# FTC's Framework For Assessing Direct Selling Cos. Is Flawed

By **Branko Jovanovic, Pablo Robles and Lia Bozzone** (May 9, 2023)

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Ever since the parties filed post-trial briefs in late November 2022, the proponents and opponents of direct selling have been anxiously awaiting U.S. District Judge Barbara Lynn's decision in Federal Trade Commission v. Neora LLC, in which the FTC alleged in the U.S. District Court for the Northern District of Texas that Neora operated an illegal pyramid scheme.

While the expert reports in this case remain under seal, a September 2021 paper published by a group of FTC economists called "Economics at the FTC: Multi-level Marketing and a Coal Joint Venture" provides a valuable description of an analytical framework that FTC consumer protection economists and Stacie Bosley may have used to assess the legality of Neora's business model.[1]

Distinguishing companies with legitimate direct selling compensation models from those that operate as pyramid schemes is not a straightforward endeavor.[2]

Although the FTC has created a body of literature through which it has communicated features of direct selling companies that it views as problematic, the exact criteria for establishing the differences between a legitimate direct selling company and one operating as a pyramid scheme remain unfortunately vague.[3]

While there seems to be a general understanding regarding what constitutes a pyramid scheme — at least in its simplest form, known as the chain letter[4] — to the best of our knowledge, there is no definition of what constitutes a legitimate direct selling company.[5]

Moreover, while the director of the FTC's Bureau of Consumer Protection acknowledged the existence of legitimate direct sellers at a seminar last year, to our knowledge, the FTC has never publicly identified any such companies.[6]

This lack of clarity makes it difficult to objectively assess a direct selling company's compensation model. A direct selling company under regulatory and/or legal scrutiny cannot be contrasted with a set of legitimate direct selling companies. Instead, the FTC compares the direct selling company with a pyramid scheme or chain letter.

In September 2021, a group of FTC economists published a paper providing a description of an analytical framework that FTC consumer protection economists use to assess direct selling organizations.

The three areas of assessment — analyses of compensation plan, promotional materials and distributor training; analyses of a simulated participation scenario; and analyses of distributor data — are legitimate areas of investigation not only for the FTC but for any direct selling company assessing the viability of their model.

Their implementation creates a framework that provides many false positives, resulting in the improper conclusion that a legitimate direct selling company is running a chain letter and offers a product with no economic value.

**The FTC Applies Unwarranted Assumptions in Conducting the Simulated Participation Scenario**

The simulated participation scenario has been, with some variations, used in a number of expert reports filed on behalf of the FTC.

This method uses direct sellers' compensation plans, income representation statements, and training materials to model a hypothetical representative distributor and its advancement through the ranks.

Assuming that all distributors behave as this representative distributor, the analysis aims to determine if the direct selling company could deliver on its promises of potential income under the most favorable circumstances for the distributors or whether the company is operating like a chain letter.

The analysis also helps the FTC understand the relative strength of the incentives implied by the direct seller's compensation structure and illustrates the magnitude of potential distributor losses.

The FTC is vague on how it implements the simulated participation scenario in practice and on the impact of their assumptions on the results.

**The FTC's Unwarranted Assumptions Should Be Replaced With Empirical Distributor Data**

Part 3 of the FTC's assessment acknowledges that distributor data on commissions, recruiting and purchasing behavior is important to the FTC's assessment. This more granular data allows the FTC to "look for patterns in distributors' behaviors and outcomes" and do so with an eye toward recruitment and likeness to a chain letter.

According to the "Economics" authors, the main categories of interest when looking at the distributor data are retail sales, commissions related to recruiting, turnover and survival rates, and strategic purchasing and threshold buying.[7]

But as explained below, the results of these analyses have little value unless they are compared to the benchmark established through analyses of the legitimate direct selling operations. Furthermore, they ignore the FTC's own guidance regarding documenting of retail sales and permissiveness of some level of personal consumption.

***Retail Sales***

The retail activity of distributors and their profitability is an important determinant of distributors' ability to earn significant income from retailing products alone and the demand for direct sellers' products.

As many direct selling companies often do not keep records of retail sales from their distributors, the "Economics" authors suggest analyzing distributors' wholesale purchases as an upper bound on the potential retail sales to final consumers.

The authors argue that assuming that distributors sell all their wholesale purchases at the suggested retail price, one could calculate gross retail profits and show that no distributor could have made the advertised level of earning by retailing alone, even under these generous assumptions.

