

Pyramid Schemes and Multilevel Marketing (MLM): Two Sides of the Same Coin

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Since the recent crack down on pyramid and ponzi schemes, there have been attempts by unscrupulous persons to devise alternative means of attracting unsuspecting persons willing to do legitimate businesses for financial gains. The Caribbean Policy Research Institute [CaPRI¹] (2008) in its report titled “Investigating Informal Investment Schemes in Jamaica” stated in its analysis of the characteristics of multilevel, pyramid, and ponzi schemes that despite the heterogeneity in the structure of these organizations, they all involve large numbers of small investors who are often lured into participating in a wide range of investment activities or financial hedging through the administration of a central unit. These schemes rely predominantly on new customers/clients to fund payments to existing customers. The need for a consistent supply of new recruits for sustainability and perceived growth is paramount. Based on the CaPRI report, pyramid schemes are unsustainable investment ploys that always fail to meet the expectations of over 90% of its investors with very little emphasis on profit-making ventures or products. This paper will examine the similarity between the recently foiled financial pyramid schemes and the current multilevel marketing (MLM) strategies of consumables that are cunningly being proposed as legitimate business and entrepreneurial options. This paper will present handy information for persons interested in participating in MLM businesses and regulators in order to make informed decisions to avoid a repeat of unwise investment.

Keywords: pyramid scheme, multilevel marketing (MLM), market practices act, fraud

Introduction

At the beginning of the last decade, the Caribbean saw a fresh surge of the type of fraud popularly known as pyramid schemes. These schemes were presented to unsuspecting persons as alternative investment schemes and clubs. Initially, governments did very little to warn their citizens about these schemes not recognizing how enticing they were to people and perhaps relying on the efficacy of laws and mechanisms already put in place to deal with them. During the last decade, pyramid schemes rose and fell in countries such as Romania and Albania and by the middle of this decade, pyramid schemes were deeply rooted in countries such as Jamaica in the region with persons from all facets of society being involved in varying degrees. Even though some of these schemes originated in the Caribbean, a number of persons outside the Caribbean and especially in the United

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¹ CaPRI is a Caribbean think tank that promotes evidence-based policy making in the region.

States invested in these schemes as evidenced by the recent conviction of David Smith of Olint in the United States for wire fraud. It is believed that even persons in government within the Caribbean who should have known better were deceived by this nicely packaged fraud in wrappings of alternative investment schemes. Some believed that this was the road to financial freedom of underdeveloped countries and so disregarded public notices. According to *Daily Gleaner* (2009), the Financial Services Commission (FSC) issued a warning to the public not to invest in Worldwise scheme. The warning was not heeded by the public as persons continued to invest in the scheme. Originators of pyramid schemes supported laudable projects in society and were perceived to be the Moses leading many both poor and rich to their financial freedom. By the turn of the decade when government apparatus woke up from slumber, the warnings came too late. In February 2009, United States federal regulators charged Allen Stanford, head of the Antigua-based Stanford International Bank, and three of his firms with a massive fraud that centered on high interest rate certificates of deposit. By October 2009, according to the FSC Jamaica public notice (*Sunday Observer*, 2009), there had been about 58 unregistered alternative investment schemes in Jamaica. These unregulated investment schemes appeared to be a law unto themselves, with David Smith, head of the failed foreign exchange trading scheme, Olint, refusing to comply with the directives of the FSC in 2006, based on the statutory powers granted by the FSC under the Financial Services Act. David Smith challenged the FSC's "cease and desist" order stating that the regulators had no statutory authority to regulate his operations (Olint Corporation Limited and David Smith v The Financial Services Commission, 2006). In 2010, David Smith, pleaded guilty to four of the 30 fraud-related charges and was sentenced in Turks and Caicos Islands. In November 2010, five weeks before he began serving his prison sentence, David Smith was slapped with additional 23 count indictments on fraud charges in Florida. It is now obvious that both Stanford and Smith gave what appeared to be face lifts to pyramid and ponzi schemes which they paraded as legitimate investments. This paper attempts to show similarities between pyramid schemes and some multilevel marketing (MLM) strategies for informed decisions by regulators and investors.

