interest, which drew attention to his investment and allowed his initial investors to attract additional investors from around the country.[17] Soon, Carlo was able to guarantee a return of one hundred percent interest in ninety days.[18] As is typical of this type of scheme, he was not paying the interest with any actual earnings from the business; instead, he was using money received from subsequent investors to pay earlier ones.[19] The

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[13] *Id.*

[14] *See* Debra A. Valentine, General Counsel, Fed. Trade Comm'n, "Pyramid Schemes," presented at the International Monetary Fund's Seminar on Current Legal Issues Affecting Central Banks, 4 (May 13, 1998), *available at* http://www.ftc.gov/speeches/other/dvimf16htm (last visited Feb. 15, 2007).

[15] *Id.*

[16] *See* Christianson, *supra* note 4, at 23.

[17] *Id. See also* Valentine, *supra* note 14, at 4.

[18] *See* Christianson, *supra* note 4, at 23.

[19] *Id.* This idea often is called "stealing from Peter to pay Paul." Valentine, *supra* note 14, at 2 ("some law enforcement officers call Ponzi schemes 'Peter-Paul' scams").

magnitude of the money he made is astounding, especially considering that it was the early 1920s—at one point, Carlo was taking in one million dollars per week even though he only owned about thirty dollars in postal coupons.[20] Although these schemes may appear to work, they are mathematically proven to fail[21] because new investors are needed at a rate that is impossible to sustain due to the exponential growth of new investors that is needed to pay the

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[20] *Id.*

[21] *See* Kugler v. Koscot Interplanetary, Inc., 293 A.2d 682, 691 (N.J. Super. Ct. Ch. Div. 1972) ("[M]any participants are mathematically barred from ever recouping their original investments, let alone making profits."). A simplified version of this type of scheme is a chain letter in which a person is asked to send one dollar to somebody several levels higher and to forward the letter to several other people with the same instructions. For example, the letter might say, "Send one dollar to the person seven levels above you and forward this letter to ten people with instructions to send one dollar to the person seven levels above them. If all people who receive this letter pay the one dollar, you will receive one million dollars for your small one dollar investment." The way this is computed is by multiplying one dollar by ten (level two) by ten (level three) by ten (level four) by ten (level five) by ten (level six) by ten (level seven). People who receive these letters often picture themselves near the top of the pyramid and assume that there are one million people who could and would make the one dollar payment. The problem, apart from fading interest in the plan by later recipients, is that in order for an investor who first comes into the scheme at the fifth level to get the one million dollars, it would require the pyramid to last until the eleventh level, with one hundred percent participation at each level. By this level, the pyramid would need ten billion participants to work, far in excess of the world's population. This is computed by multiplying the level seven total (one million dollars) by ten (level eight) by ten (level nine) by ten (level ten) by ten (level eleven).

earlier investors.[22] By the time Carlo's "Ponzi scheme"[23] collapsed, there were 20,000 investors involved, and he owed them over six million dollars.[24] Ultimately, Carlo was convicted in state and federal courts of fraud and served ten years in prison.[25]

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[22] Jon M. Taylor, Ph.D ("Dr. Taylor") notes that the only reason why certain pyramids, such as Amway, appear to have survived for so long is that they continue to start new pyramids by introducing new products, while allowing earlier pyramids to collapse. TAYLOR, THE 5 RED FLAGS, *supra* note 6, at 9.

[23] While people commonly use the terms "Ponzi scheme" and "pyramid scheme" interchangeably, they do have slightly different meanings. A "Ponzi scheme" is a scheme in which money received from later investors is used to pay earlier investors. A "pyramid scheme," on the other hand, is a scheme that rewards participants for inducing other participants to join. *See* Clinton D. Howie, *Investing in Louisiana: Is it a Pyramid Scheme?: Multilevel Marketing and Louisiana's "New" Anti-Pyramid Statute*, 49 LA. B. J. 288, 288 (2002). This article will use the term "pyramid scheme" broadly to describe any arrangement in which money primarily is made by recruiting new participants into the scheme, whether or not the scheme is technically a Ponzi scheme or a pyramid scheme.

[24] *See* Valentine, *supra* note 11, at 4.

[25] *Id.*

According to the Direct Selling Association (the "DSA"),[26] more than 14.1 million Americans were involved in direct selling in 2005.[27] This number has steadily increased from 8.5 million Americans in 1996.[28] The DSA also reports that the industry had $30.47 billion of sales in 2005.[29] While many direct sellers are not engaged in business opportunity schemes, the fact that the industry is virtually unregulated has led many companies to perpetrate vast schemes on the general public by promising, or at least implying, that vast riches may be obtained

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[26] The DSA (formerly the Agents Credit Association) was founded in Binghamton, New York, in 1910 to represent door-to-door salespeople and others who primarily make their living by earning a percentage commission for the products they sell. A more complete history of the organization is available at Direct Selling Association: About DSA, History, http://www.dsa.org/about/history/ (last visited Feb. 15, 2007). Over time, the DSA's membership expanded to include a large number of MLMs, most of which are pyramid marketing schemes. The DSA takes the position that there is no pyramid marketing scheme if a legitimate product is involved. *See* Direct Selling Association: About Direct Selling, Consumer Information, http://www.dsa.org/aboutselling/consumer/ (last visited Feb. 15, 2007). This is patently false. Had Carlo Ponzi sent a bottle of vitamins to his investors along with each interest payment, that would still be a Ponzi scheme rather than a method of distributing vitamins. As a small bit of evidence of the DSA's efforts to mislead, it is worth noting that the DSA does not want potential investors in these schemes to be informed about them by reading the information contained at Pyramid Scheme Alert, www.pyramidschemealert.org (last visited Feb. 15, 2007) (Pyramid Scheme Alert, or PSA, is an outspoken opponent of the DSA). To prevent people from reading PSA's information, the DSA has registered the similar domain names www.pyramidschemealert.com and www.pyramidschemealert.net and re-routes anybody who types in those domain names to the DSA's website (both links last visited Feb. 15, 2007).

[27] This is the most recent year for which the DSA provides data. Direct Selling Association: Research/Publications, Direct Selling By The Numbers – Calendar Year 2005, http://www.dsa.org/pubs/numbers/#PEOPLE (last visited Feb. 15, 2007). Note that a direct sales company may or may not be a multi-level marketing company (MLM), although it has become very common for direct sales companies to become MLMs. *See supra* note 5.

[28] Direct Selling Association: Research/Publications, Direct Selling By The Numbers – Calendar Year 2005, http://www.dsa.org/pubs/numbers/#PEOPLE (last visited Feb. 15, 2007).

[29] *Id.*

relatively easily by following a relatively simple method.[30] In these schemes, similar to the one perpetrated by Carlo Ponzi, money contributed by new recruits is the primary source of earnings of earlier recruits. This "silent scandal" is robbing millions of people of their hard-earned money and should be given at least as much attention as the Enron and WorldCom scandals.[31] Yet, thus far, legislators and legal scholars have virtually ignored the severity of this problem.

Section I of this Article discusses the current enforcement efforts of the FTC against business opportunity schemes, including both work-at-home schemes and pyramid marketing schemes.[32] The Section begins with a history of the government's efforts to protect the public against these schemes.[33] It then focuses on the two main rules upon which the FTC now relies to attack these schemes: the Franchise Rule[34] and the FTC Act.[35] The Section concludes that current rules are inadequate to address this growing problem.

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[30] The author began the research that became the basis of this article after he saw two of his sisters leave college without a degree and move to Utah, the heart of the MLM industry, to join ACN, a well-established MLM. ACN is discussed in detail *infra* Section V.

[31] *See* Taylor, Letter to FTC, *supra* note 6, at 4. Perhaps this has not received much attention because of a perception of guilt on the part of the victims (*i.e.*, they would not have lost money if they were not greedy) and because a relatively small initial investment is involved (less than $500). This view misses the point that, over time, the victims often lose large amounts of money. This occurs, for example, they feel compelled to continue paying money to attend conferences around the country. In addition, these schemes hurt legitimate direct selling businesses because an abundance of schemes makes people skeptical to invest even in legitimate businesses.

[32] *See infra* Section I.

[33] *See infra* Section I.

[34] *See infra* Section I.A.

[35] *See infra* Section I.B.

Section II of this Article discusses efforts by the Securities and Exchange Commission (the "SEC") to prosecute pyramid marketing schemes for violations of securities laws.[36] These efforts have met with some success, although the pyramid marketing scheme industry has found ways to avoid SEC challenges.

Section III of this Article discusses other current enforcement actions against pyramid marketing schemes.[37] Specifically, this Section discusses enforcement actions of federal agencies other than the FTC and SEC[38] and enforcement actions at the state level.[39] Based upon an analysis of this law, this Section concludes that current rules are inadequate.[40]

Section IV of this Article discusses a new rule that the FTC has proposed adopting in light of the fact that the current rules are inadequate.[41] This proposed rule is called the Business Opportunity Rule (the "Proposed Rule").[42] This Section provides a detailed analysis of the Proposed Rule.[43] Although the Proposed Rule is aimed at stopping both work-at-home schemes and pyramid marketing schemes, this article focuses on pyramid marketing schemes.

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[36] *See infra* Section II.

[37] *See infra* Section III.

[38] *See infra* Section III.A.

[39] *See infra* Section III.B.

[40] *See infra* Section III.B.

[41] *See infra* Section IV.

[42] *See infra* Section IV.

[43] *See infra* Section IV.

Section V of this article discusses one well-established pyramid marketing scheme, ACN.[44] This company provides a concrete means through which to analyze the Proposed Rule. The purpose of this Section is to assess how much of an effect the Proposed Rule will have on pyramid marketing schemes like ACN.

Section VI concludes that the Proposed Rule, while a step in the right direction, will not be effective at stopping the abuses that pyramid marketing schemes now perpetrate on the general public.[45] Instead, a twofold approach must be taken to truly stop these abuses. First, the law must require that the opportunity seller provide the potential investor with enough information and time to make an informed decision.[46] Although this is the goal of the Proposed Rule, the author believes that the Proposed Rule's disclosure requirements are insufficient to accomplish this goal.[47] Second, federal law must directly proscribe pyramid marketing schemes (also called "product-based" pyramid schemes and "recruiting MLMs"), and federal law must require opportunity sellers to provide enforcement authorities with enough information to discover these pyramid marketing schemes.[48] These pyramid marketing schemes should be defined as businesses in which more than fifty percent of earnings of participants is traceable to money contributed by new recruits into the organization. Although both approaches should be

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[44] This statement is not meant to imply that ACN has ever been held to be an illegal pyramid scheme. The statement merely reflects the reality that the primary source of earnings of participants is money paid by new recruits. As discussed in this article, however, ACN goes to great lengths to disguise this fact. *See infra* Section V.

[45] *See infra* Section VI.

[46] *See infra* Section VI.

[47] *See infra* Section VI.

[48] *See infra* Section VI.

taken, the first approach alone, if done as described in this article, should have a powerful impact on companies that perpetrate these schemes on the general public.

With respect to the first approach (information and time to the prospective purchaser), the Proposed Rule should be modified to require only the following two things: (1) mandatory disclosure of meaningful income information and (2) a waiting or "cooling off" period of at least three days for the prospective purchaser to digest the information.[49] Additional requirements that exist under the Proposed Rule are not very helpful when it comes to preventing abuses, and they are unnecessarily burdensome on legitimate direct selling companies.[50] Furthermore, in order to minimize the burden on small businesses that primarily aim to make money by selling products or services, rather than through recruiting, these two requirements only should apply when there is a "public" sale of a business opportunity.[51]

With respect to the second approach (proscription of pyramid marketing schemes and notice to the government), Congress should enact meaningful legislation to prohibit product-based pyramid schemes. Once this is done, the FTC should enact additional disclosure requirements in "public" sales of business opportunities to facilitate enforcement of this federal anti-product-based pyramid scheme legislation.[52]

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[49] *See infra* Section VI.

[50] *See infra* Section VI.

[51] *See infra* Section VI.

[52] *See infra* Section VI.

The focus on "public" sales in the proposal is intended to minimize the burden for legitimate private transactions in which the seller is not taking on a broader public role.[53] This "public" focus is consistent with U.S. securities laws, which aim to protect the investing public.[54] In the business opportunity context, a simple bright-line rule is necessary, and this article proposes that an individual seller has taken on a public role whenever the seller makes an offer to sell a *business opportunity* to a group of five or more prospective purchasers at the same time or whenever the seller has in fact sold the same business opportunity to at least five different people in the prior thirty days.[55] Thus, under this proposal, a seller who merely sells products, such as herbal remedies or telephone service, to large groups of people would not be subject to these rules as long as the seller does not also sell the "opportunity" to those large groups of people.

I. FTC ENFORCEMENT ACTIONS

Congress established the FTC in 1914 to protect consumers from deceptive and misleading information in the marketplace, anti-competitive mergers, and other unfair business

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[53] Specifically, for the sake of simplicity, the rule should focus on distributors who make, or attempt to make, a significant percentage of their income from money paid by recruits, whether directly or indirectly. This rule should not affect people who primarily sell products and who only occasionally bring in a new distributor.

[54] As Professors Hamilton and Booth have noted, "The Securities Act of 1933 . . . is designed to protect investors from fraud and misrepresentation in connection with the offer and sale of securities in interstate commerce by requiring the registration of *public* offerings. . . . The goal of federal securities law is **full disclosure** of **material facts** about the securities being sold. No evaluation of the investment quality of securities is involved." RICHARD W. HAMILTON AND RICHARD A. BOOTH, BUSINESS BASICS FOR LAW STUDENTS 349 (4th ed. 2006). Furthermore, "[a]n offering to a very small number of unsophisticated potential investors may be a public offering under the 1933 Act. . . ." *Id.* at 350.

[55] *Id.*

practices, such as retail price floors and price-fixing.[56] Underlying this congressional action was a core belief that economies thrive if there is fair competition, provided that consumers have accurate information about products and services.[57] Absent that accurate information, economies become weak because consumers do not trust the system enough to invest their money in businesses.[58]

The FTC currently brings enforcement actions against FTC business opportunity scams under the following two laws:[59] (1) Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures (the "Franchise Rule")[60] and (2) Section 5 of the Federal Trade Commission Act (the "FTC Act").[61] While both laws have been relatively

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[56] *See* Valentine, *supra* note 14, at 1.

[57] *Id.*

[58] *Id.*

[59] *See* Press Release, Federal Trade Commission, FTC Proposes New Business Opportunity Rule (Apr. 5, 2006), *available at* http://www.ftc.gov/opa/2006/04/newbizopprule.htm (last visited Feb. 15, 2007). The first of these two is technically a regulation. The term "laws" is used for convenience. With the FTC Act, Congress gave the FTC the authority to create the Franchise Rule.

[60] 16 C.F.R. § 436 (2007).

