

MEMORANDUM

TO:                              General Counsel Committee

Government Relations Committee

FROM:                        DSA Legal Staff

SUBJECT:                  Research on FTC Analysis of Pyramid Schemes

DATE:                        March 27, 2020

DSA has become aware of a [paper](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3497682) that has likely been highly instructive to the Federal Trade Commission (FTC) in their recent investigations of pyramid scheme enforcement actions. The paper is authored by former FTC Bureau of Economics Director Dr. Ginger Jin, current Deputy Director Dr. Andrew Stivers and Consumer Protection Economist, Dr. Douglas Smith. It was published on the website Social Science Research Network.

Although it does not appear to be an official FTC paper or analysis, it is consistent with much of the Commission’s enforcement actions and remarks in the past six months. This confirms the reports that the FTC has a fundamental misunderstanding about mutli-level compensation. DSA will work to ensure the FTC understands the benefits of the business.

As the abstract succinctly states the authors, “find that participant optimism about the offer creates expected loss from demand - as is usual for deceptively marketed business opportunities - but also creates an opportunity for the firm to induce a transfer scheme, and associated losses related to that scheme, independent of consumer demand for any product.” (Page 1)

**Economic Assumptions**

The paper proposes a new economic analysis to determine if a business is a pyramid scheme. It is highly technical and looks at consumer expectations and calculates the likelihood of harm. It begins by assuming that an individual typically only enters into economic endeavors that they believe will benefit them financially. When the individual is induced into a transaction that negatively affects their financial welfare, then fraud is present—in this case, a pyramid scheme exists

The authors examine the expectation of individuals to recruit others into the business and how the individuals calculate the potential risk to rewards for participating in the program. The authors postulate that in many cases, an MLM exploits the prospective distributors because of overly positive expectations for recruitment and consumer demand for the product. By misleading prospective participants about the potential earnings from recruitment compensation, the scheme induces individuals to sign up even though they have no realistic expectation of commissions from retail sales. This misperception is then used to increase the company’s profits by increasing the price the company can charge for its products and services.

The paper compares a franchisor-franchisee model and parallels that to the relative economic loss against a two-level MLM company. The paper contends that the potential for overly optimistic recruitment based commissions by potential distributors is inherent in any MLM, and therefore the risk of economic loss is higher. A critical result of overly optimistic beliefs about recruitment creates an MLM that operates as a “negative wealth transfer scheme” in which they participate despite believing they will lose money on the retailing of products or services. (Page 7)

The authors even suggest that for a variety of reasons, “including existing participant beliefs or incentives of other participants to mislead firms may be able to induce participation in transfer mechanisms without providing misleading information to potential participants.” (Page 8)

**Analysis**

The authors create a model MLM to test their theory. The model MLM assumes:

Observation 1. Contracts include both the right to purchase a product from the company and the right to recruit others into the network in exchange for a reward.

Observation 2. Contracts incentivize recruitment by agents.

Observation 3. Contracts bundle eligibility for recruitment rewards with product purchase (or other up-front expenditure) by a participant.

Observation 4. Rewards are tied to product payments to the firm, which do not necessarily reflect the consumption value of the product. (Page 12)

The authors indicate that, “observations 1 and 2 capture the defining features of an MLM, that consumption, retail, and distribution roles can overlap” and that observation 3 and 4 are, “necessary in the context of this model to allow the firm to create transfers and take advantage of transfer losses.” (Page 12)

Based on their modeling, the authors believe that this overly optimistic belief of recruiting enough people will offset your direct costs running the business—including business development and services. This overly optimistic belief may also allow the company to set prices and rewards such that the average return across participants is negative. The paper does not account for or discuss the 90% buyback policy under the DSA Code of Ethics and required by all DSA members to mitigate this loss.

Because of the linkage between their own retails sales, purchases, and the commissions generated by the downline sales, the authors argue that participants are willing to take a loss on their purchases if they believe this will be overcome by the rewards from the downlines they recruited.

The paper also suggests that overly optimistic views on recruitment may be preexisting or the misleading statements may be hard to stamp out, or that the underlying structure of the compensation plan may lead to misperceptions and that there may be benefits to blocking some aspects of the compensation plan.

The paper also states that even if a business does not require recruitment, it incentivizes it by rewarding for recruiting rather than for genuine product demand, including:

* Minimum purchase requirements that can only be satisfied through personal purchases (Page 30)—as FTC Bureau of Consumer Protection Director Andrew Smith described at the DSA October Legal and Regulatory Conference as “threshold rewards.”
* Rewards that increase exponentially with higher levels of expenditure (Page 30)—as Director Smith described as “convex rewards.”

**Conclusion**

The paper does not describe how a lawful MLM may operate. They do suggest that policymakers may want to examine three crucial areas given their findings.

1. Ensure that MLMs are not misrepresenting the income earning potential.
2. Consider changes to the structure of MLMs to prevent or mitigate the harm they believe is taking place through the possibility of transfer loss.
3. The authors further suggest that policymakers should examine marketing by MLM companies to ensure participants are not given misleading information about underlying demand or supply parameters. They also suggest examining aspects of the contracts used by MLM companies (Page 27).

The paper suggests three specific ways to mitigate this supposed harm.

1. A ban on recruitment.
2. Limiting rewards to sales that are directly fulfilled to non-participant consumers, i.e. no commission on internal consumption.
3. Eliminate minimum purchase requirements to maintain eligibility or receive downline commissions. (Pages 29-30)

All of these suggestions are consistent with recent FTC enforcement actions and comments made by Mr. Smith. DSA is in ongoing conversations with the FTC to gain clarity on lawful compensation structures. We will work with Direct Selling Education Foundation Fellows to evaluate and where necessary, rebut some of this research. One such paper already available is a recently paper by Dr. Anne Coughlan; [Consumer Harm from Voluntary Business Arrangements](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3488105) which was presented at the Hudson Institute in Washington, D.C. in November 2018.

DSA is working to secure additional resources to ensure the FTC understands the benefits of the business. We will convene relevant committees as soon as possible to discuss further engagement.