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Sales Gone Wild: Will the FTC's Business Opportunity Rule Put an End to Pyramid Marketing Schemes?

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Sales Gone Wild: Will the FTC's Business Opportunity Rule Put an End to Pyramid Marketing Schemes?

Sergio Pareja*

TABLE OF CONTENTS

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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]

I. INTRODUCTION

Americans who have seen *The Music Man* may believe that they can easily spot a "Harold Hill," that is, a traveling salesman intent on defrauding people to make his fortune.[3] Day after day, however, many Americans and others around the world[4] fall prey to a similar type of deception—supposed "business opportunities"[5] in which 99.9 percent of investors lose money.[6] In the United

1. Video: ACN Business Opportunity Meeting, http://acnnv.com/Training.html (last visited Feb. 15, 2007) (videotaped copy on file with the *McGeorge Law Review*). 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) (portraying the character of Harold Hill). 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. *Id.*

4. *See* Cabot Christianson, *Bankruptcy Brief: You Can't Cheat an Honest Man: Everything You Want to Know About Ponzi Schemes*, 23 ALASKA B. RAG, Jan.-Feb. 1999, at 23 (discussing the most renowned recent foreign scam, a 1994 Albanian Ponzi scheme known as "Caritas," in which approximately three million investors lost more than one billion dollars, representing forty-three percent of Albanias's gross domestic product at the time).

5. The terminology used in this Article can be confusing because the perpetrators of scams are attempting to disguise them. In general, a sale of a business opportunity is a sale of the right to earn income. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,087 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437). 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. *Id.* Under the Proposed Rule, "Business Opportunity" is a term of art, defined as

> a commercial arrangement in which: (1) The seller solicits a prospective purchaser to enter into a new business; (2) The prospective purchaser makes a payment or provides other consideration to the seller, directly or indirectly through a third party; and (3) The seller, expressly or by implication, orally or in writing, either (i) Makes an earnings claim; or (ii) Represents that the seller or one or more designated persons will provide the purchaser with business assistance.

Id. This Article uses the term business opportunity schemes to include both work-at-home schemes and pyramid marketing schemes. "Sellers of fraudulent work-at-home opportunities deceive their victims with promises of an ongoing relationship in which the seller will buy the output that opportunity purchasers produce." *See* Business

States alone, over one and a half million people per year fall victim to pyramid marketing schemes.[7] Although there is little data available concerning the total losses experienced by victims of pyramid schemes, a recent class action settlement against Herbalife[8] revealed an average loss of $7,953 per claimant.[9] Furthermore, these schemes are consistently among the top ten fraud complaints received by the Federal Trade Commission (FTC) and state consumer protection

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Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,059 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437). Pyramid marketing schemes are "plans which 'concentrate on the commissions you could earn just for recruiting new distributors' and which 'generally ignore the marketing and selling of products and services.'" JON M. TAYLOR, CONSUMER AWARENESS INST., PRODUCT BASED PYRAMID SCHEMES: WHEN SHOULD AN MLM OR NETWORK MARKETING SCHEME BE CONSIDERED AN ILLEGAL PYRAMID SCHEME? 5-6 (2001), http://www.mlm-thetruth.com/PPSdefined2001-rev2004.pdf (on file with the *McGeorge Law Review*) (citation omitted); *see also* KEITH B. ANDERSON, BUREAU OF ECON., FED. TRADE COMM'N, CONSUMER FRAUD IN THE UNITED STATES: AN FTC SURVEY 14 (2004), http://www.ftc.gov/reports/consumerfraud/040805confraudrpt.pdf (on file with the *McGeorge Law Review*) (noting that typically, under pyramid schemes, "the income earned by participants comes ultimately from recruiting, rather than the sale of products or services consumers"). Multilevel Marketing (MLM) "is a way of distributing products or services in which the distributors earn income from their own retail sales and from retail sales made by their direct and indirect recruits." Peter J. Vander Nat & William W. Keep, *Marketing Fraud: An Approach for Differentiating Multilevel Marketing from Pyramid Schemes*, 21 J. PUB. POL'Y & MARKETING 139, 140 (2002). Direct selling is a marketing technique that typically includes in-home selling situations such as door-to-door solicitations, appointments, referrals, and product parties, as well as catalogs and the Internet to disseminate information." *Id.*

6. Letter from Jon M. Taylor, President, Consumer Awareness Inst., to Fed. Trade Comm'n, Office of the Sec'y (June 30, 2006), http://www.mlmwatch.org/06FTC/business_opportunity/taylor.html (on file with the *McGeorge Law Review*) [hereinafter Taylor, Letter to the FTC] ("*[A]pproximately 99* [percent] *of ALL participants (including dropouts) lost money, after subtracting ALL expenses*, including incentives purchases' (applying to qualification for commissions or bonuses) of goods and services from the company."); JON M. TAYLOR, CONSUMER AWARENESS INST., THE 5 RED FLAGS: FIVE CAUSAL AND DEFINING CHARACTERISTICS OF PRODUCT-BASED PYRAMID SCHEMES, OR RECRUITING MLM'S 7 (2006), http://www.mlm-thetruth.com/5RedFlags2column40pages2Color3-6.pdf [hereinafter TAYLOR, THE 5 RED FLAGS] (on file with the *McGeorge Law Review*); ROBERT L. FITZPATRICK, PYRAMID SCHEME ALERT, THE MYTH OF "INCOME OPPORTUNITY" IN MULTI-LEVEL MARKETING 3 (2005), http://www.falseprofits.com/MythofMLMIncome.doc.pdf [hereinafter FITZPATRICK, PYRAMID SCHEME ALERT] (on file with the *McGeorge Law Review*). *But see* Letter from Christine A. Varney, Hartson & Hogan, Counsel to Direct Selling Ass'n, to Donald S. Clark, Sec'y, Fed. Trade Comm'n (Sept. 29, 2006), http://www.ftc.gov/os/comments/businessopprule/rebuttal/522418-13253.pdf (on file with the *McGeorge Law Review*) ("[T]he linchpin of the comments attacking the direct selling industry is the claim that more than 99 [percent] of direct sellers that participate in a multilevel direct selling compensation plan lose money. . . . [T]his claim is . . . unsubstantiated and unverifiable.").

7. ANDERSON, *supra* note 5, at 29 (demonstrating that between May 2002 and May 2003, 1.55 million U.S. adults were victims of pyramid marketing schemes; 450,000 people were victims of business opportunity schemes). Although it is difficult to estimate the total number of victims taken in and money lost due to such schemes, it is helpful to note that the Direct Selling Association (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. DSA, FACT SHEET: U.S. DIRECT SELLING IN 2005, http://www.dsa.org/pubs/numbers/calendar05factsheet.pdf [hereinafter DSA FACT SHEET] (on file with the *McGeorge Law Review*).

8. Class Action Complaint, Jacobs v. Herbalife Int'l, Inc., No. CV-02-01431 SJO (C.D. Cal. Feb. 15, 2002).

9. Letter from Douglas M. Brooks, Martland & Brooks, LLP, to Fed. Trade Comm'n, Office of the Sec'y 9 (July 16, 2006), http://www.ftc.gov/os/comments/businessopprule/522418-10570.pdf (on file with the *McGeorge Law Review*).

divisions.[10] Unlike the sale of stocks, bonds, and franchises, the government does not strictly regulate the sale of "business opportunities."[11]

Perhaps the most famous deceptive business opportunity scheme is the one masterminded 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 various countries around the world.[13] According to Carlo's calculations, he could profit from post-World War I fluctuations in currency rates by trading and redeeming these coupons in different countries and make a profit of nearly four hundred percent.[14] Although the idea was sound in theory, it did not work in practice because the administrative costs of handling a large volume of coupons negated any profit potential.[15]

Carlo's real skill lay in convincing others that the idea worked; although he knew that it did not. In December 1919, Carlo formed the *Security Exchange Company* and began to tell his family and friends about his business opportunity so that they too could "invest" in it. Specifically, he guaranteed 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 promised interest with actual earnings from the business; instead, he was using money received from subsequent investors to pay earlier ones.[19] Considering that it was the early 1920s, the magnitude of Carlo's scheme was astounding. At one point, Carlo collected one million dollars per week, even though he only owned about thirty dollars in postal coupons.[20]

Although to innocent investors pyramid schemes may appear to work, they are mathematically proven to fail.[21] Companies need to attract new investors at a

10. 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).

11. *See infra* note 103 and accompanying text (discussing how the government regulates such sales, but provides a $500 requirement that can easily be avoided).

12. Christianson, *supra* note 4, at 23.

13. *Id.*

14. *See* Debra A. Valentine, Gen. Counsel, Fed. Trade Comm'n, Prepared Statement Presented at the Int'l Monetary Fund's Seminar on Current Legal Issues Affecting Central Banks: Pyramid Schemes (May 13, 1998), http://www.ftc.gov/speeches/other/dvimf16.shtm (on file with the *McGeorge Law Review*).

15. *Id.*

16. Christianson, *supra* note 4, at 23.

17. Valentine, *supra* note 14.

18. Christianson, *supra* note 4, at 23.

19. *Id.*; *see also* Valentine, *supra* note 14 ("[T]here is an expression that nicely summarizes this scheme: It's called 'stealing from Peter to pay Paul.' In fact[,] some law enforcement officers call Ponzi schemes 'Peter-Paul' scams.").

20. Christianson, *supra* note 4, at 23.

21. *See, e.g.*, 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

rate that is impossible to sustain due to the exponential growth of new investors needed to pay earlier investors.[22] By the time Carlo's "Ponzi scheme"[23] collapsed, he owed thousands of investors more than six million dollars.[24] Ultimately, state and federal courts convicted Carlo of fraud and sentenced him to ten years in prison.[25]

According to the Direct Selling Association (DSA),[26] more than 14.1 million Americans were involved in "direct selling" in 2005;[27] a steady increase from 8.5 million in 1996.[28] The DSA also reports that the industry had $30.47 billion in sales in 2005.[29] While many direct sellers are legitimate, the fact that the industry is virtually unregulated has led many companies to perpetrate vast schemes on the general public by promising or implying that participants may obtain vast

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one dollar to somebody several levels higher in the pyramid 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).

22. *See* TAYLOR, THE 5 RED FLAGS, *supra* note 6, at 9 (noting that a reason why certain pyramids, such as Amway, appear to last so long may be because they continue to start new pyramids by introducing new products, while allowing earlier pyramids to collapse).

23. Although many observers use the terms "Ponzi scheme" and "pyramid scheme" interchangeably, they are slightly different. *Compare* Valentine, *supra* note 14 ("In the typical Ponzi scheme, there is no real investment opportunity, and the promoter just uses the money from new recruits to pay obligations owed to longer-standing members of the program."), *with* Clinton D. Howie, *Is it a Pyramid Scheme?: Multilevel Marketing and Louisiana's "New" Anti-Pyramid Statute*, 49 LA. B. J. 288, 289 (2002) (defining a pyramid scheme as "[a] plan that compensates its participants, either directly or indirectly, based upon their recruitment of additional downline participants"). This Article uses 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. Valentine, *supra* note 14; Christianson, *supra* note 4, at 23.

25. Valentine, *supra* note 14.

26. DSA FACT SHEET, *supra* note 7; *see also* Direct Selling Ass'n, About DSA—History, http://www.dsa.org/about/history/ (last visited Aug. 26, 2007) (on file with the *McGeorge Law Review*) (noting that DSA was founded in 1910, in Binghamton, New York, to represent traveling salespersons). *But see* Pyramid Scheme Alert, www.pyramidschemealtert.org (last visited Aug. 26, 2007) (on file with the *McGeorge Law Review*) ("Beware of links to sites listed as pyramidschemealert.COM or .NET. These are deceptive lures to promotional or recruitment sites of multi-level marketing schemes."). Note that persons who type www.pyramidschemealert.com and www.pyramidschemealert.net into their browsers are automatically rerouted to DSA's website.

27. This is the most recent year for which the DSA provides data. DSA FACT SHEET, *supra* note 7.

28. *Id.*

29. *Id.*

riches easily by following a simple method.[30] In direct selling schemes, similar to the scheme perpetrated by Carlo Ponzi, money contributed by new recruits is the primary source of earnings for earlier recruits.[31] This "silent scandal" robs millions of people of their hard-earned money;[32] however, legislators and legal scholars have virtually ignored the severity of this problem.

Section II 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. The Section begins with a history of the government's efforts to protect the public from these schemes. It then focuses on the two main rules on which the FTC relies to attack these schemes: the Franchise Rule and the Federal Trade Commission Act (FTC Act). Section III discusses efforts by the Securities and Exchange Commission (the SEC) to prosecute pyramid marketing schemes for violations of securities laws.

Section IV discusses enforcement actions of federal agencies other than the FTC and SEC and enforcement actions at the state level. Section V discusses the Business Opportunity Rule (Proposed Rule) proposed by the FTC. This Section provides a detailed analysis of the Proposed Rule, focusing on pyramid marketing schemes.

