

In-line critique of information provided by Utah's Division of Consumer Protection. The notes in italic type are by Jon M. Taylor, Ph.D., Consumer Awareness Institute

Pyramid Schemes

What is a Pyramid Scheme?

Have you ever received a chain letter that asked you to mail one dollar to the top person on the list and to send the letter to 10 friends? If so, you were solicited for an illegal pyramid scheme.

Pyramid schemes are illegal money-making ventures for individuals, businesses, and small groups of people. A typical pyramid scheme involves a few individuals at the top who recruit participants who, in turn, recruit other participants to offer something of value (usually money, but in some cases, time) to the organization. Recruits are offered the promise of large sums of money if they successfully bring in others to pay money to join the pyramid. Pyramid schemes focus on the exchange of money and recruitment. Usually, there is no legitimate product being sold. ***Outdated and Misleading. This may have been true 20 years ago, but today, the vast majority of participants in – and revenues from – endless chain or pyramid selling schemes are from product-based pyramid schemes.***

How are Pyramid Schemes Disguised?

Pyramid schemes may be disguised as gift clubs, games, chain letters, buying clubs, motivational companies, mail order operations, or investment organizations. Although some pyramid schemes call themselves multi-level marketing operations, not all multi-level marketing companies are pyramids. The sale of legitimate products is what distinguishes multi-level operations from pyramids. ***Totally misleading. It sounds as though this statement was derived from propaganda supplied by the Direct Selling Association* (DSA) – the voice of the MLM industry! Or perhaps from the Better Business Bureau – which uses DSA*-fed materials, because most MLM's are paying members of the BBB – and as one would therefore expect, their information is also misleading.*** When the emphasis is on recruiting new members rather than selling something of value [*Insert comma*] the organization is probably an illegal pyramid. ***The latter sentence is a fair statement.***

How do Pyramid Schemes Work?

Basically, a pyramid scheme is formed when a single promoter (or small group of promoters) collects money from a certain number of "friends" and instructs them to collect more money from more of their "friends." The cycle goes on from there. As the pyramid grows, the number of people involved becomes too large to sustain the pyramid. Some people will fail to send in their money, or recruit the required number of "friends," and the pyramid crumbles. The majority of people end up on the "bottom" of the pyramid and inevitably will lose their initial "investment." They won't get their money back or earn their promised fortune because no one is beneath them in the pyramid adding new money to the pot. ***An important fact is omitted: The notable exception to the conclusions in this paragraph are product-based pyramid schemes, which endure through continual replacement of new recruits, through Ponzi-like recruitment waves through new areas and countries (to repay old investors), and through new product divisions, as Nu Skin/Big Planet/Pharmanex and Amway/Quixtar have done.***

****DSA= Direct Selling Association, which has virtually been taken over by the MLM industry to promote its agenda, which is to promulgate pro-MLM propaganda such as that upon which this information is based. The DSA also aggressively lobbies for legislation exempting MLM companies with legitimate products from pyramid scheme prosecution. They have succeeded in eight states, in which the legislature did not understand the implications of the fine print until it was too late. They have made efforts to promote pro-MLM (but anti-consumer) legislation in Utah, which was defeated in the 1995 legislative session. They are also actively lobbying Congress, with a few well-informed activists working to stop them – who have so far been able to do so.***

Why do Pyramid Schemes Fail?

Pyramid schemes collapse when a few people drop out or refuse to pay, and new members are not recruited in their place. In order for a pyramid scheme to profit, there would have to be a never-ending supply of potential (and willing) participants. In reality, however, the supply of participants is limited, and each new level of participants has less chance of recruiting others and a greater chance of losing money. ***This is a true statement, except that with product-based schemes, it is not the MLM companies that fail, but the “distributors” – 99.9% of them. Thus, they are continually being replaced by new victims and moving on to new markets. Currently, many of the victims are in Asia, which is ill-prepared to stop the onslaught. It is outrageous that law enforcement allows this to continue, especially in Utah – which has become a primary haven for recruiting MLM’s, or product-based pyramid schemes.***

