

Multilevel Mischief- A Myth or Reality

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Abstract: Multilevel Marketing is one of the fastest growing businesses in recent years. Several companies like Amway, Avon and Oriflame have employed this business model and have been successful. However, this model has given birth to many illegal and unethical business practices. Some people get rich through multilevel marketing, but the overwhelming majority fall by the wayside and that's not an accident. It's how exactly the way, the system works.

A large number of illegal pyramid schemes have been reported in the U.S. as a result of the growth of network marketing. The article discusses unethical network practices and the ways and means of operating a legitimate network marketing business.

Key world: Business mischeif

I. INTRODUCTION

Marketing educators need to be able to give students advice that will help them avoid unethical and/ or illegal business activities. However, as has been pointed out by Vander Nat and Keep (2002), some of these unethical/illegal marketing scams have many of the same characteristics as legitimate multilevel marketing organizations. On the legal side, things are not black and white. Sometimes it is a challenge for regulators to deal with companies that operate in the gray area.

There are practices that occur within multilevel marketing that, while not being technically illegal, may be ethically questionable. Also, most of those involved in recruiting representatives for multilevel marketing are independent contractors and not employees (Vander Nat and Keep 2002). Though a multilevel marketing organization itself may not be illegal or unethical, a particular recruiter may engage in unethical or illegal practices that are not acceptable by the standards of the company they represent. The current paper discusses the ethical and legal issues in multilevel marketing.

What Is Multilevel Marketing?

Multilevel marketing, also known as network marketing, refers to the practice of distributing, selling or supplying products and services through various levels of independent agents

(contractors, distributors etc.). These agents are paid commissions, bonuses, discounts, dividends or other forms of consideration in return for selling products or services and/or for recruiting other agents. The party who recruits other participants is the "upline" and the recruited party is the "downline". In MLMs uplines are paid bonuses or commissions on the sales made by their direct downlines and by those who are downlines of these direct downlines.

A company using this type of marketing is a MLM company. Avon, Amway, Equinox International, Mary Kay, NuSkin and Tupperware are all examples of MLM Companies. They may be legal or illegal. MLMs becomes both illegal and unethical if they operate as "pyramid" or "endless chain" schemes. (Reese, 1996).

Why network marketing appeals to businesses and individual as a business model?

For businesses, the obvious reason is the savings in terms of not having to hire full-time sales people for marketing their products. Most schemes recruit people through promises of unlimited rewards and financial freedom. They also circulate success stories of people who have worked as sales personnel and who now earn loads of money. In short, these schemes appeal to the greed of people. To most individuals, these schemes seem to be more beneficial than traditional retirement plans. This is however, far from the truth.

Pyramid Schemes and Why are they unethical?

Most network-marketing schemes however, eventually turn out to be pyramid schemes which are recruitment-driven rather than being retail-focused. Pyramid schemes ask individuals to make sizeable investments and in return grant them the license to recruit others. The investor makes money when his or her recruit gets other recruits into this network. These schemes are fraudulent and exploitative as people who enter the network at an early stage make money while those who enter late often lose money as there is a limit to the number of people who can be recruited into the network. Also, the compensation given to the investor comprises of the investment made by his or her 'downline' as they enter the network.

An example of a pyramid scheme is the Ponzi investment scam. Ponzi invested \$150 and asked a group of his friends to invest the same amount and promised

them a return of 50% in 3 months. He then asked a bigger set of friends to invest the same amount and used this investment to pay back the first set of friends with the said rate of return. Thrilled by the returns, the first set of friends enthusiastically promoted this idea and this scheme spread rapidly. Although the initial set of participants received handsome returns, the people who entered the network at a later stage lost money as there were no more people who were left to be recruited. This clearly is a recruitment-based scheme. The scheme looks the same even if a product is introduced to make it seem retail-focused.

Reason why these schemes are unethical is that they are recruitment centric rather than product centric. We can point two points which tells the principles for governing which corporates are ethically legitimate. First, a company primary focus should be on the marketing of non harmful products to consumers. It is not in public interest to encourage corporations to concentrate on money making per se. As it leads to exploitation of people. Second, a corporation's focus should be on growing through developing the market for their non harmful products, not on growth per se.

Businesses based on network marketing can also be operated by legal means. Since a network marketing scheme can easily transform into a fraudulent pyramid scheme, requirements need to be followed for the scheme to be declared as legitimate. A legitimate network marketing scheme must monitor the performance of its recruited agents to ensure retail sales and should charge low one-time fees for an individual to purchase the right to market the product. Also, it should have buy-back policies for situations when an agent is stuck with excess inventory when the market becomes over-saturated. These requirements are necessary but not sufficient to ensure a legitimate network marketing business.