Section VI of this Article discusses American Communications Network (ACN), a well-established pyramid marketing scheme that provides a concrete

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30. *See, e.g.*, ACN, Our Business Presentation, http://www.acninc.com/acn/us/opportunity/business/ (last visited Aug. 26, 2007) (on file with the *McGeorge Law Review*) ("For possibly the first time in your life, you have an opportunity to determine your own salary, to finally earn what you're worth; to work when you want, and with who you want; and most importantly, to be in control of your life. Are you ready to be in the driver's seat of your life?"). 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 VI.

31. *See, e.g.*, SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 475-76 (5th Cir. 1974).

> Koscot thrives by enticing prospective investors to participate in its enterprise, holding out as a lure the expectation of galactic profits. . . . "Many if not all of the persons, seeking to become Koscot distributors are attracted by the lure of money to be earned by high-pressure recruiting of other persons into the Koscot program, rather than the sale of the cosmetics themselves."

Id. (citation omitted); SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 479-80 (9th Cir. 1973).

> These meetings are like an old time revival meeting . . . . Their purpose is to convince prospective purchasers, or "prospects," that [the pyramid scheme] is a sure route to great riches. . . . [S]peakers describe, usually in a frenzied manner, the wealth that awaits the prospects if they will purchase one of the plans. . . . The goal of all of this is to persuade the prospect to purchase a plan . . . so that he may become a "salesman", and thus grow wealthy as part of the [scheme]. . . . Once he has bought a plan that empowers him to help sell the plans to others, the task of the purchaser is to find prospects and induce them to attend Adventure Meetings [so they will, in turn, purchase a plan].

Id.

32. *See* Taylor, Letter to FTC, *supra* note 6. 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. For example, victims 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.

means through which to analyze the Proposed Rule. Additionally, Section VI assesses the likely effect the Proposed Rule will have on businesses like ACN.

Ultimately, this Article proposes a two-fold approach to stop the abuses associated with pyramid marketing schemes. First, the law must require that opportunity sellers provide potential investors with enough information and time to make an informed decision. Second, federal law must directly proscribe pyramid marketing schemes and require opportunity sellers to provide enforcement agencies with enough information to discover whether they are engaging in pyramid marketing schemes. To minimize administrative burdens on legitimate companies, this reporting requirement should be eliminated for companies that do not actively make public sales of the business opportunity.

II. FTC ENFORCEMENT ACTIONS

In 1914, Congress established the FTC to protect consumers from deceptive and misleading information in the marketplace, anti-competitive mergers, and other unfair business practices, such as retail price floors and price-fixing.[33] Underlying this congressional action is a core belief that economies thrive if there is fair competition and consumers have accurate information about products and services.[34] Absent accurate information, economies become weak because consumers do not trust the system enough to invest their money in businesses.

The FTC currently brings enforcement actions against business opportunity scams under the following two laws: (1) Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures (Franchise Rule)[35] and (2) Section 5 of the Federal Trade Commission Act, often called the "Deceptive Trade Practices" section of the Act.[36] While successful in defeating traditional pyramid schemes,[37] neither law has been effective at stopping work-at-home or pyramid marketing schemes.[38]

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 a widespread distrust of the

33. Valentine, *supra* note 14.

34. *Id.*

35. 16 C.F.R. § 436 (2007).

36. 15 U.S.C. § 45 (2000).

37. 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 sell products 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. *See supra* note 31.

38. *See* Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,055, 19,060 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437).

stock market.[39] In order to instill confidence in the system and facilitate free and rapid trading of securities, Congress enacted the Securities Act of 1933 (1933 Securities Act)[40] followed by the Securities and Exchange Act of 1934 (1934 Securities Act) (collectively referred to as the Securities Acts).[41] These Acts were instrumental in restoring consumer confidence and allowing the stock market to recover.[42] Because they were aimed at protecting passive investors in "securities," the Securities Acts did not apply to persons who bought businesses with intentions of actively operating them.[43] At the time, that application was appropriate. The widespread sale of franchise rights to prospective franchisees had not started, and a massive market of "business opportunities" did not yet exist. The stock market crash had shaken consumer confidence in securities, and that is all Congress sought to redress with the Securities Acts.[44]

However, 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 the franchise business format, as companies such as Tastee Freeze, Dairy Queen, McDonald's, Dunkin' Donuts, and numerous others began to franchise.[45] Under the franchise model, a franchisor licenses 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 paid to the franchisor.[46] Because the franchisee purchased a business with the intent to actively operate it, the Securities Acts did not apply.

In the 1970s, the FTC discovered widespread franchise fraud.[47] Much like the stock market before the 1929 crash, investors gained confidence in the franchise system and invested in franchises without investigating the company.[48] 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.[49] Because of the growth of this deceptive behavior and to facilitate healthy growth of the franchise system, the FTC adopted a pre-sale disclosure rule commonly called the "Franchise Rule."[50]

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39. *See* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

40. 15 U.S.C. §§ 77a–77aa (2000).

41. 15 U.S.C. §§ 78a–78u (2000).

42. *See* Landis, *supra* note 39, at 30.

43. *Id.* at 31-32.

44. *Id.* at 30.

45. *See* H.R. REP. NO. 101-4, at 6 (1990).

46. *See* DANIEL C. K. CHOW & THOMAS J. SCHOENBAUM, INTERNATIONAL BUSINESS TRANSACTIONS 377 (2005); *e.g.*, Miller v. McDonald's Corp., 945 P.2d 1107, 1109 (Or. Ct. App. 1997).

47. *See* 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, 614 (Dec. 21, 1978) (to be codified at 16 C.F.R. pt. 436).

48. *Id.*

49. *See id.*

50. *Id.*

The Franchise Rule seeks to prevent fraud by requiring franchisors, and other business opportunity sellers, to disclose material information to purchasers before selling a franchise, or other business opportunity.[51] However, like the Securities Acts, this rule does not prevent a buyer from making a bad or risky investment; it merely aims to ensure that the purchaser is fully informed and able to determine whether the offer is in his or her best interest.[52] This rule is an effort to balance the benefits of encouraging franchise growth by requiring material disclosures and the burden of those disclosures on the franchise industry.

Under the Franchise Rule, a seller of a business, including a franchise, is legally obligated to disclose the following prior to a sale:

(1) The seller's name, address, principal place of business, type of business, and the name of parent company, if any;[53]

(2) The seller's background, litigation history, and bankruptcy history;[54]

(3) The offer's terms and conditions;[55]

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51. *Id.* After submission of this Article, new rules were promulgated that divided the original franchise rule into a new rule applicable only to franchises, 16 C.F.R. pt. 36, and a new rule applicable only to business rule, 16 C.F.R. pt. 37. Although the new rules have an effective date of July 1, 2007, franchisors and business opportunity sellers may continue to apply the original Franchise Rule until July 1, 2008. All references to the "Franchise Rule" in this Article are to the original Franchise Rule, which applies to both franchises and business opportunities. The differences between the original Franchise Rule, applicable to both franchises and business opportunities, and the new version of that rule, applicable only to franchises, do not appear to materially alter the conclusions and recommendations contained in this Article.

52. The Franchise Rule does not substantively affect the sale. *See* Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,055 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437). 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, Fed. Trade Comm'n, FTC Issues Updated Franchise Rule (Jan. 23, 2007), http://www.ftc.gov/opa/2007/01/franchiserule.htm [hereinafter Press Release, FTC Issues Updated Franchise Rule] (on file with the *McGeorge Law Review*). A Notice Containing the Final Rule Language and the Statement of Basis and Purpose was released the same day and published in the Federal Register, noted 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 the 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.

Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities, 72 Fed. Reg. 15,444, 15,543 n.975 (Mar. 30, 2007) (to be codified at 16 C.F.R. pts. 436 & 437). In short, the Final Rule, which was effective on July 1, 2007 and granted 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 15,543. For convenience, this Article refers to sections of the original Franchise Rule rather than the new bifurcated rule.

53. 16 C.F.R. § 436.5(a)(1), (3), (5) (2007).

54. *Id.* § 436.5(b)-(d).

(4) A statistical analysis of existing outlets of the business; whether company-owned or franchised;[56]

(5) The name, address, telephone number of the one-hundred closest franchise outlets;[57] and

(6) Audited financial statements.[58]

In addition, the seller must disclose certain specific financial information if it chooses to make any representation regarding projected financial performance of franchises.[59]

To minimize the compliance costs for smaller investments, the FTC included three significant exceptions to the Franchise Rule.[60] 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 within six months of purchase ("minimum threshold").[61] Second, voluntary purchases of reasonable amounts of inventory at wholesale prices do not count toward this $500 threshold ("wholesale exception").[62] 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 ("training and buy-back exception").[63] Unfortunately, pyramid marketing schemes capitalize upon these exceptions to avoid enforcement actions.

Since it took effect in the 1970s, the FTC has brought more than two hundred enforcement actions under the Franchise Rule.[64] The FTC has been particularly successful at stopping fraudulent "business opportunities" related to the sale of

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55. *Id.* § 436.5(e)-(g).

56. *Id.* § 436.5(t).

57. *Id.* § 436.5(t)(4).

58. *Id.* § 436.5(u).

59. *Id*. § 436.5(s)(1) ("The FTC's Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document."). If a franchisor makes any representation concerning financial performance, the franchisor must substantiate those representations in writing, disclosing, inter alia, the material bases and assumption upon which any projections are made, differentiating between historic and future financial performance, and further identifying whether the representation relates to performance across all existing outlets or a subset of outlets. *Id*. § 436.5(s)(3). If the franchisor is offering representations pertaining to a particular location, the franchisor may provide a supplemental disclosure containing information particular to that location. *Id*. § 436.5(s)(5). However, the sale of an existing outlet requires only the actual operating results of that outlet. *Id*. § 436.5(s)(4).

60. *See* Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,055 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437).

61. *Id.* at 19,055 & n.10 (citing 16 C.F.R. § 436.2(a)(2), (a)(3)(iii)).

62. *Id.* (citing 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)).

63. *Id.* at 19,055 & nn.14-15 (citing 16 C.F.R. § 436.2(a)(1)(ii)(B)(1)-(3); FTC v. Academic Guidance Serv., Inc., No. 92-3001 (D. N.J. 1992)).

64. Press Release, Fed. Trade Comm'n, FTC Proposes New Business Opportunity Rule (Apr. 5, 2006), http://www.ftc.gov/opa/2006/04/newbizopprule.shtm [hereinafter Press Release, FTC Proposes New Business Opportunity Rule] (on file with the *McGeorge Law Review*).

vending machines and rack displays.[65] However, enforcement under the Franchise Rule has been unsuccessful at stopping work-at-home and pyramid marketing schemes.[66]

1. Work-at-Home Schemes

The Franchise Rule does not cover most work-at-home schemes because of the training and buy-back exception; specifically, the rule does not apply if the buyer can sell the goods back to the business opportunity seller rather than directly to end-users.[67] In addition, the wholesale exception often exempts these schemes because victims pay large amounts to buy "supplies." Thus, the Franchise Rule does not usually cover business opportunities such as craft assembly and envelope stuffing.[68]

Work-at-home schemes tend to prey on the elderly, the unemployed, the disabled, stay-at-home parents, and non-English speakers.[69] Sellers tell victims that they must purchase the materials to assemble products up-front. Sellers assure buyers that once they assemble the products or stuff the envelopes, the seller will then repurchase the products to sell to the general public, provided a market is available.[70] The seller misrepresents the market for these goods and suggests that the goods will likely be bought back.[71] Of course, no buy-back occurs, and victims are left with worthless products and lose all or part of their investment.[72]

2. Pyramid Marketing Schemes

Pyramid marketing schemes commonly deceive consumers with the lure of huge potential incomes.[73] The typical scheme is similar to the one perpetrated by

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65. *See* Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,060 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437).

66. *See id.* at 19,059-61.

67. *Id*. at 19,055 (citing 16 C.F.R. § 436.2(a)(1)(ii)(A)(1)-(3)).

68. *See id*. at 19,055 & n.16 (citing FTC v. Misty Stafford, No. 3: CV 05-0215 (M.D. Pa. 2005); FTC v. Sun Ray Trading, Inc., No. 05-20402 CIV-Seitz/Bandstra (S.D. Fla. 2005)).

69. *See id.* at 19,059 & n.55 (citing 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)).

70. *See id.* at 19,059.

71. *Id.*

72. *Id.* 19,059 & n.60 (citing FTC v. Misty Stafford, No. 3: CV 05-0215 (M.D. Pa. 2005)) ("In addition, fraudulent work-at-home opportunity sellers frequently invent undisclosed conditions and limitations for rejecting the work performed by purchasers and refusing to buy back the goods the purchasers produce.").