Pyramid Schemes

A pyramid literally is a triangular-shaped structure with the apex being the top tier, expanding as it gets closer to the base. As the name suggests pyramid, schemes are characterized by the same shape with one or few persons being at the apex and the majority of persons being at the base of the structure, hence the shape of a triangle. A pyramid scheme is often described as a "business opportunity". The distinctive characteristic of this "business opportunity" is that the only way participants can make money is by recruiting other members to the scheme who quickly find out that their successes depend entirely on their ability to recruit other persons to the scheme. The scheme promises very high returns over relatively short periods, which is what makes it attractive, there is little or no product or service to generate income needed to justify the level of high returns promised and there is a high dependence on testimonials to prove credibility. The testimonials are however usually from a few persons at the top of the pyramid who are making the high profits. The persons at the bottom of the pyramid lose.

Types of Pyramid Schemes and How They Work

There are several types of pyramid schemes. This paper will focus on two basic types: naked pyramids and product-based pyramids.

Naked pyramid scheme. A naked pyramid starts with one person who is at the apex of the pyramid and recruits a number of persons, for example, 10 other persons to participate in an “investment opportunity”, each of whom is required to invest \$100. Once they have invested in this scheme, they are required to recruit 10 other persons to participate in the same “business opportunity”. Assuming that each recruit is successful, they will all end up with \$900 profit having only invested \$100. Promotion within the scheme is based on how many recruits a participant brings in. An example of the naked pyramid scheme is a gifting scheme.

Product-based pyramid scheme. A product-based pyramid has all the features of a naked pyramid with the addition of a product which gives the impression of legitimate sales taking place. The initial recruiter as a distributor of the product recruits, for example, 10 sales persons who each pays an amount (\$500) for a starter kit of products to sell, from which the distributor gets 10% of each starter kit sold. The distributor also gets 10% of each product sold by his recruits and any additional starter kits they sell. Typically, these products are not in high demand and the recruits quickly realize that the only way to make money is by recruiting other persons to buy starter kits knowing very well that selling the products is a difficult task.

Pyramid scheme is a category of fraud in that persons are deceived into believing that once they invest an amount, they will make significant profits in a very short period of time. In most instances, there is no product or service being offered, and even where there are, these products have little or no resale value, making the potential for earnings without recruiting very low or relatively insignificant compared with projections made. Irrespective of the type of pyramid scheme, mathematically, it is impossible for everyone to make money, as the wider the base of the pyramid becomes, the smaller the pool of potential recruits. The closer the recruits are to the bottom of the pyramid, the more likely they are to lose their investments due to market saturation and inability to get new recruits, and the scheme eventually collapses. The persons at the bottom of the pyramid who are not able to recruit would have invested and lost their money. The bottom line is that pyramid schemes are not sustainable.

A number of countries, such as USA, European Union countries, New Zealand, Australia, Canada, and Barbados, have legislation directly prohibiting pyramid selling schemes in their consumer protection laws in addition to general and specific fraud legislation. However, there are other countries, such as Jamaica, which have legislations dealing with fraud and unregulated investment schemes but where there is no specific prohibition of pyramid schemes. The Jamaica Consumer Protection Act (The Jamaica Parliament, 2005) provided for offences such as misleading advertising but has no specific provision prohibiting pyramid selling schemes. Pyramid schemes in these jurisdictions are unregulated and in the absence of robust scrutiny, there are more and more convoluting schemes being devised as the tricksters strategize new ways to avoid detections. Their target market is unsuspecting victims who are attracted by the promise of extremely high returns in relatively short periods for doing very little.

MLM

The marketing of products using individuals as sales persons is perhaps one of the earliest forms of marketing strategies. For hundreds of years, sales persons found creative ways of wooing buyers. However, this strategy of getting buyers sometimes called recruiters has been taken to another level in more recent time using a concept generally referred to as MLM or network marketing. MLM businesses draw income primarily from expansion of the hierarchical network of independent sellers conceived. The main purpose of the system is to recruit new distributors which in the hierarchy of the system can be climbed. Using a MLM strategy, a large

number of products such as cosmetics, cookware and health products, and more recently, coffee are sold through a large network of distributors. Sales persons who are sometimes called independent business owners (IBO) are recruited based on an attractive “sell” of the potential to earn significant amounts from an initial investment made to buy an instant business. Proponents of this strategy argue that it is a legitimate method of selling commercially viable products and services. The key element of a legitimate MLM is having commercially viable products and services to sell.

