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BLOG

The FTC's Radar, and How to Stay Under It

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2020 and 2021 have brought an unprecedented amount of FTC scrutiny to the direct selling channel. With some companies under formal investigation and many others receiving warning letters, it is no surprise that industry leaders want to better understand what the FTC is looking for and ways to prevent becoming an FTC target. Below we explore the most important areas that the FTC is scrutinizing and provide suggestions on how companies can reduce regulatory risk by implementing certain changes.

I. Improper Business Opportunity Claims Often Trigger Broader FTC Scrutiny

Business opportunity claims stating or implying that distributors can quit their jobs, earn thousands of dollars a month, or get rich quick are often what prompt the FTC to take a closer look. The FTC's complaint against AdvoCare International L.P. emphasized the company's recruiting videos and published documents as evidence AdvoCare touted financial results for distributors that were allegedly atypical and misleading.[1] And the FTC began investigating Neora almost simultaneously with TINA.org filing its complaint against Neora, alleging deceptive marketing practices and compiling over 100 alleged examples of improper claims.[2]

COVID has only heightened the FTC's hyper-focus on improper claims. Over the summer of 2020, the FTC sent letters to multiple direct sellers regarding alleged improper claims. These letters, coupled with public FTC statements as recently as last month, make clear the agency is closely monitoring the marketplace for those it believes may be capitalizing on the anxiety, fears and economic uncertainty caused by the coronavirus pandemic.

The FTC has focused its scrutiny on claims that capitalize on the economic crisis by highlighting the ability to replace income or achieve a prosperous lifestyle. The FTC has also emphasized that companies must refrain from making deceptive claims about a product's ability to treat or prevent COVID. The FTC's letters remind companies that it is unlawful “to advertise that a product can prevent, treat, or cure human disease unless you possess competent and reliable scientific evidence . . . substantiating that the claims are true at the time they are made.”[3]

Direct sellers can count on the FTC remaining very focused on improper business opportunity and product claims—especially claims concerning COVID. Direct sellers should contact their field immediately and make clear that promotional material, including social media posts, must accurately describe the earning opportunities available to participants, be based on objective evidence, and reflect the typical earning results. Direct sellers should provide their field with specific guidance on impermissible business opportunity and product claims surrounding their products and the business opportunity, as well as any specific disclaimers that must be used when making permissible claims. Finally, but perhaps most importantly, companies must add “COVID” and related terms to their lists of “trigger” words for compliance monitoring.

Direct sellers will never be able to wholly prevent distributors from making improper claims. Rather, to avoid enforcement actions direct sellers must be laser focused on: (1) educating distributors to avoid making improper claims; (2) promptly identifying and removing such claims; and (3) punishing distributors who routinely make such claims. Companies must empower their compliance teams to take swift action to remove these claims and punish the offenders in a consistent manner, regardless of a distributor’s level of success. One effective way to ensure investigations into improper claims do not linger is to suspend the non-compliant distributor’s account until s/he removes the improper claims. Further, to prevent ongoing violations, disciplinary measures must have teeth, such as a “three strikes you are out” policy, with escalating consequences for each violation. And companies must be willing to cut ties with distributors who demonstrate a pattern of non-compliance.

To ensure their efforts are actually working, direct sellers should conduct annual audits of their compliance measures. Audits ensure companies are: (1) identifying the “right” improper claims and handling them efficiently to prevent the FTC from ever finding them; and (2) gathering the “right” evidence demonstrating an effective compliance program—the evidence that will vindicate the company if the FTC does come knocking.

II. The FTC Remains Focused on Compensation Plans

In addition to improper claims, in the last year, the FTC made clear it is also looking for compensation plan red flags in deciding what companies to pursue. In October 2019, Director Andrew Smith explained the two main questions the FTC confronts when evaluating a compensation plan are (1) whether a program overly incentivizes recruitment; and (2) whether the program creates incentives for distributors to purchase more products than actually needed. Smith doubled down on these guidelines in his speech last month at the MLM Conference. To answer these questions, the FTC evaluates compensation plans for the following red flags: threshold-based, convex, and duplication rewards.