This comparison, however, is irrelevant as the advertised earnings are based on the current organizational structure, which allows for commissions from downline sales.[8]

While the "Economics" authors point out that analyzing distributors' wholesale purchases does not necessarily reflect retail sales and consumer demand for the direct sellers' products, as some of it could reflect purchases unrelated to genuine demand — for example, qualifying for commissions — they make an important omission.

In their discussion of retail sales and genuine demand, they neglect to consider distributors' personal consumption of an MLM product. Any analysis of genuine demand that fails to consider distributors' personal consumption will necessarily underestimate genuine demand for the products.

***Commissions Related to Recruiting***

According to the "Economics" authors, distributor-level commission data can be used to evaluate the accuracy of representation statements[9] and the magnitude of recruitment-based earnings.[10]

The key utility of commission data is that they allow for visibility into the breakdown of revenues for the different bonuses and give insight into the general flow of money throughout an organization.

The "Economics" authors note that "[a] highly unequal distribution [of distributor payouts] is consistent with commission flows within a chain letter scheme and within direct sellers that have been found defective in the past." However, many legitimate businesses have a highly unequal payout structure.

Without a benchmark calculated based on the distributor-level data for legitimate direct sellers — or approximated using their income disclosure statement — which would provide an allowable level of inequality within a direct selling company, no conclusion can be drawn about the legitimacy of the company. The "Economics" authors provide no such benchmark.

***Turnover and Survival Rates***

Because a chain letter scheme relies on continuous geometric growth to continue making profits, the "Economics" authors further propose investigating how long distributors stay within the organization.

The "Economics" authors do not offer any guidance regarding the turnover rate or distributor tenure that would be consistent with a company operating as a legitimate direct selling company.

However, even in absence of the turnover rate based on the data from legitimate direct selling companies, the Direct Selling Association's 2019 and 2020 Growth and Outlook Survey report turnover rates of 43.3% in 2018[11] and 45.8% in 2019.[12]

These turnover rates are significantly lower compared to those in other industries where distributors could obtain comparable employment — for example, sales and service positions in the Retail Trade or in the Accommodation and Food Services sectors.[13]

***Strategic Purchasing and Threshold Buying***

The "Economics" authors appear to conduct the genuine demand analyses by identifying the volume potentially associated with strategic purchasing:

> Another area of particular interest is the size and timing of wholesale purchases, and what that timing may indicate with regard to the motivations for purchasing. If purchasing is driven primarily by the idiosyncrasies of retail demand that face each distributor, then it seems reasonable to expect little to no correlation in the amounts or timing of wholesale purchasing across distributors. On the other hand, if purchasing is driven by the desire to qualify for commissions, then one might expect that purchases would be made in the amounts and at the times needed to meet those qualification requirements.[14]

While some degree of strategic purchasing is expected, especially if the compensation plan allows for the qualification thresholds, a relatively low purchase volume clustering near these thresholds would indicate that distributors purchase to meet genuine demand as opposed to a desire to reach the threshold necessary to receive rewards.

The question is, what is the percentage of volume potentially associated with strategic purchasing that would amount to a concern that the investigated company's business model is inconsistent with a legitimate direct selling operation?

**Conclusion**

From an economic perspective, the keys to assessing whether a direct selling company operates as a legal organization should be determining whether there is genuine demand for the company's product, and if so, finding the percentage of retail sales that is acceptable.

It is therefore crucial to establish whether a direct seller's products provide real consumption value for consumers regardless of whether those consumers are also participants in the business opportunity.[15]

Assessing whether a company operates as a legitimate direct selling company or as an illegal pyramid scheme is ultimately an empirical question that cannot be answered without access to and analyses of distributor-level business intelligence data for the direct seller in question.

While a correct implementation of the analyses put forth by the "Economics" authors would be useful in accessing the viability of a direct seller's own compensation plan, the lack of appropriate benchmarks and the assumptions that are inconsistent with the distributor data limit their validity.

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***Disclosure: Jovanovic is the expert witness for direct seller Financial Education Services Inc. in FTC v. FES in the*** *U.S. District Court for the Eastern District of Michigan* ***.***

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[1] See Wosińska, M., Givens, D., Lau, Y., D. Smith, C. Tylor and B. Wallace (2021) "Economics at the FTC: Multi-level Marketing and a Coal Joint Venture," Review of Industrial Organization 59, pp. 629–650.