[61] 15 U.S.C. § 45 (2000). This is often referred to as the "Deceptive Trade Practices" section of the act.

successful at defeating traditional pyramid schemes,[62] they have not been very effective, for reasons discussed below,[63] at stopping work-at-home schemes and pyramid marketing schemes.[64]

A. The Franchise Rule

The Great Depression, which began with the stock market crash at the end of 1929 and lasted through most of the 1930s, created widespread distrust of the stock market.[65] In order to instill confidence in the system so as to facilitate the free and rapid trading of securities, Congress enacted the Securities Act of 1933 (the "1933 Securities Act")[66] and followed that with the Securities and Exchange Act of 1934 (the "1934 Securities Act") (both acts are referred to collectively as the "Securities Acts").[67] These acts, discussed in greater detail below,[68] were instrumental in restoring consumer confidence and allowing the stock market to once again grow.[69] Because these acts were aimed at protecting passive investors in "securities," they did

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[62] The term "traditional" pyramid scheme is used in this article to mean a scheme that does not involve the sale of any products. "Pyramid marketing schemes" (or "product-based pyramid schemes" or "recruiting MLMs") are plans that follow the basic format of traditional pyramid schemes, but in which a product is being sold in connection with the pyramid scheme. The overriding characteristic of all pyramid schemes, whether traditional or product-based, is that most of the money used to pay recruits comes from later recruits to the scheme.

[63] *See infra* Sections I.A and I.B.

[64] *See supra* note 5.

[65] *See* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

[66] 15 U.S.C. §§ 77a–77aa (2000).

[67] 15 U.S.C. §§ 78a–78u (2000).

[68] *See infra* Section II.

[69] *See* Landis, *supra* note 65.

not apply to anyone who bought a business with the intention of actively operating it.[70] At the time, that made a lot of sense. The widespread sale of franchise rights to prospective franchisees had not yet begun in earnest nor was there the massive market of "business opportunities" that exists now. Consumer confidence had been shaken with respect to the stock market, and that is what Congress sought to redress.[71]

In the 1950s and 1960s, with the end of World War II and the growth of our highway system under President Eisenhower, Americans witnessed the explosive growth of business format franchising as companies such as Sheraton, Tastee Freeze, Dairy Queen, Wendy's, McDonald's, Holiday Inn, Burger King, and numerous others began to franchise.[72] In this model, the business format franchisor sells patents, trademarks, know-how, etc. to the franchisee, who then has the right to utilize that successful business model in exchange for a recurring fee or royalty that it pays to the franchisor.[73] Because the franchisee was purchasing a business with the intent of actively operating it, this generally was not the kind of investment to which the Securities Acts would apply.

In the 1970s, the FTC discovered that franchise and business opportunity fraud was rampant.[74] Much like the stock market before the 1929 crash, investors had gained confidence in

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[70] *Id.*

[71] *Id.*

[72] *See Franchising in the U.S. Economy: Prospects and Problems, Committee on Small Business, House of Representatives*, 101st Cong. 6-7 (1990).

[73] *See* DANIEL C. K. CHOW AND THOMAS S. SCHOENBAUM, INTERNATIONAL BUSINESS TRANSACTIONS 377 (2005). *See also* Miller v. McDonald's Corp., 945 P.2d 1107 (Or. Ct. App. 1997).

[74] 16 C.F.R. § 436 (2007). *See also* Statement of Basis and Purpose, 43 Fed. Reg. 59,614 (Dec. 21, 1978).

the franchise system and would invest in a franchise without much investigation of the company.[75] Unscrupulous franchisors took advantage of a large trusting public by misleading potential investors into believing that the company was much more profitable than it actually was.[76] Because of the growth of this type of behavior and in order to facilitate the continued healthy growth of the franchise system, the FTC adopted a pre-sale disclosure rule commonly called the Franchise Rule.[77]

The Franchise Rule was aimed at preventing fraud by requiring franchisors (and certain other sellers of businesses) to disclose material information to the purchaser before the sale.[78] Like the Securities Acts, this rule does not prevent a buyer from choosing to make a bad or risky investment—it merely aims to ensure that the purchaser is fully informed so that he or she can

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[75] Statement of Basis and Purpose, 43 Fed. Reg. 59,614 (Dec. 21, 1978).

[76] *Id.*

[77] *Id.*

[78] *Id.*

determine if the offering is in his or her best interest.[79] There were obviously competing concerns at issue here: required disclosure of material information would encourage the growth of the franchise industry by giving potential investors more confidence in the system, but this same disclosure requirement could destroy the industry if it were so burdensome that the cost of compliance exceeded a franchisor's profit margin.

Under the Franchise Rule, a seller of certain business opportunities is under a legal obligation to disclose the following prior to the sale:

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[79] *I.e.*, the Franchise Rule does not substantively affect the sale. *See* Proposed Rule, *supra* note 10, at 19,055. Note that on January 23, 2007 the FTC issued a press release regarding an "Updated Franchise Rule" (also referred to as a "Final Rule") that bifurcated the Franchise Rule into two separate sections. The first section, 16 C.F.R. pt. 436, applies only to the sale of franchises. The second section, 16 C.F.R. pt. 437, applies to the sale of business opportunities. Press Release, Federal Trade Commission, FTC Issues Updated Franchise Rule (Jan. 23, 2007), *available at* http://www.ftc.gov/opa/2007/01/franchiserule.htm (last visited Feb. 17, 2007). A Notice Containing the Final Rule Language and the Statement of Basis and Purpose released the same day and intended for publication in the Federal Register, notes the following:

> In response to the business opportunity [notice of proposed rulemaking], the Commission received over 17,000 comments, many opposing the inclusion of multilevel marketing companies under the proposed rule. Several comments specifically questioned the paperwork burdens that might be imposed by part 437 amendments. E.g., DSA. Business Opportunity NPR Commission staff is currently analyzing the comments. For now, however, only those business opportunities covered by the original Franchise Rule – such as vending machine and rack display opportunities – remain covered under part 437.

Notice Containing the Final Rule Language and the Statement of Basis and Purpose (hereinafter "Statement of Basis"), 72 Fed. Reg. _____, _____ n.975 (_____, 2007)(NOT YET AVAILABLE), *available at* http://www.ftc.gov/os/2007/01/ R511003FranchiseRule FRNotice.pdf (last visited Feb. 17, 2007). In short, the Final Rule, which is effective on July 1, 2007 and which grants sellers of franchises and business opportunities permission to use the original Franchise Rule until July 1, 2008, does not substantively affect the treatment of business opportunity sales; it merely provides a separate section while the FTC considers the Proposed Business Opportunity Rule. *Id.* at _____. For convenience, this article will refer to sections of the original Franchise Rule rather than the new bifurcated rule.

(1) Certain information about the seller;[80]

(2) The seller's background, litigation history, and bankruptcy history;[81]

(3) The offer's terms and conditions;[82]

(4) A statistical analysis of existing outlets of the business, whether company-owned or franchised;[83]

(5) Information about prior purchasers of franchises of the business, including the names and address of the ten prior purchasers residing most closely to the proposed purchaser;[84] and

(6) Audited financial statements.[85]

In addition, the seller must disclose certain specific financial information if it chooses to make any representation regarding financial performance of franchises.[86]

To minimize the compliance costs for smaller investments, the FTC decided to include three significant exceptions to the Franchise Rule, and these exceptions are what pyramid marketing scheme promoters now capitalize upon.[87] First, the Franchise Rule does not apply to business opportunities in which the purchaser does not need to make a payment of $500 or more

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[80] 16 C.F.R. §§ 436.1(a)(1) and (3) (2007).

[81] 16 C.F.R. §§ 436.1(a)(2)-(5) (2007).

[82] 16 C.F.R. §§ 436.1(a)(7)-(15) and (17)-(18) (2007).

[83] 16 C.F.R. § 436.1(a)(16) (2007).

[84] *Id.*

[85] 16 C.F.R. § 436.1(a)(20) (2007).

[86] 16 C.F.R. §§ 436.1(b)-(c) and (e) (2007).

[87] *See* Proposed Rule, *supra* note 10, at 19,055.

within six months of purchase.[88] Second, voluntary purchases of reasonable amounts of inventory at wholesale prices do not count in determining whether the buyer has paid the seller $500 or more within the first six months after purchase.[89] Finally, the Franchise Rule does not apply if the purchaser is merely paying for training or if the buyer and seller agree that the seller will buy back and resell goods assembled by the buyer.[90]

Since the Franchise Rule took effect in the 1970s, the FTC has brought more than two hundred enforcement actions against business opportunities under this rule.[91] The FTC has been particularly successful at stopping fraudulent "opportunities" related to the sale of vending machines and rack displays.[92] It has not been successful at stopping work-at-home schemes and pyramid marketing schemes under the Franchise Rule.[93]

1. Work-at-Home Schemes

Most work-at-home schemes are not covered by the Franchise Rule because of the third exception to the rule; specifically, the rule does not apply if the goods are sold back to the business opportunity seller rather than directly to end-users.[94] In addition, the second exception

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[88] 16 C.F.R. §§ 436.2(a)(2) and (a)(3)(iii) (2007).

[89] Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures; Promulgation of Final Interpretive Guides, 44 Fed. Reg. 49,966, 49,967 (Aug. 24, 1979).

[90] *See* 16 C.F.R. §§ 436.2(a)(1)(ii)(B)(1)-(3) (2007). *See also* FTC v. Academic Guidance Serv., Inc., No. 92-3001 (D.N.J. 1992).

[91] *See* Press Release, Federal Trade Commission, FTC Proposes New Business Opportunity Rule (Apr. 5, 2006), *available at* http://www.ftc.gov/opa/2006/04/newbizopprule.htm (last visited Feb. 15, 2007).

[92] *See* Proposed Rule, *supra* note 10, at 19,060.

[93] *See id.* at 19,059-19,061.

[94] 16 C.F.R. §§ 436.2(a)(1)(ii)(A)(1)-(3) (2007).

to the rule often exempts these schemes from the rule because victims pay large amounts to buy "supplies." Thus, business opportunities such as craft assembly ventures and envelope stuffing usually are not covered by the Franchise Rule.[95]

Work-at-home schemes tend to prey on the elderly, the unemployed, the disabled, stay-at-home parents, and people who do not speak English.[96] The basic scam is simple enough. Victims are told that they must purchase the materials to assemble products up-front from the seller of the opportunity. They are assured that, once they assemble the products or stuff the envelopes, the seller of the opportunity will buy the assembled products back to then sell them to the general public, provided a market is available.[97] The seller misrepresents to the victim that there is a market for these goods and that they will likely be bought back.[98] Of course, no buy-back ever occurs, and the victim is left with a bunch of worthless products and a lot less money.[99]

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[95] *E.g.*, FTC v. Misty Stafford, No. 3; CV 05-0215 (M.D. Pa. 2005) and FTC v. Sun Ray Trading, Inc., No. 05-20402 CIV-Seitz/Bandstra (S.D. Fla. 2005). *See* Proposed Rule, *supra* note 10, at 19,055.

[96] *See, e.g.*, FTC v. USS Elder Enterprises, Inc., No. SA CV-04-1039 HS (ANX) (C.D. Cal. 2004) (craft assembly "opportunity" aimed at Hispanic immigrants); FTC v. Esteban Barrios Vega, No. H–04–1478 (S.D. Tex. 2004) (product assembly "opportunity" aimed at Hispanic immigrants); FTC v. Castle Publ'g, Inc., No. A03CA 905SS (W.D. Tex. 2003) (envelope-stuffing "opportunity" aimed at the elderly, disabled, and unemployed); FTC v. Medicor LLC, No. CV01-1896 (CBM) (C.D. Cal. 2001) (various work-at-home schemes aimed at Hispanic immigrants, the disabled, and stay-at-home parents). *See also* Proposed Rule, *supra* note 10, at 19,059.

[97] Proposed Rule, *supra* note 10, at 19,059.

[98] *Id.*

[99] Commonly, the seller invents undisclosed conditions and limitations to justify refusing to buy back the work. *Id.*

2. Pyramid Marketing Schemes

Pyramid marketing schemes commonly deceive consumers with the lure of huge potential incomes.[100] The typical scheme is not very different from the one perpetrated by Carlo Ponzi:[101] new investors must, directly or indirectly, buy in to the "opportunity," and those funds are the primary source of income to people who are higher up in the pyramid.[102] In order to fall within the first exception to the Franchise Rule, sellers generally are careful to charge less than $500 to buy in to the "opportunity."[103] By doing this, the Franchise Rule does not apply, and therefore the seller has no duty to disclose anything. Thus, sellers can hide the fact that the vast

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[100] *E.g.*, FTC v. 2Xtreme Performance Int'l, LLC, No. JFM 99CV 3679 (D. Md. filed Dec. 9, 1999) ("about $2,000 in the first month. . . and then it went to $60,000"); FTC v. Bigsmart.com, No. CIV 01-0466 PHX ROS (D. Ariz. filed Mar. 12, 2001) ("50 people made over $50,000 their first month! We also had a $100,000 first month money earner!"); FTC v. FutureNet, Inc., No. CV-98-1113 GHK (BQRx) (C.D. Cal. filed Feb. 17, 1998) ("If you're serious, we can show you how to make ten thousand a month; and you know, we have people doing thirty thousand a month."); FTC v. Nia Cano, No. 97-7947-CAS (AJWx) (C.D. Cal. filed Oct. 29, 1997) ("as much as $18,000 per month"); FTC v. Global Assistance Network for Charities, No. 96-2494 PHX RCB (D. Ariz. filed Nov. 5, 1996) ("over $89,000 a month"); FTC v. NexGen3000.com, No. CIV-03-120 TUC WDB (D. Ariz. filed Feb. 21, 2003) ("each activated business center has the potential to earn up to $60,000 per week"); FTC v. SkyBiz.com, No. 01-CV-0396-EA (X) (N.D. Okla. filed May 20, 2001) ("he's making $76,000 a week and growing"). *See* Proposed Rule, *supra* note 10, at 19,060.

[101] *See supra* Introduction.

[102] This is done "indirectly" when promoters of the schemes disguise the fact that the money is primarily coming from recruiting new participants. As an example of this, *see* discussion of ACN *infra* Section V.

[103] As an example of this, note that ACN charges $499 to become a distributor. *See infra* Section V. It seems patently obvious that this number was chosen to avoid the mandatory disclosures of the Franchise Rule.

majority of people who buy in to the opportunity drop out and that more than ninety percent of investors do not even recoup their investment.[104]

B. The FTC Act

The FTC Act broadly prohibits "unfair or deceptive acts or practices in or affecting commerce."[105] The FTC currently uses this broad general rule to attack scams that fall within the exceptions to the Franchise Rule, such as work-at-home schemes and pyramid marketing schemes.[106] However, because gathering evidence of "unfair" or "deceptive" acts is extremely difficult, this provision is used infrequently. In fact, the FTC reports that from January 1997 through December 2005 consumers lodged 17,858 complaints[107] with the FTC against pyramid marketing schemes (with aggregate injuries of nearly fifty million dollars);[108] but, since 1990, the FTC has only brought twenty cases against pyramid marketing schemes under the FTC Act.[109]

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[104] *See* Proposed Rule, *supra* note 10, at 19,060.

[105] 15 U.S.C. § 45 (1997) (this is technically "Section 5" of the FTC Act, but for convenience, this article will refer to Section 5 as the "FTC Act").

[106] *See* Proposed Rule, *supra* note 10, at 19,060-61.

[107] Realistically, it must be assumed that this number is a tiny fraction of the total number of injuries suffered because the relatively small up-front investment amount (less than $500), the hassle of filing a complaint, and the embarrassment factor of feeling "duped" would lead the overwhelming bulk of people not to bother filing complaints. *See* FED. TRADE COMM'N, *supra* note 5, at 80 (showing that only 1.4% of fraud victims file complaints with any federal agency at all, including the FTC).

[108] *See* Proposed Rule, *supra* note 10, at 19,061.

[109] *Id.* at 19,060-61.

