



DIRECT SELLING ASSOCIATION

## Legitimate Direct Selling vs. Illegal Pyramid Schemes A White Paper

### CONTACT:

Amy Robinson  
(202) 452-8866  
arobinson@dsa.org

www.dsa.org  
www.directselling411.com  
@dsa411

The Direct Selling Association (DSA) and member companies have long sought to differentiate between legitimate multilevel direct selling companies and illegal pyramid promotional schemes. The products and services sold by legitimate multilevel direct selling companies are in fact used or consumed, and compensation is based upon those sales for consumption by the end-user. In a pyramid scheme, the product or service - if any actually exists - is not used or consumed by anyone; instead money is made from the mere act of recruiting new participants into the scheme.

The U.S. Federal Trade Commission (FTC) has regulatory authority over many U.S. business activities, including direct selling. That authority has been used to set anti-pyramid standards and has been instrumental in determining the business standards used by legitimate multilevel companies in the United States.

*Koscot Interplanetary Inc.*, 86 F.T.C. 11106 (1975), found that pyramid schemes are inherently deceptive and in contravention of § 5 of the Federal Trade Commission Act, 15 U.S.C. § 45. See also, *In re Ger-Ro-Mar, Inc.*, 84 F.T.C. 95 (1974) rev'd 518 F.2d 33 (2d Cir. 1974), *Holiday Magic Inc.*, 84 F.T.C. 748 (1974). The FTC's decisions in *Koscot* provided a broad definition of unlawful pyramid schemes; the Commission's basic test was that a pyramid rewards recruiting alone "unrelated to the sale of product to ultimate users" through headhunting fees and inventory loading. Violations of the *Koscot* standard must be determined using an analysis of whether or not sales of product to ultimate users are taking place and driving the compensation mechanism, and in light of what features exist in the plan to prevent the evils of a pyramid scheme.

After *Koscot*, the FTC refined its general analysis in *In re Amway*, 93 FTC 618 (1979), which has served as the U.S. standard for distinguishing bona fide marketing plans from illegal pyramids for more than 30 years. Many direct selling companies and law enforcement officials have relied on the tests established in *Amway*. That decision did not question the legitimacy of compensation to participants in a direct selling multilevel company based upon their own or other participant's actual use and consumption of the company's products. In *Amway*, salespeople received compensation for products they purchased and sold to other distributors and other consumers.

The *Koscot* and *Amway* analyses, together, have set clear standards for determination of whether a plan is a pyramid scheme or a bona fide marketing plan. Law enforcement, legislators, the public and direct selling companies across the United States have relied upon these standards as clear legal distinctions between bona fide marketing plans and pyramid schemes. (continued)



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### Voluntary Standards Demonstrating Compensation Based on Sales

A number of self-imposed company rules that Amway had developed were identified by the *Amway* case as evidence to the Commission that the plan was not a pyramid scheme. Many companies have adopted similar internal rules in an effort to protect participants and distinguish themselves from pyramid schemes. Such internal company rules are helpful and can be indicative of a plan's legitimacy, but are neither legally mandated nor a guarantee, standing alone, that a company is not a pyramid scheme. Similarly, in consent decrees between the FTC and individuals and companies determined by the FTC to have violated the FTC Act, the parties have sometimes agreed to versions of these internal company rules, or other mechanisms, to ensure that compensation is paid primarily for product sales and not for recruitment. The FTC has made clear that statements and conclusions made within those orders are not intended to represent the state of the law for the general public.<sup>1</sup>

The model for these voluntary standards came out of the practices of some legitimate companies in the 1970s. In 1979, the FTC decided definitively that Amway was not a pyramid scheme.<sup>2</sup> The FTC Commissioners determined that Amway compensated individuals on the basis of product sales and not primarily on the basis of recruitment. Among the evidence cited to determine that the typical abuses of pyramids were not present - a set of internal company measures previously adopted by Amway to eliminate the very problems described above.<sup>3</sup> Since then, the direct selling industry has embraced various updated versions of these internal company policies. Again, voluntary adoption of these protections does not guarantee that an operation is not a pyramid scheme and absence of these measures does not constitute a pyramid, but the existence of the rules provides strong evidence that a company is eliminating even the possibility of pyramid like abuses.

### **Examples of protections included in DSA's Code of Ethics:**

*Inventory Buyback* – In addition, Direct Selling Association member companies pledge to repurchase inventory from any salesperson who decides to leave the business. Any inventory purchased in the year prior to a salesperson's departure is repurchased for at least 90 percent of what was originally paid. Thus, the proverbial problem of "inventory loading" – a garage full of inventory that no one can sell - and the resultant loss of thousands of dollars is eliminated.

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<sup>1</sup> Staff Advisory Opinion – Pyramid Scheme Analysis, Federal Trade Commission, (January 14, 2004) "These 'fencing-in' provisions only apply to the defendant signing the order and anyone with whom the defendant is acting in concert. They do not represent the general state of the law."

<sup>2</sup> See, *In re. Amway Corp.*, 93 F.T.C. 618 (1979)

<sup>3</sup> Id.



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*No Large Up-Front Fees* - DSA members have also pledged not to charge unreasonable, large up-front fees to become a direct seller.

*No “Headhunting Fees”* - DSA members have also pledged not to make payments for recruiting an individual a primary part of their compensation plans. Instead, DSA members pay for the sale of real product to real users – not for recruitment.

*No Outrageous, Unsubstantiated Earnings Claims* – DSA members pledge not to make claims that salespeople can make large amounts of money without time, commitment and effort, and any earnings claims that are made must be based on documented evidence and a real track record.