There are several practices or behaviours that indicate that a company and its agents are not product centred but are recruitment centered schemes-i.e. schemes promising participation easy money to be paid out of the investments of other participants instead of legitimate sales revenue. These are as follows:

1. Focussing on growth through the recruitment of people instead of on sales of a non harmful product.
2. Requiring substantial upfront fees from those who are recruited to sell the product.
3. Pressuring recruits to purchase corporate products for their own consumption or to stockpile large amount of company's inventory.

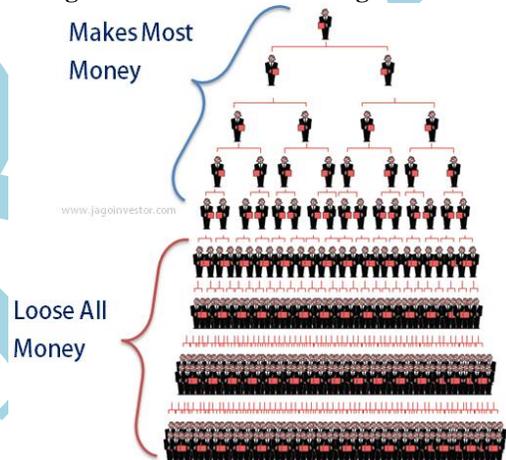
Pyramid schemes typically use these tactics. As they are recruitment centered and not in public interest, therefore are unethical.

II. CONDITIONS THAT MAKE MLMs LEGAL AND ETHICAL

A legitimate MLM company will pay the distributor in three basic ways:

- Commission on products you sell to your retail customers and buy yourself
- Commission on products your distributor sells to their own customers
- Commission on products they sell to their distributors, and so on down the line up to five to seven levels down from you. (Note, in order for a legitimate MLM to be financially viable, your compensation has to stop after a certain number of levels down from you) (Dunn 2008)

Diagram of MLM Marketing



In general the MLMs must do the following to be legitimate:

1. Monitor performance of independent agents to ensure that they really are making retail sales.
2. Have buy back policies in place so that independent contractors do not get stuck with excess product.
3. Charge low upfront fees for the right to market the MLM product
4. Make purchases of sales training materials completely voluntary (Koehn 2001)

This paper proposes five guidelines that anybody should follow for obtaining "marketing opportunity".

1 Where is the money coming from?

Legitimate multilevel marketing companies compensate their salespeople for selling products or services to ultimate consumers and not for simply recruiting people. This is the primary distinction between a legitimate direct selling opportunity and an illegal pyramid scheme. In the Webster v. Omnitrition case (9th Circuit 1996), this distinction was presented as the sine qua non of legitimate marketing.

In a pyramid scheme, members are paid for recruited not for recruiting not for selling products or services. When the people join the network they pay fees. We notice that no products are being moved. People make money by recruiting. This is illegal and any operation such as this must be absolutely avoided. As soon as identified by regulating officials, it will be shut down.

In a legal marketing opportunity no incentives are simply given for signing someone up. The only money that would be made would come from actually moving products once the person becomes involved. So, for example, say a person who signs up must pay \$100. For that \$100, the person gets some literature and product sample. In the cleanest case, neither this person's sponsor nor anyone in this person's line-of-sponsorship will receive any compensation on this \$100 sale. It is only when the person takes the marketing tools and uses them to move products that anyone gets compensated. That is the cleanest example. No money is made whatsoever when people are signed up. Money is made only when the person moves products.

The gray area is there because of inventory (for a discussion of inventory issues in multilevel marketing, see Croft, Cutts, and Mould 2000). To be effective in Direct Selling Companies, a person must carry inventory. In theory, this inventory will be sold to customers. However, it must be purchased before it is sold. The person's line of sponsorship legitimately deserves to be compensated for this inventory moving through the organization. It is difficult for a direct selling company to compensate independent salespeople when the inventory is sold to customers rather than when it is purchased for inventory. The only feasible time to compensate the sales representatives is when they purchase the inventory from the company.

This can create problem. Company may require only a small fee for a member to get started but the person is sold a huge quantity of inventory. Companies can slip into unethical issues where more money is being made from the inventories being sold to new recruits than is made from legitimate sales to bona fide customers. In the direct selling industry these are termed as "inventory loading" or "front-loading".

It must be noted that it may not even be the direct selling firm itself that is guilty of front-loading. It may be the people who are recruiting new representatives who are padding their pockets by encouraging these new recruits to purchase excess, unneeded inventory. However, legitimate firms do have policies in place to prevent front-loading.