In 1975 (before the Franchise Rule was enacted), the FTC began to pursue Amway[110] for deceptive business practices.[111] After years of litigation, the FTC ruled in Amway's favor that it was not an illegal pyramid scheme.[112] In the decision, the FTC identified a "pyramid scheme" as

> 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 the sale of the product to ultimate users.[113]

In the decision, the FTC also created what is now known as the "Amway Safeguards Rule."[114] According to this rule, Amway was held to not be a pyramid scheme because (1) it bought back goods of terminating distributors, (2) it required distributors to have sales to at least ten customers per month, and (3) it required distributors to sell 70% of the products they purchased each month to non-distributors.[115] This decision has made it immensely more difficult for the FTC to prosecute companies under the FTC Act because MLMs with the advice of legal counsel now routinely implement the Amway Safeguards to ensure that they will not be prosecuted as illegal pyramid schemes. In reality, these "safeguards" do not have much an impact because they merely create mechanical steps that companies can follow to avoid

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[110] Amway is now called Quixtar in North America. *See* FITZPATRICK, *supra* note 6, at 35.

[111] *See* Jeffrey A. Babener, *Network Marketing and the Law*, 24 VA. B. ASS'N NEWS J. 35, 35 (1998).

[112] In re Amway Corp., 93 F.T.C. 618 (1979).

[113] *Id.* at 106 (citing In re Koscot Interplanetary, Inc., 86 F.T.C. 1106, 1180 (1975), *aff'd sub. nom.*, Turner v. FTC, 580 F.2d 701 (D.C. Cir. 1978)).

[114] *See* Babener, *supra* note 111, at 35.

[115] In re Amway Corp., 93 F.T.C. at 716-17.

prosecution. Thus, as long as a company follows these steps, earnings of participants can be derived primarily from money contributed by new recruits, and nobody will be prosecuted.[116]

Assuming that Amway Safeguards are in place, the only way to prosecute pyramid marketing scheme under the FTC Act is to find that it has misrepresented earnings potential. This is extremely difficult to do because these companies typically tout the success of a few people at the top of the pyramid and then include a generic disclaimer such as the following one used by ACN:

> *Success as an ACN Representative is not guaranteed, but rather influenced by an individual's specific efforts. Not all ACN Independent Representatives make a profit and no one can be guaranteed success as an ACN Independent Representative.*[117]

Because of this "disclosure," the company can assert, perhaps successfully, that it did not misrepresent anything. In fact, one person in the company actually may have received the huge amounts of income that the company alleges that he or she has received.[118] The problem often is not that the company is misstating what the person has made; instead, the problem more commonly lies in what the company implies or what it intentionally does not say.[119]

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[116] *See* ACN discussion *infra* Section V.

[117] American Communications Network, Inc., Opportunity, http://www.acninc.com/ acn/ us/opportunity/index.jsp (last visited Feb. 17, 2007) (hard copy on file with author).

[118] *See* Jon M. Taylor, Rebuttal Comments to the DSA's comments to the FTC regarding the Proposed Business Opportunity Rule, 3 (Aug. 7, 2006), *available at* http://www.ftc.gov/os/ comments/businessopprule/rebuttal/522418-13113.pdf (last visited Feb. 16, 2007) ("It should be noted that even in the worst of the chain selling schemes found on the DSA membership roster, one can find participants who are making a lot of money – at or near the top of their respective pyramids.").

[119] Although some companies surely must lie about how much the people at the top make as well.

Unfortunately, the current rules do not require the company to say more. By touting the millions made by the top salesperson in the company and by not mentioning the number or percentage of people who fail to make any meaningful profit, the company is reasonably expecting that the target will infer that he or she can reasonably expect to make a similar amount of money.

By making earnings representations, whether the company specifically says so or not, it is implying that a new participant who pays the sign-up fee can make the same amount of money that has been represented simply by following the company's plan.[120] Often this is virtually impossible because, if the money primarily comes from new participants, later participants mathematically cannot make that kind of money because the pyramid is much more likely to collapse before they can do so.[121] According to a groundbreaking study of several large pyramid marketing schemes, 99.9 percent of participants lost more money than they made by investing in the scheme.[122] As Dr. Taylor of the Consumer Awareness Institute notes, "The chance of profiting from a single spin of the roulette wheel at Caesar's Palace in Las Vegas is 48 times as great."[123] Yet recruiting conferences, or "opportunity meetings" as promoters like to call them, tout the success of the top one-tenth of one percent of their distributors without revealing that the bottom 99.9 percent do not even recoup their investment. This is akin to placing a large sign

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[120] For example, *see* quotes from ACN's Andre Maronian, *supra* notes 1 and 2 and accompanying text.

[121] *See* FITZPATRICK, *supra* note 6, at 9.

[122] *See* TAYLOR, THE 5 RED FLAGS, *supra* note 6, at 14. *See also* FITZPATRICK, *supra* note 6.

[123] *See* TAYLOR, THE 5 RED FLAGS, *supra* note 6, at 16.

above the roulette wheel at Caesar's Palace announcing that "This Wheel is an Amazing Business Opportunity."[124]

II. SEC ENFORCEMENT ACTIONS

Under the 1933 Securities Act, "securities" must be registered with the SEC.[125] In addition, Rule 10b-5 of the 1934 Securities Act prohibits "materially false or misleading statements" in connection with the sale of securities.[126] Failure to comply with these securities laws is a crime, and a single violation may result in up to a $10,000 fine and five years in prison.[127] Furthermore, the SEC can stop a violating company from conducting business, freeze the assets of the company, place the company into receivership, and make it disgorge its profits.[128]

In the MLM context, it is very rare for the SEC to attack a company for failure to register.[129] Rather, almost all cases involve claims of materially false or misleading statements.[130] Thus, the following two questions should be asked, in the following order, with

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[124] This is a variation on the following comment made by Dr. Taylor: "[R]esearch demonstrates that it is no more appropriate to refer to most MLMs as 'business opportunities' than it is to place a 'Business Opportunity' sign above gaming tables in Las Vegas." Letter from Jon M. Taylor, *supra* note 6, at 4.

[125] 15 U.S.C. § 77f-g (2000).

[126] 15 U.S.C. § 78j(b) (2000); 17 C.F.R. § 240.10b-5 (2006).

[127] 15 U.S.C. § 77x (2000).

[128] *See* Spencer M. Reese, *Securities Law and MLM – What's the Deal?*, Section II (1999), http://www.mlmlaw.com/library/guides/securities4.html (last visited Feb. 17, 2007).

[129] The author has not discovered any cases in which the SEC prosecuted an MLM merely for failure to register.

[130] *See, e.g.*, *SEC v. International Loan Network, Inc.*, 770 F.Supp. 678 (D.C. 1991).

respect to any MLM to determine if it is in fact a pyramid marketing scheme: (1) is there a security, and, if so, (2) has fraud been committed?

A. Is there a Security?

To determine if a "security" is involved, begin with the definition of "security" in the 1933 Securities Act.[131] This definition includes a laundry list of terms, the most inclusive of which is the term "investment contract."[132] Because most MLMs do not issue stock or bonds to potential investors, the usual question to ask in the MLM context is whether the potential investor is investing in an "investment contract." If it is, then it is an investment in a security.

The seminal test of whether there is an "investment contract," and therefore a "security," is set out in *S.E.C. v. W.J. Howey Co.* (the "*Howey* test").[133] Under that test, to be found an investment contract, a transaction must be one "in which a person (1) invests his money (2) in a

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[131] The 1933 Securities Act defines "security" as

> any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(a)(1) (2000).

[132] *Id.*

[133] 328 U.S. 293 (1946).

common enterprise and (3) is led to expect profits (4) solely from the efforts of a promoter or a third party."[134] The thrust of this rule is consistent with the original purpose of the Securities Acts; that is, to protect passive investors who earn their money through the efforts of others.[135] Those who expect to reap profits from their own active participation and efforts in the business are assumed to be sufficiently knowledgeable and engaged to protect their own investments.[136] While the *Howey* test would appear to be a straightforward four-part test, courts have applied the test very inconsistently.

Under part 1 of the *Howey* test (whether the person invests his money), the issue is whether there has been an *investment* of money as opposed to a mere payment of money or purchase of a product. Pyramid marketing schemes typically have tried to avoid meeting this prong of the *Howey* test by having an investor nominally purchase a product rather than invest money in the opportunity.[137] In this case, courts have looked beyond the form of the transaction to the substance of the transaction to determine if the payment is really an investment in the right to get paid for recruiting new members to the company.[138] As a result of this "substance versus form" analysis, it is now very difficult to avoid the first prong of the *Howey* test (*i.e.*, it is difficult for a pyramid marketing scheme to assert that there has not been an "investment" by a

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[134] Douglas M. Fried, *General Partnership Interests as Securities Under the Federal Securities Laws: Substance Over Form*, 54 FORDHAM L. REV. 303, 309 (1985), *citing S.E.C. v. Howey*, 328 U.S. at 298-99.

[135] *See Howey*, 328 U.S. 293.

[136] *See id.* at 303-04.

[137] *See, e.g.*, S.E.C. v. Int'l Loan Network, Inc., 770 F.Supp. 678 (D.D.C. 1991).

[138] *Id.*

new participant) if that participant must purchase products or pay money in order to become a participant in the "opportunity."[139]

Under part 2 of the *Howey* test (whether there is a common enterprise), the issue is whether a "common enterprise" exists between the investor and the promoter.[140] The test of whether there is commonality between them has proven very difficult for courts to apply, and Federal Appeals Courts are split on how to determine if there is a common enterprise.[141] The three most common tests that courts apply to determine if there is a common enterprise are (1) horizontal commonality, (2) strict (or narrow) vertical commonality, and (3) broad vertical commonality.[142] It is unnecessary to analyze each of these tests because in the pyramid marketing scheme context courts commonly assume the commonality test has been met.

Under part 3 of the *Howey* test (whether the investor is led to expect profits), the test is once again whether an investor is paying money in the hopes of making money or if the investor is merely purchasing a product. The United States Supreme Court has noted that securities laws do not apply if somebody "merely purchases a commodity for personal consumption or living

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[139] *See* Capone v. Nu Skin Canada, Inc., No. 93-C-0285-S (D. Utah, Mar. 27, 1997) (order denying summary judgment).

[140] An analysis of the common enterprise test is beyond the scope of this article. *See* S.E.C. v. Glenn W. Turner Enters., Inc., 474 F.2d 476 (9th Cir. 1973). *See also* Wals v. Fox Hills Dev. Corp., 24 F.3d 1016 (7th Cir. 1994).

[141] *See* Mordaunt v. Incomco, 469 U.S. 1115 (1985).

[142] *See id.* at 1115-1117. For cases dealing with broad vertical commonality, see S.E.C. v. Koscot Interplanetary, Inc., 497 F. 2d 473 (5th Cir. 1974) and S.E.C. v. Cont'l Commodities Corp., 497 F.2d 516 (5th Cir. 1974). For a case dealing with strict vertical commonality, see Mordaunt v. Incomco, 686 F.2d 815 (9th Cir. 1982). For cases dealing with horizontal commonality, see Salcer v. Merrill Lynch, 682 F.2d 459 (3rd Cir. 1982), Curran v. Merrill Lynch, 622 F.2d 216 (6th Cir. 1980), *aff'd on other grounds,* 456 U.S. 353 (1982), and Deckebach v. La Vida Charters, Inc. of Florida, 867 F.2d 278 (6th Cir. 1989).

quarters for personal use" rather than "parts with his money in the hopes of receiving profits. . . ."[143] In the same case, the Court also noted that "[i]n some transactions the investor is offered both a commodity or real estate for use and an expectation of profits. . . . The application of the federal securities laws to these transactions may raise difficult questions that are not present in this case."[144] In the pyramid marketing scheme context, although there may be a purchase of products by the new recruit, the recruit's overarching investment motive is usually readily apparent. Thus, this third prong is virtually always met in the pyramid marketing scheme context.

The fourth prong of the *Howey* test (whether the purported profits arise solely from the efforts of a promoter or a third party) is by far the most critical prong in the pyramid marketing scheme context. In fact, courts often virtually ignore the first three prongs to first determine if this fourth prong applies. The seminal case dealing with the fourth prong in the pyramid marketing scheme context is *S.E.C. v. Glenn W. Turner Enterprises, Inc*.[145] In this Ninth Circuit case, the court held that the defendant, the operator of the widely-publicized "Dare to be Great" program, met this prong (in addition to the first three) and was therefore issuing a security.[146] Although "Dare to be Great" participants were told that they had to work to make money, prospects were led to believe in the "near inevitability of success to be achieved by anyone who

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[143] United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 858 (1975).

[144] *Id.* at 853 n.17.

[145] 474 F.2d 476 (9th Cir. 1973).

[146] *Id.* "Dare to be Great" was a motivational course, and disguised pyramid scheme, marketed by Glenn W. Turner in the early 1970s. For an interesting article on the history of this scheme, *see* http://www.time.com/time/magazine/article/0,9171,877473,00.html.

purchases a plan and follows Dare's instructions."[147] The court thus rejected the defendant's argument that profits were not expected "solely" by the efforts of others because the participant also needed to bring recruits to Dare conferences to have any chance of success.[148] The court rejected a strict interpretation of the word "solely" and held that the fact that some small efforts were needed by participants was insufficient to cause the arrangement to fail the fourth prong – in substance, participants were led to believe that they would make money with a minimal amount of effort based primarily on the efforts of others.[149]

It is worth noting that a few states do not even apply the *Howey* test to a securities analysis. Instead, they use a more flexible, but similar, test known as the "risk capital test."[150] While no federal court has applied the risk capital test, it is important to be aware of the test because this test is often used to enforce state securities laws and the U.S. Supreme Court may one day choose to extend it to apply to federal securities laws. Under the risk capital test, there is an investment contract, and therefore a security, if all four of the following four requirements are met:

1. An offeree provides an initial value (capital) to an offeror;

2. This initial value, or at least a portion of it, is subject to the "risks" of the enterprise;

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[147] *Id.* at 479.

[148] *Id.* at 481-83.

[149] *Id.*

[150] This test was established in the case of Silver Hills Country Club v. Sobieski, 361 P.2d 906 (Cal. 1961) and refined in State of Hawaii v. Hawaii Market Center, Inc., 485 P.2d 105 (Haw. 1971).

3. The offeror induced a reasonable understanding that the offeree, by investing, would gain a valuable benefit beyond the initial value; and

4. The offeree does not have or obtain control over the managerial decisions of the enterprise.[151]

Well-advised MLMs take steps to avoid being classified as securities under both the *Howey* test and the risk capital test by stressing the work that it will take for the investor to "build the business." For example, MLM attorney Spencer M. Reese states that "distributors must perform the sales and enrollment functions" and that "no company should ever present its program with the claim that the company, the structure of the compensation plan, or the prospect's upline, will do the work for them."[152] Mr. Reese also notes that, despite the promise of residual income, "distributors should have ongoing responsibilities throughout their MLM career."[153]

In the seminal Ninth Circuit case of *Webster v. Omnitrition International, Inc.*,[154] the court ignored the *Howey* and the risk capital tests altogether.[155] Instead, the court merely assumed that any "pyramid" is *per se* a security.[156] Furthermore, the court held that if the

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[151] *State of Hawaii*, 485 P.2d at 109.

[152] Reese, *supra* note 128, at Section IV.D. The term "upline" means a person directly higher in the pyramid than the recruit. *See, e.g., id.*

[153] *Id.* at Section IV.E.