73. *Id.* at 19,060 ("It is not uncommon for promoters of [pyramid] schemes to claim potential incomes of thousands of dollars a week or month."). For examples of incomes claimed by promoters, see *id.* at 19,060 n.72 ("FTC v. 2Xtreme Performance Int'l, LLC, No. JFM 99CV 3679 (D. Md. filed Dec. 9, 1999) (claiming income totaling 'about $2,000 in the first month . . . and then it went to $60,000'), FTC v. Bigsmart.com, No. CIV 01-

Carlo Ponzi:[74] new investors must buy into the "opportunity," and those funds are the primary source of income for those higher in the pyramid.[75] In order to fall below the minimum threshold of the Franchise Rule, sellers are careful to charge less than $500 to buy into the "opportunity."[76] Consequently, the Franchise Rule does not apply, and the seller has no duty to disclose any information. Thus, sellers can hide "the fact that the vast majority of those who have joined the program—often ninety percent or more—will not recoup their investment."[77]

B. The FTC Act

Section Five of the FTC Act broadly prohibits "unfair or deceptive acts or practices in or affecting commerce."[78] The FTC currently uses Section Five to attack scams falling within the exceptions to the Franchise Rule.[79] Because gathering evidence of "unfair" or "deceptive" acts is extremely difficult, the FTC does not use this provision frequently. In fact, the FTC reports that from January 1997 through December 2005, consumers lodged 17,858 complaints against pyramid marketing schemes, but, since 1990, the FTC has only brought twenty cases against pyramid marketing schemes under the FTC Act.[80]

0466 PHX ROS (D. Ariz. filed Mar. 12, 2001) (claiming that '[fifty] 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) (advertising that 'If you're serious, we can show you how to make ten thousand a month . . . [a]nd, 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) (promising that 'as much as $18,000 per month' can be earned), FTC v. Global Assistance Network for Charities, No. 96-2494 PHX RCB (D. Ariz. filed Nov. 5, 1996) (claiming that 'over $89,000 a month' could be earned), FTC v. NexGen3000.com, No. CIV-03-120 TUC WDB (D. Ariz. filed Feb. 21, 2003) (claiming that 'each activated business center has the potential to earn up to $60,000 per week'), and FTC v. SkyBiz.com, No. 01-CV-0396-EA (X) (N.D. Okla. filed May 20, 2001) (claiming that 'he's making $76,000 a week and growing')."").

74. *See supra* Part I.

75. This is done "indirectly" when promoters of the schemes disguise the fact that the money is primarily coming from recruiting new participants. *See* The ACN Compensation Plan Overview, http://users.tns.net/~mpat/scam/compensation/index.html (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*) (noting that ACN disguises how distributors earn money by recruiting new participants). For further discussion of ACN, see *infra* Section V.

76. *See* Exposing the Truth About ACN MLM, http://users.tns.net/~mpat/scam/ (last visited Aug. 31, 2007) [hereinafter Exposing the Truth] (on file with the *McGeorge Law Review*) (noting that ACN charges $499 to enroll as a new recruit); *see also* ACN Compensation Plan Overview, *supra* note 75 (explaining that "[p]eople who choose the Customer Representative level pay a one-time training and application fee of $99. Those choosing the Team Trainer level pay $499."). It seems patently obvious that this number was chosen to avoid the mandatory disclosures of the Franchise Rule.

77. *See* Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,060 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437).

78. 15 U.S.C. § 45(a)(1) (2000). Technically, this is "Section 5" of the FTC Act, but for convenience, this Article will refer to Section 5 as the "FTC Act."

79. *See* Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,059-61 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437).

80. *Id.* at 19,060-61. 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

In 1975, before the Franchise Rule's enactment, the FTC "pursued" Amway[81] for deceptive business practices.[82] After years of litigation, the FTC ruled that Amway was not an illegal pyramid scheme.[83] In its decision, the FTC identified a "pyramid scheme" as

> [t]he 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.[84]

The FTC also created the "Amway Safeguards Rule."[85] Amway was not a pyramid scheme because of three consumer protection safeguards in its company policies: (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 seventy percent of the products they purchased each month to non-distributors.[86]

The Amway decision has made it significantly more difficult for the FTC to prosecute companies under the FTC Act. MLMs, with the advice of legal counsel, now routinely implement the Amway Safeguards to ensure they will not be prosecuted as illegal pyramid schemes. In reality, these "safeguards" merely create mechanical steps that companies can follow to avoid prosecution. Thus, as long as a company utilizes the three Amway Safeguards identified by the FTC, it will not be prosecuted, even though the earnings of participants may be derived primarily from the payments of new recruits.[87]

Assuming most companies have the Amway Safeguards in place, the only way to prosecute a pyramid marketing scheme under the FTC Act, in the author's opinion, is to prove that a company has misrepresented its earnings potential. This is 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: "[s]uccess 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."[88] Because of such "disclosures,"

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people not to bother filing complaints. *See* ANDERSON, *supra* note 5, at 81 (showing that only 1.4 percent of defrauded consumers filed complaints with federal agencies, including the FTC).

81. *See* FITZPATRICK, PYRAMID SCHEME ALERT, *supra* note 6, at 34 n.12 ("Quixtar is just a new name for the largest and oldest of MLMs, Amway.").

82. Jeffrey A. Babener, *Network Marketing and the Law*, 23 VT. B. J. & L. DIG. 35, 35 (1997).

83. *In re* Amway Corp., 93 F.T.C. 618, 710 (1979).

84. *Id.* at 715 (citing *In re* Koscot Interplanetary, Inc., 86 F.T.C. 1106, 1180 (1975)) (emphasis omitted).

85. Babener, *Network Marketing and the Law*, *supra* note 82, at 35.

86. *In re Amway Corp.*, 93 F.T.C. at 717.

87. *See id.* at 715-16; *see also* ACN discussion *infra* Section V.

88. ACN, Explore the Opportunity, http://www.acninc.com/acn/us/opportunity/index.jsp (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*).

companies may successfully assert that they did not misrepresent their earning potential. "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."[89] The problem is not that the company misstates such a person's income. The problem is the company's intentional omissions and implications suggest that such an income is typical and attainable.[90] Unfortunately, the exceptions to the current rules allow bare disclaimers, undercut by misleading marketing, to substitute for meaningful disclosure.

Through these misleading earnings representations, MLM companies imply that any new participant who pays the sign-up fee can make vast amounts of profit simply by following the company's plan. However, because profits in a MLM organization primarily come from new participants, it is mathematically impossible for later participants to earn large profits because of the exponential number of new recruits needed to sustain a profit.[91] According to a groundbreaking study of several large pyramid marketing schemes, 99.9 percent of participants lost more money than they gained when investing in the schemes.[92] "The chance of profiting from a single spin of the roulette wheel at Caesar's Palace in Las Vegas is [forty-eight] times as great."[93] Yet recruiting conferences, or "opportunity meetings," herald 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.[94] This is akin to placing a large sign above the roulette wheel at Caesar's Palace announcing that "[t]his Wheel is an Amazing Business Opportunity."[95]

III. SEC ENFORCEMENT ACTIONS

Absent very narrow statutory exemptions, "securities" must be registered with the SEC pursuant to the 1933 Securities Act.[96] In addition, Section 10(b) and Rule 10b-5 of the 1934 Securities Exchange Act prohibits persons from making

89. *See* Jon M. Taylor, Rebuttal Comments to the DSA's Comments to the FTC Regarding the Proposed Business Opportunity Rule, Aug. 7, 2006, http://www.ftc.gov/os/comments/businessopprule/rebuttal/522418-13113.pdf (on file with the *McGeorge Law Review*).

90. However, some companies likely lie about how much the people earn at the top of the pyramid. *See* TAYLOR, THE 5 RED FLAGS, *supra* note 6, at 35.

91. *See* FITZPATRICK, PYRAMID SCHEME ALERT, *supra* note 6, at 9-10.

92. TAYLOR, THE 5 RED FLAGS, *supra* note 6, at 14; FITZPATRICK, PYRAMID SCHEME ALERT, *supra* note 6, at 4 (providing that Amway participants suffered a ninety-nine percent annual loss rate while a "tiny number of promoters at the top" profited).

93. TAYLOR, THE 5 RED FLAGS, *supra* note 6, at 16 (alteration omitted).

94. *Id.* at 14.

95. Taylor, Letter to the FTC, *supra* note 6 ("[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.").

96. *See generally* 15 U.S.C. §§ 77a-aa (2000).

materially "untrue" or "misleading" statements "in connection with the purchase or sale of any security."[97] Failure to comply with federal securities laws is a crime, and a single violation may result in up to a $10,000 fine and five years in prison.[98] Furthermore, the SEC can stop a violating "company from conducting business under its compensation plan, freez[e] the company's assets, plac[e] the company into a receivership, suspend[] the trading of the company's stock (if it is publicly traded), and order[] the company to disgorge itself of all ill-gotten profits."[99]

In the MLM context, it is rare for the SEC to attack a company for failure to register.[100] In fact, almost all cases involve claims of materially false or misleading statements.[101] Thus, to determine whether an MLM is in fact a pyramid marketing scheme, the following two questions should be asked: (1) is there a security and, if so, (2) has fraud been committed?

A. Is There a Security?

The definition of "security" in the 1933 Securities Act includes a laundry list of terms, the most inclusive of which is the "investment contract."[102] Because most MLMs do not issue stock or bonds to potential investors, courts must determine whether the MLM recruit is purchasing an investment contract.[103]

The seminal test of whether there is an investment contract, and therefore a security, is the test developed in *SEC v. W.J. Howey Co.*[104] Under the *Howey* test, "[t]o be considered an investment contract, the contract, transaction or scheme

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97. 15 U.S.C. § 78j (2000); 17 C.F.R. § 240.10b-5 (2006).

98. 15 U.S.C. § 77x (2000).

99. Spencer M. Reese, *Securities Law and MLM - What's the Deal?*, 1999, http://www.mlmlaw.com/library/guides/securities4.html (on file with the *McGeorge Law Review*).

100. The author has not discovered any cases in which the SEC prosecuted an MLM merely for the MLM's failure to register. This is likely because the MLM's sales agents, but not the organization itself, would be liable under the 1933 Securities Act. Prior to *Pinter v. Dahl*, 486 U.S. 622 (1988), the federal circuits were divided over the issue of who bore liability for selling unregistered securities. Some held that only the seller who was in privity with the purchaser was liable. *See, e.g.*, Sanders v. John Nuveen & Co., Inc., 619 F.2d 1222, 1226 (7th Cir. 1980). Others held that persons who were a "substantial factor" or "proximate cause" of the sale could be liable. *See, e.g.*, Jett v. Sunderman, 840 F.2d 1487, 1491 (9th Cir. 1988). The *Pinter* court held liability attached to sellers and those who solicited securities sales. 486 U.S. at 647. "Thus, a buyer cannot recover against his seller's seller unless the remote seller solicits the purchase." *Id.* at 644 n.21. Conversely, a 10b-5 action brought under the 1934 Securities Exchange Act does not require privity between the purchaser and seller or remote solicitator. Rather, fraudulent activity that occurs "in connection" with a securities' sale or purchase is sufficient to trigger liability. *See* Baretge v. Barnett, 553 F.2d 290, 291 (2d Cir. 1977).

101. *See, e.g.*, SEC v. Int'l Loan Network, Inc., 770 F. Supp. 678, 693-95 (D.D.C. 1991); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 475-76 (5th Cir. 1974); SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476 479-80 (9th Cir. 1973).

102. *Int'l Loan Network, Inc.*, 770 F. Supp. at 688 ("The statutory definitions of a security in § 2(1) of the 1933 Act and § 3(a)(10) of the 1934 Act are very broad, covering stocks, notes, and bonds as well as investment contracts and profit-sharing agreements.").

103. *See id.*

104. 328 U.S. 293, 298-99 (1946).

under scrutiny must be one in which a person (1) invests his money (2) in a common enterprise and (3) is led to expect profits (4) solely from the efforts of a promoter or a third party."[105] The thrust of this rule is consistent with the original purpose of the Securities Acts "to protect passive, uninformed investors."[106] Courts assume that those who expect "to reap profits through their own efforts and active participation in the venture" are sufficiently knowledgeable and engaged to protect their own investments.[107] While the *Howey* test appears straightforward, courts have applied the test inconsistently.

Under the first part of the *Howey* test, the issue of whether a person invests money turns on whether a person is making an investment or purchasing something for personal use or consumption. Pyramid marketing companies have typically tried to avoid this prong by having an investor purchase a product rather than invest money in the opportunity.[108] Accordingly, courts have looked beyond the form to the substance of the transaction to determine if the payment was really an investment in the right to get paid for recruiting new members to the company.[109] As a result of this "substance versus form" analysis, it is difficult for companies to avoid the first prong of the *Howey* test if a participant must purchase products in order to become a participant in the "opportunity."[110]

Under the second part of the *Howey* test, a court must determine if a "common enterprise" exists between the investor and the promoter.[111] Federal appeals courts are split on how to determine whether there is a common enterprise.[112] The three tests that courts most commonly apply are (1) horizontal commonality,[113] (2) strict vertical commonality,[114] and (3) broad vertical com-

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

106. *Id.* at 303; *see also Howey*, 328 U.S. at 299 ("[The Court's decision] permits the fulfillment of the statutory purpose of compelling full and fair disclosure . . . .").