However, there are certain MLM strategies where the focus is not on the product but on the recruitment of IBOs. These MLM businesses are often referred to as motivational organizations focusing mainly on luring potential IBOs to recruitment/motivational meetings where they are told about extraordinary income opportunity in the business. Speakers claim that they have personally become wealthy. In addition, recruits are told that they need to purchase marketing materials which may include books, tapes, and sample kits and attend seminars offered by acclaimed distributors in order to become successful distributors. At these meetings, there is often a “big do” about how much profit is being made by specific distributors (team leaders) who are usually persons who joined the scheme early. Testimonials of these persons usually centre on how they use initial investment which is the cost of a starter kit/sample products to earn exponential profits. Some MLMs have taken the tactics of recruitment, a step further by enticing and appealing to ostentatious life styles through announcement of give-away expensive cars, diamonds, and other luxury items to top-performing recruiters/distributors. Selling products to end users is not the main criterion.

The disturbing aspect of these MLMs is that a high proportion of the subsequent IBOs when interviewed admit that they have not made any significant profit as envisioned and they usually have to fall back on testimonials of early IBOs to convince potential IBOs. The cost of the product is usually unrealistic and so the focus is on recruiting IBOs rather than on selling the product. Often, IBOs are encouraged to give away some of the products they purchased to potential IBOs in a bid to encourage them to join the scheme.

Inference and Implications

Whilst the originators of various MLM businesses have maintained that they do legitimate business, court judgments and settlements by these MLM businesses suggest otherwise. Amway, a USA-based MLM company involved in the production and distribution of household products, including cleaning agents, cookware, vitamins, food supplements, skin care products, make-up, hair, body, and oral care products is perhaps arguably, the largest, oldest, and best-known representative of MLM. Amway in 2010 announced that it agreed to pay restitution to consumers and reform costs estimated at over \$150 million. A class action had been filed against Amway in 2007 by former distributors for Quixtar (former name used by Amway in the USA) alleging that the MLM business was a pyramid scheme which induced sales persons to buy thousands of dollars of overpriced products and useless “success tools” and recruit others to do the same in an endless chain scheme that doomed, by designing nearly all to losses (Pyramid Scheme Alert, 2010). According to *West Michigan Business* (2010), Chris Knape reported the same class action on November 3, 2010, stating that Amway announced a deal to pay \$34 million in cash and to provide \$22 million worth of products to settle the 2007 class action suit. The claimants alleged that the company and some of its top-level distributors operated an illegal pyramid scheme. One of the main aspects of the class action is the charge that Amway misleads consumers with false income claims and promises of business opportunity. Pyramid Scheme Alert analysis of Amway showed that 99% of all who signed up never earned a profit. Even though Amway in the settlement stated that it admitted no

wrongdoing, it has been suggested that the fact that it agreed to pay its accusers, incur other remedial costs up to \$150 million, and choose not to allow the case to go to trial might be interpreted as compelling evidence of guilt. Prior to 2010, government regulators in England sought to close down Amway on allegation of defrauding consumers. Criminal charges have also been brought in India and the organization is also being sued for deception and fraud in Canada by consumers.

Another MLM organization, Global Online Systems Inc., a Canadian associate of Herbal Life (USA), according to Pyramid Scheme Alert (2004), pleaded guilty to deceptive marketing and paid a fine of \$150,000. An investigation by the Canadian investigation bureau led to admission of guilt to two counts of violation of the deceptive marketing provisions of the Competition Act. It was revealed that participants were paid to recruit and were required to purchase specific amounts of products in order to participate in the MLM. Investigations revealed that the organization used exaggerated income claims in their recruiting. Also, in the same year, another associate company of Herbal Life, Newest Way to Wealth which is the recruiting organization of Herbal Life, settled an action with victims of their MLM in the USA in the tune of \$6 million.

In Belgium, the commercial court in Brussels found Herbal Life International Belgium guilty of contravening the Market Practices Act and sentenced the organization to pay a fine of 5,000 euro per infringement with a maximum of 250,000 euro (Test-Aankoop vs. Herbal Life International, 2011). The action was brought by a non-profit organization, Test-Aankoop registered in Belgium. Test-Aankoop alleged that Herbal Life incorporated and promoted a pyramid scheme where persons upon payment of a fee had the opportunity to receive income either by recruiting new consumers/customers to the system or by selling or using the products. Herbal Life in its response to the action stated that it offered its products via a legal multilevel sales method. The Commercial Court in Brussels (A.R. 2004/7787) in its judgment ruled that Herbal Life International Belgium was in breach of Articles 4, 91, and 99 of the Market Practices Act regarding market practices and consumer protection, because it had established, managed, or promoted a pyramid scheme whereby the consumers or businesses stood to make money, which was more likely the result of introducing new consumers or businesses into the scheme than from the sale or use of its products (Test-Aankoop vs. Herbal Life International, 2011). The court found that in order to obtain goods at a fair price with a view to using them, the consumer had to become a distributor.