### **Other industry practices to which the FTC has pointed as evidence that compensation is based on sales, not recruitment:**

*A Minimum Customer Rule* – Many direct selling companies have adopted some version of the company policy the FTC found helpful in the Amway case. It provided that in order to receive compensation a certain number (ten in that case) of sales to customers had to be demonstrated in any month. Again these are merely self-imposed company policies.

*A 70% Rule* – Similarly, although not required by law or regulation, many companies have adopted a policy similar to one of Amway’s internal policies rules. That protection provided that “every distributor must sell at wholesale and/or retail at least 70% of the inventory he bought during a given month in order to receive [compensation]...” The FTC found this as helpful evidence that inventory loading was not taking place in the *Amway* case.

It is important to remember that these protections are industry practices and not mandated by the government. These are best practices learned over the years and consumer protection measures voluntarily adopted by most direct selling companies in one form or another.

Correspondingly, some have suggested that a legitimate company must have all of these voluntary measures rules in place in order not to be considered a pyramid. However, to be clear, companies need not adopt these specific internal company measures in place to constitute a legitimate business.<sup>4</sup> What determines legal sufficiency and legitimacy is simple and straightforward - if compensation comes primarily from recruitment of participants who pay to become involved – it’s illegal. If compensation comes primarily from sale of product to real users – including salespeople – it is legal.

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<sup>4</sup> See, Staff Advisory Opinion – Pyramid Scheme Analysis, Federal Trade Commission, (January 14, 2004) & *FTC FACTS for Consumers, The Bottom Line about Multilevel Marketing Plans and Pyramid Schemes*, (2009), Neither of these analyses even mentions any of these so called “rules” let alone indicates they are necessary for a legitimate direct selling company.



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### Purchase and Use of Product by Direct Salespeople

DSA surveys indicate that 91 percent of sellers purchase some product for personal use, and almost 33 percent of total product sold, on average, is ordered for personal or household use by direct sellers themselves.<sup>5</sup>

Nearly 16 million Americans engaged in direct selling in 2011, some as full-time entrepreneurs seeking to build a business and some as part-time representatives hoping to earn a little extra money. Others sign up as representatives simply to purchase products or services for their own use at a discount and never sell to anyone else. Regardless of their income expectations, almost all direct sellers use the products themselves.

There is no general legal standard, either federally or in the states, suggesting that compensation based on personal use or consumption by sellers should be limited. Bona fide marketing plans almost invariably award compensation on the products or services consumed by their distributors, their families, and other purchasers. While these incentives initially are based upon the purchases made by recruits of the participant, they are made effectively contingent upon sales to ultimate consumers taking place by adoption and enforcement of rules which, together, encourage these sales and prevent inventory loading. If participants or recruits otherwise find themselves with inventory they cannot or do not wish to resell, they may return the goods to the company and receive back substantially the same price they paid, less any compensation previously paid on the unsold goods.

In 1995, Omnitrition International, Inc., a marketer of nutritional supplements, was sued in a class action alleging, among other things, that the company was a pyramid scheme in violation of federal and state law. The U.S. District Court granted summary judgment in favor of Omnitrition; plaintiffs appealed to the U.S. Court of Appeals for the Ninth Circuit. In its decree remanding the case for trial on the merits, the court called into question the legitimacy of compensation based on internal consumption. While the court's misstatement was only "dicta", i.e., language which should not be considered binding in subsequent cases, it was nonetheless of great concern to direct sellers. The decision of the Court in this Omnitrition case **was not** a final adjudication of the case but instead remanded the case to the trial court for final resolution. The decision was interlocutory in nature, and its dictum cannot be cited as law or even as a statement of generally accepted opinion.<sup>6</sup>

<sup>5</sup> See DSA 2002 *National Salesforce Survey* (as conducted by Research International). DSA describes the purchase of a company's products or services by its field sales forces and their families for their own consumption as "internal consumption."

<sup>6</sup> Since 1995, DSA is aware of only one (unreported) federal judicial decision in which the Omnitrition dicta has been persuasively cited; that decision will be appealed.

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Compensation based on internal consumption was (and remains) a long-accepted and legal aspect of direct sales. To ensure that the Omnitrition case dicta did not create a misunderstanding about the longstanding legitimate sales and purchase behaviors of direct salespeople, DSA has engaged in an ongoing dialogue with law enforcement and other interested parties about the direct selling model and internal consumption.

### Settled View of Internal Consumption

As a result of that constructive dialogue, we believe that law, and resultant anti-pyramid enforcement, to be quite clear and settled on this issue - compensation received by salespeople for products they themselves buy and use, and those bought and used by other salespeople within their organization, is a legitimate, legal and ethical practice and not evidence of illegal pyramid activity.

In January 2004, DSA received a Staff Advisory Opinion from the FTC Division of Marketing Practices stating that “...the amount of internal consumption in any multi-level compensation business does not determine whether or not the FTC will consider the plan a pyramid scheme.” The letter further defines an illegal pyramid scheme as “a multi-level compensation system funded primarily by payments made for the right to participate in the venture,” and elaborates by distinguishing pyramid schemes from legal buyers clubs.<sup>7</sup>

### Conclusion

The direct selling industry, law enforcement, and millions of salespeople and consumers understand that internal consumption is a completely legitimate part of many direct selling companies and is not an indication of a pyramid scheme. Any statements calling into question the legitimacy of internal consumption is not based in fact or law.

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<sup>7</sup> “The purchase of goods and services is not merely incidental to the right to participate in a money-making venture, but rather the very reason participants join the program” (discussing buyers clubs).