How a Typical Pyramid is Organized

A simple pyramid - for example, a five level program built on recruitment by fours (***most classic no-product pyramid schemes we have seen in recent years were 1-2-4-8, with 15 participants at only four levels***) - might work like this:

- A new recruit would pay \$100 to "join" the organization. ***These kinds of numbers apply to no-product schemes. But with product-based pyramid schemes, or recruiting MLM’s, the investment often totals millions of dollars for thousands of recruits (each spending hundreds or even thousands of dollars in over-priced products) over a period of time, often contracted at the time of recruitment for monthly auto-ship deliveries paid for by automatic bank withdrawal. The product purchases are the “pay to play” feature; i.e., disguised or laundered investments in the pyramid or endless chain marketing scheme.***
- That money would then be disbursed at regular intervals by the company - \$25 to the recruiter, \$25 to the company, and \$50 to the recruiter's "upline" in the form of \$10 payments to the recruiter's recruiter, and so on through five levels. ***This is way out of date. The old no-product pyramid schemes are mild in comparison to today’s product-based recruitment schemes, in which the number of levels can number 8, 12, or even an infinite number of levels. In the case of Nu Skin, Amway, Nikken, etc., which use a breakaway pay plan, the downline consists of breakaway “organizations,” or separate pyramids. Nu Skin constitutes a mega-pyramid of whole pyramids of participants (victims), so that a “Blue Diamond” may be collecting overrides on tens of thousands of downline victims. Such MLM’s are far worse than the obvious no-product schemes one can easily recognize.***
- The new recruit would recover the \$100 "fee" by recruiting four more people, each of whom would pay the recruiter \$25.
- From this point a participant would then make money from all recruiting done by the four recruits and their recruits.
- Assuming successful recruiting by four people down through each of five levels, a participant could (but probably never will) make a cumulative total of \$54,560:
 1. \$160 on the first level - e.g., four people each recruiting four others at \$10 a person ($4 \times 4 = 16 \times \$10 = \160);
 2. \$640 on the second level - e.g., 16 people each recruiting four persons at \$10 each ($16 \times 4 = 64 \times \$10 = \$640$);
 3. \$2,560 on the third level ($64 \times 4 = 256 \times \10);
 4. \$10,240 on the fourth level ($256 \times 4 = 1024 \times \10);
 5. \$40,960 on the fifth level ($4 \times 1024 = 4096 \times \10).
 6. \$54,560 total ($\$160 + \$640 + \$2,560 + \$10,240 + \$40,960$)

Again, all these figures are mild compared to product-based pyramid schemes. By comparison, product-based pyramid schemes make no-product pyramid schemes –or even gambling – look like a safe investment! (see below – and statistics from Consumer Awareness Institute or from Pyramid Scheme Alert.)

Pyramid Reality

- Pyramids are illegal. Because pyramid sales plans are by their very nature deceptive, they are illegal. There is a real risk that a pyramid operation will be closed down by police and the

participants subject to fines and possible arrest. ***The greater risk – at least in Utah – is that the worst ones will not be shut down – and that victims will only be treated on a case-by-case basis as complaints come in – if any! Unfortunately, this is precisely what has happened in this state, with the passive attitude and reactive practices of law enforcement on this issue.***

- Pyramids are deceptive. Participants in a pyramid, whether they mean to or not, are deceiving those they recruit. ***The more clever ones also deceive law enforcement. Few would pay to join if the odds stacked against them were fully explained. Amen. This is very true – and probably the most valid statement in this article. If adequate and valid disclosure were required (which would require considerable sophistication to set up), all but the most naïve consumers could be protected – even if the worst schemes were allowed to continue. Who would join if they knew that less than one in 1,000 would profit?***
- Pyramids are losers. Pyramid Schemes are based on simple mathematics: many losers pay a few winners. ***This is even more true with product-based pyramid schemes. Thousands of “losers” (victims) may feed one of the “top of the pyramid promoters” (TOPPS) in a program as highly leveraged as, for example, Nu Skin or TNI (Morinda).***
- Pyramids inevitably collapse because it is mathematically impossible to recruit the numbers of people required to support the pyramid. A nine-level pyramid, which is built when each participant gets six "friends" to join, would involve over ten million people!

