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BLOG

Recent FTC Paper Likely Overstates MLMs' Pyramid Potential

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A recent paper[1] by members of the Federal Trade Commission's (FTC) Bureau of Economics describes a new pyramid-scheme hallmark to add to the FTC's growing list[2] – a pyramid scheme creates and exploits overly positive recruitment expectations to increase the company's profits. In other words, by misleading potential participants about the earning potential from recruitment-related rewards, pyramid schemes induce participants to join even if they have no expectation of earning a profit from retail sales.

However, the authors take the analysis a step further. Using a simplified economic model intended to capture the unique characteristics of an MLM, the authors contend that this potential for profit from over-optimistic recruitment expectations is inherent in the structure of *any* MLM. Thus, although it is framed as an effort to distinguish legitimate MLMs from pyramid schemes, the paper suggests that *every* MLM is in danger of becoming a pyramid due to a factor that is at least partly outside of the MLM's control – what its distributors believe about their ability to recruit new distributors to the organization.

Guided by the views of experts in the MLM industry, we find the paper problematic because it relies on assumptions that likely overstate an MLM's risk of becoming a pyramid. Thus, while the paper serves as an important reminder to MLMs to ensure that participants receive accurate information regarding their earning potential, it fails to acknowledge the safeguards that many MLMs have already built, or should promptly build, into their business models. Those safeguards are discussed below, following an analysis of the paper.

The Paper's Assumptions

In his recent analysis of the FTC paper, MLM expert Dr. Branko Jovanovic outlines two key assumptions in the authors' economic model that could result in the paper's overstating an MLM's potential to become an illegal pyramid.[3]

First, the paper assumes that participants in MLMs are risk-neutral rather than risk-averse. As Dr. Jovanovic explains, "risk-neutral participants are more prone to forming overoptimistic expectations about business opportunity payoffs compared with those who are risk-averse."[4] In contrast, if participants are risk-averse, they are likely to temper this

optimism with more realistic recruitment beliefs and consider the risk associated with any expected losses from retail sales.

Second, the paper does not account for the "undo" option that many MLMs provide participants—the option to return products purchased within the last twelve months for a full refund if the enterprise turns out not to be profitable for the participant. Some MLMs also permit participants to receive a full refund for the purchase of a start-up package within a specified time after the participant joins. The absence of these options in the paper's economic model is significant because the undo option protects participants from financial loss as a result of their over-optimistic expectations. Thus, as Dr. Jovanovic notes, "an undo option would stem much of the harm caused to the participant and make it more challenging for an MLM to continue perpetuating" the pyramid.[5]

What the Paper Says

Keeping these assumptions in mind, we turn to the paper's findings. Using the authors' simplified economic model, the paper explains that the recruitment aspect of MLMs creates the potential for something the authors call "transfer losses," which occurs when participants lose money because they overestimated their ability to recruit new participants to the enterprise. Assuming, as the paper does, that the MLM requires participants to purchase a minimum quantity of the product to maintain their eligibility to recruit,[6] transfer losses result when participants are unable to recoup the cost of that minimum product quantity through recruitment.

The problem with transfer losses, in the paper's view, is that if participants are overly optimistic about their future ability to earn compensation for recruitment, they will be willing to participate in the MLM even if they know they will lose money on retail sales. In other words, participants will enroll in the enterprise and purchase products that they don't need and can't sell because of the earning potential inherent in recruitment. If those participants expected to recruit more participants than they did—if their recruitment expectations were overly optimistic—the participants will suffer a transfer loss. However, because the MLM still received the purchase price of the required minimum quantity of the product, the MLM remained profitable despite its participants' net losses.