Threshold-Based Rewards
A threshold reward is one that can only be earned upon the achievement of a minimum-purchase requirement within a certain time period. For example, compensation that only kicks in where a distributor purchases a minimum amount of product each month.

If a company’s compensation plan contains threshold rewards, distributors will typically cluster their purchases around the minimum purchase amount. So if, for example, a particular reward is only available to distributors who purchase $100 per month, an audit of distributor sales is likely to reveal a high number of distributors who purchased exactly (or just above) $100 per month. Such clustering, the FTC argues, is evidence that distributor purchases are driven by a desire to be eligible for rewards, rather than genuine demand.

The FTC can easily identify threshold-based rewards from publically available compensation plans and such rewards will bring FTC scrutiny. Perhaps the easiest way to address the issue is to remove the threshold altogether. But there is nothing inherently unlawful about offering incentives for greater levels of sales productivity; the problem comes when distributors are able to manipulate the system by making purchases not tied to genuine demand. If a company wants to maintain threshold rewards, it should tie such thresholds to end user sales—i.e., sales to non-distributors. Companies should also design a defensible mechanism—e.g., a retail receipts program—to ensure that only product purchases made to satisfy genuine demand count toward eligibility for rewards.

Convex Rewards
A reward that increases at greater purchasing levels at a disproportionately higher rate than the incremental increase in purchasing volume is known as a convex reward. For example, a commission rate of 5% on sales of $150 per month that jumps to 10% for sales of $200 per month is an example of a convex reward (i.e., a 33% increase in sales entitles the distributor to a 100% increase in commission). The FTC argues convex rewards tempt distributors to purchase relatively small amounts of product not tied to genuine demand in the hope of attaining significantly greater rewards.

Convex rewards, like thresholds, are less problematic when decoupled from distributor purchases not motivated by genuine demand; that is, when rewards are based on legitimate sales to end users. A company may also eliminate convex rewards by “flattening” its payout structure so increases in rewards are more proportional to increases in purchases.

Duplication
Generally speaking, duplication seems to be the FTC’s term for rewards tied to recruitment, where distributors with greater downlines receive greater rewards. The FTC’s concern is that distributors are incentivized to recruit an ever-expanding network of sellers, all competing with each other for an ever-decreasing pool of non-distributor customers, rather than to sell products in response to genuine demand. Companies should eliminate aspects of their compensation plan that merely encourage distributors to recruit new members for the business opportunity. Instead of rewarding distributors for recruiting new distributors, companies should offer incentives for finding new customers and increasing product sales to such customers.

Be Realistic About the Business Impact of These Changes
Eliminating problematic features of a compensation plan is daunting because of the impact it could have on the company’s bottom line. It is thus helpful to conduct an economic analysis to model the expected impact of any proposed changes, so that a company can make an informed decision about the expected cost of the changes. Often, the business impact of removing problematic elements is not as great as a company might suppose and approaching leadership with a clear presentation of the expected costs and benefits of removing features that will invite FTC scrutiny goes a long way toward achieving buy-in from decision makers.

III. Conclusion

Misleading claims and compensation plan red flags are the “low-hanging fruit” that entice FTC scrutiny. Wise companies will make changes to eliminate them. We specialize in legal and regulatory issues affecting direct sellers, and we have helped many clients shore up their policies and procedures, enhance their compliance systems, and remove problematic elements from their compensation plans. Please reach out to us if you would like to discuss. And remember, just a little diligence on these matters now goes a long way toward causing the FTC to devote its limited enforcement resources elsewhere.

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[1] *FTC v. AdvoCare International, L.P.*, Case No. 4:19-cv-00715 (E.D. Tex. Oct. 2, 2019).

[2] Letter from TINA.org (dated July 12, 2016), https://www.truthinadvertising.org/wp-content/uploads/2016/07/7_12_16-ltr-from-TINA-to-FTC-re-Nerium.pdf.

[3] *See, e.g.* Letter from FTC (dated October 10, 2020), https://www.fda.gov/inspections-compliance-enforcement-and-criminal-investigations/warning-letters/griffo-botanicals-610434-10072020

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