

MULTILEVEL MARKETING (MLM) vs PYRAMID SCHEME-FROM LEGAL PERSPECTIVE

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Multilevel marketing is a popular marketing method often practiced by direct selling companies. However, it has been manipulated in the form of the illegal pyramid scheme or commonly known as the get-rich-quick scheme. This paper intends to discuss the differences between MLM and pyramid schemes, the regulations on MLM and anti-pyramid laws in other countries, and the loopholes of the existing Direct Sales Act 1993 in Malaysia especially regarding provisions on MLM technical operations. It was suggested that amendments or provisions should be made on the MLM operations particularly provisions concerning start-up fees, inventory loading and a balanced compensation system. Additionally, consumer education and awareness as well as stringent enforcement should also be enforced.

INTRODUCTION

Over the decade, direct selling industry has developed and flourished into a multi-billion dollar business worldwide. Multilevel marketing (MLM) is a marketing methods that is used by nearly 60 percent of direct selling companies (refer Table 1). MLM has been manipulated by the direct sellers in many ways. It has been associated with pyramid schemes, get-rich-quick schemes, chain letters, ponzi schemes, internet scams, etc. It has victimised the genuine MLM operators and consequently the consumers at large.

Table 1: Types of Direct Selling Licenses as at Dec 2000

Type	Amount	Percentage (%)
Multi level marketing	427	60.0
Single level marketing	199	27.9
Mail order	69	9.7
Single level marketing & mail order	17	2.4
Total	712	100%

The problem arised because of the complexity of the MLM itself and also due to the ignorance of the consumers on the matter. The attractive and lucrative returns from pyramid system seems to deceive consumers into believing it. The pyramid plays on the psychology of 'instant money' and greediness of human until it can influence the educated professionals, religious individuals, especially the average public.

Pyramiding occurs partly due to the inadequate legislation on the legitimate MLM system. The existence of the Direct Sales Act 1993 do not seems to be able to curb the pyramid schemes. The operations of pyramids schemes is still rampant and seems to be able escape the law.

The objectives of this paper are as follows:

- i) to specify the differences between the legitimate MLM and illegal pyramid schemes.
- ii) to discuss the different anti-pyramid law implemented in other countries
- iii) to identify loopholes in the Direct Sales Act 1993 relating to pyramid schemes.
- iv) to suggest additional legal provisions to eliminate the pyramid scams and to improve the MLM system.
- v) to give awareness on the danger of pyramid to consumers as well as educating consumers on legitimate MLM.

MULTILEVEL MARKETING (MLM) AND PYRAMID SCHEME

Multilevel marketing (MLM) which is also known as “network marketing” is a legitimate system practiced by direct selling companies. In a legitimate multilevel marketing arrangement, distributors are engage in both direct selling and in sponsoring new distributors for the business, thereby building an independent sales force in the process. Kotler et al (1999) define multilevel marketing as:

"a variant of direct selling whereby direct selling companies recruit independent businesspeople or individuals who act as distributors for their products, who in turn recruit and sell to subdistributors, who eventually recruit others to sell their products, usually in customer homes. A distributor's compensation includes a percentage of the sales to the entire sales group that the distributor has recruited as well as earnings on the direct sales to retail customers."

Offen (president of WFDSA) defines multilevel marketing as a compensation plan which must fulfill two conditions: personal sales and group sales. The direct seller is required to do personal sales of products and services of the company to customers. At the same time they have to recruit new members into the plan. In this way they can build and manage their own sales force by recruiting, motivating, supplying and training others to sell the companies product. (James, 1999).

