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## MULTI-LEVEL MARKETING: COMPARATIVE PERSPECTIVES AND INDIAN DILEMMA

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**Abstract:** *This paper systematically introduces and analyses the concepts of Direct Selling, Multi-level Marketing and Illegal Ponzi Pyramid schemes. Multi-level marketing is a multi-million dollar global industry. There exists a thin line differentiating a valid Multi-level Marketing scheme and bogus Pyramid money circulation scheme. The Indian courts reading Multi-level Marketing schemes as synonymous with Money Circulation schemes defined in Prize Chits and Money Circulation (Prohibition) 1978 Act have held all Pyramid and Multi-level Marketing schemes illegal. The paper elucidates the position of law in India, as distinct from United States, and argues for the legalisation of Multi-level Marketing schemes.*

**Keywords:** *Direct Selling, Multi-level Marketing, Ponzi Pyramid Schemes, Money Circulation, Amway.*

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## INTRODUCTION

"Multi-level" or "network" marketing is a form of business that uses independent representatives to sell products or services to family, friends, and acquaintances. It is a business strategy, which involves participants at various levels, the level above getting returns through the perpetuation of the business at the levels below it. Basically, it works on the principle of multiplication duplication, or geometrical increase of the retail or sale activity, as the case may be. The survival of the system, thus, depends on the chain of recruiting at lower functional levels, which sustains the levels above it. A representative earns commissions from retail sales he or she makes, and also from retail sales made by other people that he or she recruits. While on the one hand it could arguably be a successful marketing strategy, which involves creating an increasing market based on increasing outreach, it has underlying concerns of being an unfair trade practice, long-term unsustainability and the uneven distribution of the benefits and costs in the event of the success or failure of the strategy. The present paper differentiates between valid multi-level marketing and other schemes and analyses the position in India and United States. The need for a specific legislation on the subject has been argued in course of the paper.

## MLM AND OTHER PONZI/PYRAMID SCHEMES

### **Direct Marketing**

Direct selling or direct marketing in simple words is "Face to Face marketing" away from a retail store<sup>1</sup>. Direct marketing is not a new concept. It's existence dates back to millennia. Hawkers, peddlers, caravans were part of an ancient tradition of direct selling. Though being an oldest method of commercial distribution, Direct Selling is often misunderstood. The definitions of direct marketing are nebulous and broad<sup>2</sup>.

Baker<sup>3</sup>, Hart and Stapelton<sup>4</sup> distinguish direct marketing by the absence of "Middle Men". Some confuse Telemarketing with Direct marketing, Benette<sup>5</sup> terms direct selling as a

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<sup>1</sup> Robert A. Peterson and Thomas R. Wotruba., What Is Direct Selling? Definition, Perspectives, and Research Agenda, *The Journal of Personal Selling & Sales Management*, Vol. XVI, No. 4, 1996, pp.1-16.

<sup>2</sup> *Supra* 1.

<sup>3</sup> Baker, Michael J, *Macmillan Dictionary of Marketing and Advertising*, New York, Nichols Publishing, 1984; Baron, Davies and Swindly., *Dictionary of Retailing*, Macmillan Press, London., 1991.

<sup>4</sup> Hart, Norman A. and John Stapleton, *The Marketing Dictionary*, 4th ed., Oxford, England. 1992.

<sup>5</sup> Bennett, Peter D., *Dictionary of Marketing Terms*, Chicago: American Marketing Association, 1988.



“Marketing approach” whereas, Clemente calls it a “Sales approach.”<sup>6</sup> Paul Herbig, Rama Yelkurm<sup>7</sup> identify Direct Marketing with typically two characteristics:

- Intermediaries are bypassed.
- The salesperson is either an employee or contracted to market on behalf of the company.

Going by this definition, it is apparent that every company has or uses a direct marketing component.

Direct Selling Organizations can be of various types; multi-level format, network, hierarchal structure or the organization can be flat.

### **Multi-level Marketing**

Multi-level marketing (MLM) is a method of distributing products or services in which consumers down the hat of distributors. As said earlier, it involves face to face selling in its simplest form.<sup>8</sup> It involves a method of doing business in which traditional intermediaries are bypassed<sup>9</sup>. The most popular form of Direct Selling is MLM.

MLM has two distinguishing features namely:<sup>10</sup>

- The presence of sponsorship/friendly lines that create financial ties between distributors; these ties become basis for intense societal relations. Suppose X recruits Y, X becomes Y's *sponsor* and immediate *upline*. Y recruits Z, T, U who become X's *downline*. Z, T and U as personal recruits of Y, are Y's *frontline*. People recruited by same sponsor Y are on same *level* and members of the same *generation* (Z, T, and U). Sponsorship lines seem like family trees and in fact are often called *genealogies*. Suppose persons S and Y are both recruited/sponsored by X. However, Y has been far more aggressive, heavily recruiting, than S; Y will become more financially successful than S even though they are on the same plane/level and had entered the business together. The higher the sales a group generates, the higher would be the amount of commission received by X.
- There are numerous Recognition Levels. A complete series of honorific titles and

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<sup>6</sup> Clemente, Mark N., *The Marketing Glossary*, New York: American Management Association, 1992

<sup>7</sup> Paul Herbig & Rama Yelkurm, A Review of the Multilevel Marketing Phenomenon, *Journal of Marketing Channels*, Vol. 6(1) 1997, pp.17-33.

<sup>8</sup> *Supra* 1.