6
36
216
1,296
7,776
46,656
279,936
1,679,616
10,077,696

In some of the more highly leveraged recruiting MLM’s, such as Nu Skin and TNI, the perverse mathematical odds are far worse. If a participant needs over 2,000 downline participants to earn profits exceeding a minimum wage for their efforts in building a downline (which is the case for Nu Skin, TNI, and numerous other MLM’s), the “pyramid” looks more like this:

***2,000 – two thousand on the first level
x 2,000 = 4,000,000 – four million on the second level
x 2,000 = 8,000,000,000 – eight billion on the third level, which is more people than live on the earth!***

Why Would Anyone Pay to Join a Pyramid?

Pyramid promoters are masters of group psychology. At recruiting meetings they create a frenzied, enthusiastic atmosphere where group pressure and promises of easy money play upon people's greed and fear of missing a good deal. It is difficult to resist this kind of appeal unless you recognize that the scheme is rigged against you. ***True statement, except that much of MLM recruiting is far more subtle, using person-to-person recruiting between family members and friends. Few of the perpetrators see themselves as such. In fact, all are victims, except those at the very top and those managing the infrastructure – many of whom profit hugely from the product investments of a multitude of victims (almost all of which is never recovered, in spite of “generous buy back” provisions).***

Multi-level Marketing Companies

Multi-level marketing companies differ from pyramid schemes because they are usually legitimate business opportunities. ***Absolutely false, except to those willing to accept the line of the DSA and the MLM industry.*** The sale of legitimate products is what distinguishes multi-level marketing operations from pyramids. ***Totally misleading – sounds like this statement came directly from the DSA (or the BBB, which got its misleading information from the DSA).*** If the emphasis in a multi-level marketing company is to build a sales force rather than sell the company's products, it may be an illegal pyramid.

This is a true statement, except that when Utah's pyramid scheme law is understood, the words "may be" should be replaced with "probably is".

The Difference Between Pyramid Schemes and Multi-level Marketing

Many pyramid promoters attempt to make their schemes look like a multi-level marketing company by using a line of near-worthless products or newsletters and claiming to be in the business of selling them. ***This is more the exception than the rule with the most exploitive of the major MLM's. In fact, most of the leading MLM's go to great lengths to enhance their credibility by coming up with outstanding, even "magical," formulas that cannot be purchased anywhere else – or so they say.*** In pyramid schemes, little or no effort is made to actually market the products. ***True, but with MLM's the marketing is primarily in the form of recruitment of new participants, who buy the products to "do the business."*** Often there is not even an established market for the products. Rather the "sale" of such merchandise is used as a front for the transactions which occur only among and between the operation's distributors. ***This is actually the case with almost all Utah-based MLM'S, except that the MLM company facilitates the transaction by doing the shipping, billing, etc..***

In pyramid schemes, the emphasis in the sales pitch is on recruiting - building up the organization and the number of participants and on collecting the "start up" fee - not on selling the products. ***Another misleading statement. The start-up fee in product-based schemes is small, but only a lead-in to the real investment, which is a commitment to buy hundreds, or even thousands, of dollars of products for "resale" – little of which actually happens. And most "pay to play" product investments are made by subscription to monthly shipments and paid by automatic bank drafts – bleeding recruits gradually of thousands of dollars over time.*** Pyramid schemes want to make money from you, not the product sales. ***Although the MLM's typically make a big effort to appear to focus on legitimate product sales, their numbers do not support that emphasis. In a randomized sample survey of Utah County households, for example, we found at over four distributors recruited for every one actual customer who was not part of an MLM network.***