According to Jones (2000), the person who recruited a new member is called a 'sponsor'. Then the sponsor will recruit new members which are called

'downline'. The sponsor, the sponsor's sponsor, etc. will be known as the 'upline'. This forms a structure a bit like a family tree. The sponsor's compensation will include a percentage of the sales of the entire sales group as well as earnings on the sponsor's personal sales to ultimate customers. Performance bonuses are based on personal achievement which reward high achievers. MLM becomes illegitimate when one of the conditions is not performed. It is derived exclusively from sales of goods and services to ultimate consumers and users. Ultimate consumers include those sales persons who purchase products for their personal or family use. No money is earned merely by recruiting additional participants into the plan.

Therefore the common features of a legitimate MLM consists of the low membership fees and cash investment, prohibition on inventory overloading, returnable goods, actively selling of quality products and services and prohibition of exaggerated earnings.

The benefits of MLM are; opens up opportunities to individual, fairly simple and inexpensive way of starting business without any qualifications needed, offers supplementary incomes, unique and innovative products offered at reasonable price, reduce advertising cost and reduce shelf space competition in retail stores.

Due its simple and flexible method of building an independent business, it is open to manipulation and fraud. The system is often abused through illegal operations of pyramid schemes which is also known as chain letter, get rich quick scheme, snow balls, chain selling, quick money scheme, ponzi scheme, referral selling and investment lotteries. Malaysian connotation for such deceitful operations are 'Saham Rakyat', 'Skim Insan', 'Dana Rakyat', 'Program Ehsan', 'Skim Bantuan Saudara Amal Hijrah' and 'Skim Alternatif Munuju Alaf Baru'. Statistic of complaints on get-rich-quick schemes is shown below (see Table 2)

Table 2: Consumer Complaints Of Direct Sales And Pyramid Schemes

Year	Direct Sales	Get-rich-quick	Mail Order
2000 (1 st half year)	19	11	3
1999	29	21	9
1998	48	18	4
1997	54	36	14
1996	38	23	5
1995	63	32	6
1994	23	4	60
1993	22	8	85
1992	30	18	79
1991	33	27	95

Pyramid selling is defined as a scheme in which a recruit pays for the opportunity to receive future benefits which are primarily derived from that recruit's introduction of additional participants in the scheme rather than from the sales of product to consumers. It is a mechanism by which promoters enrich themselves through the payments made by recruits to such schemes.(WFDSA, 2000).

Furthermore, Direct Selling Education Foundation of Canada (1998) define pyramid schemes as illegal scams in which large numbers of people at the bottom of the pyramid pay money to a few people at the top. Each new participant pays for the chance to advance to the top and profit from payments of others who might join later.

In pyramid selling, the so-called products are often gimmicks such as certificates, website, spurious training programs, magazine subscription, illusory discount and exotic cures and intangible products. Pyramiding company often takes on a product and claims to be in the business of selling them to the consumers. However little or no effort is made to actually market the products. Instead the focus is on recruiting. Furthermore most disguised pyramid often choose product which are cheap to produce but have no established market value.(Direct Selling Education Foundation USA, 1998). The common factors that differentiate MLM from pyramid are summarized in Table 3.

Table 3: Comparison between MLM and Pyramid

MLM	Pyramid
• Active selling	- passive selling
• Offer genuine business opportunity based on sale of quality products	- claim to offer products but no effort to market them
• Both personal sales and recruitment	- merely focus on recruiting
• Discourage inventory overloading	- allow overstocking of inventory
• Low start-up fees	- excessive start-up fees
• Returnable stock	- non –returnable stock
• Quality and innovative products	- product with no established market value

MALAYSIAN DIRECT SALES ACT 1993

In Malaysia Direct Sales Act 1993 was enacted with the intention to ensure consumer protection, encourage growth of ethical direct selling methods and to eliminate pyramid schemes or other deceptive schemes. The principle objective of the Act is to provide the licensing of persons carrying on direct sales business where only companies with a valid licence from the Ministry of Domestic Trade and Consumer Affairs are allowed to engage in a direct selling business. (section 4, DSA 1993). The application must include a legitimate marketing plan which the Ministry would use as the basis for its decision on whether to grant a license or not. (section 5, DSA 1993 and Regu.3, Direct Sales Regulations 1993).The licence granted under the Act is still subject to revocation or restriction under sections 8 and 9 respectively. (Section 8 and 9, DSA 1993).