[154] 79 F.3d 776 (9th Cir. 1996).

[155] *See id.*

[156] *Id.* at 784.

program was in fact a pyramid scheme, then it automatically constituted fraud under Section 12(2) of the 1933 Securities Act and under Section 10 of the 1934 Securities Act.[157]

The pyramid scheme analysis of *Webster* is more difficult for MLMs to overcome than the *Howey* and the risk capital tests because so many MLMs are so clearly disguised pyramid schemes; that is, although they sell a product, most of the money made by participants is directly traceable to money paid by new recruits. MLM attorney Spencer M. Reese has some additional insightful suggestions that, in practice, are very difficult for MLMs to follow.[158] For example, Mr. Reese notes that, in order to avoid being classified as a pyramid scheme, the "primary emphasis of the program must be on generating sales to end user consumers, not on recruitment of new participants into the compensation plan."[159] He adds that MLMs should "[b]e careful not to offer a plan pursuant to which commissions are actually 'recruitment based bonuses,'" and "NEVER, NEVER, NEVER, pay a commission out of a sign up fee."[160]

Although MLMs clearly utilize such advice on paper, the reality is that it is impossible for most MLMs to comply because most are in fact pyramid marketing schemes that rely on recruiting and funds provided by new recruits to pay the recruiter. This is often well-hidden. ACN,[161] for example, is careful to tie the payment of recruiting bonuses to the *acquisition of new customers* by those recruits, which hides the fact that most of the money used to pay those

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[157] *Id.* at 784-86.

[158] *See* Reese, *supra* note 128, at Section IV.F.

[159] *Id.*

[160] *Id.*

[161] *See* Section V *infra*.

recruitment bonuses almost certainly comes from sign-up fees paid by those new recruits.[162] In addition, ACN's training materials state that "ACN strictly prohibits ACN Independent Representatives from making any claims or guarantees related to earnings/income, whether express or implied";[163] nevertheless, actual sales pitches, such as the two quotes from the ACN Senior Vice President at the beginning of this article,[164] commonly promise vast riches[165] from merely following a simple, mechanical system.[166] Such statements, if discovered, would likely cause any amounts paid up-front to a company such as ACN to be an investment in a "security" under the holding of *S.E.C. v. Glenn W. Turner Enterprises, Inc.*[167]

To summarize, there currently are three possible ways in which the amount paid by a new distributor to an MLM could be a "security" under the Securities Acts: (1) the *Howey* test, (2) the risk capital test, or (3) a pyramid scheme analysis (*per se* a security). Well-advised MLMs generally posture themselves well *on paper* to minimize the risk of a challenge under these three approaches. In practice, however, these companies are commonly promoting

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[162] *See* Section V *infra*.

[163] United Networks International Training On Line Page, Getting It Right (2005), http://uniteam1.com/pages/Trainingonline.html (last visited Feb. 17, 2007) (hard copy on file with author).

[164] *See supra* text accompanying notes 1 and 2.

[165] *See supra* notes 1-2 and accompanying text. *See also, e.g.,* Web video: ACN How to make a million dollars, http://www.youtube.com (search "ACN How to make a million dollars") (last visited Feb. 17, 2007) (videotaped copy on file with author); Web video: ACN Cribs 2, http://www.youtube.com (search "ACN Cribs 2") (last visited Feb. 17, 2007) (videotaped copy on file with author).

[166] *See, e.g.,* Art Napolitano, Senior Vice President, UNI Team1.com, Step by Step Strategy to Success in Network Marketing, http://uniteam1.com/pages/trainingmaterials.html (follow "Step by Step to Success!") (last visited Feb. 17, 2007) (hard copy on file with author).

[167] *See supra* text accompanying notes 146-150.

investments in "securities." Of course, enforcement based on what these companies do in practice is extremely difficult, given the SEC's limited resources and the astounding amount of money being made by people at the top of MLMs. Often, the only possibility of enforcement is through private causes of action. Given the relatively small amount of money that an individual plaintiff could recover and the burdens and costs of litigation, individual causes of action are not very desirable. Given the fact that securities law precludes punitive damages, class action lawsuits are not particularly desirable either.

B. Has Fraud Been Committed?

Once it is determined that there is a security, the next question to ask in the MLM context is whether fraud has been committed.[168] Typically, if the SEC finds that there is a security, it will then attempt to prove that fraud has been committed in violation of at least one of the Securities Acts.[169] The two primary ways in which the SEC can find that fraud has been committed are the following: (1) it is a material omission, and thus fraud, in the pyramid scheme context to fail to disclose that a pyramid must eventually collapse and that most participants will lose their investment;[170] and (2) it is deceptive, and thus fraudulent, to lead investors to believe that they can earn the income represented by the sellers when few, if any, actually earn that amount of income.[171] Proof of these transgressions, however, is extremely difficult and time consuming to

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[168] As mentioned, this second step is not necessary under a pyramid scheme analysis. Under that analysis, if there is a pyramid scheme, it is *per se* a security and fraud has been committed. *See* Webster v. Omnitrition International, Inc., 79 F.3d 776, 784 (9th Cir. 1996).

[169] *See, e.g.*, *id.*; S.E.C. v. Galaxy Foods, Inc., 417 F.Supp. 1225 (E.D.N.Y. 1976).

[170] *See, e.g.,* S.E.C. v. Better Life Club of America, Inc., 995 F.Supp. 167 (D.D.C. 1998); S.E.C. v. Int'l Loan Network, Inc., 770 F.Supp. 678 (D.D.C. 1991).

[171] *See Galaxy Foods*, 417 F.Supp. 1225.

obtain. The SEC must record what actually has been said at a company's "opportunity meetings." This obviously is not happening to any significant extent, leaving huge gaps in meaningful enforcement mechanisms against this dreadful practice.

III. OTHER ENFORCEMENT ACTIONS

A comprehensive examination of all federal and state enforcement actions against product-based pyramid schemes is beyond the scope of this article. Nevertheless, it is helpful to be aware of the assortment of ways in which authorities currently prosecute these schemes to understand why a more comprehensive rule like the Proposed Rule is necessary.

A. Other Federal Enforcement Actions

The U.S. Department of Justice sometimes works with investigative agencies such as the U.S. Postal Inspection Service and the Federal Bureau of Investigation (the "FBI") to criminally prosecute pyramid schemes for such crimes as money laundering, tax fraud, and mail fraud.[172] The usual issue of proof makes prosecution difficult and labor intensive.

B. State Enforcement Actions

At the state level, most prosecution falls under state pyramid scheme laws and state securities laws, and most prosecutions are handled by local prosecutors, state Attorneys General (usually the Consumer Protection Division), and state securities agencies. If any broad statement can be made about these state cases, it is that state laws vary widely, these laws are difficult to enforce against companies that operate in many states and nations, and sometimes these laws are more helpful than detrimental to product-based pyramid schemes.

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[172] *See*, *e.g.*, U.S. v. Gold Unlimited, Inc., 177 F.3d 472 (1999) (affirming conviction of pyramid promoters David and Martha Crowe for money laundering and money laundering conspiracy under 18 U.S.C. § 1957 and mail fraud under 18 U.S.C. § 1341).

A common type of state pyramid scheme law is what is referred to as an "Amway exception" anti-pyramid statute.[173] As discussed above, the Amway exceptions are widely viewed as favorable to the industry promoting product-based pyramid schemes.[174] States that have enacted Amway exception anti-pyramid statutes[175] include Alabama, Arizona, Florida, Georgia, Idaho, Illinois, Louisiana, Maryland, Massachusetts, Mississippi, Missouri, New Mexico, North Dakota, Oklahoma, Tennessee, Texas, Utah, and Wyoming.[176]

State securities acts, known as "blue sky" laws, are often similar to federal securities laws in the sense that they only apply to investments in "securities."[177] These laws often differ from federal laws because they often look at the merits of a security offering, while federal law is based on a philosophy of full disclosure (*i.e.*, federal law does not judge the quality of a security but merely requires that the offeror disclose material information about the company.[178] Like the federal laws, state laws produce inconsistent results, particularly with respect to whether the scheme is a security.[179] In part, this is because state securities laws that are modeled after federal law are often subject to a Howie-type analysis that produces inconsistent results under federal law. As a New Jersey prosecutor noted, for example,

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[173] *See* Howie, *supra* note 23.

[174] *See supra* Section I.B.

[175] As of the end of 2001. These statutes generally provide that a company that employs the Amway Safeguards is not an illegal pyramid scheme.

[176] *See* Howie, *supra* note 23, at 289 n.4.

[177] *See* Reese, *supra* note 128, at Section II.

[178] *See* HAMILTON AND BOOTH, *supra* note 54, at 346, 349.

[179] *See* Eric Witiw, *Selling the Right to Sell the Same Right to Sell: Applying the Consumer Fraud Act, the Uniform Securities Law and the Criminal Code to Pyramid Schemes*, 26 SETON HALL L. REV. 1635, 1640-1642 (1996).

> Although it appears from the case law in other jurisdictions that pyramid sales are securities, that question is unresolved under the New Jersey decisions. . . . This unresolved question of whether pyramid sales are merchandise or securities casts a cloud over criminal prosecution under New Jersey's Uniform Securities Law.[180]

Perhaps the most useful state laws in the pyramid marketing scheme context are state business opportunity laws. According to the FTC's website, twenty-six states currently have such laws on their books.[181] Under these laws, business opportunity sales are prohibited unless the seller provides the prospective purchasers with a disclosure document before the sale, which also must be filed with a state agency.[182] The primary problem with these rules is that pyramid marketing schemes can work around them by offering the opportunities in states without stringent disclosure requirements.

In summary, state laws are very difficult to enforce against pyramid marketing schemes. As Dr. Taylor has written, "state disclosure rules and other state statutes are inadequate because pyramid marketing schemes by their very nature quickly spread across state lines and become unmanageable by state law enforcement agencies."[183] This alone demonstrates the need for a comprehensive federal rule.

IV. THE FTC'S PROPOSED BUSINESS OPPORTUNITY RULE

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[180] *Id.* at 1645.

[181] *See* Federal Trade Commission, State Offices Administering Business Opportunity Disclosure Laws, http://www.ftc.gov/bcp/franchise/netbusop.htm (last visited Feb. 17, 2007). These states include Alaska, California, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia, Washington, and Wisconsin.

[182] *Id.*

[183] Letter from Jon M. Taylor, *supra* note 6.

On April 12, 2006, the Federal Trade Commission published a Notice of Proposed Rulemaking (the "Notice") and the Proposed Rule.[184] As of the date of submission of this article, the Proposed Rule has not been enacted or withdrawn.[185]

A. Overview of the Proposed Rule

In recognition of the fact that many sellers of "opportunities" easily avoid the disclosure requirements of the Franchise Rule either by offering to repurchase products from the victim or by keeping the initial investment below $500, the Proposed Rule aims to cast a wide net. It requires, in connection with the sale of any "business opportunity," that the offeror of the opportunity make certain disclosures at least seven days[186] before the prospective purchaser signs a contract or pays any money, whichever occurs first.[187] In recognition of the fact that the disclosure requirements under the Franchise Rule can be burdensome, the Proposed Rule

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[184] Proposed Rule, *supra* note 10.

[185] The Notice requested comments and required all comments to be submitted by June 16, 2006, with rebuttal comments to be submitted by July 7, 2006. *Id.* On June 1, 2006, the FTC extended the comment period to July 17, 2006, and the rebuttal period to August 7, 2006. Business Opportunity Rule, 71 Fed.Reg. 31,124 (June 1, 2006). On August 15, 2006, the FTC further extended the rebuttal period to September 29, 2006. Business Opportunity Rule, 71 Fed. Reg. 46,878 (Aug. 15, 2006). Although a "Final Rule" was issued as 16 C.F.R. pt. 437, this appears to serve almost as a placeholder while the FTC considers the Proposed Rule. *See supra* note 79.

[186] Note that this is an actual cooling off period before a contract can be signed or money can be paid. This is not merely a rescission right, which would be useless in the high pressure cult-like, MLM context because of the unlikelihood that people actually would rescind once a contract is signed. Once they sign a contract, most will feel committed to the program. *See infra* note 234 and accompanying text.

[187] Proposed Rule, *supra* note 10, at 19,067, 19,088 (to be codified at 16 C.F.R. pt. 437.2).

requires the disclosure of significantly less information than is required under the Franchise Rule. Specifically, the FTC's website describes the Proposed Rule as follows:

> The [P]roposed [R]ule would eliminate the $500 minimum investment requirement from the Franchise Rule, meaning it would apply to all business opportunities, even if they have a smaller start-up cost. The [P]roposed [R]ule also would eliminate many of the 20 disclosures that are required for franchises (trademarks, for example), but do not apply to business opportunities.[188] Instead, the [P]roposed [R]ule would require a one-page disclosure addressing five items: whether or not sellers make earnings claims; a list of any criminal or civil legal actions against the seller or its representatives that involve fraud, misrepresentations, securities, or deceptive or unfair trade practices; whether the seller has cancellation or refund policies and such policies' terms; the total number of purchasers in the past two years and the number of those purchasers seeking a refund or to cancel in that time period; and a list of references.
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> The [P]roposed [R]ule would not require any business opportunity seller to make an earnings claim. However, if they did make an earnings claim, they would be required to provide additional substantiation in the form of an "Earnings Claims Statement.". . . The [P]roposed [R]ule also would prohibit unfair or deceptive practices that are common among fraudulent business opportunity sellers, including:
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> • misrepresentations about the material terms of the business relationship;
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> • the use of shills;[189]
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> • misrepresentations of endorsements or testimonials;
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> • failure to honor territorial protection guarantees; and

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[188] If the Franchise Rule applies (*i.e.*, if the initial investment is $500 or more), the seller of the opportunity must make extensive disclosures. Under the proposed Business Opportunity Rule, which would apply when the initial investment is less than $500, the seller would have a duty to disclose far less than under the Franchise Rule.

[189] In this context, a "shill" is a slang term for "a person who poses as a customer in order to decoy others into participating. . . ." WEBSTER'S NEW UNIVERSAL UNABRIDGED DICTIONARY 1165 (1996).

- failure to honor refunds.[190]

B. Analysis of the Proposed Rule

The FTC is offering the Proposed Rule in light of its review of the ineffectiveness of the Franchise Rule in preventing certain widespread fraudulent practices, such as work-at-home schemes and pyramid marketing schemes.[191] The FTC is also offering the Proposed Rule in light of the fact that "[b]y far, the most frequent allegations in [FTC] business opportunity cases pertain to false or unsubstantiated earnings claims."[192] The Proposed Rule is a welcome effort to address a major problem, although it is unlikely to stop abusive product-based pyramid schemes because disclosure alone will not penalize the company making the offering. Congressional legislation specifically drafted to stop product-based pyramid scheme abuses is also necessary to

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[190] Press Release, Federal Trade Commission, FTC Proposes New Business Opportunity Rule (Apr. 5, 2006), *available at* http://www.ftc.gov/opa/ 2006/04/newbizopprule.htm (last visited Feb. 17, 2007).

[191] *See* Request for Comments Concerning Trade Regulation Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 60 Fed. Reg. 17,656 (Apr. 7, 1995); Proposed Rule, *supra* note 10, at 19,059. *See also* discussion of these schemes *supra* Sections I.A.1-A.2. It is worth noting that "business opportunities" covered by the Franchise Rule consistently rank among the top 10 categories of consumer fraud complaints reported to the FTC. Proposed Rule, *supra* note 10, at 19,058.

