

FTC Staff Advisory Opinion, Pyramid Schemes Analysis, 2004

January 14, 2004

Mr. Neil H. Offen,
President Direct Selling Association
1275 Pennsylvania Ave., NW Suite #800
Washington, DC 20004-2411

Re: Staff Advisory Opinion — Pyramid Scheme Analysis

Dear Mr. Offen:

Thank you for your inquiry requesting a staff Advisory Opinion regarding the Federal Trade Commission's analysis of pyramid schemes. You have identified two areas of concern: 1) the Commission's analysis of compensation based on personal consumption by members of a multi-level company's sales force ("internal consumption"); and 2) the legal significance of consent orders that the Commission has entered into with several pyramid scheme operators. I am pleased to provide you with the following staff guidance.

Internal Consumption

Much has been made of the personal, or internal, consumption issue in recent years. In fact, the amount of internal consumption in any multi-level compensation business does not determine whether or not the FTC will consider the plan a pyramid scheme. The critical question for the FTC is whether the revenues that primarily support the commissions paid to all participants are generated from purchases of goods and services that are not simply incidental to the purchase of the right to participate in a money-making venture.

A multi-level compensation system funded primarily by such non-incidental revenues does not depend on continual recruitment of new participants, and therefore, does not guarantee financial failure for the majority of participants. In contrast, a multi-level compensation system funded primarily by payments made for the right to participate in the venture is an illegal pyramid scheme.

In a pyramid scheme, participants hope to reap financial rewards well in excess of their investment based primarily on the fees paid by members of their "downlines."¹ Downline members pay these fees to join the scheme and meet certain prerequisites for obtaining the monetary and other rewards offered by the program. A participant, therefore, can only reap rewards by obtaining a portion of the fees paid by those who join the scheme later. The people

who join later, in turn, pay their fees in the hope of profiting from payments of those who enter the scheme after they do. In this way, a pyramid scheme simply transfers monies from losers to winners. For each person who substantially profits from the scheme, there must be many more losing all, or a portion, of their investment to fund those winnings. Absent sufficient sales of goods and services, the profits in such a system hinge on nothing more than recruitment of new participants (i.e., fee payers) into the system.

The Commission's recent cases, however, demonstrate that the sale of goods and services alone does not necessarily render a multi-level system legitimate. Modern pyramid schemes generally do not blatantly base commissions on the outright payment of fees, but instead try to disguise those payments to appear as if they are based on the sale of goods or services. The most common means employed to achieve this goal is to require a certain level of monthly purchases to qualify for commissions. While the sale of goods and services nominally generates all commissions in a system primarily funded by such purchases, in fact, those commissions are funded by purchases made to obtain the right to participate in the scheme. Each individual who profits, therefore, does so primarily from the payments of others who are themselves making payments in order to obtain their own profit. As discussed above, such a plan is little more than a transfer scheme, dooming the vast majority of participants to financial failure.²

¹A participant's downline usually consists of the people the participant recruits to join the program as well as the people her recruits recruit, and so on through a predetermined number of levels.

²It is important to distinguish an illegal pyramid scheme from a legitimate buyers club. A buyers club confers the right to purchase goods and services at a discount. If a buyers club is organized as a multi-level reward system, the purchase of goods and services by one's downline could defray the cost of one's own purchases (i.e., the greater the downline purchases, the greater the volume discounts that the club receives from its suppliers, the greater the discount that can be apportioned to participants through the multi-level system). The purchase of goods and services within such a system can, therefore, be distinguished from a pyramid scheme on two grounds. First, purchases by the club's members can actually reduce costs for everyone (the goal of the club in the first place). Second, the purchase of goods and services is not merely incidental to the right to participate in a money-making venture, but rather the very reason participants join the program. Therefore, the plan does not simply transfer money from winners to losers, leaving the majority of participants with financial losses.

Consent Orders

With regard to your second question, the Federal Trade Commission often enters into consent orders with individuals and companies that the Commission has determined have violated the FTC Act. To protect the public from those who have demonstrated an unwillingness to follow the law, these orders often contain provisions that place extra constraints upon a wrongdoer that do not apply to the general public. These "fencing-in" provisions only apply to the defendant signing the order and anyone with whom the defendant is acting in concert. They do not

represent the general state of the law.

For example, when the Commission brings a pyramid scheme action, the case often concludes with a consent order. The scope and severity of the order will depend upon the facts of the case; however, most such orders contain definitions that exclude any sale to a participant in the business from the calculation of the venture's legitimacy. These definitions draw very clear lines for those who have demonstrated a willingness to violate the law, but are not intended to represent the state of the law for the general public.

Thank you for your inquiry.

Sincerely, James A. Kohm
Acting Director of Marketing Practices

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Jeffrey A. Babener, of Portland, Oregon, is the principal attorney in the law firm of Babener & Associates. For more than 25 years, he has advised leading U.S. and foreign companies in the direct selling industry, including many members of the Direct Selling Association. He has lectured and published extensively on direct selling and many of his writings will be found at www.mlmllegal.com, of which he is Editor. He is a graduate of the University of Southern California Law School, where he was an Editor of the USC Law Review.

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