The legislation against pyramid schemes only available in section 7 of the Act. Section 7(1) provides that “no licence shall be granted to a person who intends to carry on a direct sales business which involves any scheme or arrangement for the sale or distribution of goods or services where such person, for a consideration, acquires the opportunity to receive a pecuniary benefit which is not dependent on the volume or quantity of goods or services sold or distributed or to be sold or distributed for purposes of resale but which is based, to any extent, upon the inducement, by himself or others, of additional persons to participate in such scheme or arrangement.”

Furthermore subsection (3) provides “where a person being a director, manager, secretary or other similar officer of a body corporate is guilty of an offence under this section, he shall be liable to a fine not exceeding two hundred and fifty thousands ringgit or to imprisonment for a term not exceeding three years or both.”

The main thrust of this section is to curb pyramid schemes but so far it has been ineffective in stopping them. One of the main weaknesses of the Act is that it is not able to bring within its ambit the various schemes being introduced in the market and therefore there are many schemes which escapes it. The Act emphasize more on licensing and modes of operating business for direct selling companies. Currently the Act only impose a maximum of 3 years and a fine of RM 250 000 or both on those found guilty operating such schemes. No penalty is imposed on participants of the schemes. (Utusan Konsumer, April, 2000).

It has been reported that most of the cases on pyramid schemes involve illegal deposit taking which is an offence under section 25(1) of the BAFIA 1989. The section provides that no person shall receive, take or accept deposits except in accordance with a valid licence granted under the Act. By virtue of the Fourth Schedule of the Act, where a person is found guilty under the section, he shall be liable for a fine up to one million ringgit or ten years imprisonment. According to

Bank Negara, 14 get-rich-quick schemes have been brought to the court between 1989 to 1999 for violation of the BAFIA. The amount of money collected by the operators totaled some RM 12.5 million. (Utusan Konsumer, April, 2000).

MLM REGULATIONS AND ANTI-PYRAMID LAWS WORLDWIDE

In combating pyramid schemes and other deceptive schemes, several laws and regulations have been imposed and implemented in the United States of America, Canada, United Kingdom, Australia, Singapore and other countries worldwide.

i) Federal Trade Commission Act, 1979 of the United States.

In the United States there are a few laws which regulate the multilevel marketing and pyramid schemes consisting of federal and state law. Besides section 5 of the Federal Trade Commission Act 1979, various states prefer to deal with pyramid law violation under lottery, business opportunity and investment securities law, Deceptive Trade Practice Acts, US Postal Lottery and Fraud laws, Securities Act 1933 and 1934.

Illegal pyramid schemes started in the US by the late 1960s and early 1970s whereby the schemes were fraudulently developed through out the US. There are several cases of pyramid schemes that had been brought to the court by the Federal Trade Commission. For example one pyramid scheme alone (Holiday Magic) had defrauded a number of investors of more than US\$ 250 million. In Koskot's case (1975) and Turner's case (1978), the Court has defined fraudulent pyramid schemes as follows;

" Such schemes are characterized by the payment by participant of money to the company in return for which they receive (1) the right to sell a product and (2) the right to receive in return for recruiting other participant into the programmed rewards which are unrelated to the sale of the product to ultimate users." (Smith, 1984).