107. Fried, *supra* note 105, at 303-04.

108. *See, e.g.*, *Int'l Loan Network, Inc.*, 770 F. Supp. at 681.

109. *Id.* at 688-90.

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

111. An analysis of the common enterprise test is beyond the scope of this Article. For discussions of the common enterprise test, see, for example, SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 n.7 (9th Cir. 1973) ("A common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."), and Wals v. Fox Hills Dev. Corp., 24 F.3d 1016, 1017-18 (7th Cir. 1994).

112. *See* Mordaunt v. Incomco, 469 U.S. 1115, 1115 (1985) (White, J., dissenting from the denial of certiorari).

113. *See* Terry L. Sexton Jr., *The Circuit Courts' Split on the Common Enterprise Element of Securities Regulation—A Small Matter, or a Trap for the "Martha Stewarts" of the Business World?*, 7 DUQ. BUS. L.J. 111, 115 (2005) ("[T]he 'horizontal' commonality approach 'involves an inquiry into whether the transaction involved the joint participation of more than one investor in the investment of funds or the sharing of profits.'" (citing John F. Wagner Jr., Annotation, *"Common Enterprise" Element of Howey Test to Determine Existence of Investment Contract Regulable as "Security" Within Meaning of Federal Securities Act of 1933 (15 U.S.C.A. § 77a et seq.) and Securities Exchange Act of 1934 (15 U.S.C.A. § 78a et seq.)*, 90 A.L.R. FED. 825 (2004))). For cases dealing with horizontal commonality, see Salcer v. Merrill Lynch, Pierce, Fenner & Smith Inc., 682

monality.[115] 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.[116]

Under the third part of the *Howey* test, whether the investor is led to expect profits, the test distinguishes between an investor who pays money in hopes of making a profit and an investor that merely purchases a product.[117] The U.S. Supreme Court noted that securities laws do not apply if somebody merely "purchases a commodity for personal consumption or living quarters for personal use" rather than "parts with his money in the hope of receiving profits."[118] 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."[119] In the context of pyramid marketing schemes, although a new recruit may purchase products, the recruit's overarching investment motive is usually readily apparent;[120] thus, the 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 the most critical prong in the pyramid marketing scheme context. The seminal case dealing with the fourth prong in pyramid marketing schemes is *SEC v. Glenn W. Turner Enterprises,*

F.2d 459, 460 (3d Cir. 1982), Curran v. Merrill Lynch, Pierce, Fenner & Smith Inc., 622 F.2d 216, 224-25 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982), and Deckebach v. La Vida Charters, Inc., 867 F.2d 278, 281-84 (6th Cir. 1989).

114. *See* Sexton, *supra* note 113, at 116 (stating that the "narrow vertical" approach is where "the investor and the promoter share in the losses and profits of the investment"). For a case dealing with strict vertical commonality, see Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982), *cert. denied*, 469 U.S. 115 (1985).

115. *See* Sexton, *supra* note 113, at 118 ("The 'broad vertical' approach focuses on whether 'the success or failure of the investment made in the transaction is primarily dependent upon the expertise or efforts of the investment promoter.'" (citing Wagner, *supra* note 113)). For cases dealing with broad vertical commonality, see SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478-79 (5th Cir. 1974), and SEC v. Cont'l Commodities Corp., 497 F.2d 516, 521-23 (5th Cir. 1974).

116. *See, e.g.*, *Glenn W. Turner Enters., Inc.*, 497 F.2d at 482 (articulating the vertical commonality standard); *Koscot Interplanetary, Inc.*, 474 F.2d at 476 (adopting Ninth Circuit's vertical commonality standard); Webster v. Omnitrition Int'l, 79 F.3d 776, 784 (9th Cir. 1996) (interpreting *Glenn W. Turner Enterprises* to stand for the proposition that a pyramid scheme is per se an investment contract within the meaning of the federal securities laws). *But cf.* United States v. Holtzclaw, 950 F. Supp. 1306, 1316 (S.D. W.Va. 1997) (holding a pyramid scheme was not a security under the horizontal commonality test, because "a common enterprise exists only when the transaction contemplates a multiplicity of investors contemporaneously holding equipotential interests in the enterprise.").

117. SEC v. Int'l Loan Network, Inc., 770 F. Supp. 678, 690 (D.D.C. 1991).

118. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 858 (1975).

119. *Id.* at 853 n.17.

120. Courts will look to the purchaser's "primary motive" to determine whether money has been expended for investment or consumption. JOHN C. COFFEE, JR., JOEL SELIGMAN & HILLARY A. SALE, SECURITIES REGULATION 282 (10th ed. 2007); *see, e.g.*, Rice v. Branigar Org., Inc., 922 F.2d 788 (11th Cir. 1991) (holding that lots in a beach club development were not "securities"; the purchasers bought their lots to use them rather than to derive profits from entrepreneurial efforts of developers).

Inc.[121] In this case, the Ninth Circuit held that the widely-publicized "Dare to be Great" program met this prong, in addition to the other three prongs, and was therefore issuing a security.[122] Although "Dare to be Great" participants were told they had to work to make money, prospects were led to believe in the "near inevitability of success to be achieved by anyone who purchases a plan and follows Dare's instructions."[123] The court thus rejected the defendant's argument that participants did not expect profits "solely" by the efforts of others because the participant also needed to bring recruits to Dare conferences to have any chance of success.[124] The court rejected a strict interpretation of the word "solely" and held the minimal efforts made by participants were insufficient to cause the arrangement to fail the fourth prong.[125] Dare led participants to believe that they would profit from the effort of others.[126]

A few states do not apply the *Howey* test, instead relying on a more flexible but similar "risk capital test."[127] Although no federal court has applied the risk capital test, this test is often used to enforce state securities laws, and the U.S. Supreme Court may one day choose to extend it into the federal arena. Under the risk capital test, there is an investment contract, and therefore a security, if all four of the following requirements are met:

> (1) An offeree furnishes initial value to an offeror, and (2) a portion of this initial value is subjected to the risks of the enterprise, and (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.[128]

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

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121. 474 F.2d at 482-83.

122. *Id.* at 478. "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 *Fast-Buck Gospel*, TIME, Nov. 29, 1971, http://www.time.com/time/magazine/article/0,9171,877473,00.html (on file with the *McGeorge Law Review*).

123. *Glenn W. Turner Enters., Inc.*, 474 F.2d at 479.

124. *Id.* at 481-83.

125. *Id.*

126. *Id.*

127. *See, e.g.*, Silver Hills Country Club v. Sobieski, 361 P.2d 906, 908-09 (Cal. 1961) (establishing the risk-capital test); Hawaii v. Hawaii Mkt. Ctr., Inc., 485 P.2d 105, 109 (Haw. 1971) (redefining the risk-capital test).

128. *Hawaii Mkt.*, 485 P.2d at 109.

for the investor to build the business.[129] For example, MLM attorney Spencer M. Reese states that "distributors must perform the sales and enrollment functions" and "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."[130] Mr. Reese also notes that, despite the promise of residual income, "distributors should have ongoing responsibilities throughout their MLM career."[131]

In the seminal Ninth Circuit case, *Webster v. Omnitrition International, Inc.*, the court ignored the *Howey* and the risk capital tests altogether.[132] Instead, the court put a substantial gloss on *Glenn W. Turner Enterprises,* interpreting the case to stand for the proposition that any "pyramid" is a per se security.[133] The reviewing court reversed summary judgment for Omnitrition because there were triable issues of material fact relating to Omnitrition's claims in its oral communications to purchasers that it was not a pyramid scheme.[134] On remand, the trial court was to determine whether, in fact, Omnitrition was a pyramid scheme. If it was, then Omnitrition's scheme constituted actionable fraud under the securities laws.[135]

The pyramid scheme analysis in *Webster* is more difficult for MLMs to overcome than the *Howey* or the risk capital tests because many MLMs are disguised pyramid schemes. 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, may be difficult for MLMs to follow.[136] Mr. Reese notes that, in order to

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129. ACN, for example, is careful to state on its website that success is influenced "by an individual's specific efforts." ACN, Overview: Explore the Opportunity, http://www.acninc.com/acn/us/opportunity/index.jsp (last visited Aug. 31, 2007) (on file with *McGeorge Law Review*).

130. Reese, *supra* note 99, § IV, pt. D (defining "upline" as a person directly higher in the pyramid than the recruit); *see also Glenn W. Turner Enters., Inc.*, 474 F.2d at 482-83; JON M. TAYLOR, CONSUMER AWARENESS INST., PRODUCT-BASED PYRAMID SCHEMES: WHEN SHOULD AN MLM OR NETWORK MARKETING PROGRAM BE CONSIDERED AN ILLEGAL PYRAMID SCHEME? 6 (2001), http://mlmthetruth.com/PPSdefined2001-rev2004.pdf (on file with the *McGeorge Law Review*) ("Upline—the direct line of distributors who are above a given distributor in the MLM distributor hierarchy or pyramid scheme and who receive overrides from his/her sales or purchases." (emphasis omitted)).

131. Reese, *supra* note 99, § IV, pt. E.

132. 79 F.3d 776, 781-82 (9th Cir. 1996).

133. *Id.* at 784 ("By the very structure of a pyramid scheme, participants' efforts are focused not on selling products but on recruiting others to join the scheme. Under the reasoning of Glenn W. Turner, this is enough to bring investments in the program within the definition of 'investment contracts.'").

134. *Id.* at 784-85.

135. *Id.* at 784-86. The *Webster* court held that if Omnitrition was, in fact, a pyramid scheme, it would be liable under section 12(2) of the 1933 Securities Act because it misrepresented whether it was a pyramid scheme in its oral communications with purchasers. *Id.* at 785-86. It further held that "operation of a pyramid scheme violates 10b-5's prohibition against engaging in an 'act, practice or course of business which operates as a fraud or deceit upon any person.'" Nevertheless, a jury would have to determine whether "promotion of a pyramid scheme demonstrates the necessary fraudulent intent" to be liable under section 10 of the 1934 Securities Act. *Id.* at 785.

136. *See* Reese, *supra* note 99, § IV, pt. F.

avoid being classified as a pyramid scheme, "[t]he primary emphasis of the program must be on generating sales to end user consumers, not on recruitment of new participants into the compensation plan . . . ."[137] He added 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."[138]

Although MLMs utilize Reese's advice on paper, it is impossible for most MLMs to comply because most rely on recruiting and funds provided by new recruits to pay the recruiter. ACN,[139] for example, carefully ties the payment of recruiting bonuses to the *acquisition of new customers* by those recruits, hiding the fact that most of the money used to pay those recruitment bonuses comes from sign-up fees paid by new customers.[140] In addition, ACN's training materials states, "ACN strictly prohibits ACN Independent Representatives from making any claims or guarantees related to earnings/income, whether express or implied";[141] nevertheless, actual sales pitches, such as the two quotes from the ACN Senior Vice President noted at the beginning of this Article,[142] commonly promise vast riches[143] by following a simple, mechanical system.[144] 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 *Glenn W. Turner Enterprises.*[145]

To summarize, there are three possible tests to determine whether the amount paid by a new distributor to an MLM is a "security" under the Securities Acts: (1) the *Howey* test, (2) the risk capital test, and (3) a pyramid scheme analysis (a per se security). Well-advised MLMs position themselves well *on paper* to minimize the risk of a challenge under these three approaches. In practice, however, these companies commonly promote investments in "securities." Given the SEC's limited resources compared to the astounding amount of money made by people at the top levels of MLMs, enforcement based upon company practice

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137. *Id.*

138. *Id.*

139. *See infra* Section V; *see, e.g.*, Exposing the Truth, *supra* note 76.

140. *See infra* Section V; *see, e.g.*, Corporate Narc, The ACN Scam, http://www.corporatenarc.com/the-acn-scam.php (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*).

141. United Networks Int'l Documentation Page, Getting It Right, 2005, http://uniteam1.com/pages/Documentation.html [hereinafter Getting It Right] (on file with the *McGeorge Law Review*).

142. *See supra* text accompanying notes 1-2.

143. *See supra* notes 1-2 and accompanying text; *see also, e.g.*, Video: Imagine Your Future, http://www.youtube.com/watch?v=d_Ody_eypRQ (last visited Sept. 1, 2007) (copy on file with the *McGeorge Law Review*); Video: ACN Cribs 2, http://www.youtube.com/watch?v=OGi5WuvfIac (last visited Sept. 1, 2007) (copy on file with the *McGeorge Law Review*).

