

We welcome our guest columnist David Van Sambeek. He is an attorney with the law firm [Wellman & Warren, LLP](#). David Van Sambeek is specialized in direct selling and network marketing. He has counseled companies and distributors and has launched direct selling companies in numerous countries. Van Sambeek shares his views and opinions with us on this most controversial issue.

Guest Post by David Van Sambeek

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### **Is This a Pyramid, a Ponzi, or a Legitimate MLM?**

Despite all media attention, I have noticed that many individuals, including those in the media, haven't grasped the differences between an illegal pyramid and a ponzi scheme (and NO, they are not the same thing). In this article, I will address the differences between ponzis, illegal pyramids, and multi-level marketing companies. So what's the difference...

#### **The Ponzi**

A Ponzi Scheme can be defined with one simple statement: "Robbing from Peter to pay Paul." These schemes vary somewhat, but usually promote and solicit for what appear to be real investment opportunities. Popular Ponzis use valuable assets to entice investors into parting with their money, e.g. gold mines, oil drilling, diamonds, and beach front real estate. Some ponzis may own the asset they are soliciting for investment, and others are simply promoting the opportunity to invest in an asset that doesn't even exist.

Until December 2008, the most infamous Ponzi (and the scheme's namesake) was started in Boston by an Italian immigrant named Charles Ponzi. In the 1920's, Mr. Ponzi discovered the Postal Reply Coupons system (also called International Reply Coupons) and developed a scheme that would eventually defraud investors out of millions of dollars. These coupons allowed an individual in one country to send mail (with the reply coupon enclosed) to a recipient in another country. The recipient could then exchange the enclosed coupon for a postage stamp to reply to the original letter. Each coupon was priced at the cost of postage in the country of purchase, but the coupons could be exchanged for stamps in the country where the coupon was redeemed. Mr. Ponzi realized that if there were differing rates for postage in different countries, one could potentially generate a profit. At the time the cost of postage in Italy was much lower than the cost of postage in the U.S. Ponzi's scheme was to purchase the coupons in Italy, at the prevailing lower rate, then exchange the coupons for the higher-priced US stamps, which he would sell at face value. Ponzi solicited his friends, family and business associates to invest in his new "business," offering a 50% return on investment in 45 days or 100% in 90 days.

Some of Ponzi's initial investors were paid off as promised, thus creating a frenzy among new, bigger investors. As investment money poured in, Ponzi saw that his original profit margins were too ambitious, and he began taking some of the new investors' money to repay previous investors. Eventually, Ponzi gave up on any

attempt to run his coupon business to generate legitimate returns, and the business became solely focused on taking in investment capital to pay off earlier investments.

Ponzi's scheme was destined to collapse. As you could imagine, investigators began to ask questions, and quickly learned that if Ponzi was running his business as he alleged, he would require more than 150,000,000 coupons to cover the investment capital that he had raised. Unfortunately, the US post office only had about 27,000 coupons in circulation. Soon after, Ponzi was arrested, his "business" collapsed, and millions of dollars of investor funds were lost.

Here you can see that the soul of a Ponzi Scheme is investment. The Ponzi mastermind comes up with some sort of new opportunity that pays an incredible rate of return. Regardless of the specific details of the plan, a Ponzi Scheme always has a mastermind who ends up taking from one investor to pay another.

In December 2008, a new master mind was crowned as the reigning king of all ponzi schemes. Bernard Madoff, former chairman of the NASDAQ and founder of Bernard L. Madoff Investment Securities, has been charged with orchestrating the largest investor fraud scheme ever. Investigators estimate that millions, if not billions, of investor funds were lost through Madoff's complex investment program.

For years, and possibly decades, Madoff perpetrated his fraud on countless investors promising returns of 10%-20% per year. These investors were drawn to Madoff because he was able to generate steady returns in up markets and down markets. Many potential investors actually begged Madoff to take their money and invest on their behalf. In many circles, having Bernard Madoff manage one's investments was the ultimate in prestige. Though Madoff managed hundreds of millions of dollars in assets (and possibly billions), few investors understood his plan or even knew where Madoff had invested their capital.

To all those that trusted Madoff with their money, it appeared as though Madoff was generating gains, but in reality he was paying investors with money that wasn't there. Bernard's downfall came with the stock market crash in late 2008 and the investors' demands to pull their cash.