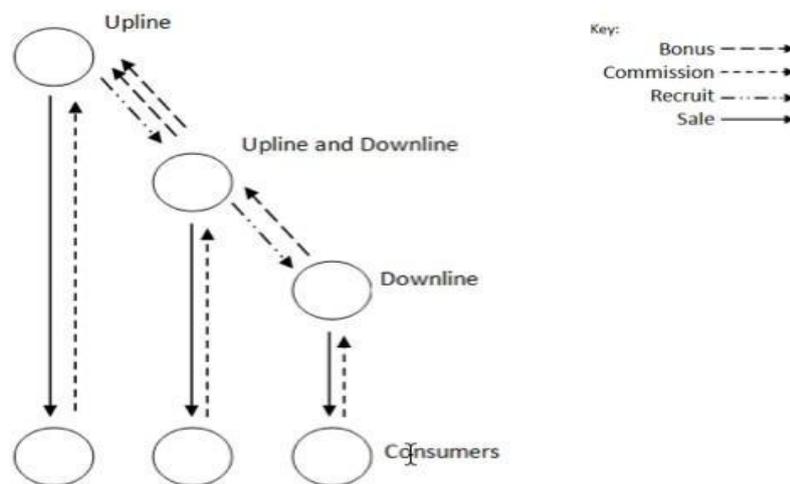
<sup>9</sup> *Supra* 3.

<sup>10</sup> *Supra* 1.

perks are available. For example, Amway has various levels of recognition, each with its own unique title and perks. One begins as a basic distributor, works his/her way up through the ranks from Silver Producer to Gold Distributor to Platinum Direct Distributor to Ruby Direct Distributor climbing up the ladder to Crown Direct Distributor to Crown Ambassador Direct Distributor. But, none of the levels and titles is Authoritative. In MLM schemes, authority basically does not exist.

Kohen<sup>11</sup> describes the sponsored who recruits another participant as an “upline” of the recruit. The recruited becomes the “downline” of the recruiter. The up-lines are paid commissions and bonuses on the sales made by their respective downline members. The company using multi-level marketing method is a MLM company. The MLM Company can be a firm, an individual, corporation or other business entity. Oriflame, Amway, Mary Kay, Tupperware, Modicare are few examples of MLM entities.

Figure 1: A visual model of the operations of an MLM



Source: Jennifer Beasley, Distinguishing Pyramid Schemes and Multilevel Marketing, 2012.

The four advantages of MLM are:

- Word of mouth sales means savings on marketing and advertising costs.
- Exclusivity of its own products means the company can charge more than similar products in stores.
- The technique develops loyal customers who enjoy buying from other people they know; and

<sup>11</sup> Daryl Kohen, *Ethical Issues Connected with Multi-Level Marketing Schemes*, Kluwer Academic Publishers.,2001, pp 153-160.



- The system can motivate sales people with higher commissions on increased sales.<sup>12</sup>
- In the 1990s, MLMs expanded at an ever increasing rate. There were estimates of more than 300 MLM's selling nutritional products alone. Environ International had more than 7000 distributors only after a year of operation. Freelif International sold vitamin supplements and had more than 13,000 distributors and a revenue of over \$10 million The Direct Selling Association estimated it as a significant business in 44 countries worldwide with global retail sales of \$68 billion from over 17 million distributors. However, MLM schemes are often linked with Ponzi Pyramid schemes. There exists a thin line between the two and hence, there is a need to delineate MLM schemes with Ponzi Pyramid Schemes.

### **Pyramid Schemes**

Pyramid schemes are plans which "concentrate on the commissions you could earn just for recruiting new distributors" and which "generally ignore the marketing and selling of products and services". An example of definitions used by state regulators is the following:

"Pyramid scheme" means any sales device or plan under which a person gives consideration to another person in exchange for compensation or the right to receive compensation which is derived primarily from the introduction of other persons into the sales device or plan rather than from the sale of goods, services, or other property<sup>13</sup>.

Pyramid marketing schemes commonly deceive consumers with the lure of huge potential incomes<sup>14</sup>. Pyramid means a multi-layered network of subscribers to a Money Circulation Scheme formed by subscribers enrolling one or more subscribers in order to receive any quick or easy money benefit, directly or indirectly, as a result of enrolment. Pyramid marketing schemes can be mainly classified into the following, viz. :

### **Naked Pyramid Scheme**

Naked Pyramid Scheme (NPS) refers to a blatant pyramid scheme that is easy to detect because no products are offered, merely a participation fee or "investment." Chain letters work on the same principle. A continuous chain of "participants" or "investors" is recruited, in which each pays a fee to participate and receives money by recruiting others into the system. Naked Pyramid schemes are nothing but a money circulation scheme between

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<sup>12</sup> Bernstein, Ronald A., *Successful Direct Selling*, Engelwood Cliff, NJ., Prentice-Hall., 1994.

<sup>13</sup> "Pyramid Schemes," Div. of Consumer Protection, State of Utah, United States; Similar to definitions used in other States.

