

A Look Into FTC's Thinking On Pyramid Scheme Potential

By **Branko Jovanovic, Pablo Robles and Jeremy Smith** (March 23, 2020)

Recent decisions and resolutions issued by the Federal Trade Commission have indicated features of multilevel marketing, or MLM, companies that the FTC views as problematic.[1] For example, since 2014, the FTC has released complaints and stipulations that identify aspects of Vemma Nutrition Co.'s,[2] Herbalife Ltd.'s[3] and AdvoCare International LP's[4] business models that it views unfavorably.

Given the uncertain nature of regulation surrounding the MLM industry, MLM companies are closely following these complaints and stipulations, as well as speeches by FTC leaders.[5]

In December 2019, however, Ginger Jin, former director of the FTC's Bureau of Economics; Andrew Stivers, FTC deputy director; and Douglas Smith, an FTC economist, unveiled a working paper, titled "The Alchemy of a Pyramid: Transmutating Business Opportunity Into a Negative Sum Wealth Transfer," that flew largely under the radar.

This paper, which explores the mechanisms through which an MLM firm has the potential to become a pyramid scheme,[6] provides valuable insight into the FTC's attitude toward the MLM business model.

According to this paper, a company might operate an illegal pyramid scheme disguised as an MLM when:

- At least some participation incentives are independent of any retail demand (i.e., participants can make money without actually generating sales to end-users); and
- The ultimate result is a negative-sum transfer mechanism, meaning that the company causes an overall loss for participants through the transfer of money from one group of participants to another.[7]

This article summarizes the paper's assumptions, key messages and policy implications in nontechnical terms.

The Paper's Findings

Jin, Stivers and Smith explain that the money-making potential of a legitimate MLM rests on the existence of sufficient consumer demand for products to cover both the company's cost of making the products and participants' costs of selling the products. While a company can have a product with some consumer demand that generates consumer surplus (the difference between the price that consumers pay and the price that they are willing to pay), the company could still be a pyramid scheme if the overall costs to participants exceed the total surplus generated through sales to end users.



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The authors create a model that accounts for uncertainty around:

- Potential consumer demand for the MLM's product; and
- The MLM participant's potential opportunity to earn money from recruiting other participants.

Using this model, they find that participants might be willing to engage in a negative-sum transfer mechanism (i.e., make payments to the company for products they do not plan to consume or sell) because they have inaccurate beliefs about demand for the product (i.e., beliefs about their ability to make money through retail sales), as well as inaccurate beliefs about the existence of future participants willing to be recruited into the company (i.e., beliefs about their ability to make money through commissions, bonuses, etc.).

The authors show that these expectations are crucial to a pyramid scheme's success. Inaccurate optimistic beliefs about recruiting new participants could cause current participants to accept a loss on retail sales in anticipation of making money overall through recruitment.

If participants are willing to accept a loss on retailing the product because they are optimistic about recruitment, then they are willing to personally purchase products from the company that are unrelated to final consumer demand. While these purchases could appear to be evidence of legitimate retail demand from an outside perspective, such purchases contribute to the negative-sum transfer mechanism.

Importantly, their model implies that even if an MLM has a viable product that can be sold for a profit, overly optimistic participants could still cause the average return across all participants to be negative.

If an MLM can make its participants overly optimistic about their ability to make money through recruitment, the MLM can raise the price of its products well above the price at which supply for the products could be absorbed by final consumer demand (thus making them undesirable to a large fraction of potential final consumers). However, participants may be willing to continue losing money selling the product as long as they remain optimistic about their potential future earnings from recruitment.

Implications for Policy

Policymakers must ensure that would-be MLM participants are not given misleading information about the opportunity to earn money and recruit new members.[8]

If an MLM appears to be encouraging participants to make payments unrelated to final consumer demand for the MLM's products, forcing structural change on the MLM could benefit future participants. Jin, Stivers and Smith explain that regulators could deter an MLM from causing negative-sum transfer losses for its participants by:

- Banning recruitment, as was imposed on AdvoCare;[9]
- Limiting rewards to sales directly fulfilled to nonparticipant consumers; and
- Removing minimum purchase requirements for participants as a condition for earning recruitment rewards.[10] This would stop participants from accepting a retail

loss in the hope of earning money later through recruitment. In practice, this would end the minimum monthly personal volume requirements to receive commissions/rewards.[11] The only purchases a company could require participants to make would be an initial starter kit and annual renewal fee.

Assumptions That Could Overstate an MLM's Potential to Become a Pyramid Scheme

Jin, Stivers and Smith assume that participants are risk-neutral as opposed to risk-averse, which makes them more prone to forming overoptimistic expectations. They also fail to account for the so-called undo option offered by many MLM companies, in which overoptimistic participants can return all products for a full refund once they realize they cannot earn money.

Both of these assumptions are questionable and may overstate an MLM's potential to become a pyramid scheme. Below, we discuss each of these questionable assumptions in turn.

