
INVESTOR AWARENESS BULLETIN

A Guide To:
MULTI-LEVEL MARKETING PROGRAMS
and
A Warning About:
PYRAMID SCHEME FRAUDS



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MULTI-LEVEL SALES FRAUD

Legitimate multi-level marketing programs are common in Arizona. These programs emphasize the sale of a product or service. Pyramid sales schemes, however, are illegal. The schemes require the constant recruitment of new investors to fund individuals further up the pyramid. Separating the legal multi-level marketing programs from the illegal pyramid sales schemes often is difficult because pyramids may use a “product” or a “service” to enhance the appearance of legitimacy.

The Arizona Corporation Commission’s Securities Division has prepared this bulletin as an informational guide for the type of investigation that individuals should undertake before investing or participating in any multi-level marketing program.

These programs, like all investment and business ventures, have elements of risk. No particular multi-level marketing plan is guaranteed to be profitable, no matter how diligently an individual has investigated the program prior to investing. Investigation prior to investment, however, can reduce the risk of fraud.

WHAT IS A MULTI-LEVEL MARKETING PROGRAM?

A multi-level marketing program is a sales arrangement where participants receive income from the sale of a product or service and from the membership fees of subsequent participants who join the program.

A typical multi-level program might include some or all of the following revenue generation elements:

1. A membership fee charged each participant for joining the organization based upon inventory and promotional costs attributable to the participant's recruitment.
2. A commission paid by the organization for every sale of the company's products or services made by the selling participant.
3. A fee or "bonus" paid by the organization to each participant who either directly or indirectly recruits another individual to join.
4. A commission or "bonus" paid by the organization to each participant based upon the sales activities of other individuals who the participant has either directly or indirectly recruited to join the organization.

As an aid to understanding how a legitimate multi-level marketing program might operate, consider the following hypothetical example:

After listening to a group presentation concerning the merits of a company called S.D. Widgets, individual "X" decides to join its sales organization.

For a membership fee of \$1,000, "X" receives a membership card, the right to sell S.D. Widgets, company sales literature, and inventory. "X" also may recruit members for the S.C. Widgets sales force.

For each S.D. Widget that “X” sells, S.D. Widgets pays “X” a commission of \$200. For each S.D. Widget sold by a person “X” recruited to join the organization, “X” receives an additional bonus of \$50.

Finally, for each person that “X” convinces to join S.D. Widgets, “X” receives a bonus of \$25. If a person that “X” convinced to join S.D. Widgets convinces another individual to join, “X” receives an additional bonus of \$10.

As the example shows, the participants may receive commissions from four sources. The emphasis in a legitimate multi-level marketing program remains commissions derived from the sale of products or services.

WHAT IS A PYRAMID SALES SCHEME?

A pyramid scheme is one in which a promoter promises extraordinary profits based on an ever-expanding circle of new sales people. Thus, to join a pyramid program, the recruit gives money or some other consideration to an individual or organization. In return, the recruit will receive compensation derived **primarily** from the introduction of other person into the program. The sale of goods or services generates a small proportion, if any, of the income. Any person who establishes, operates, advertises, or promotes a pyramid scheme in Arizona is guilty of a felony.

In the example above, if the bulk of the compensation received by S.D. Widgets participants comes from

bonuses paid them for recruiting other people to join the organization, the scheme constitutes an illegal pyramid program.

Pyramid schemes are illegal because they are inherently fraudulent: they need an inexhaustible supply of new participants. Consequently, the number of individuals who would lose their money under such schemes becomes greater and greater as the scheme is allowed to spread. For example, in one Arizona scheme a promoter told potential investors that if they joined the scheme for \$1,000 their names would go on a membership chart. The \$1,000 would be divided as follows: \$500 would go to the person directly above the investor's name on the chart (the person who convinced the investor to join the organization), and \$500 would go to the person at the very top of the pyramid chart.

Under the scheme, each person who paid \$1,000 would start that person's own pyramid chart, thus placing his or her own name at the very top of the pyramid. The promoters explained that if that initial investor recruited 128 new individuals to join the scheme, the initial investor would make \$64,000.