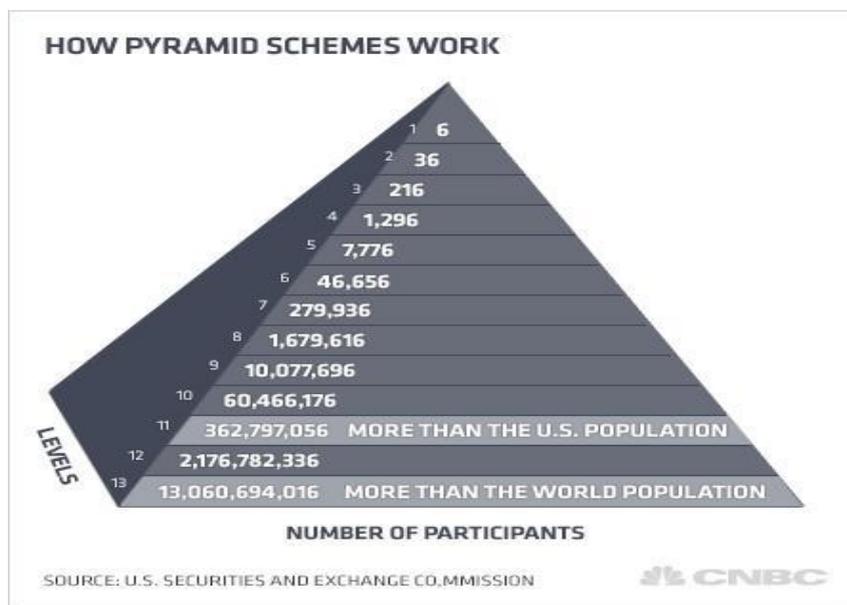
<sup>14</sup> Pareja, Sergio, Sales Gone Wild: Will the FTC's Business Opportunity Rule Put an End to Pyramid Marketing Schemes? 39 *McGeorge Law Review* 84 (2008).



multi layered network of individuals. There does not exist any product.

A *product-based pyramid scheme* (PPS) is a pyramid scheme that in most respects resembles a naked pyramid scheme, except that products are purchased by distributors, primarily for resale. Such product purchases, often combined with other incentives, qualifies distributors for commissions in ascending levels in the distributor hierarchy.

A pyramid scheme works well for only a very small number of people at the top of the pyramid. Geometric Progression rules the math behind the Pyramid scheme. The Pyramid scheme becomes so wide that it is hard to sustain.



### **Ponzi Schemes**

A Ponzi scheme is closely related to a pyramid because it revolves around continuous recruiting; but in a Ponzi scheme the promoter generally has no product to sell and pays no commission to investors who recruit new "members." The history of Ponzi schemes can be related to Charles Ponzi who organized the Securities Exchange Company in Boston in 1919 and issued promissory notes payable in 90 days with 50 percent interest and kicked off a storm of investment frenzy which duped just about everyone, including politicians, law enforcement officers, and reporters. He tricked speculators by using the money of new investors to pay old investors huge 'profits'. Ponzi took in over \$15 million from this and other schemes before his house of cards collapsed, causing losses for thousands and leading to jail time and his eventual deportation to Italy in 1934<sup>15</sup>. Ponzi and pyramid schemes do

<sup>15</sup> The Nature and History of Ponzi Schemes, Available at <http://www.sjsu.edu/faculty/watkins/ponzi.htm> last



have similarities. Both are fraudulent arrangements for the receipt and redistribution of money with early participants winning and those who enter later losing. In each case, it is essential to continue the game with new infusions of money, for if the play ends and there is an accounting, there must be a deficit and cries of pain. But where Ponzi promised a definite return on one's investment-albeit a huge one-the possibilities in a pyramid were almost limitless as new subscribers feed those who joined before. Furthermore, the machinery of the pyramid is always explained and is, in fact, one of its alluring features, whereas Ponzi plans invariably refer obscurely to exotic investments that are really irrelevant and usually non-existent. In some cases, the pyramid seems almost acceptable socially, as in the cases of chain letters or distributorship plans, but there has never been any question about the vice of Ponzi schemes<sup>16</sup>.

The differences that exist between a MLM scheme and a Pyramid Scheme may be represented as follows<sup>17</sup>.

MLM Schemes	Fraudulent Pyramid Schemes
Legitimate MLM schemes are operated away from retail stores. There is a valid/certified product or service being marketed.	'Pyramid' means a multi layered network of subscribers to a Money Circulation Scheme formed by subscribers enrolling one or more subscribers in order to receive any quick or easy money benefit, directly or indirectly, as a result of enrolment.
They offer genuine business opportunities.	Pyramid schemes involve products which are cheap to produce and have no established market value. New miracle products, exotic cures, mattresses, online surveys are some of these.
The cost of entry is reasonable.	Cost of entry is extremely high.
Plans and schemes are performance based	Just consist of a plain naked pyramid scheme.
Returns are dependent on the marketing skills, motivation and the time invested by the distributor.	Returns are un-proportional and are quick money making schemes.
Bonuses are based on sale of products	Incentives and bonuses are recruitment based.
Enrolment is usually not compulsory.	Enrolment is compulsory.
Business is by sale of products or by services provided.	Business is only primarily based on recruitment.

visited on 20th April 2014.

<sup>16</sup> Joseph Bullgatz, *Ponzi Schemes, Invaders From Mars, And More Extraordinary Popular Delusions*. New York: Harmony Books, 1992, p. 36. See also, Jon M. Taylor., *When Should an MLM or Network Marketing Program Be Considered an Illegal Pyramid Scheme?*, Ph.D. Consumer Awareness Institute, 2000.

<sup>17</sup> The Indian Direct Selling Industry, *Annual Survey*, PHD Chamber Of Commerce and Industry, 2012-13.