Assumption of Participant Risk Aversion

The paper assumes that MLM companies and participants are insensitive to risk (i.e., risk-neutral). While risk neutrality is a standard assumption when modeling company behavior, individuals (e.g., participants) are generally assumed to be risk-averse.[12]

While the assumption of participants' risk neutrality greatly simplifies the model and might not have a significant impact in the case of small losses, risk-neutral participants are more prone to forming overoptimistic expectations about business opportunity payoffs compared with those who are risk-averse. If participants are assumed to be risk-averse, they would be less likely to join an MLM that could be operating as a pyramid scheme. Of course, if an MLM were to exaggerate the recruitment probability, even risk-averse individuals could opt to participate.

Failure to Consider the Undo Option

The FTC's stipulation against Herbalife required the company to make changes to its refund policy to protect overoptimistic participants against significant losses, affording them an undo option.

Specifically, participants are entitled to a full refund — including any taxes, fees and shipping costs — for any unopened products purchased within the previous 12 months. New participants can also obtain a full refund for the cost of any startup package for at least their first 12 months with the company, with shipping costs paid by the company if a return is required.

Despite this protection, the undo option is noticeably absent from the paper. This omission is surprising given that the undo option would seem to protect overly optimistic participants from financial loss.

If a participant holds inaccurate beliefs regarding the demand for an MLM's product or the probability of future recruitment success, then the undo option would allow them to return all products they may have purchased in participating in the negative-sum transfer. Although the participant would still experience an economic loss from participating in the

pyramid scheme when they could have been spending their time more productively, an undo option would stem much of the harm caused to the participant and make it more challenging for an MLM to continue perpetuating negative-sum transfers.[13]

Conclusion

The key takeaway from the paper by Jin Stivers and Smith is that every MLM is in danger of becoming a pyramid if its distributors have overly optimistic beliefs about their ability to recruit new distributors to the organization. Even though the authors do not take into account the undo option and, therefore, might overstate the risk of a legitimate MLM being classified as a pyramid scheme, the paper suggests that managing participants' expectations related to their potential to recruit and earn money is essential to operating a legitimate MLM.

While participants' beliefs regarding their potential success are at least partly outside of an MLM company's control,[14] certain mechanisms employed by MLMs can potentially lower their risk of being classified as a pyramid scheme. In addition to offering an efficient and effective return policy, these mechanisms include recommendations outlined by Andrew Smith, director of the FTC's Bureau of Consumer Protection:

1. Ensuring that income claims accurately reflect income potential and account for participants' expenses.[15]
2. Adjusting compensation plans so that:
 - Only receipted sales to final customers are rewarded; and
 - Certain rewards that encourage recruitment and are not directly linked to genuine demand are eliminated, including:
 - Minimum purchase requirements that can only be satisfied through distributors' personal purchases';[16]
 - Rewards available only to participants who recruited others;[17] and
 - Rewards that increase exponentially with greater levels of expenditure.[18]

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[1] Multi-level marketing (MLM) organizations (also known as "direct selling organizations") are business enterprises that use a workforce of non-salaried contractors to sell products or services supplied by the firm. Participants in an MLM business opportunity earn income through commissions on their own sales and through sales made by participants that they recruit.

[2] On December 15, 2016, the FTC announced that “Vemma Nutrition Company will end the business practices that the FTC alleged created a pyramid scheme,” with a monetary judgment of \$238 million in favor of the FTC. “Vemma Agrees to Ban on Pyramid Scheme Practices to Settle FTC Charges.” FTC Press Release, December 15, 2016, Accessed February 15, 2020, <https://www.ftc.gov/news-events/press-releases/2016/12/vemma-agrees-ban-pyramid-scheme-practices-settle-ftc-charges>.

[3] On July 15, 2016, the FTC announced that Herbalife agreed “to restructure their U.S. business operations and pay \$200 million to compensate consumers to settle Federal Trade Commission charges that the companies deceived consumers into believing they could earn substantial money selling diet, nutritional supplement, and personal care products.” FTC Press Release, July 15, 2016, Accessed February 15, 2020, <https://www.ftc.gov/news-events/press-releases/2016/07/herbalife-will-restructure-its-multi-level-marketing-operations>. See also <https://www.ftc.gov/system/files/documents/cases/160715herbalife-stip.pdf>.

[4] On October 2, 2019, the FTC announced that “Multi-level marketer AdvoCare International, L.P. and its former chief executive officer agreed to pay \$150 million and be banned from the multi-level marketing business to resolve Federal Trade Commission charges that the company operated an illegal pyramid scheme that deceived consumers into believing they could earn significant income as ‘distributors’ of its health and wellness products.” FTC Press Release, October 2, 2019, Accessed February 15, 2020, <https://www.ftc.gov/news-events/press-releases/2019/10/multi-level-marketer-advocare-will-pay-150-million-settle-ftc>.