Significantly, the paper does not limit this observation to illegal pyramids—instead, the implication of its findings is that the MLM business model incentivizes even a legitimate MLM to cause a net loss across all participants for the benefit of the company. Because transfer losses are not tied to retail demand, if an MLM cultivates overly optimistic recruitment expectations among its participants, the MLM can continue to make money from its participants' recruiting activities regardless of the retail success of the product. In addition, an MLM may even be incentivized to raise the price of its products above the price that end-consumers are willing to pay because participants will still purchase them to remain eligible for recruitment-related bonuses. In the paper's view, then, an MLM is at risk of becoming a pyramid if it capitalizes on either or both of these incentives by: (1) misleading participants about their earning potential from recruitment; and/or (2) raising the product's price above the market price warranted by true retail demand.

In answer to its cautions regarding the MLM model, the paper offers three mechanisms MLMs could implement to combat transfer losses: (1) banning recruitment altogether; (2) changing the compensation plan to tie rewards only to sales of the product to consumers – not recruitment; and (3) removing minimum purchase requirements for participants to be eligible to earn rewards.

What the Paper Means—and Doesn't Mean—for MLMs

Although the authors suggest banning recruitment to avoid the dangers they describe, this is, of course, not a viable option for MLMs. The ability to earn money off of one's downline is a key feature of the MLM model, so asking MLMs to eliminate recruitment would essentially require them to stop being MLMs altogether. Especially in light of the paper's questionable assumptions and the other safeguards we describe below, we do not believe banning recruitment is necessary for MLMs to maintain compliance with FTC guidelines and prevent being deemed a pyramid scheme.

Rather, let's discuss some viable options that many MLMs have already implemented, and the rest should consider.

- First, MLMs should eliminate all minimum purchase requirements that can solely be satisfied by distributor purchases. If an MLM maintains any minimum volume requirements, those requirements should only be able to be satisfied through distributors' personal consumption purchases at reasonable levels based on the purchasing habits of retail and preferred customers. Even better, MLMs should consider excluding all distributor personal consumption purchases from minimum volume requirements in their compensation plans.
- Second, MLMs could consider limiting the volume distributors earn through their personal purchases from counting toward qualification for higher ranks, bonuses, or other rewards.
- Third, MLMs should conduct regular internal and external audits of their compensation plans and, wherever possible, tether distributor compensation to sales of products to end-consumers.
- Fourth, to offset the risk of transfer loss, MLMs must ensure that their "undo option" for unused inventory operates efficiently and effectively to protect overly optimistic distributors from loss.
- Fifth, and perhaps the most significant takeaway from the paper is that managing participants' expectations as to their earning potential, especially with regard to recruitment, is essential to operating a legitimate MLM. MLMs must ensure that they are closely monitoring participants' income, compensation plan, and lifestyle claims and prohibiting improper claims that could inflate new distributors' beliefs regarding their earning potential through recruitment. This requires the MLM to have a robust compliance team that is operating at full capacity. In our experience, MLM compliance departments need to be audited often both internally and externally to ensure that they are performing optimally and identifying the largest risks to the company, including risks that could result in distributors or others overstating the opportunity for recruitment.

We often perform compensation plan and compliance audits for our MLM clients to help them recognize weaknesses in both their compensation plan and compliance departments. These audits assist our clients in ensuring the company and its distributors are not cultivating over-optimistic recruitment expectations and running afoul of the FTC's pyramid scheme guidance.

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[1] Andrew Stivers, et al., "The Alchemy of a Pyramid: Transmutating business opportunity into a negative sum wealth transfer," *SSRN* (Dec. 3, 2019).

[2] The paper notes that its analysis and conclusions do not necessarily reflect those of the FTC. *See id.*

[3] Branko Jovanovic, et al., "A Look Into FTC's Thinking On Pyramid Scheme Potential," Law360 (March 20, 2020).

[4] *Id.*

[5] *Id.*

[6] This is a third key assumption to the paper's findings. As with the assumption that there is no "undo option," many of the paper's concerns are reduced or eliminated if an MLM's compensation structure does not include a minimum product purchase requirement.

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Authors

John Sanders, Jr.

Katrina Eash

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