Products have 100% buy-back guarantees to ensure protection of end-consumer as per company policy.	No buy-back facilities.
Products are supplied to meet genuine demand and direct sellers are encouraged to hold minimal inventory and replenish as and when need arises.	“Front loading” is encouraged. Therefore, products are thrust upon the direct sellers, irrespective of their ability to sell the product and the actual market demand.
Every sales person had to abide by the Industry Model Code of Ethics.	No Code of Ethics.

## LEGALITY OF MLM- A COMPARATIVE PERSPECTIVE

### *United States of America*

MLM/Pyramid schemes have existed since 1919. An Independent Congress Agency, the Federal Trade Commission, was established in the year 1914 to ensure that the free markets work. The FTC is the leading federal administrative agency force behind protecting consumers from fraudulent MLM, pyramid schemes and the like. FTC defines MLM as follows<sup>18</sup>:

- Any marketing program in which participants pay money to the program promoter in return for which the participants obtain the right to recruit additional participants, or to have additional participants placed by the promoter or any other person into the program participant’s downline, tree, cooperative, income center, or other similar program grouping;
- Sell goods or services;
- Receive payment or other compensation; provided that: (a) the payments received by each program participant are derived primarily from retail sales of goods or services, and not from recruiting additional participants nor having additional participants placed into the program participant’s downline, tree, cooperative, income center, or other similar program grouping, and (b) the marketing program has instituted and enforced rules to ensure that it is not a plan in which participants earn profits primarily by the recruiting of additional participants rather than retail.

Pyramid scheme plans (as currently defined by the FTC and in some state legislations) concentrate on the commissions one could earn just for recruiting new distributors and

<sup>18</sup> See, FTC Consumer Alert, Lotion and Potions- The Bottomline about Multilevel Marketing Plans, FTC, January, 2000. Available at <http://www.consumer.ftc.gov/articles/0065-multilevel-marketing>. Last visited on 17<sup>th</sup> April 2014.



which generally ignore the marketing and selling of products and services. An example of definitions used by state regulators is the following:

“Pyramid scheme” means any sales device or plan under which a person gives consideration to another person in exchange for compensation or the right to receive compensation which is derived primarily from the introduction of other persons into the sales device or plan rather than from the sale of goods, services, or other property<sup>19</sup>.

The FTC Act broadly prohibits “unfair or deceptive acts or practices in or affecting commerce”<sup>20</sup>. The essential features of an illegal pyramid scheme as defined by the FTC are schemes characterized by the payment by participants 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 participants into the program rewards which are unrelated to sale of the product to ultimate users. As is apparent, the presence of this second element, recruitment with rewards unrelated to product sales, is nothing more than an elaborate chain letter device<sup>21</sup> in which individuals who pay a valuable consideration with the expectation of recouping it to some degree via recruitment are bound to be disappointed.<sup>22</sup> In US, the Federal Trade Commission is just one among many agencies that have the authority to file suit to stop this type of fraud<sup>23</sup>. The Securities and Exchange Commission also pursues these schemes, obtaining injunctions against so-called “financial distribution networks” which in fact sell unregistered “securities”.

The U.S. Department of Justice, in collaboration with investigative agencies like the FBI and the U.S. Postal Inspection Service, prosecutes pyramid schemes criminally for mail fraud, securities fraud, tax fraud, and money laundering<sup>24</sup>.

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<sup>19</sup> FTC Consumer Alert, December 1996.

<sup>20</sup> 15 U.S.C. § 45 (1997) (this is technically “Section 5” of the FTC Act, but for convenience, this article will refer to Section 5 as the “FTC Act”).

<sup>21</sup> In a chain letter scheme a person is asked to send one dollar to somebody several levels higher and to forward the letter to several other people with the same instructions. For example, the letter might say, “Send one dollar to the person seven levels above you and forward this letter to ten people with instructions to send one dollar to the person seven levels above them. If all people who receive this letter pay the one dollar, you will receive one million dollars for your small one dollar investment.” The way this is computed is by multiplying one dollar by ten (level two) by ten (level three) by ten (level four) by ten (level five) by ten (level six) by ten (level seven). People who receive these letters often picture themselves near the top of the pyramid and assume that there are one million people who could and would make the one dollar payment.

<sup>22</sup> *In re Koscot Interplanetary, Inc.*, 86 F.T.C. 1106, 1180 (1975), *Turner v. FTC* 580 F.2d 701 (D.C.Cir. 1978).

<sup>23</sup> Adam Epstein, Multi-level marketing and its brethren: the legal and regulatory environment in the down economy, 12 *Atlantic Law Journal* 91 (2010).

<sup>24</sup> See e.g. *U.S. v. Crowe*, 4:95CR-13-C (W.D. Ky. 1995) (charging an alleged pyramid promoters with mail fraud under 18 U.S.C. § 1341).



In the landmark Amway decision<sup>25</sup>, the Court ruled that Amway was not a pyramid scheme since it adopted measures which did not amount to an illegal pyramid scheme. The distributors had to sell 70% of the previously purchased products before reordering. Further, there were “buy-back rule”, initial investment rule and other measures which did not equal Amway to an illegal business activity.<sup>26</sup> 20 years later in *Gold Unlimited, Inc.* case, the majority upheld the criminal conviction for a corporate *Get Rich Quick* scheme, which focused more on pyramiding and less on retailing<sup>27</sup>. Similarly, in *Webster v. Omnitrition, Int'l Inc.*,<sup>28</sup> the Ninth Circuit Court of Appeals, citing Amway as well, noted that pyramid schemes are said to be inherently fraudulent<sup>29</sup>.