Madoff had all the prerequisites of a successful Ponzi schemer. He had the credentials as a former chairman of the NASDAQ, a philanthropist, and a member of the most prestigious social clubs on the east coast. He didn't claim astronomical returns, just consistent increases year in and year out. Finally, he marketed himself as an investment genius who would turn down potential investors if he deemed them unworthy of this expertise. Madoff's self-marketing created investor frenzy and money came pouring in until his collapse and subsequent arrest.

### **The Illegal Pyramid**

In its most basic form, an illegal pyramid scheme exists where an individual is recruited by someone and pays for the opportunity to receive compensation solely from the recruitment of others. Take note that this article is using the term illegal pyramid. A common misunderstanding among the general public is that all businesses with a triangle or pyramid structure are illegal pyramids. This is not

true. Many Multi-Level Marketing (MLM) businesses have a legitimate network of distributors, selling a real product or service. Although their distributor structure may resemble a pyramid, this does not mean that the MLM company is operating in violation of the law. The company becomes an illegal pyramid when they pay distributors for the recruitment of others.

The classic illegal pyramid schemes are easy to identify, but some pyramids attempt to disguise their operation as legitimate multi-level marketing or network marketing opportunities. These disguised pyramids may have real products for sale, but often the products are only being sold to the pyramid participants at vastly inflated rates and there are no true retail sales to the general public.

During the late 90's, FutureNet came under government scrutiny as an illegal pyramid scheme. FutureNet's original "business opportunity" purportedly sold WebTV terminals to consumers. Individuals who wished to become FutureNet distributors could pay the applicable fee and receive the right to retail the WebTV terminals to the public. As with most disguised illegal pyramids, FutureNet's WebTV terminals were often sold at prices higher than other traditional retailers, like Sears or Radio Shack.

FutureNet's marketing opportunity utilized two different types of distributorships that an individual could purchase. The FutureNet "Consultant" distributorship cost approximately \$195 and an "Internet Consultant" distributorship upgrade cost an additional \$499-599. As a FutureNet Consultant, distributors were promised commissions on each product or service sale made by themselves or some other distributor in their downline ("downline" typically refers to those distributors that are enrolled under a distributor). Internet Consultants would receive the same commissions for product or service sales, but they would also receive compensation for selling additional distributorships. This is where FutureNet caught the eye of various federal regulators. Since the Internet Consultants were promised compensation of \$200-\$400 for each new Internet Consultant they recruit and an additional \$25-\$50 for each Internet Consultant that is recruited by someone in their downline. FutureNet was paying compensation for the recruitment of others. Moreover, FutureNet actually claimed that their distributors could receive substantial income for the rest of their lives from purchases made by new distributors in their downline, without any personal sales by the distributors themselves.

Once the Federal Trade Commission caught wind of the FutureNet "opportunity," the typical regulatory action was taken: a complaint was filed, a receiver was put into place, assets were frozen and a restraining order was imposed.

In the eyes of many participants, the FutureNet business looked like a legitimate MLM company, but illegal pyramids go to great lengths to conceal their true fraudulent intent. Innocent investors are easily lured into an illegal pyramid by a convincing sales pitch, promising an easy money-making opportunity. All illegal pyramids must inevitably collapse because of the size restraints associated with the pyramids exponential growth.

For example, let's say the Widget Company is an illegal pyramid. This company offers compensation solely for the recruitment of others. The company requires

participants to recruit five new participants before receiving commission on their recruitments. If every person that joins successfully recruits the 5 new participants the company growth will look like this: the first level will have one participant, the second level has 5 participants, the third level has 25, the fourth 125. By the time the eleventh level is reached there will be 48,828,125 participants in the level and a total of 51,269,531 participants in the entire pyramid. An additional 244,140,625 new participants will be required to go to the twelfth level. This means that once the twelfth level is reached almost every human being in the United States will be participating in the Widget Company's pyramid scheme. At some point every pyramid will be unable to attract new participants; and once there are no new participants the scheme will fall apart and many participants at the bottom of the pyramid will lose their investment.

### **What to Watch Out For...**

If you find yourself being solicited to invest directly into a new company that promises huge returns on your investment funds, do your due diligence. This company could be a Ponzi Scheme looking for the next round of funds to keep the Ponzi alive. On the other hand, if you are getting a sales pitch for a new MLM or money making opportunity, make sure you understand what the company is selling. Ask yourself: Are the products being sold at a fair price? How are the distributors being paid? Are there any real retail sales to customers outside of the company? The multi-level marketing industry is a great way for members of the public to start their own businesses selling products or services to consumers, but do your homework.

Remember, if it sounds too good to be true... well, you know the rest.