[192] Proposed Rule, *supra* note 10, at 19,057. *See* STAFF OF THE BUREAU OF CONSUMER PROTECTION, FRANCHISE AND BUSINESS OPPORTUNITY PROGRAM REVIEW 1993-2000: A REVIEW OF COMPLAINT DATA, LAW ENFORCEMENT, AND CONSUMER EDUCATION 38 tbl.I.1, 39 tbl.I.2 (2001) (showing 127 Franchise Rule allegations and 94 Section 5 allegations pertaining to earnings claims issues in FTC enforcement actions), *available at* http://www.ftc.gov/reports/ franchise93-01.pdf (last visited Feb. 17, 2007).

truly stop these schemes.[193] In addition, the Proposed Rule should be modified before it is finalized to address some of the pyramid marketing scheme evasion tactics discussed in this article.

The Proposed Rule applies only to business opportunities that are not covered by the Franchise Rule. The Proposed Rule defines "business opportunity" as a commercial arrangement in which (1) the seller solicits somebody to enter into a new business, (2) the prospective purchaser makes a payment or provides other consideration to the seller or a third party, and (3)

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[193] Some notable commentators have argued that broad congressional legislation on this issue would be ineffective because the MLM lobby is so powerful that the inevitable result actually would be legislation that would facilitate the use of product-based pyramid schemes:

> While it may seem advisable to revise laws to better reflect the realities of [pyramid marketing schemes], it would be risky to do so. Unless legislators are well informed on the issues (requiring extensive time and study), the DSA will likely enter the fray with powerful resources and influence the legislation in the direction of legalizing all MLM[]s which offer legitimate products. (See [Jon M. Taylor's] analysis of DSA-initiated legislation in Utah and analysis by Robert Fitz[P]atrick of Pyramid Scheme Alert of DSA legislative initiatives.

TAYLOR, THE 5 RED FLAGS, *supra* note 6, at 23. This is a legitimate risk. However, educating Congress on this issue, despite lobbying efforts to the contrary, is within the realm of possibility and a worthwhile goal. Furthermore, even if consumer advocates do not seek congressional action, that will not stop the DSA from acting first, as it did when it sponsored the failed "Anti-Pyramid Promotional Scheme Act of 2003," which would have effectively, and misleadingly, given a congressional stamp of approval to all pyramid marketing schemes. *See* Pyramid Scheme Alert, What the US Congress and Regulators Need to Know About the Anti-Pyramid Promotional Scheme Act of 2003, http://www.pyramidschemealert.org/PSAMain/news/DSABill/DSAbill_analysis.html (last visited Feb. 17, 2007). In fact, the DSA recently stated, in connection with the Proposed Rule, that it "also continues its efforts to educate members of the United States Congress on this important challenge to the direct selling community." Direct Selling Association, DSA Submits Comments to Federal Trade Commission (FTC) on Proposed Rule, http://www.dsa.org/press/ Misc/index.cfm?documentID=750 (last visited Feb. 17, 2007).

the seller either makes an earnings claim or represents that the purchaser will be provided with business assistance.[194]

1. Solicitation to Enter into a Business

The "business opportunity" definition in the Proposed Rule contemplates that sellers are soliciting people to enter into new businesses rather than just soliciting them to buy goods or services.[195] Thus, the Proposed Rule, if made final, will have no effect whatsoever on the MLM distributor who is merely seeking out customers for the company's products. The Rule will affect—and in fact is designed to directly affect—those distributors who are seeking out new distributors.

2. Consideration Paid

The Proposed Rule would apply if any consideration is paid for the business opportunity. This, of course, differs from the Franchise Rule in that the Franchise Rule applies only if consideration of at least $500 is paid during the first six months after purchase.[196] The word "consideration" includes monetary payments, whether present or future, as well as a share of profits.[197] The rule applies if payment is made directly to the seller or, to prevent easy evasion of the rule, indirectly to the seller through a third party.[198]

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[194] *See* Proposed Rule, *supra* note 10, at 19,063, 19,087 (to be codified at 16 C.F.R. pt. 437.1(d)).

[195] *See id.*

[196] *See supra* Section I.A.

[197] Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures; Promulgation of Final Interpretive Guides, 44 Fed. Reg. 49,966, 49,967 (Aug. 24, 1979).

[198] Proposed Rule, *supra* note 10, at 19,063, 19,087 (to be codified at 16 C.F.R. pt. 437.1(d)(1)-(2)).

3. Earnings Claims or Business Assistance

If the seller either makes an earnings claim or offers business assistance, and if the first two requirements[199] are met, then the Proposed Rule will apply, meaning that the seller will need to disclose the required information at least seven days before the contract is signed or the consideration is paid, whichever occurs earlier.[200] If the seller does not either (1) make an earnings claim or (2) offer business assistance, then, regardless of whether the first two requirements are met, the Proposed Rule will not apply, meaning that no disclosure will be required.

The FTC's experience has demonstrated that "the making of earnings claims underlies virtually all fraudulent business opportunity schemes. . . . [S]uch claims are highly relevant to consumers in making their investment decisions and typically are the single most decisive factor in such decisions."[201] Because of the significance of earnings claims in a purchaser's decision and because of the number of complaints that the FTC receives about earnings claims, it has decided that the rule should apply as broadly as possible. Specifically, the Proposed Rule states that the term "earnings claim"

> means any oral, written, or visual representation to a prospective purchaser that conveys, expressly or by implication, a specific level or range of actual or potential sales, or gross or net income or profits. Earnings claims include, but are not limited to:
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> (1) Any chart, table, or mathematical calculation that demonstrates possible results based upon a combination of variables; and

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[199] *I.e.*, (1) solicitation to enter into a business and (2) consideration paid. *See* Proposed Rule, *supra* note 10, at 19,063, 19,087 (to be codified at 16 C.F.R. pt. 437.1(d)(1)-(2)).

[200] *Id.*

[201] *Id.* at 19,063-64.

(2) any statements from which a prospective purchaser can reasonably infer that he or she will earn a minimum level of income (*e.g.*, "earn enough to buy a Porsche," "earn six-figure income," or "earn your investment back within one year").[202]

If the seller makes no earnings representations whatsoever in connection with the sale of the business[203] but offers business assistance, the Proposed Rule will apply, provided of course that the first two requirements are met.[204] The term "business assistance" only refers to situations involving the "establishment or operation of a business" and not to "a written product warranty or repair contract, or guidance in the use, maintenance, and/or repair of any product to be sold by the purchaser or of any equipment acquired by the purchaser."[205] This provision obviously is aimed at distinguishing sales of goods or services from the sale of a business.

4. Disclosure Document

If all three elements of the "business opportunity" definition are met, then the seller of the business opportunity must prepare and furnish the prospective purchaser with a one-page

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[202] *Id.* at 19,087 (to be codified at 16 C.F.R § 437.1(h)). Thus, under this Proposed Rule, the fact that an ACN distributor drives extremely costly BMW and Mercedes automobiles bearing Utah license plates reading "THX ACN" and "ONLY 499" would be earnings claims. Web video: ACN Cribs 2, http://www.youtube.com (search "ACN Cribs 2") (last visited Feb. 17, 2007) (videotaped copy on file with author). Earnings claims such as this routinely occur in the MLM industry despite the fact that, in its written materials, ACN "strictly prohibits" earnings claims. *See supra* note 163 and accompanying text.

[203] This is a scenario that is almost impossible to imagine occurring when one considers the breadth of the definition of earnings claims.

[204] *See* Proposed Rule, *supra* note 10, at 19,087 (to be codified at 16 C.F.R. pt. 437.1(d)(3)(ii)).

[205] *Id.* (to be codified at 16 C.F.R pt. 437.1(c)).

disclosure document.[206] In addition, if the seller makes any earnings claims, then the seller must provide the prospective purchaser with an earning claims statement.[207] The seller must provide the basic disclosure document and the earning claims statement, if any, "in writing [to the prospective purchaser] at least seven calendar days before the earlier of the time that the prospective purchaser: (a) Signs any contract in connection with the business opportunity sale; or (b) makes any payment or provides other consideration to the seller, directly or indirectly through a third party."[208] The purpose of this seven-day period is to provide the prospective purchaser with sufficient time "to review the basic disclosure document and any earnings claims statement, as well as conduct a due diligence review of the offering, including contacting references."[209]

Because one of the main groups that the Proposed Rule aims to protect is immigrants with limited ability to speak English,[210] the disclosure document should be available in multiple languages if the offer to sell the opportunity is made in those languages. The Proposed Rule does not require this, but failing to do so would render the disclosure document meaningless in many cases. Specifically, the seller should be required to provide the disclosure document to the

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[206] *Id.* at 19,088 (to be codified at 16 C.F.R pt. 437.2). Only the seller of a business opportunity has this obligation. Others, such as brokers, locators, or suppliers, do not have this obligation. *See id.* at 19,067.

[207] *Id.* at 19,088-89 (to be codified at 16 C.F.R pt. 437.4(a)(4)). Presumably, this means that a "business opportunity" that only meets that definition because the seller offers business assistance, rather than earnings claims, will not need to provide the earnings claims statement.

[208] *Id.* at 19,088 (to be codified at 16 C.F.R pt. 437.2).

[209] *Id.* at 19,067. The FTC notes in its Notice of Proposed Rulemaking that "a shorter period may be warranted," and it "solicits comment on whether it should adopt a shorter time period." *Id.*

[210] *See supra* note 96 and accompanying text.

prospective purchaser in the same language in which the seller communicates the business opportunity to the prospective purchaser. It is easy to envision an "opportunity meeting" being conducted in Spanish with attendees being given an English disclosure form and then being told in Spanish, with no further explanation, "Just sign these few documents and give us a payment to make this wonderful opportunity happen."[211]

In general, the disclosure document requires the seller to provide the prospective purchaser with a one-page form (and possibly some attachments) that contains identifying information, a standard preamble, and five substantive disclosures.[212] These five substantive disclosures, discussed in greater detail below, include (1) earnings claims, (2) legal actions, (3) cancellation or refund policy, (4) cancellation or refund request history, and (5) references.[213]

The identifying information that is required under the Proposed Rule appears to be reasonable and, from the public comments on the Proposed Rule, non-controversial. Specifically, the document will need to disclose the seller's name, business address, telephone number, the name of the salesperson offering the business opportunity, and the date.[214]

The proposed preamble would state that the information in the disclosure document "can help you in deciding whether to purchase a business opportunity."[215] It would also note that "no

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[211] *See* cases cited *supra* note 96.

[212] Proposed Rule, *supra* note 10, at 19,068, 19,091 (to be codified at 16 C.F.R. pts. 437.3(a) and Appendix A).

[213] *Id.*

[214] *Id. See also* Part 436—Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, Promulgation of Trade Regulation Rule and Statement of Basis and Purpose, 43 Fed.Reg. 59,614, 59,642 (Dec. 21, 1978).

[215] Proposed Rule, *supra* note 10, at 19,068, 19,091 (to be codified at 16 C.F.R. pts. 437.3(a) and Appendix A).

governmental agency has verified the information."[216] Finally, it would advise prospective purchasers to obtain more information from the FTC at its website or by phone and to check state law requirements with their state's Attorney General office.[217]

The five substantive disclosures would take the form of "yes" or "no" boxes to check.[218] The first of these disclosures ("earnings claim") is by far the most important disclosure.[219] As currently written, the Proposed Rule would allow earnings claims as long as they are reasonable and the seller can substantiate them.[220] The seller would have a duty to disclose whether or not the seller makes any earning claims.[221] If the seller does make earnings claims, the seller would then need to provide the prospective purchaser with an earning claims statement.

Unfortunately, given how most pyramid marketing schemes operate, enforcement of the earning claims disclosure requirement will be extremely difficult and will be evaded easily. First, companies are likely to change their internal regulations applicable to distributors to specifically prohibit distributors from making any earning claims statement, if their internal regulations do not already do this.[222] Second, companies could provide all distributors with forms to provide to prospective purchasers. The forms, which prospective purchasers will be required to sign, will state that the seller has made no earnings claims disclosures. Third, all

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[216] *Id.*

[217] *Id.*

[218] *Id.*

[219] This opinion is based on the FTC's statement that "the making of earnings claims underlies virtually all fraudulent business opportunity schemes." *Id.* at 19,063.

[220] *Id.* at 19,068.

[221] *Id.*

[222] *See*, *e.g.*, note 163 *supra*.

sellers likely will routinely check the "no earnings claims" box. Prospective purchasers certainly will be told that this is occurring because they are a company that complies with the technical requirements of the law, and no earnings are guaranteed. Under these circumstances, it would be very difficult and labor intensive to prosecute companies for violations, just as it currently is. FTC investigators would need to attend opportunity meetings to gather evidence. Even if they were to obtain enough evidence at the meetings, the companies could just respond that the people at those meetings were independent contractors who violated the company's written policies.

The FTC, like the SEC, should be working to protect the *public* whenever a company takes on a *public* role.[223] It is inconceivable that any public sale of "the opportunity" would NOT involve earnings claims. Thus, the rule should require a mandatory earnings disclosure by the individual seller any time a seller of a business opportunity takes on a public role. This could be defined in the final rule as any time either (1) the opportunity is being offered to more than five people in one setting, or (2) the individual seller has sold the opportunity to more than five people during the previous thirty days. Such a change would eliminate the burden on people who primarily are making money by selling a product but who may occasionally invite a friend into the business. This change also would acknowledge the reality that anybody who regularly sells "opportunities," especially to groups of people, is making earnings claims.

The second disclosure (legal actions) would require the seller to disclose if it or "any affiliate or prior business of the seller" has been the subject of specific types of legal actions

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[223] *See* note 54 *supra*.

within the last ten years.[224] These include "any civil or criminal actions for misrepresentation, fraud, securities law violations, or unfair or deceptive practices."[225] "[D]isclosure of such actions is required regardless of whether the claim is brought in a court or administrative action or arbitration proceeding, and whether it is brought by a private party or a governmental agency."[226] Although this information is relevant, it could be misleading. The disclosure of all actions, rather than convictions, virtually presumes that the seller was guilty. It also gives an inordinate amount of power to the enemies of a particular company, who might bring an action solely to require the company to disclose the action to every prospective purchaser. Accordingly, this disclosure, if required in the final rule, should be limited to convictions or similar holdings in which the seller was found to be guilty.

The third disclosure (cancellation or refund policy) would require that sellers disclose all terms and conditions of any cancellation or refund policy.[227] This information is extremely material to prospective purchasers because it "create[s] the impression that the business opportunity offer is either risk-free or a low financial risk. Indeed, the [FTC's] Staff Program Review found that 24% of business opportunity complaints involved consumers seeking to cancel their purchase (818 of 4512 complaints), and 22% involved a refund policy issue (752 of 4512 complaints)."[228] Under the Proposed Rule, if a seller claims to have a cancellation or

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[224] Proposed Rule, *supra* note 10, at 19,088 (to be codified at 16 C.F.R. pt. 437.3(a)(3)). Note that this provision is based upon a similar provision in the Franchise Rule, 16 C.F.R. § 6.1(a)(4), and on UFOC Guidelines, UFOC Item 3. *See id.* at 19,068 n.154.

[225] *Id.* at 19,088 (to be codified at 16 C.F.R. pt. 437.3(a)(3)).

[226] *Id.* at 19,069.

[227] Proposed Rule, *supra* note 10, at 19,088 (to be codified at 16 C.F.R. pt. 437.3(a)(4)).