Since the Amway decision in 1979 and its progeny, factors used to determine whether a business is a legitimate MLM or an illegitimate pyramid scheme, include:

- Products have no real world marketplace and that the marketing program is a cover for a scam;
- Products are sold at inflated prices;
- That there is a substantial front loading or buy-in qualification for the membership;
- That there is an initial cash investment over \$500;
- That members must purchase ancillary products or services to remain in the program;
- Whether the MLM has an inventory repurchase policy in the event that the member leaves the MLM;
- That the emphasis is, or has become, more focused on rewards for recruiting than selling goods or services; and
- Whether there are misrepresentations related to membership earnings claims or outright misrepresentations related to potential income by the member<sup>30</sup>.

Though, there is no federal anti-pyramid statute in the United States, but all states have

<sup>25</sup> *In re Amway*, 93 FTC 618 (1979).

<sup>26</sup> Known as the-Amway safeguards, See JEFFREY A. BABENER, *Network Marketing and the Law*, 57 23, 35 (1997); See also, Pareja, supra note 2, at 95.

<sup>27</sup> *U.S. v. Gold Unlimited, Inc.*, 77 F.3d 472, 475 (6th Cir. 1999).

<sup>28</sup> *Webster v. Omnitrition Int'l, Inc.*, 79 F.3d 776 (9th Cir 1996); See also, Pareja, supra n. 14, at 101- 02.

<sup>29</sup> *In re Koscot Interplanetary, Inc.*, 86 F.T.C. 1106, 1181(1975)

<sup>30</sup> See also, Stephen Barrett, Casewatch, Quixtar Facing Class Action Lawsuit, [http://www.casewatch.org/civil/amway/class\\_action\\_complaint.shtml](http://www.casewatch.org/civil/amway/class_action_complaint.shtml) (noting that Pyramid Scheme Alert's Robert Fitz Patrick submitted a declaration asserting that in 2001.



provisions banning illegal Pyramid or Chain schemes<sup>31</sup>. However, the statutes do not declare MLM *per se* as prohibited. But since *the Amway* case, there still exists doubt and confusion with regard to MLM schemes in light of the new Herbalife case<sup>32</sup>, wherein a petition has been filed for enforcement and to promulgate trade regulation concerning unfair and deceptive acts and practices in the multi-level marketing industry<sup>33</sup>.

### **India**

The Indian story of Direct Selling has had a remarkable growth over the years. The direct selling industry has grown at 27% during 2010-11, expanding from INR 41200 million in 2009-10 to INR 52294 million in 2010-11. The robust growth in the segment has been contributed by 28% growth in organized and 17% growth in the unorganized segments of the industry during 2010-11. The industry grew at 24% during 2009-10, 17% during 2008-09, 13% during 2007-08 and 9% during 2006-07<sup>34</sup>.

Oriflame International in 1995 was the first multinational to open direct marketing operations in India. Avon India along with Tupperware followed the footsteps of Oriflame and opened their shop during late 1996. Modicare, the first home grown MLM major, started business in 1996. Though MLM is a relatively new entrant, Pyramid schemes have existed in India<sup>35</sup>. There have been numerous pyramid scams which have been involved in fraud and money circulation. Goldquest, a particularly successful pyramid scheme, is stated to have collected about INR 300 crores in India, with the majority of members hailing from AP. Singapore-based SpeakAsia Online Limited<sup>36</sup> is supposed to have swindled INR 2276 crores with more than 24 lakh investors. The MDs of QuestNet and Amway<sup>37</sup> were arrested on charges of Cheating, though there exists major differences between the working, structure and operations of these two entities. The Legislature has failed to enact laws to

<sup>31</sup> See, § 646.609 Oregon Unlawful Trade Practices Act; Minnesota Statute, Section 325F.69.

<sup>32</sup> See, Douglas M. Brooks, Robert Fitzpatrick and Bruce Craig, *The Pyramid Scheme Industry: Examining Some Legal and Economic Aspects of Multi-Level Marketing* (2014) Available at [http://www.mlmmwatch.org/11Legal/pyramid\\_scheme\\_industry.pdf](http://www.mlmmwatch.org/11Legal/pyramid_scheme_industry.pdf) last visited on 17th April 2014.

<sup>33</sup> <http://pyramidschemealert.org/wordpress/wp-content/uploads/2014/02/Petition-of-Ad-Hoc-Coalition-Concerning-MLM-Final.pdf>. Last visited 8th April 2014.

<sup>34</sup> Rajan Saxena, *Marketing Management*, Tata McGraw-Hill Publishing Company Ltd., 3<sup>rd</sup> ed., 2006.

<sup>35</sup> *Supra* n.34; S. Ananth, Harmless Fraud : Pyramid Schemes in Andhra Pradesh., *The Urban Frontier*, p. 471-83, 2007.

<sup>36</sup> Available at <http://www.hindustantimes.com/india-news/inside-speakasia-ponzi-scam-how-2-4-million-indians-lost-savings/article1-1167405.aspx>, last visited 18 April 2014.

