



# AMERICAN UNIVERSITY OF ARMENIA

ՀԱՅԱՍՏԱՆԻ ԱՄԵՐԻԿԱՆ ՀԱՄԱԼՍԱՐԱՆ

## LL.M. Program

ԻՐԱՎԱԳԻՏՈՒԹՅԱՆ ՄԱԳԻՍՏՐՈՍԻ ԾՐԱԳԻՐ

### TITLE

**FINANCIAL PYRAMIDS AND NETWORK MARKETING. DIFFERENCES IN  
LEGAL ASPECT**

### STUDENT'S NAME

**VACHAGAN ARSEN GASPARYAN**

### SUPERVISOR'S NAME

**PROF. GOR MARGARYAN**

### NUMBER OF WORDS

**8152**

# TABLE OF CONTENTS

**LIST OF ABBREVIATIONS 3**

**INTRODUCTION 4**

**CHAPTER 17**

**MULTILEVEL OR NETWORK MARKETING7**

**§DEFINITION AND CHARACTERISTICS OF MULTILEVEL OR NETWORK  
MARKETING7**

**§HISTORY. FTC V. AMWAY CASE9**

**CHAPTER 2 11**

**FINANCIAL PYRAMIDS11**

**§DEFINITION AND CHARACTERISTICS11**

**§TYPES OF PYRAMIDS12**

**§THE ECONOMIC CONSEQUENCES OF FINANCIAL PYRAMIDS. 15**

**CHAPTER 3 17**

**DIFFERENCES BETWEEN MLM SCHEMES AND FINANCIAL PYRAMIDS17**

**§LEGAL DEFINITIONS AND DISTINCTIVE FEATURES17**

**§SUPERVISING INSTITUTIONS: DSA22**

**CHAPTER 4 24**

**REGULATIONS IN THE REPUBLIC OF ARMENIA: SUGGESTIONS24**

**§LEGAL ISSUES IN RA24**

**§POSSIBLE SOLUTIONS26**

**CONCLUSION28**

**BIBLIOGRAPHY31**

## **LIST OF ABBREVIATIONS**

FTC	Federal Trade Commission of the United States of America
DSA	Direct Selling Association
WFDSA	World Federation of Direct Selling Associations
RA	Republic of Armenia
USA	the United States of America
MLM	Multi-level Marketing

## INTRODUCTION

Network marketing is a way that direct-seller companies use to promote their sales. Network marketing is also called multi-level marketing, which is more inclusive in its sense (the difference will be explained in details below). In the case of direct-selling, the company pays a percentage to distributors from their sales. Network marketing companies are based on direct selling. Customers buying the product from distributors can also become distributors and earn money and so on. Typically, distributors earn commissions, not only for their sales but also for sales made by the people they recruit<sup>1</sup>. But financial pyramids have no product to sell. It is the only circulation of money. To be involved in a financial pyramid, a person should invest some fixed money and invite others to invest the same amount of money. The revenue of the person who invited is based on the amount of money which due to him is invested in financial pyramids. Creating or controlling a financial pyramid is criminally punishable. The problem is that there are financial pyramids which are very similar to network marketing companies and potential customers cannot distinguish them. The result of this is that many people may lose money and this may cause catastrophic damages to the economy of the state. There are many cases that the pyramids put the state in crisis. For example, in the 1990s there was a pyramid in Albania in which was invested 1 billion dollars by the population, which equals 43% of GDP at that time. As a result, political power changed in the country, the economy appeared in chaos, and nearly 2,000 people died in the conflict.<sup>2</sup> There are also network marketing companies which act by law, and many people may earn money and establish their own business. Almost there is no law in Armenia regulating this sphere. There are no proper state bodies which are specialised in this sphere and can exercise supervision. Only Criminal Code stipulates the definition of pyramids and liability for them. CBA has the Financial Monitoring Center which controls the financial system in terms of money laundering and terrorism financing. Many network marketing companies exist in Armenia, and there is a need to control their activity and stipulate some criteria for them. There is no