What the promoters failed to tell investors in the scheme was that in order for the first 255 people on the pyramid chart to obtain \$64,000, 32,512 new investors would need to be recruited. For those 32,512 investors to each earn their \$64,000, more than 4 million new investors would be required, and for those 4 million investors to make their \$64,000 532 million new investors would be necessary!

As you can see, a pyramid scheme is nothing more than a mathematical con game. Do not allow yourself to become a victim of a pyramid scam.

ASK THE PROMOTERS TO PROVIDE YOU WITH FINANCIAL STATEMENTS

If the promoters cannot or will not provide you with financial documents concerning the program, do not invest. You cannot make a fully informed investment decision on the basis of the promoters' undocumented claims of potential profitability. Furthermore, such financial statements may allow you to determine if the marketing program is a legal multi-level marketing program, where most of the compensation is based upon the sale of products or services.

Also, ask the promoters to disclose how many participants have been signed up and in what geographic areas. You then should request actual figures on the profits earned by those participants and the source of those profits—product sales or recruitment commissions.

WHEN YOU INVEST, TAKE THE PROGRAM DOCUMENTS TO YOUR ACCOUNTANT, ATTORNEY, OR INVESTMENT ADVISER

Let an independent professional advise you as to whether or not you should invest in the program. Do not simply rely on the statements of the promoters profiting from your investment. Independent experts can determine whether this is the type of program for you, based upon the investment risks and your own financial condition.

They also may be able to determine the program's legitimacy.

CHECK OUT THE PROMOTERS OF THE MARKETING PROGRAM THOROUGHLY BEFORE GIVING THEM ANY OF YOUR MONEY!

Get the names and addresses of all of the principals associated with the multi-level marketing program. Ask them about their prior business experience and whether or not they have ever filed for bankruptcy. You would be amazed at the number of self-proclaimed "financial wizards" promoting "get-rich-quick" programs who have themselves previously filed for bankruptcy. Ask for bank references, professional references, and the names of current participants in the program, and then contact those people. Lastly, contact the Arizona Corporation Commission's Securities Division, your local Better Business Bureau, the Attorney General's office, and any other local consumer organizations or governmental agencies (especially the County Attorney's Office in your county) in order to determine whether any of the promoters have current legal problems or a criminal history.

FOR MORE INFORMATION

Unlike most economic activity, no new money is created in a pyramid sales scheme; those who get in early take money from those who join later. Thus, for everyone who makes money, some other person must lose money.

Such schemes may violate the Arizona Securities Act (administered by the Arizona Corporation Commission)

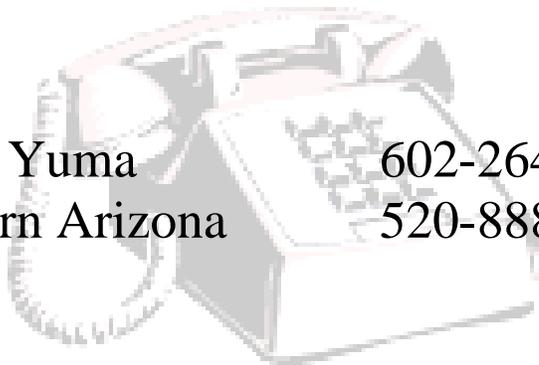
and the Consumer Fraud Act (enforced by the Attorney General's Office and your County Attorney's Office). State authorities treat pyramid schemes seriously and will take steps to combat such frauds by criminal or civil actions. If you have questions or concerns about a particular multi-level marketing program, call one of the numbers listed below.

IMPORTANT TELEPHONE NUMBERS

Arizona Corporation Commission's
Securities Division 602-542-4242
(Toll free within Arizona) 1-866-VERIFY-9

Arizona Attorney General's Office
Complaint & Information Center 602-542-5763

Better Business Bureau
Phoenix, Flagstaff, Yuma 602-264-1721
Tucson and Southern Arizona 520-888-5454



For additional information on how to investigate any offering before you invest, see “How Do I Verify Before I Buy Investments?” available in hard copy by visiting the Investor Info Center at www.azinvestor.gov and ordering online or by calling the Division's Investor Education Coordinator at **602-542-0428**.