144. *See, e.g.*, Art Napolitano, Senior Vice President, UNI Team1.com, Step by Step Strategy to Success in Network Marketing, http://uniteam1.com/PDFfiles/STEP%20BY%20STEP%20STRATEGY%20TO%20SUCCESS%20v3.pdf (last visited Sept. 1, 2007) (on file with the *McGeorge Law Review*).

145. 474 F.2d 476, 480-81 (9th Cir. 1973) (adopting a broad definition of "security"); *see supra* text accompanying notes 128-32.

is difficult. Often, private causes of action provide the only possibility of enforcement. However, because of 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, and because securities laws preclude punitive damages, class action lawsuits are also undesirable.

B. Has Fraud Been Committed?

Once the existence of a security has been determined, the next question is whether fraud has been committed.[146] Typically, the SEC or another plaintiff will first attempt to demonstrate that the MLM in question is a security and then attempt to prove fraud in violation of at least one of the Securities Acts.[147] The two primary areas where the SEC can make a showing of fraud are when (1) the company makes a material omission in failing to disclose that a pyramid must eventually collapse and most participants will lose their investment[148] and (2) the company deceptively misleads investors into believing they can earn the income represented by the sellers when few, if any, actually earn that amount.[149] Proof of these transgressions, however, is difficult and time consuming to obtain. The SEC must record a company's actual representations at its "opportunity meetings." This does not appear to occur routinely, thus leaving huge gaps in meaningful enforcement mechanisms.

IV. 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 in order 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 (FBI), to criminally prosecute pyramid schemes for money

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

147. *See, e.g.*, *id.*; SEC v. Galaxy Foods, Inc., 417 F. Supp. 1225, 1238, 1244-48 (E.D.N.Y. 1976).

148. *See, e.g.*, SEC v. Better Life Club of Am., Inc., 995 F. Supp. 167, 176 n.13 (D.D.C. 1998); SEC v. Int'l Loan Network, Inc., 770 F. Supp. 678, 695 (D.D.C. 1991).

149. *See, e.g.*, *Galaxy Foods*, 417 F. Supp. at 1244-47.

laundering, tax fraud, and mail fraud.[150] However, 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. Local prosecutors, state Attorneys General (usually the Consumer Protection Division), and state securities agencies handle most prosecutions.[151] Because state laws vary widely, they are difficult to enforce against companies that operate in many states and nations. In fact, these laws may be more helpful than detrimental to product-based pyramid schemes.

A common type of state pyramid scheme law is referred to as an "Amway Exception" anti-pyramid statute.[152] As discussed above, the Amway Safeguard Rule is widely viewed as favorable to the industry promoting product-based pyramid schemes.[153] States that have enacted Amway exception anti-pyramid statutes[154] include Alabama, Arizona, Florida, Georgia, Idaho, Illinois, Louisiana, Maryland, Massachusetts, Mississippi, Missouri, New Mexico, North Dakota, Oklahoma, Tennessee, Texas, Utah, and Wyoming.[155]

State securities laws, known as "blue sky" laws, are often similar to federal securities laws in that they only apply to investments in "securities."[156] These laws often differ from federal laws because they examine the merits of a security offering, while federal law is based on a philosophy of full disclosure. Federal law does not judge the quality of a security but merely requires that the offeror disclose material information about the company.[157] Like the federal laws, state laws produce inconsistent results, particularly with respect to whether the scheme is a security.[158] In part, this is because state securities laws that are modeled after federal law are often subject to a *Howey*-type analysis.[159] As a New Jersey prosecutor noted, "[a]lthough it appears from the case law in other jurisdictions

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150. *See, e.g.*, United States v. Gold Unlimited, Inc., 177 F.3d 472, 489 (6th Cir. 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).

151. *See, e.g.*, Mo. Att'y General's Office, Consumer Prot. Div., http://ago.mo.gov/divisions/consumerprotection.htm (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*).

152. *See* Howie, *supra* note 23, at 291 n.4.

153. *See supra* Section I.B; *In re* Amway Corp., 93 F.T.C. 618, 716-17 (1979).

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

155. Howie, *supra* note 23, at 291 n.4.

156. *See* Reese, *supra* note 99, § II.

157. ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS FOR LAW STUDENTS 346, 349 (4th ed. 2006).

158. *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, 1640-42 (1996).

159. *Id.* at 1635-36

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."[160]

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.[161] "Most of these laws prohibit the sale of business opportunities unless the seller gives potential purchasers a pre-sale disclosure document that has first been filed with a designated state agency."[162] The primary problem with these laws is that companies operating pyramid marketing schemes can work around these laws by offering the opportunities in states without stringent disclosure requirements.

In summary, state laws are difficult to enforce against pyramid marketing schemes. "[S]tate disclosure rules and other statutes are inadequate because pyramid marketing schemes by their very nature quickly spread across state lines and become unmanageable by state law enforcement agencies."[163] This alone demonstrates the need for a comprehensive federal rule.

V. THE FTC'S BUSINESS OPPORTUNITY RULE

On April 12, 2006, the FTC published a Notice of Proposed Rulemaking (the Notice) and the Proposed Rule.[164] As of the date of this Article's submission, the Proposed Rule had not yet been enacted.[165] After submission, the Proposed Rule was modified and made final, with an effective date of July 1, 2007 (the Final Rule).[166] Because of timing constraints, this Article focuses on the Proposed Rule. The differences between the Proposed Rule and the Final Rule do not appear to materially alter the conclusions and recommendations in this Article.

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160. *Id.* at 1645.

161. *See* Fed. Trade Comm'n, State Offices Administering Business Opportunity Disclosure Laws, http://www.ftc.gov/bcp/franchise/netbusop.htm (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*) (including 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).

162. *Id.*

163. Taylor, Letter to FTC, *supra* note 6.

164. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,054 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt 437).

165. *Id.* at 46,878 (requesting comments and requiring all comments to be submitted by June 16, 2006, with rebuttal comments to be submitted by July 7, 2006). On June 1, 2006, the FTC extended the comment period to July 17, 2006, and the rebuttal period to August 7, 2006. *Id.* at 31,124. On August 15, 2006, the FTC further extended the rebuttal period to September 29, 2006. *Id.* at 46,878.

166. FTC Business Opportunities Rule, 16 C.F.R. §§ 471.1-471.3 (2007). In reality, the Final Rule will not affect most business opportunity promoters until July 1, 2008, because they can opt to apply the original Franchise Rule until that date. Disclosure Requirements and Prohibitions Concerning Business Opportunities, 72 Fed. Reg. 15444, 15563 (Mar. 30, 2007).

A. Overview of the Proposed Rule

In recognition of the fact that many sellers of "business opportunities" can 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 that, in connection with the sale of any "business opportunity," the offeror of the opportunity make specific disclosures at least seven days[167] before the prospective purchaser signs a contract or pays any money, whichever occurs first.[168] Recognizing the burden of disclosure requirements under the Franchise Rule, the Proposed Rule requires the disclosure of significantly less information. 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 [twenty] disclosures that are required for franchises (trademarks, for example), but do not apply to business opportunities.[169] 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." . . .

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167. 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* TAYLOR, THE 5 RED FLAGS, *supra* note 6, at 11.

168. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,067, 19,088 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437.2).

169. 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.

> 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;
> - the use of shills;[170]
> - misrepresentations of endorsements or testimonials;
> - failure to honor territorial protection guarantees; and
> - failure to honor refunds.[171]

B. Analysis of the Proposed Rule

The FTC offers the Proposed Rule in light of the ineffectiveness of the Franchise Rule in preventing certain widespread fraudulent practices, such as work-at-home schemes and pyramid marketing schemes.[172] The FTC also offers 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."[173] 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 truly stop these schemes.[174] In addition, the

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170. WEBSTER'S NEW UNIVERSAL UNABRIDGED DICTIONARY 1165 (1996) (defining "shill" as a slang term for "a person who poses as a customer in order to decoy others into participating . . . .").

171. Press Release, FTC Proposes New Business Opportunity Rule, *supra* note 64.

172. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,058-59 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437) (noting that "business opportunities" covered by the Franchise Rule consistently rank among the top ten categories of consumer fraud complaints reported to the FTC); *see also* discussion of these schemes *supra* Parts II.A.1-A.2.

173. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,057 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437) (showing 127 Franchise Rule allegations and ninety-four Section 5 allegations pertaining to earnings claims issues in FTC enforcement actions (citing STAFF OF THE BUREAU OF CONSUMER PROT., FRANCHISE AND BUSINESS OPPORTUNITY PROGRAM REVIEW 1993-2000: A REVIEW OF COMPLAINT DATA, LAW ENFORCEMENT, AND CONSUMER EDUCATION 38-39 (2001), http://www.ftc.gov/reports/franchise93-01.pdf (on file with the *McGeorge Law Review*))).

174. 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 facilitates 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.

Proposed Rule should be modified to address some of the pyramid marketing scheme evasion tactics discussed in this Article.

The Proposed Rule applies 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 a prospective purchaser to enter into a new business; (2) The prospective purchaser makes a payment or provides other consideration to the seller, directly or indirectly through a third party; and (3) The seller, expressly or by implication, orally or in writing, either: (i) Makes an earnings claim; or (ii) Represents that the seller or one or more designated persons will provide the purchaser with business assistance.[175]

1. Solicitation to Enter into a Business

The "business opportunity" definition in the Proposed Rule "contemplates that business opportunity sellers will solicit prospective purchasers to enter into new businesses, as opposed to merely soliciting purchasers for goods or services."[176] Thus, the Proposed Rule will have no effect on the MLM distributor who seeks out customers for the company's products. The Rule will affect—and is designed to directly affect—only distributors who seek out new distributors.

2. Consideration Paid

The Proposed Rule would apply if a participant pays any consideration for the business opportunity.[177] This differs from the Franchise Rule, which only applies if a participant pays a minimum of $500 during the first six months after purchase.[178] The word "consideration" includes "monetary payment[s], share[s] of profits, or a current obligation[s] to make a payment at a future date."[179] The

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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 (on file with the *McGeorge Law Review*). 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 Ass'n, DSA Submits Comments to Federal Trade Commission (FTC) on Proposed Rule, http://www.dsa.org/press/Misc/index.cfm?documentID=750 (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*).

175. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,087 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437.1(d)).

176. *See id.* at 19,063.

177. *Id.*

178. *Id.* at 19,055.

179. *Id.* at 19,063.

Proposed Rule would apply if payment is made directly to the seller or indirectly by a third party, preventing easy evasion of the rule.[180]

3. *Earnings Claims or Business Assistance*

Additionally, for the Proposed Rule to apply, the seller must also make either an earnings claims statement or offer business assistance. If all the requirements are met, the seller will be required to disclose specific information at least seven days before the new recruit signs the contract or pays the consideration, whichever occurs first.[181]

The FTC's experience demonstrates 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."[182] Due to the significance of earnings claims in a purchaser's decision and the number of complaints that it receives about earnings claims, the FTC has decided to apply the Proposed Rule 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:
>
> (1) Any chart, table, or mathematical calculation that demonstrates possible results based upon a combination of variables; and
> (2) [A]ny 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 a six-figure income," or "earn your investment back within one year").[183]

Provided that the first two requirements are met, if the seller makes no earnings representations in connection with the sale of the business[184] but offers

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180. *Id.*

181. *Id.* at 19,067.

182. *Id.* at 19,063-64.

183. *Id.* at 19,087. Recall that ACN charges $499 to become a distributor. *See supra* note 76 and *infra* Section V. Thus, under this Proposed Rule, the fact that an ACN distributor drives an extremely costly BMW and Mercedes automobiles bearing Utah license plates reading "THX ACN" and "ONLY 499" would be earnings claims. *See* Video: ACN Cribs 2, *supra* note 143. 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 141 and accompanying text.

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

business assistance, the Proposed Rule will apply.[185] 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."[186] The FTC likely aimed this provision at distinguishing sales of goods or services from the sale of a business.

4. Disclosure Document

If all three elements of "business opportunity" are met, the seller of the business opportunity must prepare and furnish the prospective purchaser with a one-page disclosure document.[187] In addition, if the seller makes any earnings claims, the seller must provide the prospective purchaser with an earnings claims statement.[188] The basic disclosure document and the earnings claims statement, if any, must be provided "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 a payment or provides other consideration to the seller, directly or indirectly through a third party."[189] The seven-day period provides 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."[190]

The Proposed Rule aims to protect immigrants with limited English-speaking ability,[191] and, in the author's opinion, the disclosure document should be available in multiple languages if the seller offers the opportunity in a non-English language. 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 prospective purchaser in the same language in which the seller communicates the

185. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,087 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437.1(d)(3)(ii)) ("*Business assistance* means the offer of material advice, information, or support to a prospective purchaser in connection with the establishment or operation of a new business.").

186. *Id.*

187. *Id.* at 19,088. Only the seller of a business opportunity has this obligation. *Id*.