---

<sup>1</sup> <https://www.consumer.ftc.gov/articles/0065-multilevel-marketing>

<sup>2</sup> [https://www.cba.am/Storage/AM/downloads/FDK/Annual%20Reports/Analysis\\_on\\_pyramids\\_arm.pdf](https://www.cba.am/Storage/AM/downloads/FDK/Annual%20Reports/Analysis_on_pyramids_arm.pdf)

much information for population and as a result of they may become victims of financial pyramids. There is no guidance on how to distinguish them. I will present what measures can be taken to inform the population, make them knowledgeable about this sphere. As there are many people in such kind of companies, they have various behaviours and they may conduct in deferent ways, even deceive the people, make non-real but desirable offers. If the company is legal, it should have rules of conduct, and when the distributor violates them, the company can <<punish>> them. But non-legal companies have no document to control their activity. They act in a way in which they want. Their aim is only to sell or recruit and earn more money no matter how many people may suffer. In foreign countries, for example in the USA, there are different effective measures to keep the people informed and supervise such kind of activity. Particularly, the webpage of FTC (Federal Trade Commission) has many articles concerning the MLM, how to distinguish MLMs and pyramids, also consumers can apply the FTC with a complaint, and it has effective measures to bring the responsibility. The USA also has DSA (Direct Selling Association), and it has very strict criteria for companies to join and become a member. When a company becomes a member, DSA gives license and allows the company to use its logo. DSA is so influential in this sphere, that when people see the logo on the webpage or documents of the company, it already inspires trust. Almost all developed states have their DSA, and they are a member of WFDSA (World Federation of Direct Selling Associations). So almost all the developed countries have proper mechanisms to inform and protect the consumers, but Armenia doesn't.

This topic is essential because people, legitimate MLM companies and even the state may suffer because of financial pyramids. Any financial pyramid from abroad can penetrate Armenia and act for years as an MLM company, and no one can prevent its activity. When this company collapses, many people lose money, a huge amount of money goes abroad, and it can cause a crisis as I mentioned above. Also, there are financial pyramids hidden behind network marketing or MLM. As the main characteristic of the financial pyramid is that it is the only circulation of money, there is no product, many of them use product which is overpriced and the high price is explained as that the product has some material or non-material singularities. But the listed singularities don't exist; they are only mentioned to raise the price.<sup>3</sup> The situation is different when a company offers services, which people

---

<sup>3</sup> [https://www.cba.am/Storage/AM/downloads/FDK/Annual%20Reports/Analysis\\_on\\_pyramids\\_arm.pdf](https://www.cba.am/Storage/AM/downloads/FDK/Annual%20Reports/Analysis_on_pyramids_arm.pdf)

cannot see or check quality in advance. They even don't know that particular service exists or not. To succeed, the members of financial pyramids make very attractive offers, promise huge profits and persuade people to invest money or buy some product. As in Armenia people hardly make ends meet, the salaries are low people to have prosperous life borrow money or take loans etc. After the purchase when they understand that the reality is different, they have no way out. They should continue their activity, recruit people or lose money. Taking into account the economic status, this can have crucial consequences. When people see others who are involved in financial pyramids and cannot earn money, or they see how the members act, how they persuade people they get a negative impression about all this sphere.

On the other hand, there are lawful companies, which sell products or provide services and people can use it for their own need. Legitimate companies may suffer because of this and because of the lack of information. Network marketing emerges in the USA, and this sphere is well developed. FTC which is the primary source of information for consumers has published many articles which include many suggestions and recommendations to consumers, what facts and information about the company they should take into account. For example, FTC in an article about MLM says that before the purchase considers the products, see what product they sell, whether the product has quality, whether people need that product or whether the product is overpriced or not.