[228] *Id.* at 19,070.

refund policy (and it is not required to have one), it must attach to the disclosure document a description of its policy.[229] This information is relevant to the prospective purchasers' decision, and the burden on the seller to provide this information is small. However, in the interest of keeping the final rule administratively simple, and in the interest of minimizing "information overload" for prospective purchasers, the FTC should delete this requirement.

The fourth disclosure (cancellation or refund request history) is also extremely relevant to the prospective purchaser's decision, but the burden on the seller is much higher. This disclosure rule would require sellers to disclose cancellation or refund requests made by prior purchasers during the prior two years.[230] "Cancellation or refund request" means any request to cancel or any request for a full or partial refund, whether or not the person making the request has the right to the cancellation or refund.[231] Because of the burden of tracking the number of refund requests and because of the potential negative consequences to the seller of disclosing all refund requests, such a disclosure requirement would encourage sellers to do away with refund policies altogether. Because refund policies are desirable, this particular disclosure requirement should be deleted from the Proposed Rule.

The fifth disclosure (references) requires the seller to disclose the name, city, state, and telephone number of the ten most recent purchasers nearest to the prospective purchaser's location (or of all prior purchasers if fewer than ten).[232] Alternatively, a seller may provide a

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[229] *Id.*

[230] *Id.* at 19,088 (to be codified at 16 C.F.R. pt. 437.3(a)(5)).

[231] *See id.* at 19,070 n.172.

[232] *Id.* at 19,088 (to be codified at 16 C.F.R pt. 437.3(a)(6)).

prospect with a national list of all purchasers.[233] This requirement seems unnecessary and is not cost-effective. First, the burden on the seller is extraordinary while the value to the prospective purchaser is small. The data regarding the ten most recent purchasers can be manipulated very easily. For example, prior to a large "business opportunity meeting," sellers can sell to ten "friendly" local people so as to then disclose them as the references. Even forgetting the possibility of manipulation of data, real data may be worthless. If a seller is active in a particular market, then the ten most recent purchasers are likely to be people who have not yet realized the error of their investment. They may still be programmed to believe in the opportunity. This may be the case even a year after somebody has invested. As Dr. Taylor reports, "It is extremely rare for [pyramid marketing scheme] victims to recognize the fraud . . . without intensive de-programming by a knowledgeable consumer advocate. They have been conditioned to blame themselves – not the . . . program – for their 'failure.'"[234] Thus, this type of disclosure may actually have the effect of encouraging investments in pyramid marketing schemes.

The second problem with the references requirement is the issue of privacy. Prior purchasers may not want this information disclosed. Presumably they would be able to request that this information not be disclosed, but that would open to the door to evasion by the seller. The seller could then just ask all purchasers if they want personal information disclosed; and many, if not most, would probably decline. Furthermore, sellers have a legitimate concern that it would be too easy for competitors to obtain distributor lists if their information were disclosed.

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[233] *Id.*

[234] TAYLOR, THE 5 RED FLAGS, *supra* note 6, at 11.

In short, the problems with the disclosure of references greatly outweigh the benefits of this disclosure. This requirement should be removed.

5. Earnings Claim Statement

Under the Proposed Rule, if a seller makes an earnings claim in connection with the sale, then the seller must (1) have a reasonable basis for the claim, (2) have written materials to substantiate the claim, (3) make written substantiation available to the prospective purchaser and to the FTC, and (4) attach an "Earnings Claim Statement" to the disclosure document.[235] Under the Proposed Rule, the Earnings Claim Statement must state the following information:

(i) The title "**EARNINGS CLAIM STATEMENT REQUIRED BY LAW**" in capital, bold type letters;

(ii) The name of the person making the earnings claim and the date of the earnings claim;

(iii) The earnings claim;

(iv) The beginning and ending dates when the represented earnings were achieved;

(v) The number and percentage of all purchasers during the stated time period who achieved at least the stated level of earnings;

(vi) Any characteristics of the purchasers who achieved at least the represented level of earnings, such as their location, that may differ materially from the characteristics of the prospective purchasers being offered the business opportunity; and

(vii) A statement that written substantiation for the earnings claim will be made available to the prospective purchaser upon request.[236]

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[235] Proposed Rule, *supra* note 10, at 19,088 (to be codified at 16 C.F.R. pt. 437.4).

[236] *Id.* at 19,088-89 (to be codified at 16 C.F.R pts. 437.4(a)(4)(i)-(vii)).

The earnings claim statement, which should be required of all "public" sales of business opportunities, is the single most important piece of information to be disclosed by business opportunity sellers. Unfortunately, this aspect of the Proposed Rule must be revised if the FTC hopes to minimize the existence of product-based pyramid schemes.

The earnings claims disclosure has the following two potential purposes: (1) to inform the prospective purchaser about the realistic possibilities of making money in the company and (2) to provide the FTC, and perhaps other government agencies, with enough information to determine if the "opportunity" is in fact a disguised pyramid scheme. Ensuring that purchasers are informed will reduce the effectiveness of these schemes because most people who invest do so only because they think they are likely to make a fortune. Moreover, ensuring that the government is informed is critical to enforcing anti-pyramid scheme laws.

The key information that potential investors need to know is how much prior investors actually have made. Averages alone are not very useful, especially because companies tend to base that information on "active participants," that is, people who have not dropped out.[237] Obviously, information about people who have dropped out is very significant. Thus, the seller of the opportunity should be required to provide the prospective purchaser with the following six pieces of information in the language in which the sales pitch occurs:

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[237] *See*, *e.g.*, ACN Canada, Earning Statement, posted at ACN Canada, Opportunity, Overview, http://www.acncanada.ca/acn/ca_en/opportunity/index.jsp (last visited Feb. 18, 2007). The earnings statement information was presumably added to the website as a result of pressure by Canadian government authorities. This information does not appear to be available at any other ACN website. *See* note 318 *infra*.

1. The total number of people (the "Whole Group") who were registered as distributors of the company's products during the twelve month period ending on the last day of the month two months prior to the disclosure date (the "Measuring Period");[238]

2. The number of people who became new distributors during the Measuring Period;

3. The number of people who ceased being distributors during the Measuring Period;

4. The mean (or average) *net* income for the Whole Group during the Measuring Period;[239]

5. The median *net* income for the Whole Group during the Measuring Period;[240] and

6. The method used to compute net income. This should include money received by all participants reduced by money paid to the company, including any sign-up fee, any annual fee, amounts paid for products, shipping costs, costs of training seminars, and similar fees.

All six of these requirements would help people to avoid being misled, which should be the primary focus of the new law (*i.e.*, disclosure to purchasers and a reasonable waiting period).[241] None of this information, however, will help authorities determine if the

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[238] Thus, if disclosure occurs on May 5, 2007, for example, the disclosure should report the total number of people who were distributors at any time from April 1, 2006 through March 31, 2007. This delay between the close of the twelve-month period and the disclosure date provides companies with ample time to compile the data and e-mail it to all distributors.

[239] Mean net income is computed by adding up the total net income for the Whole Group and dividing by the total number of people in the Whole Group.

[240] Median net income is computed by determining the net income number above which 50% of the Whole Group and below which 50% of the Whole Group has their net income.

[241] This focus on the disclosure of material information to prospective purchasers, without looking to the substance of the transaction, is analogous to the approach taken by federal securities laws. *See* note 54 *supra* and accompanying text.

"opportunity" is a disguised pyramid scheme.[242] In fact, the above information is not very relevant to a pyramid marketing scheme inquiry. The heart of any pyramid marketing scheme is based on one simple concept: earnings of participants are primarily derived, whether directly or indirectly, from recruiting new participants rather than from selling a product.[243] This is easy to hide. Thus, an additional disclosure to the government would be necessary to address this issue.[244]

The only way to adequately inform the government with respect to pyramid marketing schemes is to require the filing of a separate earnings statement that clearly distinguishes (1) earnings derived from retail sales from (2) earnings derived, even indirectly, from amounts paid by new recruits. To do this, the company must disclose verifiable retail-based income

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[242] This more substantive approach is more analogous to the approach of traditional "blue sky" laws. *See* note 177 *supra* and accompanying text.

[243] Determining if this is occurring is much easier said than done. Companies with legal counsel go through great lengths to hide this fact to avoid being classified as a pyramid scheme. These well-informed companies know better than to merely distribute bonuses for recruiting new members out of fees paid by new members. Instead, for example, they pay a bonus to a recruiting distributor when a newly-recruited member obtains a certain number of customers. The trick is that the bonus, although delayed and nominally tied to new customers, overwhelmingly comes from sign-up fees paid by the new distributor. *See* discussion of ACN *infra* Section V. It is much more difficult to identify the scheme when new distributors do not pay money for joining, or when they pay a nominal fee. In these schemes, the new distributors purchase products.

[244] Because of the complexity of addressing this issue, the simplest approach is to first pass the purchaser disclosure rule to determine if it alone will deter enough people from getting involved. If purchaser disclosure alone proves to be insufficient, then government disclosure should be added.

earned at each level in the company's hierarchy.[245] For example, assume Company X has only two distributors (for simplicity, both are at the same level) who each buy ten boxes of herbal medicine from the company for $1,000. Distributor A sells her entire box for $1,200. Distributor B sells part of her box for $300 and stores, uses, or gives away the rest. The company's average retail-based income at that level is negative $500.[246] The distributors would have to report that retail-based income to the company, which, in turn, would compile similar data on all retail-based sales. Anything short of this level of disclosure would mean that the FTC will be unable to efficiently investigate pyramid marketing schemes.

C. Public Comments Regarding the Proposed Rule

According to the website of the Direct Selling Association ("DSA"), the Proposed Rule will have a "devastating impact" on its members.[247] MLMs and MLM support organizations have vigorously encouraged their members to write to the FTC with their comments,[248] and approximately 17,000 comments were ultimately submitted to the FTC.[249] Even a cursory review of these comments indicates that the MLM industry views the Proposed Rule as a huge

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[245] *See* Robert L. FitzPatrick, *Comments and Recommendations from Pyramid Scheme Alert on the Proposed FTC Business Opportunity Rule, Notice of proposed rulemaking, R511993* (June 1, 2006), *available at* http://www.pyramidschemealert.org/PSAMain/ news/PSA-FTC %20Commentary.pdf (last visited Feb. 18, 2007).

[246] This is a net profit of $200 from Distributor A minus Distributor B's $700 loss.

[247] Direct Selling Association, DSA Submits Rebuttal Comments to Federal Trade Commission (FTC) on Proposed Rule, http://www.dsa.org/press/misc/ index.cfm? documentID=869 (last visited Feb. 18, 2007).

[248] *See, e.g.,* Jeffrey Babener, Babener & Associates, FTC Proposed Business Opportunity Rule: DSWA Speaks Out (2006), http://www.mlmlegal.com/FTC%20Business %20Opportunity %20Rule/DSWAresponse.html (last visited Feb. 18, 2007).

[249] *See* Statement of Basis, *supra* note 79, at n.975.

threat.[250] Moreover, the industry clearly has provided suggested language—or, more likely, form letters—to supportive members of the schemes, given that a vast number of the letters are virtually identical.[251]

If any recurring message can be derived from the public comments, it is that the number one complaint about the Proposed Rule is the seven-day waiting period from the day a seller discloses required information to a prospective purchaser until the day when the prospective

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[250] Dr. Taylor is correct when he notes that "[t]he vast majority of the 'Public Comments' objections to [the FTC's] proposed disclosure rule come from MLM adherents, not from sponsors of legitimate business opportunities. This is because meaningful disclosure about MLM[]s or chain sellers could expose the stark truth: They are pyramid marketing schemes that enrich the MLM company and TOPP[]s (top of the pyramid promoters) at the expense of a multitude of downline victims!" Letter from Jon M. Taylor, *supra* note 6.

[251] Letters available at Federal Trade Commission, #178 FTC Matter No.: R511993 16 CFR Part 437 Notice of Proposed Rulemaking: Business Opportunity Rule, Form Letters, http://www.ftc.gov/os/comments/businessopprule/Indexflm.htm (last visited Feb. 18, 2007). The FTC notes the following on its website:

> **Note:** Over 5,000 of the public comments that were filed in paper form with the Commission on this proceeding were variants of "form letters" - i.e., letters that are based on all or part of a generic form letter template. Accordingly, the FTC is posting only one representative public comment for each different form letter variety identified. The FTC has created this separate "Form Letter" index page to distinguish these form letter examples from other letters, so that members of the public can find them more easily on the site. Appended to each of these representative comments is a list of the names of additional commenters who submitted that particular variety of form letter. Please note that these appended lists are limited to paper submissions only; form letters submitted via electronic means are posted individually on the site, and can be found in the general alphabetical index by commenter name.

Id.

purchaser can pay money or sign a contract.[252] The reasons for this complaint range from calling it "confusing and burdensome,"[253] to noting concern that the "proposed waiting period will give the public the idea that there's something wrong with me or the . . . business plan,"[254] to calling it "quite burdensome . . . to keep such detailed records"[255] to finding the waiting period to be "unnecessary."[256] There are many more stated reasons, but this is intended to be a sampling of the objections.

The industry relies on high pressure sales to sell the opportunity to sell. These high pressure settings are often called "opportunity meetings." These meetings are used to persuade participants that they can make a fortune if they join the company. The goal is obviously to catch people in the emotion of the moment and recruit them. If people have time to think about the decision, research the company, or talk to reasonably intelligent friends, they would be far less likely to sign a contract or pay money. This is certainly why the industry feels so threatened by this aspect of the Proposed Rule. While reasonable minds can quibble over the appropriate

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[252] This message is conveyed very early in a huge percentage of the letters, often using virtually identical language. For example, Julie Gunhus of "Stampin' Up!" writes, "One of the most confusing and burdensome sections of the proposed rule is the seven-day waiting period to enroll new demonstrators. This waiting period gives the impression that there might be something wrong with the plan." Similarly, Mark Cedarleaf of "Cedarleaf Wellness" writes, "One of the most confusing and burdensome sections of the proposed rule is the seven day waiting period to enroll new distributors." Likewise, S. Long of "4Life" writes, "One of the most confusing and burdensome sections of the proposed rule is the seven day waiting period to enroll new distributors." The numbers of letters with comments virtually identical to these is extensive. *See supra* note 248.

[253] *Id.*

[254] Letter from "XanGo" distributors, Eric F. & Heidi A. Welch. *See supra* note 251.

[255] Letter from "Healing Essentials" distributor, Debbie Hunter. *See supra* note 251.

[256] Letter from "XanGo" distributors, Jeremiah and Patricia Arnett. *See supra* note 251.

waiting time needed to stop people from making emotional investments that are virtually guaranteed to fail, certainly a few days are needed. Whether it is three, five, or seven days is not the issue; what is critical is a wait period of at least a few days. If this was an amazing opportunity on the day of the opportunity meeting, it should still be an amazing opportunity seven days later. If it is not, there is a problem.

A detailed analysis of all comments to the Proposed Rule is beyond the scope of this article. However, in addition to the seven-day wait period, certain other common complaints recur regularly throughout the letters. First, distributors are concerned about releasing information about all lawsuits involving misrepresentation or unfair or deceptive practices because this would include situations in which the company is found to be innocent of the alleged violation.[257] Second, distributors are concerned about privacy issues related to releasing information about prior purchasers.[258] Interestingly, there is not a lot in the letters about the earnings claim disclosure requirements. Perhaps that is because, as explained above,[259] companies could easily work around that requirement to continue their deceptive practices.