<sup>37</sup> Available at <http://www.thehindu.com/news/cities/Hyderabad/malaysian-woman-held-wanted-in-cheating-cases-detained-at-chennai-airport/article5707005.ece>, <http://www.thehindu.com/business/Industry/amway-india-chairman-2-directors-arrested/article4756688.ece>, last visited 18 April 2014.



differentiate between valid and fraudulent Direct Selling schemes. The courts have also failed to differentiate between valid MLM and other Pyramid and Ponzi schemes under The Prize Chits and Money Circulation Schemes (Banning) Act, 1978 (The Act).

Section 2(c) of the Act defines "money circulation scheme" as: any scheme, by whatever name called, for the making of quick or easy money, or for the receipt of any money or valuable thing as the consideration for a promise to pay money, on any event or contingency relative or applicable to the enrolment of members into the scheme, whether or not such money or thing is derived from the entrance money of the members of such scheme or periodical subscriptions.

Section 3 of the Act imposes prohibition on promotion or conduct of any prize chit or money circulation scheme or enrolment as a member to any such chit or scheme or participation in it otherwise or receive or remit any money in pursuance of any chit or scheme. Further, the penal provisions elucidated under Section 4 of the Act state that whoever contravenes the provisions of Section 3 shall be punishable with imprisonment for a term which may extend to three years or with fine which may extend to Rs. 5,000/- or with both.

If a person in promotion or conduct of any prize chit or money circulation involves himself in the acts enumerated in Section 5(a) to (f) of the Act, he shall be punishable with imprisonment for a term which may extend to three years or fine which may extend to Rs. 3,000/- or both. A minimum sentence of one year and a fine of Rs. 1,000/- is also prescribed in respect of those offences. Under Section 6 of the Act, where an offence has been committed by a company every person who at the time of the commission of offence was in-charge of and was responsible to the company for the conduct of the business of the company as well as the company shall be deemed to be guilty of the offence.

Pyramid and MLM schemes may also attract Section 420 of the Indian Penal Code 1860 which describes the offence of cheating. The Supreme Court in *Kuriachan Chacko and Ors v. State of Kerala*<sup>38</sup> opined that if there exists an intention to lure public towards quick and easy money making schemes and in the absence of such representation, the victims would not have invested, then, Section 420 IPC 1860 is attracted.

The Indian Courts have also decided few cases on the issue of Prize, Chit and Money

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<sup>38</sup> Manu/SC/2852/2008.



Circulation. In *State of Bengal v. Swapan Kr. Guha*<sup>39</sup>, Sanchita Investments, a registered partnership firm with a share capital of INR 7,000/- started its business in finance and investments. On a report given by the Commercial Tax Officer concerned, FIR was registered with the allegations that the firm had been offering 48 per cent interest which was later reduced to 36 per cent and that, therefore, it was involved in money circulation scheme for making of quick or easy money. The firm and its partners filed two writ petitions in the Calcutta High Court under Article 226 of the Constitution of India for quashing the FIR. The High Court allowed the writ petition and quashed the FIR and the State of West Bengal filed appeal by Special Leave in the Supreme Court. In this case, the Supreme Court made an in-depth analysis of Section 2(c) of the Act and interpreted that any and every activity for the making of quick or easy money by itself would not fall within Clause (c) of Section 2 of the Act and that making of such quick or easy money must depend upon any event or contingency relative or applicable to the enrolment of members into the scheme. It was held that to hold a person guilty of an offence under Section 4 read with Section 3 and Section 2(c) of the Act, the following were required:

- There must be a scheme;
- There must be members of the scheme;
- The scheme must be for the making of quick or easy money on any event or contingency relative or applicable to the enrolment of members into the scheme or there must be a scheme for the receipt of any money or valuable thing as the consideration for a promise to pay money on any event or contingency relative or applicable to the enrolment of members into the scheme;
- The event of contingency relative or applicable to the enrolment of members into the scheme will however not be in any way affected by the fact whether or not such money or thing is derived from the entrance money of the members of such scheme or periodical subscription.

The learned Judge held that the words “on any event or contingency relative or applicable to the enrolments of members into the scheme whether or not such money or thing is derived from the entrance money of the members of such scheme or periodical subscription” applies to, (a) quick or easy money, and (b) for the receipt of any money or

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<sup>39</sup> Manu/SC/0120/1982.



valuable thing as consideration for promise to pay money and not merely to the latter. Having so analysed the definition of "money circulation scheme", the Supreme Court applied the said definition to the allegations made in the FIR and negated the contention that the scheme attracted the provisions of Section 2(c) of the Act.

In *M/S Apple FMCG Marketing Pvt. Ltd. v. Union of India*<sup>40</sup>, the petitioner prayed for a writ of declaration that selling products through the Network Marketing System is legal and not in contravention of the provisions of the Prize Chits and Money Circulation Schemes (Banning) Act, 1978 or any other law.

M/s Apple FMCG Marketing Private Limited was a company registered under the Companies Act, 1956. It marketed various products including shampoo, tea, coffee powder, after-shave lotion, etc. under the brand-name 'Joy Eternal' through "network marketing". The marketing process was carried out directly by recruiting distributors of the products and services. There was no service fee for registration as distributor. Any person who was interested was given a product for the price fixed. The distributors were encouraged to enrol more distributors. The commissions were given only as per the volume of sales made by the individual distributor and his team.