So how can a legitimate direct selling firm combat front-loading? Actually there is a strong legal precedent for the best way to do so. A landmark case that established multilevel compensation plans as legitimate business enterprises was the FTC's review of Amway in 1979 (93 FTC 618). Two of the key policies that Amway had in

force that seemed to have swayed the review that Amway was a legitimate business practice were their buyback policy and their inventory sales policy. In particular, Amway had a policy that it would buy back unsold inventory. It also required that 70% of the inventory a distributor purchased in any given month must be sold in the month it was purchased. Thus, sponsors could not make money by loading up their distributors with inventory and distributors would not be stuck with a lot of unsold inventory. Legitimate MLMs have a buyback policy that is enforced. In the Direct Selling Association's code of ethics, member companies are required to repurchase, on commercially reasonable terms, inventory of members when the relationship is terminated. The avoidance of front loading is a legal as well as ethical responsibility to be fulfilled.

People should not join the company where the money is made from recruiting rather than movements of products.

2 Products sold in network are legal.

Are the products able to benefit the lives of the people who buy them or will they have to push low-value products on friends and family in order to receive compensation? A classic test for a pyramid scheme has been known as the Koscot test, named after the case of *Koscot v. FTC* (1975). The rule is that, to avoid being considered an illegal pyramid scheme, compensation must be based on sales to ultimate customers. Because of this, almost all the opportunities require the movement of some products.

People are required or forced to buy products that are over priced. They would have never even considered purchasing the product at the price being charged if it were not for the prospects of making money. They may even be encouraged to sell to relatives who are willing to support their business venture. Some classic examples of these schemes have occurred in phone cards, web space, and discount shopping cards. People were recruited into selling 100 minute long-distance phone cards for \$25. That amounts to \$0.25 a minute. The only apparent reason that someone would pay that much for long distance is that it enables them to become part of a compensation plan. By purchasing phone cards at that price, the buyer gets compensated by getting others to do the same. The same thing happened with web space.

People buy product not because of their inherent value. They are buying because they see the chance to make money or they are helping their friends or relatives to make money.

Note that this does not imply that the products need to be the lowest priced products on the market. Few multilevel marketing opportunities can consistently compete with that market position. The point was made earlier that multilevel marketing seems to fit a niche in the market for products that are either technologically advanced or have features that require significant explanation. Generally,

such cases are not low priced products. They are usually more expensive products offering unique benefits to consumers. The question is not whether they are the lowest priced products, but rather whether they are of sufficient value to justify the price.

3 What is the cost to stay in the business?

As a matter of fact money should not be involved to stay in the business. More is the money being involved; higher are the chances that money is made solely by recruiting people rather than selling products. There are three types of costs a person must consider when evaluating a multilevel marketing opportunity: registration, inventory, and training.

Almost all direct selling organizations require a registration fee to get involved. This fee covers the cost of maintaining an account and the necessary literature to get started. Because a high registration fee sends up a red flag to both regulators and prospects, registration fees are typically low. Even organizations that are ethically questionable tend to have low registration fees. They try to get their money through other means.

4 Amount of efforts required in the business

Students are often looking for ways to increase their money that will not take much time, which makes them easy targets for get-rich-quick schemes. They show up at a meeting where a lot of people are excited. A well dressed person shows up in a nice car and promises them that they can make a lot of money real quick with little work. The student looks at the peripheral cues (the clothing and the car) and concludes that the speaker is credible. The crowd causes the social proof phenomenon to operate (see Cialdini 1998).

The ironic part is that legitimate direct selling opportunities that use multilevel compensation plans are the antithesis of the get-rich-quick mentality. People who have developed long-term income this way have built this income slowly. Eventually, a direct selling business may generate a very large income but only after significant up-front work has been done. If students are looking for immediate money, they should get a job. Only those students with the entrepreneur mentality who are willing to do the work of slowly developing clients and teams of independent sales representatives are going to succeed in direct sales.

5 How old is the Company.

If a company is a legitimate direct selling company, a new recruit should be able to make money regardless of when he or she becomes involved. As Vander Nat and Keep (2002) warn, "The probability of success for new entrants in a pyramid scheme decreases with the size of the pyramid regardless of the actions taken (or not) by individual participants" (p. 141). Is it ethical to recruit people who need to get in on the ground floor to make

money? That means the quality of the opportunity diminishes over time and the person I am recruiting has a smaller chance of being successful than I do. A person is ill-advised to get involved with an opportunity where the newness of the company is a primary selling point.

III. CONCLUSION

Network marketing poses many ethical challenges as is evident from the above discussion. Employing such a business model and succeeding in that endeavour is difficult. MLMs cannot exist without recruiting a large number of agents in the network but in order to stay in the business they need to follow ethical practices. The current measures for protecting the distributors are not adequate enough due to many reasons. It is impractical to see how MLMs could exist if recruits did not approach to friends and relatives.

However, such marketing is swarming with ethical perils. If the people will join, not with the greed of making money quickly, if they will work hard enough, they will not be inclined to reflect about the means to this end. There are true success stories such as that of Amway which believe in ethical network marketing. However, ethical networking marketing is possible only if the people joining the network are aware of its fallacies.

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