[2] According to the FTC, a direct selling company operates as a pyramid scheme if participants pay money to receive (i) the right to sell a product and (ii) the right to receive, in return for recruiting other participants into the program, rewards that are unrelated to the sale of product to ultimate users. See FTC vs. Koscot Interplanetary, Inc.

[3] Since 2014, the FTC has investigated Vemma Nutrition, Herbalife, and AdvoCare, and released Complaints and Stipulations that define aspects of each company's business model that it views unfavorably. Furthermore, the FTC has released guidance to inform consumers how they can detect and avoid participating in pyramids schemes. In addition, FTC economists have written academic papers on the subject (see i.e., See Wosińska et al.. and Stivers, A., Smith, D., Jin, G., "The Alchemy of a Pyramid: Transmutating Business Opportunity Into a Negative Sum Wealth Transfer" (December 3, 2019). Available at SSRN: https://ssrn.com/abstract=3497682 or http://dx.doi.org/10.2139/ssrn.3497682). FTC Directors have also given speeches to the Direct Selling Association outlining their views. For example, see the remarks delivered by Andrew Smith, Director of the FTC's Bureau of Consumer Protection, to the participants of the DSA Legal and Regulatory Seminar on October 8, 2019. The excerpts of Director Smith's speech are included in Plaintiffs' Original Verified Complaint for Declaratory Judgment, Preliminary, and Permanent Injunctive Relief, Nerium International and Jeffrey Olson v. Federal Trade Commission, Civil Action No. 1:19-cv-7189, The United States District Court for the Northern District of Illinois, Eastern Division, filed on November 1, 2019.

[4] In a chain letter scheme, participants pay a fee to obtain the right to recruit other participants. When recruits are found, they make the same payments to join, and a portion of their payments go to the original participant as a commission. The right to earn commissions may extend through multiple levels, with the original participant receiving commissions when her recruits, and her recruits' recruits, etc., bring in successive new cohorts. A chain letter thus operates as a transfer scheme, with money from new recruits flowing upward to (earlier) successful recruiters. See Wosińska et al.

[5] It appears that the existence of the multi-level marketing structure itself can be viewed as an indicator of a pyramid scheme. For example, one of the co-authors of Wosińska et al. paper characterized a pyramid scheme as "a recursive arrangement in which a participant pays on the payments made by others whom she recruits and convinces to chase the same opportunity," where "[t]he right to earn commissions may extend down many levels of what is known as a participant's 'downline.'"

[6] For example, during the Q&A portion of FTC Director Levine's remarks delivered at the DSA Legal and Regulatory Seminar, when asked, "Do you believe multi-level compensation structures are legitimate," Director Levine answered, "I think we've seen many legitimate multi levels." See https://www.ftc.gov/news-events/news/speeches/remarks-samuel-levine-direct-selling-association-legal-regulatory-seminar, and the Q&A transcript. However, he did not identify any existing MLMs as legitimate.

[7] Note that the distributor-level data analyses Wosińska et al. describe are rarely used in practice.

[8] Assuming that all distributors sell their wholesale purchases at 100% retail prices would generate significant commissions from distributors' downlines.

[9] Commission data can help validate statements regarding distributors' earnings. Furthermore, with these data, one can investigate claims made by individual distributors and determine the number of distributors with a similar experience.

[10] It does appear that Wosińska et al. are considering all commissions – not simply recruitment based rewards (i.e., a payment for simply recruiting a new individual).

[11] DSA 2019 Growth & Outlook Report, table "Detailed Survey Data Tabulations," p. 50.

[12] DSA 2020 Growth & Outlook Report, table "Detailed Survey Data Tabulations," p. 57.

[13] Turnover rates in the Retail Trade and Accommodation and Food Services sectors were 58% and 75% in 2018 and 58.4% and 78.9% in 2019, respectively. Job Openings and Labor Turnover, Bureau of Labor Statistics, March 15, 2019. Job Openings and Labor Turnover, Bureau of Labor Statistics, March 11, 2021.

[14] Wosińska et al. p. 639.

[15] One of the concerns that Wosińska et al. raise is if the "distributors [are] told that consuming the product at a high level is part of pursuing the business." Ideally, when assessing personal consumption, a good benchmark would be the purchasing level of customers who cannot recruit—preferred customers, who usually receive some sort of benefit for taking part in the program but who cannot earn rewards from other people or sell the product to others.