188. *Id.* at 19,088-89. Presumably, this means that a "business opportunity" that only meets that definition because the seller that offers business assistance, rather than earnings claims, will not need to provide the earnings claims statement.

189. *Id.* at 19,088.

190. *Id.* at 19,067 ("[T]he Commission recognizes that for business opportunity sales—as opposed to more complex franchise sales—a shorter period may be warranted. Accordingly, the Commission solicits comment on whether it should adopt a shorter time period.").

191. *See, e.g.*, Fed. Trade Comm'n, Bogus California Operation Targets Hispanic Consumers with Work at Home Opportunity Scam, Sept. 7, 2004, http://www.ftc.gov/opa/2004/09/compamericana.shtm (on file with the *McGeorge Law Review*).

business opportunity. For example, a company could conduct an "opportunity meeting" in Spanish, where attendees, who received English disclosure forms, could be persuaded to "[j]ust sign these few documents and give us a payment to make this wonderful opportunity happen."[192] Such a scenario would circumvent the purpose of the Proposed Rule.

In general, the disclosure document requires a seller to provide a prospective purchaser with a one-page form that contains identifying information, a standard preamble, and five substantive disclosures.[193] These five substantive disclosures, discussed in greater detail below, include (1) earnings claims, (2) legal actions, (3) cancellation and refund policies, (4) cancellation and refund request histories, and (5) references.[194]

Based on public comments, the Proposed Rule's required identifying information is reasonable and non-controversial. Specifically, the disclosure document must disclose the seller's name, business address, telephone number, the name of the salesperson offering the business opportunity, and the date.[195]

The proposed preamble to the disclosure document would state that the information provided in the disclosure document "'can help you in deciding whether to purchase a business opportunity.'"[196] The preamble would also warn that "'no governmental agency has verified the information.'"[197] 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's office.[198]

The first three of the five substantive disclosures in the disclosure document would take the form of "yes" or "no" boxes to check.[199] The first of these disclosures (earnings claims) is the most important.[200] As currently written, "[the Proposed] Rule would permit sellers to make an earnings claim, provided there is a reasonable basis for the claim and the seller can substantiate the claim at the time it is being made."[201] The seller's duty to disclose is dependant on whether or

192. *See id.* (discussing how a Los Angeles-based business was cited by the Federal Trade Commission for targeting Spanish-speaking consumers with work-at-home business opportunities).

193. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,068, 19,091 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pts. 437.3(a) and app. A).

194. *Id.*

195. *Id.*; *see generally* 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, 59,614-20 (Dec. 21, 1978) (to be codified at 16 C.F.R. pt. 436).

196. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,068 (to be codified at 16 C.F.R. pt. 437.3(a)).

197. *Id.*

198. *Id.*

199. *Id.*

200. *Id.* at 19,063 ("[T]he making of earnings claims underlies virtually all fraudulent business opportunity schemes.").

201. *Id.* at 19,068.

not the seller makes any earnings claims.[202] If the seller makes any earnings claims, the seller would also need to provide a corresponding earnings claims statement.[203]

Unfortunately, in the author's opinion, enforcement of earnings claims disclosures will likely be difficult and easy to evade. First, companies are likely to change their internal regulations to specifically prohibit distributors from making any earnings claims statements, if this is not already the case.[204] Second, companies could provide distributors with forms for prospective purchasers. The forms, which prospective purchasers will be required to sign, can simply state that the seller has made no earnings claims disclosures. Third, all sellers are likely to check the "no earnings claims" box. This can be explained to prospective purchasers as technical compliance with the law. Under these circumstances, it would be difficult and labor intensive to prosecute companies for violations. FTC investigators would need to attend opportunity meetings to gather evidence. Even if such evidence could be obtained, the companies could counter that the leaders holding those meetings were independent contractors in violation of written company policy.

The FTC, like the SEC, should protect the *public* whenever a company takes on a *public* role.[205] It is inconceivable that any public sale of an opportunity would NOT involve earnings claims. Thus, the author believes that the Proposed Rule should require an earnings disclosure by the individual seller any time a seller of a business opportunity assumes a public role. A "public" role could be presumed any time (1) a seller offers the opportunity to more than five people in one setting, or (2) the individual seller sold the opportunity to more than five people during the previous thirty days. This change would eliminate the burden on people who primarily make money by selling a product but occasionally invite a friend into the business. This change would acknowledge that anybody who regularly sells "opportunities," especially to groups of people, makes earnings claims.

The second disclosure, legal actions, would require disclosure if the seller or "[a]ny affiliate or prior business of the seller" "has been the subject of any civil or criminal action for misrepresentation, fraud, securities law violations, or unfair or deceptive practices within the [ten] years immediately preceding the date that the business opportunity is offered."[206] Further, "disclosure of such actions is required regardless of whether the claim is brought in a court or administrative

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202. *Id.*

203. *See id.* at 19,063-64.

204. *See, e.g.*, Getting It Right, *supra* note 141.

205. *See* HAMILTON & BOOTH, *supra* note 157.

206. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,088 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437). Note that this provision is based upon a similar provision in the Franchise Rule, 16 C.F.R. § 436.1(a)(4) (2007), and on UFOC Guidelines. *See id.* at 19,068 n.154; Unif. Franchise Offering Guidelines, http://www.nasaa.org/content/Files/UniformFranchiseOffering Circular.doc (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*).

action or arbitration proceeding, and whether it is brought by a private party or a governmental agency."[207] Although this information is relevant, it could be misleading and used by competitors to harm non-pyramid scheme companies. Disclosure of all actions, whether or not successful, presumes the seller's guilt. 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, if this disclosure is included in the Proposed Rule, it should be limited to convictions or adverse rulings.

The third disclosure, cancellation and refund policies, would require sellers to disclose all terms and conditions of any cancellation or refund policy.[208] This information is material to prospective purchasers because it

> creat[es] 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 [twenty-four percent] of business opportunity complaints involved consumers seeking to cancel their purchase (818 of 4512 complaints), and [twenty-two percent] involved a refund policy issue (752 of 4512 complaints).[209]

Under the Proposed Rule, if a seller claims to have a cancellation or refund policy (and the seller is not required to have one), a disclosure document with a description of its policy must be attached.[210] This information is relevant to a prospective purchaser's decision, and the burden on the seller to provide this information is small. That being said, refund policies distract potential purchasers from what should be the core focus of the Proposed Rule. Specifically, the rule should focus on earnings claims and a waiting period. As mentioned, sellers of business opportunities sell the "opportunity" by using high-pressure sales tactics and by implying that great riches can be earned easily. This should be the focus of the Proposed Rule. Accordingly, to minimize "information overload" for prospective purchasers, the FTC should delete this requirement.

The fourth disclosure, cancellation or refund request history, is also relevant to the prospective purchaser's decision, but the significant burden disclosure would place on the seller may discourage refund policies. This disclosure rule would require "that sellers disclose cancellation or refund requests made by prior purchasers during the past two years."[211] The terms "cancellation or refund request" are broad, including any request for cancellation or a full or partial refund, whether or not the requester had the contractual right to receive such a

207. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,069 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437).

208. *Id.* at 19,088.

209. *Id.* at 19,070.

210. *Id.*

211. *Id.* at 19,070.

remedy."[212] Due to the burden of tracking the number of refund requests and the potential negative consequences to the seller of disclosing all refund requests, such a disclosure requirement would discourage refund policies.[213] 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 located nearest to the prospective purchaser's location.[214] Alternatively, a seller may provide a prospect with a national list of all purchasers.[215] This requirement seems unnecessary and costly. Companies may easily manipulate data regarding the ten most recent purchasers. 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.[216] Additionally, the genuine data may be worthless. If a seller is active in a particular market, then the ten most recent purchasers are likely 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. "It is extremely rare for [pyramid marketing scheme] victims to recognize the fraud . . . without intensive de-programming by a knowledgeable consumer advocate. Companies condition participants to blame themselves—not the . . . program—for their 'failure.'"[217] Thus, by providing unwitting references, this type of disclosure may actually encourage investments in pyramid marketing schemes.

The second problem with the references requirement is the issue of privacy. Prior purchasers may not want their information disclosed. Presumably they would be able to request that this information not be disclosed, but that would open the door to more manipulation. The seller could ask all purchasers if they want personal information disclosed; many, if not most, would probably decline. Furthermore, sellers have a legitimate concern that the disclosure would enable competitors to easily obtain their distributor lists. In short, the problems with the disclosure of references greatly outweigh the benefits, and the requirement should be removed.

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212. *Id.* at 19,070 n.172.

213. To avoid prosecution under the FTC Act, the Amway Safeguards currently require that business opportunity sellers utilize a refund policy. *See In re* Amway Corp., 93 F.T.C. 618, 710, 715, 117 (1979); *supra* text accompanying notes 83-84, 86. However, the adoption of the Business Opportunity Rule will provide a new safe harbor for business opportunity sellers, independent of the Amway Safeguards.

214. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,088 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437).

215. *Id.*

216. *But see supra* note 170 and accompanying text.

217. TAYLOR, THE 5 RED FLAGS, *supra* note 6, at 11.

5. Earnings Claim Statement

To make an earnings claims statement under the Proposed Rule, 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.[218] The Earnings Claim Statement must provide 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.[219]

The earnings claims statement is the single most important piece of information to be disclosed by business opportunity sellers, and the FTC should revise this part of the Proposed Rule if it hopes to discourage product-based pyramid schemes.

The earnings claims disclosure has, in the author's opinion, 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; most people who invest do so because they believe they are likely to make a fortune. Moreover, ensuring that the government is informed is critical to enforcing anti-pyramid scheme laws.

Potential investors need to know how much profit prior investors actually realize. Averages alone are not very useful, especially because companies tend to

218. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,088 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437.4).

219. *Id.* at 19,088-89.

base that information solely on the profit of the "active participant," a sample that can be easily skewed and omits participants that leave the company due to poor returns.[220] Thus, the seller of the opportunity should be required to provide the prospective purchaser with the following six pieces of information during the sales pitch:

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");[221]
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;[222]
5. The median *net* income for the Whole Group during the Measuring Period;[223] 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 help people avoid being misled, which should be the primary focus of the new law.[224] None of this information, however, will

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220. *See, e.g.*, ACN Canada, ACN One World, One Vision, http://www.acncanada.ca/acn/ca_en/opportunity/index.jsp (last visited Aug. 31, 2007) [hereinafter ACN Canada] (on file with the *McGeorge Law Review*).

> ACN Canada Earnings Statement: The average ACN Canada active Independent Representative in 2006 earned over $500. *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.

Id. (emphasis added). 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.

221. 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.

222. 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.

223. Median net income is computed by determining the net income number above which fifty percent of the Whole Group and below which fifty percent of the Whole Group has their net income.

224. HAMILTON & BOOTH, *supra* note 157, at 349 (focusing 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).

help authorities determine if the "opportunity" is a disguised pyramid scheme.[225] 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 concept: earnings of participants are primarily derived, directly or indirectly, from recruiting new participants rather than from selling a product.[226] Because this information is easy for companies to hide, an additional disclosure to the government is necessary to address this issue.

The only way to adequately inform the government about pyramid marketing schemes is to require a filed separate earnings statement to distinguish earnings derived from retail sales from earnings derived, even indirectly, from amounts paid by new recruits. To do this, the company must disclose verifiable retail-based income earned at each level in the company's hierarchy.[227] 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.[228] 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. Absent this level of disclosure, the FTC will be unable to efficiently investigate pyramid marketing schemes.

Because these government disclosures obviously would be a burden on businesses, and because the FTC is striving to facilitate the growth of business, while protecting the public,[229] there should be a de minimus exception under which companies that take on a very limited public role would not need to disclose anything to the government. Specifically, any company in which ten percent or fewer of its distributors made a "public" sale of the opportunity within the prior three months would not be required to file any report with the FTC. Again, a "public" role would mean "(1) a seller offers the opportunity to more

225. Shifting the focus to a more substantive approach that would look at the merits of the security offering is more analogous to the approach of traditional "blue sky" laws. *But see id.* (noting that blue sky laws, in contrast to federal securities laws, consider the "investment quality of securities . . . involved").

226. *But see* Reese, *supra* note 99, § IV (describing how companies can avoid having their business plans classified as pyramid schemes). 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 infra* Section VI. 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.

227. *See* ROBERT L. FITZPATRICK, COMMENTS AND RECOMMENDATIONS FROM PYRAMID SCHEME ALERT ON THE PROPOSED FTC BUSINESS OPPORTUNITY RULE R511993 (2006), http://www.pyramidschemealert.org/PSAMain/news/PSA-FTC%20Commentary.pdf [hereinafter FITZPATRICK, COMMENTS AND RECOMMENDATIONS] (on file with the *McGeorge Law Review*).