The Court clarified that the scheme creates chain of customers and only when the chain progresses without any break in any of the links, the 'principal distributor' gets more commission. If, for any reason, the chain is broken, at any stage, then the principal distributor's commission would get reduced proportionally to that extent. Therefore, it is not correct to say that there is no chain of customers in the process. The contention that no service charge was collected appeared to be incorrect in view of the fact that every person who purchases a kit has to pay a service charge of Rs.50/- for each kit. From the very fact that 65 per cent is earmarked for paying as commission to the distributors, it is clear that the value of the product is only 35 per cent of the sale price. That is, when the goods are sold at R550/, the actual value of the goods that are sold is only Rs.188/- .

It further opined that the progress of the chain of customers, at some point of time, will get saturated and the distributor, who purchases the goods, will not find any purchaser/sub-distributor to sell or enrol afresh. At that time, due to the progress of the chain, in the manner stated above, such persons will not find new members may be in lakhs or even

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<sup>40</sup> MANU/TN/0021/2005.



millions. Therefore, lakhs or even millions of people are bound to lose their entire money. The Court concluded that the so-called Multi-level Marketing, though called by a very attractive name, squarely falls within the definition of 'Money Circulation Scheme' under the Act. Hence, it is prohibited by the Act. It directed the law enforcing authorities to take appropriate action.

Amway, an unlimited liability registered Company, a wholly owned subsidiary of Amway Corporation, United States of America is engaged in manufacture and marketing of its various products through a network of distributors. In 2004, Amway was granted permission for setting up of manufacturing units of personal care cosmetic products, home care products, nutrition range of products. The complainant, Mr.A.V.S.Satyanarayan, was explained about a 9-6-3 scheme. Under the scheme, 1 member had to enrol 9 members and then those members would enrol 6 other members each and further each of these 6 members would further enrol 3 members. Thus, a single distributor would enrol a total of 225 members. The complainant stated that Amway was instigating and causing mental agony to distributors by forcing them to join to recruit new distributors. The complaint stated that the scheme was a Money Circulation Scheme banned under Prize and Chit Fund Act 1978<sup>41</sup>.

The Court referring to the two factor test as laid down in *Swapan Kumar Guha Case*<sup>42</sup> held that:

- The money which the member at the top of the line gets depends upon the members whom he enrolls or the members enrolled by him enrol. This provides a mode for making *QUICK AND EASY MONEY*.
- The distributor makes money by the act of enrolment of a new member which is *CONTINGENT AND RELATIVE*<sup>43</sup>.

The Court ordered that the scheme and the way in which it is structured makes it quite apparent that once a person gets into this scheme he will find it difficult to come out of the web and it becomes a vicious circle for him. In any event, the petitioners have not specifically denied the turnover they are achieving and the income they are earning towards

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<sup>41</sup> Manu/AP/0307/2007.

<sup>42</sup> *Supra n.* 39.

<sup>43</sup> Each member on his enrolment pays Rs. 4,400/-. Payment of Rs. 4400/- by a member on his enrolment and his future earnings through marketing/enrolling other members constitutes event or contingency relative to his enrolment.



the initial enrolment of the distributors, the renewal subscription fee and the minimum sales being achieved by the distributors. By no means can it be said that the money which the first petitioner is earning is not the quick/easy money. By promising payment of commission on the business turned out by the down-line members sponsored either directly or indirectly by the up-line members (which constitutes an event or contingency relative to enrolment of members), the first petitioner is earning quick/easy money from its distributors, apart from ensuring its distributor earn quick/easy money. Thus, the two ingredients are satisfied in the case of promoter too. Accordingly, the scheme run by the petitioners squarely attracts the definition of "Money Circulation Scheme" as provided in Section 2(c) of the Act.

In the above case, quick and easy money was stated to be earned by:

- Enrolment of members. (Members pay 4400 INR out of which 1800 directly goes to the company).
- Renewal of Membership: The membership has to be renewed every year by paying about INR 1000.
- Further, having a mandatory PV of 50 which forces a member to buy products worth 2000K to keep his commission alive.
- Having a mandatory PV (point value) of 50 to be achieved by each customer/distributor by selling products of INR 2000 was considered as sufficient inducement for driving the members for maintaining the PV level above the said minimum levels.

These factors were considered to term the scheme to fall under Quick and Easy money. Now, if we consider the annual revenue of Amway India which in 2012 was INR 2188 crore, the money got by subscribing candidates and yearly subscription renew amount accounts to 126 crores<sup>44</sup>, which is mere 5% of the total income. Can a mere 5% income generated from recruitment be considered as "Quick and Easy Money"?

The mandatory sale of products for the gain of commission establishes the fact and provides evidence that there exists real world products with real world demand. This criteria was laid down by FTC in the 1979 Amway's case<sup>45</sup> to differentiate fraudulent MLM

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<sup>44</sup> Here, the number of distributors considered are 4.5 lacs.

<sup>45</sup> *Supra* n. 25.



schemes with that of valid and legal MLM schemes. Further, the court reasoned that “the money which the member at the top of the line gets depends upon the members whom he enrolls or the members enrolled by him enrol” amounts to fulfilling of the second ingredient of the Section 2(c) of Prize Chits and Money Circulation (banning ) Act 1978. But, when we look into all existing models of retail marketing, this holds true. The person higher up on the business chain earns profits from the sales of the downline distributors.

The Indian Courts have not considered the differentiating factors as laid down by the FTC. The court in this case literally interpreted the definition of Money Circulation without considering the economic, social and employment significance of this scheme.