V. ACN: AN EXAMPLE OF THE PROBLEMS WITH THE PROPOSED RULE

Donald Trump recently endorsed ACN, a company in which distributors purportedly make money from selling telephone, internet, and similar services. In a video clip available on ACN's website, Mr. Trump says,

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[257] *See, e.g.,* letters from 4Life distributors, S. Long and Fernando Gomez. *See supra* note 251.

[258] *Id.*

[259] *See supra* note 163 and accompanying text.

> The beauty of ACN is you're in business for yourself, but not by yourself. You're not standing out there alone. You know – there are gonna be tough times and life is tough. You have a great partner with ACN. They're gonna help you. They're gonna be there for you. They're gonna work with you. It's a great company. It's a respected company. Everybody loves it. So use that. Take advantage of it. You're entrepreneurs, but, you know, being a lonely entrepreneur is not as good as being an entrepreneur with a great company behind you. And ACN is a great company.[260]

While Mr. Trump's endorsement says nothing about the legitimacy, legality, morality, or ethics of ACN's business, it is interesting that such a high-profile individual would endorse a pyramid marketing scheme.[261] Mr. Trump's video is now played at "opportunity meetings" to help recruit more distributors into the scheme.[262] In its fourteen years in business, ACN has grown to be a multinational company located in eighteen countries with almost 100,000 representatives, 50,000 of whom are located in the United States.[263]

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[260] Web video: ACN & Donald Trump, http://www.acninc.com/acn/us/opportunity/donald_trump.jsp (last visited Feb. 18, 2007) (videotaped copy on file with author).

[261] With respect to Mr. Trump's comment that "Everybody loves [ACN]," he presumably is unaware of the flood of vitriolic comments about ACN that now pervade the internet. Most such comments appear to be written by ex-representatives who claim that ACN is a huge pyramid scheme in which only people at the top make money. *See, e.g.,* Exposing the Truth About ACN MLM, http://users.tns.net/~mpat/scam; Cap'n Arbyte's, Into the ACN Pyramid Scam, http://arbyte.us/blog_archive/2005/04/ACN_Pyramid_Scam.html (Apr. 11, 2005, 05:16 UTC); Mike Grossman's Blog, ACN MLM Pyramid Scheme, http://www.mikegrossman.com/blog/2006/02/23/acn-mlm-pyramid-scheme-please-comment (Feb. 23, 2006, 5:21 PM); Corporate Narc, The ACN Scam, http://www.corporatenarc.com/the-acn-scam.php; Adam Hojnacki and Peter Scheck, *Get Rich Quick?*, GENERATION, Oct. 24, 2006, http://www.subboard.com/generation/articles/116164656490688.asp; Posting of at1 to Scam.com, http://www.scam.com/showthread.php?t=4706 (Aug. 7, 2005, 12:21 PM) (all websites last visited Feb. 18, 2007). This is just a small sampling. In short, this company appears to have a growing number of enemies.

[262] Listen to audio recording of August 19, 2006 Business Opportunity Meeting by Steve Niumatalolo available at http://acnnv.com/Training.html.

[263] *See, e.g.,* Audio recording: Business Opportunity Meeting – Parts 1 & 2 (Aug. 19, 2006), http://acnnv.com/Training.html (last visited Feb. 18, 2007).

From reviewing recordings of ACN's "Business Opportunity Meetings," as well as "Training Meetings" which are also used to recruit new distributors, it appears that ACN fits the stereotype of a pyramid marketing scheme perfectly.[264] Other sources confirm this as well. For example, an Australian newspaper reported that about 1,500 people attended ACN's conference at the Gold Coast Convention and Exhibition Centre on August 14, 2004.[265] Similarly, a Canadian newspaper reported that

> There's one key word at twice-weekly meetings vaunting the merits of joining ACN: Success. The sessions have the feel of a pep rally or evangelical get-together . . . . A video flashes pictures of encouragement: $100 bills, a monster house, sail boat, executive jet, hot air balloons and a beach lined with palm trees.
>
> Even God, it seems, wants people to join ACN.
>
> "We invite you to become part of our winning team," the video announcer says. "Take advantage of the life you have. Life is God's gift to you and what you do with that life is your gift to God.". . .
>
> [An ACN co-founder] gets a big laugh when he mocks skeptics who might try to dissuade would-be recruits.
>
> "Is that one of those *pyramid* things? I've heard about those," he mimics with a scrunched-up face. "I'm just warning you. I just love you so much."[266]

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[264] The stereotypical MLM is one that uses high pressure sales tactics at large "opportunity meetings" to entice purchasers to part with their money at the meetings.

[265] *Phone Network Accused of Illegal Pyramid Selling*, COURIER MAIL (Queensland, Australia), Sept. 4, 2004.

[266] *Phone Service Sold Amway Way*, THE TORONTO STAR, Sept. 20, 1997, at E1 (emphasis added). To fully appreciate ACN's recruiting tactics, *see* Web video: ACN Experience, http://www.youtube.com (search for "ACN Experience") (last visited Feb. 18, 2007) (videotaped copy on file with author).

ACN has high-powered legal representation, and distributors tout this representation when they are seeking new recruits.[267] According to the company, it has a legal advisory board that includes "three former state attorneys general, each of whom, during his term in office, made overseeing enforcement of consumer protection laws a top priority[268]. . . . The Committee has but one goal for ACN, and that is to make sure *ACN and its independent representatives*[269] are acting within the law."[270] The fact that ACN is familiar with the laws applicable to MLMs is apparent: although ACN's business structure unquestionably is a "pyramid," it obviously works to try to avoid the legal definition of a "pyramid scheme."[271] ACN also has hired a lobbyist,

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[267] *See* Web video: ACN Attorney Generals, http://www.youtube.com (search for "ACN Attorney Generals") (last visited Feb. 18, 2007) (videotaped copy on file with author).

[268] These ex-Attorneys General are Bob Stephan, former Attorney General of Kansas, Chris Gorman, former Attorney General of Kentucky, and Grant Wood, former Attorney General of Arizona. *See* United Networks International Training On Line Page, Getting It Right (2005) (emphasis added), http://uniteam1.com/pages/Trainingonline.html (last visited Feb. 17, 2007) (hard copy on file with author).

[269] This statement might lead a person to believe that these three former state Attorneys General represent both the company and the independent distributors, two parties likely to have adverse interests in the face of an SEC challenge. For example, the company provides written rules to protect itself from an SEC attack while distributors routinely ignore these "rules." *See supra* note 163. Disregarding this potential conflict of interest without a knowing waiver by the independent distributors might be a violation of the rules of professional responsibility. *See* MODEL RULES OF PROF'L CONDUCT R 1.7 (2002). Apart from professional responsibility issues, the risk that these attorneys are taking on would appear to be immense. If the SEC were to fine distributors, it is likely that these distributors would sue the attorneys for giving them bad legal advice.

[270] *See* ACN Comments, *supra* note 272, at 3.

[271] *See* discussion *infra* Sections V.A and V.B.

John W. Hesse, II, founder of CERO Strategies and ex-Senior Attorney and Director of Government Relations for the DSA, to represent its interests in Washington.[272]

A. Comments of ACN, Inc. on the Proposed Business Opportunity Rule

On July 17, 2006, ACN submitted its comments on the Proposed Rule to the FTC ("ACN's Comments").[273] These Comments demonstrate ways in which pyramid marketing schemes mislead the public and the government. For example, in ACN's Comments, it states that

> ACN uses a direct selling method of marketing whereby independent sales representatives employ so-called "warm marketing", *i.e.* sales representatives approach people on a person-to-person basis to ask whether they would like to purchase ACN telephony services. No mass-market advertising is used.[274]

Although the statement may be technically correct, it is highly misleading.[275] The apparent inference is that ACN does not do mass-market advertising. ACN's response would probably be that ACN does not do mass marketing of "telephony services." While this may be true, the FTC's concern is whether ACN is mass marketing "opportunities to sell," and it does a lot of this

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[272] *See* CERO Strategies, Background, John W. Hesse II, http://www.cerostrategies.com/background/index.html; Comments of ACN, Inc. on the Notice of Proposed Rulemaking for the Business Opportunity Rule, Notice of proposed rulemaking, 2 (Jul. 17, 2006), http://www.ftc.gov/os/ comments/businessopprule/522418-11820.pdf (last visited Feb. 18, 2007) [hereinafter ACN Comments].

[273] *See* ACN Comments, *supra* note 272.

[274] *Id.* at 2.

[275] Although the phrase "warm marketing" gives the reader a warm and fuzzy image of small family gatherings by the fireplace, the reality of ACN's recruiting methods is nothing at all like this image. *See*, *e.g.*, Web video: ACN International Event December 2006, http://www.youtube.com (search for "ACN International Event December 2006") (last visited Feb. 18, 2007) (videotaped copy on file with author).

kind of mass marketing. Even cursory internet searches find numerous mass marketing advertisements for ACN "opportunities." Following is just a small sampling:

1. "ACN Opportunity Tour Kick-Off – ACN President and Co-Founder Greg Provenzano and ACN Vice President of North American Sales Larry Raskin will be kicking off ACN's 2004 Opportunity Tour in Charlotte, NC and Seattle, WA. . . . Everyone you know who lives close to these cities deserves to see and hear about the most dynamic and compelling opportunity of our time. . .";[276]

2. "The ACN Opportunity World Tour 2005 – Featuring Larry Raskin, ACN Vice President of North American Sales. . .";[277]

3. "Business Opportunity Meeting Featuring Keynote Speaker [Regional Vice President] Mary Ordway, Wilkes Barre, PA, January 11, 2005. . .";[278]

4. "Career in sales, marketing and advertising, lucrative pay! . . . Learn how to leverage your income from self made multi millionaire . . . and a company endorsed and invested in, by Donald Trump! Monday November 13, 2006 @ 7:30PM, Omni Hotel, . . . RSVP NOW by calling @ (213) 210 1275";[279]

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[276] ACN, Inc., Action 99, http://www2.acninc.com/action99.html (last visited Jan. 22, 2007)(link expired) (hard copy on file with author).

[277] ACN Inc., Boise 1-13-05, http://www2.acninc.com/events/OppTour2005/Boise.htm (last visited Feb. 18, 2007)(hard copy on file with author).

[278] ACN Inc., Wilkes BOM, http://www2acninc.com/events/WilkesBOM.html (last visited Jan. 22, 2007)(link expired) (hard copy on file with author).

[279] Posting of job-232959298@craigslist.org to http://austin.craigslist.org/sls/232959298.html (posted on Nov. 10, 2006, 2:07 p.m. CST) (last visited Jan. 9, 2007) (listing expired) (hard copy on file with author).

5. "We invite you to explore our industry, income potential, simple business model and comprehensive support system. . . . ACN provides an excellent opportunity for those with the entrepreneurial spirit. If you have ever imagined going into business for yourself, but don't want to do it by yourself, contact me directly";[280] and

6. "Find out how Anyone Can Earn from the Deregulated Telecommunication Market by attending an ACN Presentation – Saturday, 11th November 2006. . . . Spreading the News in Leicester, England. . . . ACN Representatives £7 Guests free if accompanied by a Paying Representative."[281]

In addition to its statement about "warm marketing," ACN's Comments also note that

> ACN sales representatives do not gain any revenue from signing up new sales representatives. ACN sales representatives can only hope to generate income if they sell ACN telephony services, not if they simply recruit additional ACN sales representatives. Indeed, the overwhelming majority of ACN revenues are generated from billing and sales of telephony services to end customers. Only a small portion of those end customers are ACN sale representatives. A very small percentage of ACN's revenue is derived from the entry and renewal fee that ACN sales representatives pay to become part of the ACN sales network, and that revenue amount is more than consumed by ACN's costs in supporting the businesses of its independent representatives.[282]

Again, while the statement may be technically true, it is *highly* misleading. ACN would likely claim that the statement is correct -- most of "ACN's revenue" is not derived from money paid by new recruits. The question in a pyramid scheme analysis, however, is how much of the

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[280] Posting of heatheracnrep@yahoo.com to http://baltimore.craigslist.org/bus/246508680.html (posted on Dec. 12, 2006 at 2:31 p.m. EST) (last visited Jan. 22, 2007) (listing expired) (hard copy on file with author).

[281] The Red Apple Group, www.red-apple-group.com (last visited Jan. 22, 2007) (listing expired) (hard copy on file with author).

[282] ACN Comments, *supra* note 272, at 4.

distributors' income, not ACN's income, is derived from money paid by new recruits. ACN's Comments are careful to hide this fact, but, according to The ACN Compensation Plan Overview (the "Compensation Plan"),[283] ACN representatives make their money from the following two sources: (1) residual income and (2) customer acquisition bonuses (sometimes referred to as a "CAB").[284] Furthermore, the amount that comes from "residual income" appears to be tiny compared to the amount that comes from CABs.

With respect to residual income, there are two ways that representatives may earn residual income: (1) from that representative's own customers ("Personal Residual Income") or (2) from customers of representatives recruited by that representative ("Residual Override").[285] With respect to Personal Residual Income, a representative in theory can earn between two percent and eight percent of his own customers' monthly bills (*i.e.,* the distributor's own customers rather than customers of distributors that that distributor has recruited).[286] Specifically, representatives earn two percent of the representative's monthly billing if the representative has monthly billings of up to $1,999,[287] three percent if monthly billings are from $2,000 to $3,999,[288] four percent if monthly billings are from $4,000 to $5,999,[289] five percent if

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[283] The ACN Compensation Plan Overview, http://users.tns.net/~mpat/scam/compensation/ index.html (last visited Feb. 18, 2007) [hereinafter Compensation Plan].

[284] *Id.*

[285] *Id.*

[286] *Id.*

[287] This is a maximum of $40 for the month (*i.e.*, .02 x $1,999).

[288] This is a maximum of $120 for the month (*i.e.*, .03 x $3,999).

[289] This is a maximum of $240 for the month (*i.e.*, .04 x $5,999).

monthly billings are from $6,000 to $7,999,[290] six percent if monthly billings are from $8,000 to $9,999,[291] seven percent if monthly billings are from $10,000 to $12,499,[292] and eight percent if monthly billings are $12,500 or more.[293] To put this in perspective, assume an average phone bill of $30;[294] to achieve monthly billings of $12,500, that representative would need 417 direct customers.[295] In this case, the monthly commission would be exactly $1,000, which works out to *gross* income of $12,000 per year.[296] If commissions were solely based on this formula, this would be an entirely legal way of doing business. Nevertheless, income that would set the

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[290] This is a maximum of $400 for the month (*i.e.*, .05 x $7,999).

[291] This is a maximum of $600 for the month (*i.e.*, .06 x $9,999).

[292] This is a maximum of $875 for the month (*i.e.*, .07 x $12,499).

[293] *Id.* Monthly billings of $12,500 would produce monthly income of $1,000 (*i.e.*, .08 x $12,500).

[294] This is probably a high assumption, given the fact that one of the selling points of ACN is that customers are not charged anything for making long distance phone calls to other ACN customers. *See* Exposing the Truth About ACN MLM, http://users.tns.net/~mpat/scam/ (last visited Feb. 18, 2007).

[295] This is computed by dividing $12,500 by $30.