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

229. *See* Valentine, *supra* note 14, at 205.

than five people in one setting, or (2) the individual seller sold the opportunity to more than five people during the previous [thirty] days."[230]

C. Public Comments Regarding the Proposed Rule

According to the DSA website, the Proposed Rule will have a "devastating impact" on its members.[231] MLMs and MLM support organizations vigorously encouraged their members to write to the FTC with their comments,[232] and approximately 17,000 comments were submitted.[233] A cursory review of these comments indicates that the MLM industry views the Proposed Rule as a serious threat.[234] The industry both suggested revisions to the Proposed Rule and provided form letters to supportive members, over five thousand of which were received by the FTC.[235]

Public comments suggest that the primary complaint about the Proposed Rule is the seven-day waiting period before a prospective purchaser can pay money or sign a contract.[236] The justifications for this complaint range from

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230. *See id.*

231. Direct Selling Ass'n, DSA Submits Rebuttal Comments to Federal Trade Commission (FTC) on Proposed Rule, http://www.dsa.org/press/misc/index.cfm?documentID=869 (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*).

232. *See, e.g.*, Jeffrey Babener, Babener & Assocs., FTC Proposed Business Opportunity Rule: DSWA Speaks Out, 2006, http://www.mlmlegal.com/FTC%20Business%20Opportunity%20Rule/DSWAresponse.html (on file with the *McGeorge Law Review*).

233. *See* Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities, 72 Fed. Reg. 15,444, 15,543 n.975 (Mar. 30, 2007) (to be codified at 16 C.F.R. pts. 436 & 437).

234. *See* Fed. Trade Comm'n, 16 C.F.R. Part 437 Notice of Proposed Rulemaking: Business Opportunity Rule, Form Letters, http://www.ftc.gov/os/comments/businessopprule/Indexflm.htm (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*); *see also* Taylor, Letter to FTC, *supra* note 6 ("The 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!" (emphasis omitted)).

235. *See* Fed. Trade Comm'n, *supra* note 234 ("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." (emphasis omitted)).

236. *See, e.g.*, Letter from Julie Gunhus, Demonstrator, Stampin' Up!, to the Fed. Trade Comm'n, Office of the Sec'y (July 11, 2006) (on file with the *McGeorge Law Review*) ("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."); Letter from Mark Cedarleaf, Cedarleaf Wellness, to the Fed. Trade Comm'n, Office of the Sec'y (July 16, 2006) (on file with the *McGeorge Law Review*) ("One of the most confusing and burdensome sections of the proposed rule is the seven day waiting period to enroll new distributors."); Letter from S. Long, Indep. Distrib., 4Life, to the Fed. Trade Comm'n, Office of the Sec'y (July 17, 2006) (on file with the *McGeorge Law Review*) ("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* Babener, FTC Proposed Business Opportunity Rule, *supra* note 232.

calling it "confusing and burdensome,"[237] to expressing concern that "[t]he proposed waiting period will give the public the idea that there's something wrong with me or the . . . business plan,"[238] to calling it "quite burdensome . . . to keep such detailed records,"[239] to finding the waiting period "unnecessary."[240] This is only a sampling of the objections; with 17,000 public comments to the Proposed Rule, there are obviously many more stated reasons.

The industry relies on high pressure sales tactics to sell the opportunity to sell. These high pressure settings, often called "opportunity meetings," are used to persuade participants that they can make a fortune if they join the company. The goal is 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 others, they would be less likely to sign a contract or pay money. Thus, the Proposed Rule threatens the industry with its waiting period. While reasonable minds can differ over the appropriate waiting time needed to protect 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 waiting period of at least a few days. If the offer 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.

In addition to the seven day waiting period, other common complaints emerge. 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.[241] Second, distributors are concerned about privacy issues related to releasing information about prior purchasers.[242] Interestingly, the letters do not address the earnings claims disclosure requirements. Perhaps that is because, as explained above,[243] companies already work around similar requirements.

VI. 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.

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237. *See, e.g.*, Letter from Julie Gunhus, *supra* note 236.

238. Letter from Eric F. & Heidi A. Welch, Distribs., XanGo LLC, to the Fed. Trade Comm'n, Office of the Sec'y (on file with the *McGeorge Law Review*).

239. Letter from Debbie Hunter, Distrib., Healing Essentials, to the Fed. Trade Comm'n, Office of the Sec'y (on file with the *McGeorge Law Review*).

240. Letter from Jeremiah & Patricia Arnett, Distribs., XanGo, to the Fed. Trade Comm'n, Office of the Sec'y (on file with the *McGeorge Law Review*).

241. *See, e.g.*, Letter from Fernando Gomez, Distrib., 4Life Research USA, LLC, to the Fed. Trade Comm'n, Office of the Sec'y (July 16, 2006) (on file with the *McGeorge Law Review*).

242. *Id.*

243. *See* Reese, *supra* note 99, § IV.

In a video clip available on ACN's website, Mr. Trump says

> 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.[244]

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.[245] ACN plays Mr. Trump's video at "opportunity meetings" to recruit more distributors.[246] In ACN's fourteen years in business, it has grown into a multinational company located in nineteen countries with almost 100,000 representatives, 50,000 of whom are located in the United States.[247]

ACN appears to be a typical pyramid marketing scheme, evidenced by the company's business opportunity and training meetings.[248] 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.[249]

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244. Video: ACN & Donald Trump, http://www.acninc.com/acn/us/opportunity/trump.jsp (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*).

245. 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, *supra* note 76; Cap'n Arbyte's, Into the ACN Pyramid Scam, Apr. 11, 2005, http://arbyte.us/blog_archive/2005/04/ACN_Pyramid_Scam.html (on file with the *McGeorge Law Review*); Mike Grossman's Blog, ACN MLM Pyramid Scheme, http://www.mikegrossman.com/blog/2006/02/23/acn-mlm-pyramid-scheme-please-comment (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*); Corporate Narc, *supra* note 140; Adam Hojnacki & Peter Scheck, *Get Rich Quick?*, GENERATION, Oct. 24, 2006, http://www.subboard.com/generation/articles/116164656490688.asp (on file with the *McGeorge Law Review*); Posting of at1 to scam.com, http://www.scam.com/showthread.php?t=4706 (Aug. 7, 2005, 11:21 AM) (on file with the *McGeorge Law Review*). This is just a small sampling. In short, this company appears to have a growing number of enemies.

246. *See, e.g.*, ACN News Magazine, Life Without Boundaries, http://www2.acninc.com/1Q07_NewsMag.pdf (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*) (showing Donald Trump's picture on the cover).

247. JOHN W. HESSE, II, ACN, INC., COMMENTS OF ACN, INC. ON THE NOTICE OF PROPOSED RULE-MAKING FOR THE BUSINESS OPPORTUNITY RULE 2 (2006), http://www.ftc.gov/os/comments/ businessopprule/522418-11820.pdf [hereinafter HESSE, ACN COMMENTS] (on file with the *McGeorge Law Review*).

248. 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. *See, e.g.*, FITZPATRICK, COMMENTS AND RECOMMENDATIONS, *supra* note 227.

249. Renee Viellaris, *Phone Network Accused of Illegal Pyramid Selling*, COURIER MAIL (Australia),

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."[250]

ACN has high-powered legal representation, and distributors tout this representation when they are seeking new recruits.[251] According to the company, it has a legal advisory board that includes former state attorneys general, professors, and judges.[252] "Each committee member regularly studies ACN's practices, products and marketing strategies for compliance with the laws in every state and country in which ACN representatives operate. In addition, the board approves the Independent Representative Agreement which every new representative must sign before starting their ACN business."[253] "ACN operates its business opportunity in accordance with legal requirements and expects Independent Representatives to comply with the rules set out in the Independent

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Sept. 4, 2004, at 21.

250. Valerie Lawton, *Phone Service Sold Amway Way*, TORONTO STAR, Sept. 20, 1997, at E1 (emphasis added). To fully appreciate ACN's recruiting tactics, see Video: ACN, Experience the Excitement of an ACN International Training Event, http://video.acninc.com/Misc/Excitement.html (last visited Aug. 31, 2007) (copy on file with the *McGeorge Law Review*).

251. *See* ACN Legal Advisory Comm., http://www.acnintegrity.com/integrity.html (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*).

252. *Id.* (noting former Kansas Attorney General Robert Stephan, former Kentucky Attorney General Chris Gorman, and former Arizona Attorney General Grant Woods oversee ACN's Legal Advisory Committee). 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* Getting It Right, *supra* note 141. 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 (2007) (stating that an attorney may represent a client, when that representation involves a conflict of interests, but only if certain criteria are met). Apart from professional responsibility issues, the risk that these attorneys are taking 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.

253. ACN Legal Advisory Comm., *supra* note 251.

Representative Agreement and the Policies and Procedures."[254] ACN's familiarity with the laws applicable to MLMs is apparent. Although ACN's business structure is a "pyramid," it works to avoid the legal definition of a "pyramid scheme."[255] To this end, ACN has also hired a lobbyist, 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.[256]

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).[257] ACN's comments demonstrate how companies operating 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.[258]

Although the statement may be technically correct, it is highly misleading.[259] The inference is that ACN does not engage in mass-market advertising. ACN would likely respond that it does not mass market "telephony services." While this may be true, the FTC's concern is whether ACN mass markets "opportunities to sell," and there is significant evidence that it does. Even cursory internet searches find numerous mass marketing advertisements for ACN "opportunities."

254. Robert T. Stephan, The Formation of ACN's Legal Advisory Committee, 2007, http://www.acnintegrity.com/acnlegalformation.html (on file with the *McGeorge Law Review*).

255. *See* discussion *infra* Sections VI; *see also* Robert T. Stephan, The Difference in ACN and a Pyramid Scheme, 2007, http://www.acnintegrity.com/nopyramidscheme.html (on file with the *McGeorge Law Review*) (explaining the differences between ACN and pyramid schemes).

256. *See* CERO Strategies, Background, John W. Hesse, II, 2005, http://www.cerostrategies.com/background/index.html (on file with the *McGeorge Law Review*); HESSE, ACN COMMENTS, *supra* note 247, at 2.

257. *See* HESSE, ACN COMMENTS, *supra* note 247.

258. *Id.* at 2.

259. 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.*, Video: ACN International Event December 2006, http://www.youtube.com/watch?v=ZcPaPOVBCY0 (on file with the *McGeorge Law Review*) (showing a massive, large-scale business opportunity meeting).

Following is just a small sampling:[260]

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. . .";[261]
2. "The ACN Opportunity World Tour 2005—Featuring Larry Raskin, ACN Vice President of North American Sales. . .";[262]
3. "Business Opportunity Meeting Featuring Keynote Speaker [Regional Vice President] Mary Ordway, Wilkes Barre, PA, January 11, 2005. . .";[263]
4. "Career in sales, marketing and advertising, lucrative pay! . . . Learn how to leverage your income from [a] 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";[264]
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";[265] and
6. "Find out how <u>Anyone</u> Can Earn from the Deregulated Telecommunication Market by attending an ACN Presentation—Saturday, 11th November 2006. . . . Spreading the News in Leicester,

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260. Recent lists of business opportunity meetings, as well as flyers, can be found at My ACN for Representatives, Find a Meeting Near You!, https://acn.dataparadigm.com/meetings_dws_list.asp?CO_LA=US_EN&BC_ID=305376 (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*) (providing business opportunity meetings); My ACN for Representatives, Find a Meeting Near You!, https://acn.dataparadigm.com/meetings_dws_list.asp?CO_LA=US_EN&BC_ID=178457 (last visited Jan. 14, 2008) (on file with the *McGeorge Law Review*) (providing flyers).

261. ACN, Inc., Action 99, http://www2.acninc.com/action99.html (last visited Jan. 22, 2007) (link expired) (on file with the *McGeorge Law Review*).

262. ACN Inc., Boise 1-13-05, http://www2.acninc.com/events/OppTour2005/Boise.htm (last visited Feb. 18, 2007) (link expired) (on file with the *McGeorge Law Review*).

263. ACN Inc., Wilkes BOM, http://www2acninc.com/events/WilkesBOM.html (last visited Jan. 22, 2007) (link expired) (on file with the *McGeorge Law Review*).

264. Posting of job-232959298@craigslist.org to http://austin.craigslist.org/sls/232959298.html (posted on Nov. 10, 2006, 2:07 PM CST) (last visited Jan. 9, 2007) (listing expired) (on file with the *McGeorge Law Review*).

265. Posting of heatheracnrep@yahoo.com to http://baltimore.craigslist.org/bus/246508680.html (posted on Dec. 12, 2006 2:31 PM EST) (last visited Jan. 22, 2007) (listing expired) (on file with the *McGeorge Law Review*).

> England. . . . ACN Representatives ₤7 Guests free if accompanied by a Paying Representative."[266]

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.[267]

Again, while the statement may be technically true, it is *highly* misleading. While the statement that ACN's revenue is not primarily derived from money paid by new recruits is likely correct, the question in a pyramid scheme analysis is how much of the *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 (Compensation Plan),[268] ACN representatives make their money from the following two sources: (1) residual income and (2) customer acquisition bonuses (CABs).[269] Furthermore, the income derived from "residual income" pales compared to the amount derived from CABs.