[5] For example, see the remarks delivered by Andrew Smith, Director of the FTC’s Bureau of Consumer Protection, to the participants of the DSA Legal and Regulatory Seminar on October 8, 2019. The excerpts of Director Smith’s speech are included in Plaintiffs’ Original Verified Complaint for Declaratory Judgment, Preliminary, and Permanent Injunctive Relief, Nerium International and Jeffrey Olson v. Federal Trade Commission, Civil Action No. 1:19-cv-7189, The United States District Court for the Northern District of Illinois, Eastern Division, filed on November 1, 2019.

[6] Former FTC Economist Dr. Peter Vander Nat characterizes a pyramid scheme in an MLM context as follows: “An organization is a pyramid scheme if it rewards participants primarily for recruitment, while the firm’s product is incidental to the proposed business opportunity; moreover, the incidental nature of the product is chiefly evidenced by the payment of recruitment rewards having no cognizable or substantive relation to retail sales.” Vander Nat, Peter, “Former FTC Economist Calls for Federal Pyramid Scheme Rule,” August 31, 2015. Last Accessed April 6, 2018. <https://www.truthinadvertising.org/former-ftc-economist-calls-for-federal-pyramid-scheme-rule/>.

[7] A participant in an MLM company is an individual who (i) pays a membership fee or purchases a sign-up package required for participation and (ii) by paying a membership fee and purchasing a sign-up package, has the right to sell the company’s product and earn compensation when participants they recruit purchase the company’s product.

[8] Director Smith spoke in detail about how MLMs should report its participant’s typical earnings during his remarks at the DSA Legal and Regulatory Seminar on October 8, 2019. Specifically, Director Smith stated that MLMs should take into account participant’s costs, include participants who did not earn any compensation, and stay away from truthful testimonials made by top earners.

[9] On October 2, 2019, the FTC announced that AdvoCare International, L.P. and its former chief executive officer agreed to pay \$150 million and be banned from the MLM business. FTC Press Release, October 2, 2019, Accessed February 15, 2020, <https://www.ftc.gov/news-events/press-releases/2019/10/multi-level-marketer-advocare-will-pay-150-million-settle-ftc>.

[10] Director Smith spoke about minimum purchase requirements during his speech at the DSA Legal and Regulatory Seminar on October 8, 2019. He reinforced that minimum purchase requirements are problematic because they create incentives for participants to purchase products in order to meet earning thresholds instead of genuine consumer demand.

[11] The minimum monthly personal volume requirements are a standard feature in MLM compensation plans. Generally, this requirement sets a minimum amount a participant is required to purchase over a set period of time in order to be eligible to receive commissions on sales by participants that they recruited. The FTC's stipulation against Herbalife states that members interested in the company's business opportunity "shall not be required to purchase a minimum quantity of products," with the exception of an initial start-up kit that is not eligible for compensation. Similarly, the FTC's stipulation against Vemma, an MLM company alleged by the FTC to be an illegal pyramid scheme, prohibited the company from offering payments that link or tie "a participant's compensation, or eligibility to receive compensation, to that participant's purchase of goods or services." AdvoCare Stipulation p. 7, https://www.ftc.gov/system/files/documents/cases/161215_proposed_vemma_bk_stipulated_final.pdf.

[12] Risk-averse individuals prefer lower payouts with known risks rather than higher payouts with unknown risks. In other words, they agree with the notion that "a bird in the hand is worth two in the bush."

[13] Director Smith spoke about MLM return policies during his speech at the DSA Legal and Regulatory Seminar on October 8, 2019. Smith said that although refund policies are important, they are insufficient on their own to rebut evidence that participants are purchasing products for the purpose of reaching compensation thresholds.

[14] Director Smith further remarked that even truthful testimonials from top earners are a "red flag" for the FTC, as oftentimes the earnings from these testimonials are atypical, and thus the claims mislead consumers who believe that the stated outcome is achievable.

[15] Director Smith explained during his speech at the DSA Legal and Regulatory Seminar on October 8, 2019 that for earnings claims to be truthful and substantiated, companies need to know and be able to show that after taking into account expenses, the income claim is the generally expected achievement of distributors. He emphasized that MLMs cannot make gross income claims without stating participants' costs.

[16] Director Smith referred to these types of requirements as threshold rewards. An example of a threshold-based reward would be a situation in which a participant earns nothing until he or she reaches a threshold dollar value in product purchases, but once that threshold is reached, his or her rewards increase exponentially.

[17] Director Smith emphasized that consumer injury is likely if participants are compensated on the basis of recruitment.

[18] Director Smith referred to these types of rewards as convex rewards. For example, a participant receives \$5 if his or her group volume (the sum of volume purchases by the participant and his or her downline) is 100, and \$200 if his or her group volume is 1,000. The reward to a participant with a 10 times higher group volume receives a 40 times higher reward – an exponential rate of increase.