[296] *Net* income would be significantly less, given the fact that it appears that distributors pay $499 to join, $149 per year to continue on as a distributor, "$10+ per month in other fees," and vast amounts of money to travel to "training" meetings, stay at hotels, and register for these meetings. For a summary of these expenses, *see* Corporate Narc, The ACN Scam, http://www.corporatenarc.com/the-acn-scam.php (last visited Feb. 18, 2007). As an example of the cost to attend meetings, note that distributors are strongly encouraged to attend events such as the February 23-25, 2007 "International Convention" in Fort Worth, Texas, at a cost of $150 per person to register, $145 per night for hotel stay, plus airfare. *See* Fort Worth, Texas, ACN International Convention, http://www2.acninc.com/events/188.pdf (last visited Feb. 18, 2007) (hard copy on file with author).

distributor near the official poverty level[297] for reaching the highest bracket of monthly billings would hardly be an effective way to entice new distributors to join the company.

With respect to Residual Override, a distributor receives one-quarter of one percent (1/4%) of all monthly bills of customers five levels down in that distributor's "downline."[298] At the sixth level down a distributor's downline, the distributor will get one percent (1%) of the monthly customer bills of that downline distributor.[299] At the *seventh* level down a distributor's downline, the distributor will get six percent (6%) of the monthly customer bills of that downline distributor (note that commissions earned from bills of customers in levels one through five are still one-quarter of one percent).[300] Presumably, this one level allows sellers at opportunity meetings to claim that recruits can make "up to 6%" on downline customer bills. Beyond seven levels down, the distributor will once again get one-quarter of one percent (1/4%)[301] of the monthly customer bills of all downline distributors.[302] Thus, with the exception of the bills of

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[297] *See* U.S. Census Bureau, Poverty Thresholds 2006, http://www.census.gov/hhes/www/poverty/threshld/thresh06.html (last visited Feb. 18, 2007).

[298] *See* Compensation Plan, *supra* note 283. A distributor's downline refers to distributors recruited by that distributor. If Distributor A recruited Distributor B, then Distributor B is one level down in Distributor A's downline, and Distributor A will receive one-quarter of one percent of the monthly bills paid by Distributor B's customers. If Distributor B recruits Distributor C, and Distributor C recruits Distributor D, then Distributor D is three levels down in Distributor A's downline.

[299] Compensation Plan, *supra* note 283.

[300] *Id.*

[301] It is possible to get one-half of one percent (1/2%) in limited circumstances. *Id.*

[302] *See id.*

customers of a distributor six or seven levels below the distributor in question,[303] the norm is to receive one-quarter of one percent of all of those bills. To put this in perspective, a distributor with *10,000* "downline customers" (a vast number of customers for any direct seller) in the first five levels down would only receive Residual Override commissions of $750 per month, assuming each of those 10,000 customers has an average monthly phone bill of $30.[304] While the income potential here is astoundingly small, the company still claims one can make a fortune from residual income.[305] What is not disclosed is that, to make any significant money, one must receive percentages of the entry fees paid by new recruits. This is classic pyramid structuring.

The Customer Acquisition Bonus, or CAB, is the heart of ACN's compensation structure. It is the primary place where distributors make money. It also obviously has been crafted carefully to avoid classification as an illegal pyramid scheme, while preserving all the sinister characteristics of a pyramid scheme. Under the Compensation Plan, a CAB is awarded when a representative recruits a new representative who becomes "qualified."[306] To become qualified, that new representative, who must pay $499 for the privilege of becoming a representative, must

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[303] This anomaly was presumably included in the Compensation Plan so that "opportunity" sellers would be able to say that distributors make commissions of "up to six percent" of the bills of customers of downline distributors.

[304] This is computed as follows: $30 (monthly bill) x 10,000 customers = $300,000 monthly billing. Multiply $300,000 by one-quarter of one percent (.0025) to get $750.

[305] *See* Art Napolitano, Senior Vice President, UNI Team1.com, Step by Step Strategy to Success in Network Marketing, http://uniteam1.com/pages/trainingmaterials.html (follow "Step by Step to Success!") (last visited Feb. 18, 2007) (hard copy on file with author), in which the ACN opportunity promoter shows a chart *that only shows income from 2,187 downline customers at Level 7*.

[306] Compensation Plan, *supra* note 283.

acquire six or eight new customers.[307] Once the representative is "qualified," CABs, which range from $90 to $275 depending on the recruiter's level within ACN, [308] are issued. These CABs are paid regardless of the fact that the company may never even earn that amount from the acquired customers. The Compensation Plan is careful to specify that

> no one receives a bonus merely for bringing a new representative into the business. Bonuses are only earned when new representatives become *qualified* by acquiring the minimum number of personal customers necessary within the required time.[309]

This "qualified" requirement is an obvious effort to avoid anti-pyramid laws, and it demonstrates the difficulty of drafting rules to stop companies from engaging in pyramid schemes. Although the bonus is tied to helping a new representative acquire customers, it is clear to any objective observer where the bonus money is coming from – out of the $499 paid by new recruits (especially given the fact that the company may pay out far more money in bonuses than it ever receives from those customers, especially if the customers cancel after a couple months of service). Thus, the $499 paid by new recruits is the heart of the compensation structure. As mentioned, it is perhaps technically true that "[a] very small percentage of *ACN's* revenue" is ". . . derived from the entry and renewal fee that ACN sales representatives pay to

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[307] *Id.* The details of the differences between six and eight customers is not relevant to this discussion.

[308] A "Team Trainer" receives a CAB of $90, an "Executive Team Trainer" receives a CAB of $150, a "Team Coordinator" receives a CAB of $240, and a "Regional Vice President" receives a CAB of $275. *Id.*

[309] *Id.* (emphasis added).

become part of the ACN sales network,"[310] but this is grossly misleading. The issue is not about the source of "ACN's revenue"; the issue is the source of the *bonuses* of ACN's representatives.

Mathematically, it is obvious that those bonuses are the overwhelming bulk of the income of almost all company representatives. When ACN's Comments to the FTC say that the $499 paid by each new representative "is more than consumed by ACN's costs in supporting the businesses of its independent representatives,"[311] it likely means that such support includes bonuses paid to the representatives who acquired the new representatives. Assuming that this is correct, this is an extremely cleverly disguised pyramid scheme that will hurt thousands and thousands of people while enriching an extremely small handful.

B. How Will the Proposed Rule Impact ACN?

The Proposed Rule is likely to impact ACN's business, which is why people who are higher in the pyramid structure have expressed their unequivocal objection to it. The Proposed Rule, however, is unlikely to stop the company from inflicting the harm that it now inflicts on the world.[312]

The most frightening aspect of the Proposed Rule for companies like ACN is the seven-day waiting period.[313] As mentioned, companies like ACN rely on high-pressure sales tactics at "opportunity meetings" to recruit new representatives. A seven-day waiting period certainly will

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[310] ACN Comments, *supra* note 272, at 4.

[311] *Id.*

[312] In addition to the United States, ACN currently operates in Australia, New Zealand, Canada, Austria, Belgium, Denmark, France, Germany, Ireland, Italy, Netherlands, Norway, Poland, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. *See* ACN Inc., http://www.acninc.com/acn (last visited Feb. 18, 2007).

[313] *See supra* Section IV.C.

make ACN's recruiting efforts less effective; however, it does not require much thought to conceive of ways in which ACN could work around a seven-day waiting period. For example, ACN could have two opportunity meetings, exactly one week apart, for every potential new representative. Alternatively, ACN could mail the disclosure form to all representatives one week before the opportunity meeting. The new recruit would then have had the disclosure form for one week before the meeting. Given ACN's approach to the law—as is apparent from reading ACN's Comments—it is unlikely that the seven-day waiting period will stop them, although it will make it more difficult for them to recruit.

The disclosure requirement,[314] as it reads in the Proposed Rule, is also unlikely to have much effect on ACN's business. Because the requirement initially would just require ACN to disclose whether or not it is making an earnings claim, ACN is likely to routinely check "no." It already states in its corporate documents that "ACN strictly prohibits ACN Independent Representatives from making any claims or guarantees related to earnings/income whether express or implied,"[315] but this rule obviously is not enforced. In fact, earnings claims are rampant and highly encouraged.[316] At opportunity meetings, ACN will just state that it is not making an earnings claim. Attendees will be told that the company does not "officially" make any earnings claims for legal reasons. Attendees are likely to accept this explanation.

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[314] *See supra* Sections IV.B.4 and V.B.5.

[315] *See supra* note 163.

[316] *See* United Networks International, Getting Started, http://uniteam1.com/pages/Gettingstarted.html (last visited Feb. 18, 2007); *supra* note 165.

The two other sections of the Proposed Rule that potentially could impact ACN are (1) the disclosure of prior legal actions[317] and (2) the list of references.[318] In the end, these two requirements are similarly unlikely to have much of an impact. First, as should be apparent by now, ACN has postured itself well to avoid lawsuits.[319] Even if it has to disclose, it will be sure to state that it was found "not guilty" in most cases, which many potential recruits may view as a stamp of approval by the court – a statement that the company is innocent. Second, the list of references will only consist of people who are still with ACN, however the company chooses to define that. They will also be the newest recruits, which means they are likely to still have a favorable opinion of the company.[320] This will only further the company's recruiting efforts.

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[317] *See supra* Section V.B.4.

[318] *See supra* Section V.B.4.

[319] In fact, the two most high-profile actions against ACN did not even occur in the United States. The first was a charge by the Canadian Competition Bureau against ACN. In that case, "ACN Canada was charged with operating an illegal scheme of pyramid selling by offering recruitment bonuses to participants who paid for the right to recruit other participants." Press Release, Canadian Competition Bureau, Multi-level Marketing Firm Charged for Misleading Participants (Aug 29, 2002), *available at* http://competitionbureau.gc.ca/internet/ index.cfm?itemid=441&lg=e; Case Update, Canadian Competition Bureau, Global Online Systems Inc., *available at* http://competitionbureau.gc.ca/internet/index.cfm?itemID=1182 &lg=e#allcom (both cites last visited Feb. 18, 2007). The second action was a charge by The Australian Competition and Consumer Commission. *See ACCC wins in telco pyramid selling case*, ABC NEWS ONLINE, Mar. 23, 2005, http://www.abc.net.au/news/newsitems/ 200503/s1330443.htm (last visited Feb. 18, 2007). In both cases, the foreign government was unsuccessful in establishing that ACN violated the law. This should be strong evidence of ACN's ability to maneuver through anti-pyramid laws.

[320] The only way to give an accurate picture of the company is to require disclosure of ex-representatives.

VI. CONCLUSION

Pyramid marketing schemes ideally should be challenged on the following two sequential fronts: (1) disclosure of material information to prospective purchasers (and time to think about it), and (2) a comprehensive anti-pyramid marketing scheme rule and disclosure to the government. If the FTC determines that the impact of the first front is significant, it may not be necessary to resort to the second front.

With respect to the first front (disclosure to prospective purchasers), it is necessary to ensure that potential recruits are given a realistic picture of their earning potential at the company and sufficient time to absorb the information. At a minimum, this would mean that an individual seller of an opportunity would need to provide the prospective recruit, prior to the sale, with a written disclosure of average and median net, not gross, income of all company representatives

over a one year period.[321] The individual seller would be responsible for obtaining this information from the company, and the individual seller would not be liable for providing false or misleading information if he or she has a good faith belief in the veracity of the information provided. The company, of course, would be liable if it knowingly supplies the individual seller with false or misleading information.

With respect to the appropriate waiting period, it seems that three days would be sufficient to break the "pressure of the moment" kind of sale. This means that the individual

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[321] It is worth noting that Canadian officials were successful against ACN in at least one respect: presumably as a result of the governments efforts, ACN Canada's website now includes the following earnings statement that does not appear on any other ACN website:

> *ACN Canada Earnings Statement: The average ACN Canada active Independent Representative in 2005 earned approximately $400. Active Independent Representatives are those that earned money and acquired at least one new customer during the year. ACN Canada Independent Representatives are prohibited from making any claims of earnings other than the amounts provided above.*

ACN Canada, Earning Statement, posted at ACN Canada, Opportunity, Overview, http://www.acncanada.ca/acn/ca_en/opportunity/index.jsp (last visited Feb. 18, 2007). This is a step in the right direction, but it is deficient in many respects. First, it does not clearly note the $400 is a gross figure. When expenses, such as the $499 start-up fee are factored in, that is probably a net negative figure. Second, it does not identify the percentage of representatives that are not included in the figure. For example, suppose that 100 people were ACN representatives at some point during the year. If it turns out that only 60 people were active representatives who earned any money, then the statement should note that 40% of the total representatives over the year did not factor into that number because they did not earn anything (and likely had expenses on top of that).

As an aside, it is worth noting that the $400 number is referring to Canadian dollars (CAD). That works out to approximately $344 USD, assuming an exchange rate of $1.16 CAD for $1.00 USD. *See* OANDA.com, The Currency Site, http://www.oanda.com/convert/classic (last visited Feb. 18, 2007). Again, this is a gross figure that does not include people who did not acquire any customers or earn any money from ACN during the year.

seller must disclose the required information to the individual purchaser at least three days before the purchaser signs a contract or pays any money. As mentioned above,[322] all disclosures should be provided in writing in the same language in which the sales pitch occurs. Also, because these companies have expanded internationally, and because worldwide opinion of the United States is often tied to the behavior of U.S. companies, the disclosure rule should apply whenever a U.S. citizen or permanent resident is selling a "business opportunity" to the "public," whether in the United States or abroad.

With respect to the second front (a federal anti-pyramid marketing scheme law and disclosure to the government), the law should make it easier for government officials to identify and prosecute illegal pyramid schemes. A federal anti-pyramid marketing scheme law is desirable because it would provide uniformity. Ideally, Congress will specifically identify a pyramid marketing scheme as one in which funds provided by recruits, directly or indirectly, are the primary source of money (*i.e.*, more than 50%) used to pay the people who recruited them. With respect to "indirect" sources, the aim should be to prevent companies from asserting that they do not pay bonuses "for" recruiting. While that may technically be true, it is also irrelevant. The question is whether the money for bonuses is *traceable* to money that the new recruits pay.

In addition to congressional legislation, the FTC disclosure rule should require companies (not individual sellers) to make quarterly reports to the FTC. Ideally, these reports would be due when the company makes its estimated federal income tax payments, minimizing the accounting burden. These reports would account for all money paid by recruits at all levels separately. This

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[322] *See supra* Section IV.B.4.

would allow the government to determine whether a high percentage of money being paid to recruiters is coming from money supplied by the new recruit.

Because the waiting period and the disclosure requirements are an added burden on sellers and because the objective of these rules is to facilitate legitimate business, rather than to hinder it, by protecting the public from abuses, these rules only should apply to companies that take on a "public" role. [323] Thus, with respect to disclosures by individual sellers of the "opportunity," sellers who recruit only occasionally and who primarily sell an actual product would not be required to disclose anything to the prospective purchaser. Furthermore, with respect to the second front, there should be a *de minimus* exception. Specifically, any company in which ten percent or fewer of its distributors have made a "public" sale of the opportunity within the prior quarter would not be required to file any report with the FTC. If these steps are taken, some of the most egregious abuses will be curbed, legitimate direct selling companies will have virtually no administrative burdens, and entrepreneurs will more easily find true business "opportunities" without constant fear of being swindled by the latest Harold Hill to come to town.

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[323] As mentioned, this article proposes that an individual seller has taken on a public role whenever the seller makes an offer to sell a business opportunity to a group of five or more prospective purchasers at the same time or whenever the seller has, in fact, sold the same business opportunity to at least five different people in the prior thirty days.