In 1975, the FTC accused Amway of operating as an illegal pyramid. After four years litigation, Amway prevailed. An administrative law judge ruled that Amway's multilevel marketing program was a legitimate business opportunity as opposed to a pyramid scheme. The court drew the following conclusion;

" Given these facts, the Amway plan is significantly different from the pyramid plans condemned in Koskot, Ger-Ro-Mar and Holiday Magic. Specifically the Amway plan is not a plan where participants purchase the rights to earn profits by recruiting other participants who themselves are interested in recruitment fees rather than the sale of products." (Babener, 1999).

ii) Federal Competition Act in Canada

The Competition Act is a federal law governing business conduct in Canada. The Act explains the differences between multilevel marketing plans and schemes of pyramid selling, and sets out the responsibilities for operators and participants in these types of plans. By virtue of section 55 of the Federal Competition Act, an operation of multilevel marketing plan which violates the Act or includes any pyramid schemes would be liable for penalty or imprisonment. Section 55 deals with income representations in multilevel marketing plans and section 55.1 deals with situations where the multilevel marketing plan is deemed to be a prohibited scheme of pyramid selling.

Section 55 (1) provides that multilevel marketing plan means a plan for the supply of a product whereby the participant in the plan receives compensation for the supply of the product to another participant in the plan who, in turn receives compensation for the supply of the same or another product to other participant in the plan.

Section 55.1(1) provides that scheme of pyramid selling means a multilevel marketing plan whereby;

- a) 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;
- b) a participant in the plan gives consideration, as a condition of participating in the plan, for a specified amount of the product, other than a specified amount of the product that is bought at the seller's cost price for the purpose only of facilitating sales;
- c) a person knowingly supplies the product to a participant in the plan in an amount that is commercially unreasonable;
- d) a participant in the plan who is supplied with the product;
 - a) does not have a buy back guarantee that is exercisable on reasonable commercial terms, or
 - b) is not informed of the existence of the guarantee or right and the manner in which it can be exercised.

iii) The Fair Trading Act 1973 of the United Kingdom

In the United Kingdom pyramid selling is a typical scams. It also known as trading schemes where its principal purpose is to make money through the recruitment of new participants. The Fair Trading Act 1973 defines trading scheme as including any

arrangements made in connection with the carrying on of a business, whether those arrangements are made or recorded wholly or partly in writing or not. Trading schemes must comply with legislation in the Fair Trading Act 1973 as amended by the Trading Schemes Act 1996 and the Trading Regulations 1997.

Section 120(3) of the Fair Trading Act 1973 makes it a criminal offence to persuade someone to make a payment to a scheme by promising benefits from getting other people to join a trading scheme. It does make it unlawful to persuade someone that the main motive for joining is to profit from recruiting others or to take money from someone on the basis of such a motive.

The Trading Schemes Regulations set a minimum standards of good business practice. In a legitimate trading scheme, payments are linked essentially to genuine selling of goods or services to end users. It is illegal to base rewards for participants on the simple continued participation of other participants. It is also generally illegal to accept from participant, securities or guarantees as payment or promise of payment.

iv) Trade Practices Act 1974 of Australia.

Pyramid sales schemes also are illegal in Australia. Substantial penalties exist under the Fair Trading Act and section 61 of the Trade Practices Act 1974 was passed particularly to eliminate pyramid selling scheme. It is a criminal offence to even participate in such schemes. Section 61 prohibits the promotion of, or participation in, pyramid selling schemes in which a person makes a payment to a corporation with the prospect of receiving payments for the introduction of other participants to the scheme.

v) Multilevel Marketing and Pyramid Selling (Prohibition) Act 1973 of Singapore.

Since 1973 Singapore has enacted Multilevel Marketing and Pyramid Selling (Prohibition) Act which prohibit the registration of business that are designed to promote multilevel marketing schemes or arrangements or pyramid selling schemes or arrangements in relation to the distribution and sale of commodities.

Section 3(1) of the Act provides that it shall be unlawful for any person to promote or participate in a multilevel marketing scheme as well as pyramid scheme. Any person who was found guilty under this section shall be liable to a fine not exceeding \$30 000 or maximum five years imprisonment.