Pyramid Scheme vs. Multi-level Marketing

- Compensation based on recruiting vs. Compensation based on sales ***Nearly all Utah MLM'S are the former, but the payment is not a direct recruitment fee. The compensation plan is weighted heavily towards recruiting a large downline over time.***
- Few or no sales to consumers vs. Sell legitimate products to established markets ***Nearly all Utah MLM'S are the former.***
- Substantial start-up costs vs. Generally small start-up fee ***The typical startup costs are the setup/operating costs plus a major commitment to ongoing product purchases.***
- Potential to be stuck with large amounts of unsold goods vs. Will buy back unsold goods if you decide to quit the business – ***usually with a one-year limitation for unopened and unused merchandise. This is one of the DSA's and MLM industry's greatest victories of deception. MLM recruits are encouraged to "be a product of the products" by buying lots of products – and to open and begin using (hyper-consuming) their products (thus invalidating the buy-back option). Also, it is rare for victims of these programs to come to understand that they have been scammed within the one-year allowance for buy back. Most never know what happened to them – instead blaming themselves for their "failure."***
- Make money from you vs. Make money with you ***in spite of their vigorous statements to the contrary, nearly all Utah MLM's are the former.***

Protect Yourself

- Take your time. Don't be rushed into any business deal. ***Better to avoid all MLM's totally - especially any endless chain marketing scheme, which includes at least 17 Utah-based MLM'S.*** Show your attorney any contracts you receive from the company. ***He may understand the legal terminology, but is not likely to understand the perverse mathematics or the full effects of the compensation plan. Attorneys are not trained to do this.*** A legitimate business opportunity won't disappear overnight. ***True enough. In fact, the better business opportunities don't come through a recruitment pitch at all – you have to search them out for yourself.***

- Ask questions about the competency and experience of the company and its officers; the products, including the potential market in your area; start-up fees; buy-back provisions; and actual earnings of current distributors. **Note that the one thing prospects should be scrutinizing is not even mentioned – the compensation plan. The “5 Red Flags” (found in the pay plan – see below) mentioned below make crystal clear whether or not an MLM is an exploitive product-based pyramid scheme, in which 99.9% of participants will likely lose money.**
- Get written copies of all available company literature.
- Check with others who have experience with the company and its products. **The best source is ex-distributors, not current distributors who have a vested interest in perpetuating the scheme.** Find out if the products are actually being sold to consumers. **Does anyone do this? Apparently not (including law enforcement), based on our surveys.**
- Investigate and verify all information. **In ten years of interviewing hundreds of victims of these scams, i have yet to meet one person (even in law enforcement) who knew how to “investigate and verify all (pertinent) information.” In these clever schemes.** Contact the Division of Consumer Protection (**and this is what you get??**), your local Chamber of Commerce (**which may have MLM’s as paying members**), or the Better Business Bureau (**no better - their information flyer is totally misleading, which is not surprising, since they apparently got their information from the DSA**) if you suspect a company may be engaged in an illegal pyramid scheme.
- If a pyramid promoter or recruiter tells you that the program has been examined and approved by the Division of Consumer Protection or any other state agency, know that the claim is **not true!** The Division of Consumer Protection does NOT approve any marketing programs. **Good, but the DCP could do a much better job of providing valid and helpful information to fulfill its mission to protect consumers!** If such representations are made to you, please notify the Division.

For more information, please contact:

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For better guidelines on when an MLM or endless chain program constitutes an exploitive product-based pyramid scheme, read the free report “5 Red Flags for Identifying Exploitive Product-Based Pyramid Schemes, or Recruiting MLM’s” (drawn from ten years of comparative and statistical research on these programs), found on the web site – www.mlm-thetruth.com . Please note that, unlike the DSA, my associates and I donate our time to educate consumers and are not financed by the MLM industry.

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New web site for MLM research and guides – www.mlm-thetruth.com

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