There are two ways ACN representatives 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).[270] With Personal Residual Income, a representative can earn between two percent and eight percent of his or her customers' monthly bills.[271] Specifically, representatives earn two percent of the representative's monthly billing if the representative has monthly billings of up to $1,999;[272] three percent

266. The Red Apple Group, www.red-apple-group.com (last visited Jan. 22, 2007) (link expired) (on file with the *McGeorge Law Review*).

267. HESSE, ACN COMMENTS, *supra* note 247, at 4.

268. ACN Compensation Plan Overview, *supra* note 75.

269. *Id.*

270. *Id.*

271. *Id.*

272. *Id.* (noting a maximum of $40 for the month (i.e., .02 x $1,999)).

if monthly billings are from $2,000 to $3,999;[273] four percent if monthly billings are from $4,000 to $5,999;[274] five percent if monthly billings are from $6,000 to $7,999;[275] six percent if monthly billings are from $8,000 to $9,999;[276] seven percent if monthly billings are from $10,000 to $12,499;[277] and eight percent if monthly billings are $12,500 or more.[278]

To put this in perspective, assume an average phone bill of thirty dollars per customer;[279] to achieve monthly billings of $12,500, that representative would need 417 direct customers.[280] In this case, the monthly commission would be $1,000, which works out to a *gross* income of $12,000 per year.[281] If commissions were solely based on this formula, this would be an entirely legal way of doing business. Nevertheless, reaching the highest bracket of monthly billings would set the distributors' income near the official poverty level,[282] which is hardly an effective way to entice new distributors to join the company.

With Residual Override, a distributor receives one quarter of one percent of all monthly bills of customers in his first five levels of "downline," one percent at his sixth level, and *six percent* at his seventh level.[283] This one level allows sellers at opportunity meetings to claim that recruits can make "up to [six percent]" on downline customer bills.[284] Beyond the seventh level, a distributor will once again get one-quarter of one percent[285] of monthly customer bills.[286] Thus, with the

273. *Id.* (noting a maximum of $120 for the month (i.e., .03 x $3,999)).

274. *Id.* (noting a maximum of $240 for the month (i.e., .04 x $5,999)).

275. *Id.* (noting a maximum of $400 for the month (i.e., .05 x $7,999)).

276. *Id.* (noting a maximum of $600 for the month (i.e., .06 x $9,999)).

277. *Id.* (noting a maximum of $875 for the month (i.e., .07 x $12,499)).

278. *Id.* (noting that monthly billings of $12,500 would produce monthly income of $1,000 (i.e., .08 x $12,500)).

279. This is probably a high assumption. *See* Exposing the Truth, *supra* note 76 ("Ironically they promote this business as one with residual income, then to be competitive, they entice what should be your largest customer base with free in-company long-distance.").

280. This is computed by dividing $12,500 by $30.

281. *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, *supra* note 140 (summarizing other expenses associated with being an ACN distributor). As an example of the cost to attend meetings, note that distributors are strongly encouraged to attend events such as the September 7-9, 2007 International Convention in Baltimore, MD, at a cost of $99-$129 per person to register, $199 per night for hotel stay, plus airfare. *See* Baltimore, MD, Baltimore International Training Event, http://www.acninc.com/acn/us/opportunity/events/international/index.jsp (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*); Baltimore, MD International Training, http://www2.acninc.com/events/188.pdf (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*).

282. *See* U.S. Census Bureau, Poverty Thresholds 2006, http://www.census.gov/hhes/www/poverty/threshld/thresh06.html (on file with the *McGeorge Law Review*).

283. ACN Compensation Plan Overview, *supra* note 75. Note that commissions earned from bills of customers in levels one through five are still one-quarter of one percent.

284. *Id.*

285. *Id*. ("[R]epresentatives holding the level of Regional Vice President are eligible to receive 1/2 [percent] over-riding residual income on levels [eight] through infinity in their organizations.").

286. *See id.*

exception of the bills of customers six or seven levels below the distributor in question,[287] the norm is to receive only one-quarter of one percent of downline customer 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 would only receive Residual Override commissions of $750 per month, assuming each of those 10,000 customers has an average monthly phone bill of thirty dollars.[288] While the income potential here is astoundingly small, the company still claims one can make a fortune from residual income.[289] Ultimately, 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 (CAB) is the heart of ACN's compensation structure; it is where distributors make money. ACN carefully crafted the CAB to avoid classification as an illegal pyramid scheme, but it preserved all of a pyramid scheme's sinister characteristics. The Compensation Plan awards a CAB when a representative recruits a new representative who becomes "qualified."[290] To become qualified, a new representative must pay $499 and must acquire six or eight new customers.[291] Once the representative "qualifies," CABs are issued, ranging from $90 to $275 depending on the recruiter's level within ACN.[292] These CABs are paid even though the company may never earn that amount from the acquired customers. The Compensation Plan carefully specifies 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."[293]

This qualification requirement attempts to avoid anti-pyramid laws. This requirement also demonstrates the difficulty of drafting rules to stop companies from engaging in pyramid schemes.[294] Although the bonus is linked to customer

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287. 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.

288. ACN Compensation Plan Overview, *supra* note 75. 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.

289. *See* Napolitano, *supra* note 144 (showing a chart that only shows income from 2,187 downline customers at Level 7).

290. ACN Compensation Plan Overview, *supra* note 75.

291. *Id.* ("The dollar amounts of the Personal Customer Acquisition Bonuses you can earn are determined by your earned level.").

292. *Id.* (noting that 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).

293. *Id.* (emphasis added).

294. As a simple example, it is worth noting that a payment of $499 is just below the "minimum threshold" payment of $500 that would trigger extensive disclosure obligations under the Franchise Rule. *See* Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,055 & n.10 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437); *see also supra* text accompanying note 61. However, ACN

acquisition, it is clear the bonus money comes from the $499 paid by new recruits. The company may pay far more money in bonuses than it ever receives from those customers, especially if the customers cancel after a few months of service, and especially after considering that a thirty dollar phone bill is likely to have an extremely low profit margin. Thus, the $499 paid by new recruits is the heart of the compensation structure. It is grossly misleading, though 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 become part of the ACN sales network . . . ."[295] The issue is not ACN's revenue source; the issue is the source of the *bonuses* received by ACN's representatives.

Mathematically, the bonuses form the overwhelming bulk of the income of nearly all company representatives. ACN's Comments to the FTC saying that the $499 paid by each new representative "is more than consumed by ACN's costs in supporting the businesses of its independent representatives"[296] likely includes the customer acquisition bonuses paid to representatives. Assuming that this is correct, ACN is an extremely clever disguised pyramid scheme that has ensnared many unwary victims.

B. How Will the Proposed Rule Impact ACN?

Those higher up in the ACN pyramid structure express unequivocal objection to the Proposed Rule because it is likely to impact their business. The Proposed Rule, however, is unlikely to stop the company from continuing to operate its current business plan.[297]

The most problematic aspect of the Proposed Rule for companies like ACN is the seven-day waiting period.[298] Such companies rely on high-pressure sales tactics at "opportunity meetings" to recruit new representatives. A seven-day waiting period will make ACN's recruiting efforts less effective; however, ACN could easily work around the waiting period. ACN could schedule 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 have the disclosure form for the required one week before the meeting. The waiting period is a

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would still have to make the comparatively minimal disclosures under the Proposed Rule. *See* Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,055, 19,063, 19,067, 19,088 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437.1(d)); *see also supra* text accompanying notes 167-69, 177-79.

295. HESSE, ACN COMMENTS, *supra* note 247, at 4.

296. *Id.*

297. *See* ACN Inc., http://www.acninc.com/acn (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*) (providing that, 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).

298. *See, e.g.*, Letter from Julie Gunhus, *supra* note 236.

partial fix, not a solution: while the waiting period will make it more difficult for ACN to recruit, it is unlikely that the waiting period will stop ACN.

The disclosure requirement[299] is also unlikely to significantly affect ACN's business. The requirement initially requires ACN to disclose whether or not it is making an earnings claim; ACN will likely check "no." ACN already states, "ACN strictly prohibits ACN Independent Representatives from making any claims or guarantees related to earnings/income whether express or implied,"[300] but this rule is not strictly enforced. In fact, earnings claims are rampant and highly encouraged.[301] At opportunity meetings, ACN can comply by stating that it is not making an earnings claim. Attendees may be told that the company does not "officially" make any earnings claims for legal reasons, and potential recruits will likely accept this explanation.

Two other sections of the Proposed Rule could potentially impact ACN: (1) the disclosure of prior legal actions[302] and (2) the list of references.[303] In the end, however, these two requirements are also unlikely to have much of an impact on ACN. First, ACN has postured itself well to avoid lawsuits; in fact, the two most high-profile actions against ACN did not even occur in the United States.[304] Even if ACN has to disclose, it would probably use this disclosure as a selling point; for example, it would state that it was found "not guilty" in most cases, or that it has won most civil lawsuits. Many potential recruits may view this as a stamp of approval by the court—a statement that the company is innocent. Second, ACN can manipulate the list of references to consist of people who are still with ACN. ACN can include the newest recruits who are likely to

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299. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,088 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437).

300. Getting It Right, *supra* note 141.

301. *See id.*

302. Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054, 19,088 (proposed Apr. 12, 2006) (to be codified at 16 C.F.R. pt. 437).

303. *Id.*

304. The first was a charge by the Canadian Competition Bureau against ACN. Press Release, Canadian Competition Bureau, Multi-level Marketing Firm Charged for Misleading Participants (Aug 29, 2002), http://competitionbureau.gc.ca/internet/index.cfm?itemid=441&lg=e (on file with the *McGeorge Law Review*) ("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."); Case Update, Canadian Competition Bureau, Global Online Systems Inc., http://competitionbureau.gc.ca/internet/index.cfm?itemID=1182&lg=e#allcom (last visited Aug. 31, 2007) (on file with the *McGeorge Law Review*). 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 (on file with the *McGeorge Law Review*) ("Today Justice Brad Selway ruled the set up for ACN was a pyramid selling scheme and breached the Trade Practices Act."). 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. More recently, ACN was unsuccessful in its efforts to resist a challenge in a foreign court. Specifically, a French court found ACN France guilty of using misleading advertising and fined the company €15,000 euros. *See* Tribunal de grande instance [T.G.I.] [ordinary court of original jurisdiction] Paris, Mar. 19, 2007, N° 0418490052, 6, *available at* http://mikelpt.free.fr/ jugement20070319.pdf.

still have a favorable opinion of the company.[305] This may only further the company's recruiting efforts.

VII. CONCLUSION

Ideally, pyramid marketing schemes can be challenged on two sequential fronts: (1) disclosure of material information to prospective purchasers and (2) a comprehensive anti-pyramid marketing scheme rule which includes disclosure to the government. If the FTC determines that the impact on the first front is sufficient, it may not be necessary to resort to the second front.

With respect to disclosure to prospective purchasers, it is necessary to ensure that potential recruits are given a realistic picture of their earning potential with the company. Prospective purchasers must also be given sufficient time to absorb the information. At a minimum, this means that an individual opportunity seller must provide the prospective recruit with a written disclosure of average and median net, not gross, income of all company representatives over a one year period.[306] The individual seller would be responsible for obtaining this information from the company but 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 supplied the individual seller with false or misleading information.

A three-day waiting period would be sufficient to break the "pressure of the moment" kind of sale, as long as the rule ensures that no contract can be signed and no money can be paid until at least three days after an opportunity meeting, if the potential recruit attends such a meeting. This means that the individual seller must disclose the required information at least three days before the purchaser

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

306. 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, *supra* note 220. 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 one hundred people were ACN representatives at some point during the year. If it turns out that only sixty people were active representatives who earned any money, then the statement should note that forty percent 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 Aug. 31, 2007) (on file with the *McGeorge Law Review*). 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.

signs a contract or pays any money. All disclosures should be provided in writing in the same language in which the sales pitch occurs. 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 a federal anti-pyramid marketing scheme law and disclosure to the government, laws 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 should specifically identify a pyramid marketing scheme as one in which funds provided by recruits, directly or indirectly, are the primary source of income (i.e., more than fifty percent) 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 critical inquiry should be 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, thus minimizing the accounting burden. These reports would account for all money paid by recruits at all levels separately. This 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 the objective of these rules is to facilitate legitimate business by protecting the public from abuses, these rules should only apply to companies that take on a "public" role.[307] Thus, sellers who recruit occasionally and primarily sell an actual product would not be required to disclose anything to the prospective purchaser. Furthermore, there should be a de minimus exception to governmental disclosure. Specifically, any company in which ten percent or fewer of its distributors 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 the constant fear of being swindled by the latest Harold Hill.

307. 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.