Furthermore, section 4 of the Act prohibits the registration of a business which is designed to remote a multilevel marketing and pyramid scheme or arrangement. Section 7(1) provides that a company which promotes such schemes shall cease

promoting the same and shall resolve by special resolution that it be wound up voluntarily or resolve by special resolution that it be wound up by the court.

SUGGESTIONS

From the above discussion, it can be seen that there are still discrepancies in the legislation on multilevel marketing. To overcome these problems, modification needs to be enacted in the Direct Sales Act 1993 or the enactment of a new anti pyramid legislation which clearly state the following suggestions;

A. Under the scope of Multilevel Marketing

- i. a provision is made regarding the precise definition of 'start up fees'. It should not exceed RM100.00 in order to avoid manipulation of start-up fees. The fees should only include cost for pamphlets and selling kit.
- ii. a provision is made on the prohibition of inventory loading as a membership condition. The start up fees should not include the cost for purchasing company's inventory or product. This is to eliminate the possibility of forcing new members to overload inventory.
- ii. a provision is made on inventory overloading during the tenancy of membership. Members are not required to buy large amount of inventory prior to selling. The unsold inventory must be returnable.
- ii. a provision is made with regards to computation of compensation plan. The computation of the compensation plan to salespeople must come totally from the sales of products or services and not from recruitment of downlines. There should be two types of bonus ratios, i.e, increasing and decreasing ratios. Increasing ratio of bonus plan is for personal sales only whereas decreasing ratio is calculated for group sales. This means that the higher the personal sales, the higher the bonus or rewards received. Thus sales effort is compensated fairly. For group sales which include downline sales, decreasing bonus ratios will be used, which means, the higher the group sales the lower the bonus ratio for the uplines. An example of the calculation are as follows:

Personal sales

100 - 3000PV

Bonus ratios

Bonus: 3% - 22%

Group sales

1000 - 200 000PV

Bonus ratios:

Bonus: 12% - 2%

This kind of computation can eliminate the dependency of uplines on recruitment rewards. The amount of group sales bonus received will be still a reasonable amount but not at the expense of the downlines. This bonus scheme will also encourage personal effort in selling.

B. Consumer Education

Although the government has recently step up consumer education through the media, the consumers at large still need to be educated in legitimate direct selling operation and should be aware of their rights and duties under the Direct Sales Act 1993. The following topics should be informed to the consumers through media advertisement:

- i. the difference between MLM and pyramid schemes, i.e: get rich quick scheme or other deceptive schemes. Malpractices of MLM companies such as phantom products, high start-up fees, inventory overloading and promises of high rewards without any selling effort.
- ii. Unethical and unprofessional selling tactics of direct sellers, e.g; lucky draw, reward promises with compulsory purchases, pressure selling and deposit-taking before product delivery.
- iii. The existence of ten days cooling-off period and written direct sales contract for products more than RM 300, where no goods shall be delivered until the cooling-off period has lapsed and a written contract shall be entered between the sellers and buyers.

C. Stringent enforcement

Enforcement body should be more efficient and effective. The law enacted would be ineffective without stringent enforcement. After the license is granted to direct selling company, systematic monitoring should be established to ensure a legitimate MLM operation according to the submitted marketing plan. Ideally, this monitoring should be conducted every quarterly. The Ministry should establish a close cooperation with the police department of criminal trade.

D. Consumers responsibilities and cooperation

Besides stringent enforcement, consumers also need to play their role in combating the pyramid schemes. Consumers need to report any illegal or malpractices of MLM companies to the appropriate authorities. There should be no fear among consumers in dispensing with information and must feel responsible to curb the menace.

CONCLUSION

Pyramid scams are serious offences which must be brought to proper justice. There is an urgent need for the enactment of a comprehensive anti-pyramid law and regulation as what has been long implemented in other countries. This paper has differentiates the legitimate MLM from the illegal pyramid schemes, gives example of different laws and regulations in other countries, suggests additional provisions for law-making, encourages active participation of the related authorities and stimulates dynamic cooperation from consumers.

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