Indian Direct selling association has proposed to enact a separate legislation to cover direct selling. The main contention has been that, because of the vagueness of Prize Chits and Money Circulation (Banning) Act, 1978, genuine direct marketing agencies are being targeted. Taking queues from other countries such as Singapore, Thailand, Malaysia, Korea, Indonesia, China, Vietnam, Japan and Taiwan<sup>46</sup> which have specific legislations regulating valid Multi-level Marketing schemes, India should first define “money circulation schemes”.

Presently, the essential ingredients of section 2(c) are:

- Quick and easy money.
- Money or valuable received on an event contingent or relative.

All MLM schemes would fail with respect to the second ingredient though the money or valuable received in consideration is only a fractional part and the main consideration received is from the sale of products. It may also attract the provisions of cheating in such cases. But the essential ingredients of an MLM entity include:

- Existence and sale of Products and Services (Essential FMCG). Valid MLM schemes do not involve fancy, magic remedies or other non-essential consumer goods.
- Profits are earned by the representatives (distributors) and the company primarily from the sale of products. (there exists no fraudulent intention, since the middle level retailers are discounted or absent the transaction cost decreases thus an increase in profits.)
- The delivery of property (good) is done with due consideration and consent of the

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<sup>46</sup> Bibek Debroy, *Direct selling in India: Appropriate Regulation Is the Key.*, FICCI Indicus Analytics, April, 2013.



parties. (There is no deception involved i.e. the products delivered are not substandard and meet all the regulatory requirements).

- The revenues promised are based on the individual's distributor's effort and the rewards are based on the business volume and the point values<sup>47</sup>.

There exists no intention in a valid MLM scheme to defraud a person, make quick money or forcing a person to deliver property. But care should be taken to identify and differentiate numerous fake Pyramid schemes arising under the mask of MLM schemes<sup>48</sup>; these schemes would attract the provisions of the Prize Chits Act 1978 as well as attract Section 420 of Indian Penal Code 1860.

Kerala has been the first state to come up with a draft Kerala Multi-level Marketing (Control and Regulation) Bill, 2013<sup>49</sup>, which has raised lot of flak, as it does not allow distributors to recruit down-line members to do business.<sup>50</sup> But, this is a commendable first step taken towards legalizing Multi-level Marketing Schemes.

## CONCLUSION

India is one of the fastest growing economies in the world with the GDP and per capita income growing at an average of 7.5 % over the past decade. With economic development and growing consumerism, the retail sector in India has also undergone significant changes. Various store and non-store retail formats have evolved to cater to this growing market and direct selling is one such non-store retail format. Direct selling is one of the fastest growing non-store retail formats, recording double-digit growth in the post-reform period<sup>51</sup>. The Direct Selling industry has contributed 9869 million INR to the exchequer in form of various taxes.

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<sup>47</sup> See, MANU/AP/0307/2007. PV (Point Value) is a unit amount assigned to each product. It is an effort index, which puts emphasis on the units sold and not the selling price. Each month the PV is totalled in order to determine the performance incentive bracket. These brackets range from 3% to 21%.

BV (Business Volume) is a monetary figure assigned to each product. In order to calculate the Performance Incentive, the percentage amount determined by total PV is applied to the total BV for the month. The ratio of PV to BV in India is 1 PV = 45 BV.

<sup>48</sup> *Abdul Arshad v. State of Kerala.*, MANU/KE/1650/2011

<sup>49</sup> Available at [http://www.kerala.gov.in/docs/bills/1160\\_14.pdf](http://www.kerala.gov.in/docs/bills/1160_14.pdf), last visited on 18th April 2014.

<sup>50</sup> Available at [http://www.newindianexpress.com/states/kerala/Draft-Bill-on-MLM-Firms-Draws-Flak-from-the-Indian-Direct-Selling Association/2014/02/05/article2038712.ece](http://www.newindianexpress.com/states/kerala/Draft-Bill-on-MLM-Firms-Draws-Flak-from-the-Indian-Direct-Selling-Association/2014/02/05/article2038712.ece), last visited 18th April 2014.

<sup>51</sup> IDSA Annual Surveys since FY2010: The sales revenue by the Direct Selling Industry reached at INR 71,641 million in 2012-13 from INR 63,851 million in 2011-12 and INR 52,294 million in 2010-11. The Direct Selling Industry has registered growth rate of about 12% in 2012-13 as against healthy growth rate of 22% in 2011-12, 27% in 2010-11 and 24% in 2009-10.



The MLM, being a branch of direct selling industry, discounts the middle-men, thus, reducing the transaction cost, thereby reducing the gap between manufacture price and consumer price. With varied advantages and the employment opportunities MLM provides, there is a need to legitimize valid MLM schemes. India needs to differentiate between valid MLM schemes and Ponzi Pyramid schemes. The proposed act should henceforth, define Multi-level marketing and other Pyramid and Ponzi schemes. The statute should elaborate the differentiating elements and incorporate the Amway safeguards to differentiate between MLM and other Ponzi Pyramid Schemes. Ensuring the correct delineation by specific definitions, removing dilemma, establishment of a registration and regulatory regime, mandatory requirements for adherence to a code of ethics<sup>52</sup> would help drive fears of illegality and help Multi- level marketing schemes grow and contribute to the economy.

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<sup>52</sup> The Indian Direct Selling association sets out Code of Ethics so as to protect consumers against illegal and unethical practices. Available at <http://www.idsa.co.in/images/pdf/CodeOfEthics.pdf>., last visited 18th April 2014.