Recommendations and Conclusions

For thousands of years, unscrupulous people have devised and used incredible ways to persuade others into giving away their money, usually with the expectation of earning more (Delimpasis, 2001). This criminal act is what is generally known as fraud. Fraud has been described as occurring, when a person intends by deceit to induce a course of conduct in another, which puts other persons' economic interest in jeopardy (Pinto & Evans, 2003). It is a generic category of conduct that involves the use of dishonest or deceitful means to obtain some unjust advantages over another person or entity. Fraud encompasses all types of actions aimed at obtaining financial gains through deception (Carvajal, Monroe, Patillo, & Wynter, 2009). A pyramid scheme will therefore fall into a category of fraud. The close semblance between pyramid schemes and MLMs should therefore raise regulatory alertness.

The existence of a free-market system does not mean that there should be no rules to protect the public; instead, all sectors should be regulated in order to protect the public from unscrupulous individuals and entities. Consumer protection laws are expected to protect consumers against fraud. Due to the close semblance between

pyramid schemes and MLMs, it is imperative that specific legislation is put in place to deal with all areas of pyramid schemes. Despite questions being asked whether the participation in pyramid schemes is that of “need, greed, or ignorance” on the part of the consumer (Eaton, 2008), a corollary question may also be asked whether the regulators charged with the responsibility of protecting consumers are doing all they can to protect. Pusey (2007) argued that regulators should encourage market participants to share the regulatory burden by exercising market discipline and self-regulation. According to Wynter (2007), a responsibility is placed on the investor to research and verify the legitimacy of the investment scheme. This duty is even more obvious in light of apparent disregard to public notices issued alerting the public to the illegitimacy of the investment schemes. Government has a responsibility to ensure that all aspects of consumer protection fall under the regulatory microscope. Jurisdictions such as Belgium, Canada, and Barbados have specific provisions in consumer protection legislation dealing with pyramid schemes. However, other countries such as Jamaica have no such provisions or legislation.

Section 55(1) of the Competition Act of Canada (Department of Justice, 1985) defined pyramid selling to include MLM plan whereby a participant in the plan gives consideration for the right to receive compensation by reason of the recruitment into the plan of another participant in the plan who gives consideration for the same right. Sub-section 2 of the provision prohibits the establishment, operation, advertisement, or promotion of a scheme or pyramid selling. Contravention of the provision may result in conviction on indictment to a fine in the discretion of the court or to imprisonment for a term not exceeding five years or both. Summary conviction for the same offence may result in a fine not exceeding \$200,000 or imprisonment for a term not exceeding one year or both. The act also provides that no person who operates or participates in a MLM plan shall make any representations relating to compensation under the plan, unless the representations constitute or include fair, reasonable, and timely disclosure of information within the knowledge of the person, making the representation relating to compensation actually received or likely to be received by typical participants in the plan.

In Belgium, Article 91 of the Market Practices Act provides that setting up, managing, or promoting a pyramid system where consumers have upon payment a chance to receive income from either recruiting new consumers in the system or from sale or use of products is a misleading business practice and is considered to be dishonest and illegal.

In Barbados, section 23 of the Consumer Protection Act prohibits the promotion or operation of pyramid selling schemes. The Act defines pyramid selling scheme as a scheme that provides for the supply of goods or services or both for reward and which is considered by many participants as constituting primarily an opportunity to sell an investment opportunity rather than an opportunity to supply goods or services. The section further provides that this opportunity is unfair or likely to be unfair to many of the participants in that the financial rewards of many of the participants are dependent on the recruitment of additional participants, and the number of additional participants that must be recruited to produce reasonable rewards to participants is either not attainable or is not likely to be attained by many of the participants.

It is now imperative for jurisdictions such as Jamaica to amend its Consumer Protection Act 2005 following jurisdictions like Canada, Belgium, and Barbados to specifically deal with pyramid systems and MLM strategies decisively to avoid a repeat of a surge of investment scams and to make all jurisdictions unsafe havens for pyramid type frauds.

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