# CHAPTER I

## MULTILEVEL OR NETWORK MARKETING

### §DEFINITION AND CHARACTERISTICS

Network marketing is a business model that depends on person-to-person sales by independent representatives, often working from home. The base of network marketing is direct selling, which DSA defines as a business model that offers entrepreneurial opportunities to individuals as independent contractors to market and sell products and services, typically outside of a fixed retail establishment, through one-to-one selling, in-home product demonstrations or online. Compensation is ultimately based on sales and may be earned based on personal sales and the sales of others in their sales organisations.<sup>4</sup>

Network marketing is known by a variety of names, including multilevel marketing, cellular marketing, affiliate marketing, direct consumer marketing, referral marketing, or home-based business franchising.<sup>5</sup>

Companies that follow the network marketing model often create tiers of salespeople. That is, salespeople are encouraged to recruit their networks of salespeople. The creators of a new tier (or "upline") earn commission on their sales and on sales made by the people in the tier they created (the "downline"). In time, a new tier can sprout yet another tier, which contributes more commission to the person in the top tier as well as the middle tier.<sup>6</sup>

---

<sup>4</sup> <https://www.dsa.org/> What is direct selling?

<sup>5</sup> <https://www.investopedia.com/terms/n/network-marketing.asp>

<sup>6</sup> <https://www.investopedia.com/terms/n/network-marketing.asp>

According to the Competition Act of Canada "For the purposes of this section and section 55.1, multi-level marketing plan means a plan for the supply of a product whereby a participant in the plan receives compensation for the supply of the product to another participant in the plan who, in turn, receives compensation for the supply of the same or another product to other participants in the plan".<sup>7</sup>

Network marketing organisations sell their product directly, not using any well-defined channel of trade. In the case of network marketing, the non-employed individuals are responsible for selling the products, not the workers and they get commissions whenever they make sales. Mentioned individuals are called Independent Business Owners (IBO) because they work as if they are promoting their own business.

Suppose a person 'A' sells a product to a person 'B' and now the latter is under A in the scheme. Now A will get the commission from this purchase and whenever he makes a sale he gets commissions and also a part of B's commission when B makes a sale. Now, to earn money, B will also try to recruit a person C under him, C a person D and so on. This becomes a system with a big hierarchy.

The organisations start to rely more on direct sales than on advertisements as personalised contact has more effect. This is a network where members (not employees) are paid commissions to achieve some goals. Every member is responsible only to himself. The more he sells, the more he earns. Members are also the consumers of the network. Hence, they also get privileges, discounts and other attractive offers when they become a member.

---

<sup>7</sup> <https://laws-lois.justice.gc.ca/eng/acts/C-34/page-15.html?txthl=pyramid#s-55.1>



## **§HISTORY. FTC V. AMWAY CASE**

Network Marketing exists for about 90 years. In 1934 California Vitamin Company decided to continue its activity in a model of MLM. This company emerged as a direct sales company making salespeople that would use the purchased product for their own needs and sell to it to their relatives. Due to this, they could earn an extra \$50 per month which was not little sum at that time. Their relatives not only liked the product but they understood that they could get income by themselves by buying the product at the wholesale price and selling it to others.

In 1943, California Vitamins changed its name and became Nutrilite Corporation by which the first true Multi-Level Marketing compensation plan was implemented. Everyone who bought and sold the products of the company got paid on multiple levels of sales which they made.

In 1949, Jay Van Andel and Richard Marvin DeVoss joined Nutralite Corporation as Members, and during the next ten years, they promoted the sales of the company grew, and due to them the company prospered. They started thinking that it is unfair to be paid only once because they work made the company prosperous and due to their work the company continued to make a profit during the next years. They understood that they should be paid

relative to the benefit of the company. So they came up with the idea that they should establish their own business and in 1959 Jay and Richard started their own business in Multi-Level Marketing model called Amway.

In 1975, the US state body which is responsible for protecting the rights of consumers, Federal Trade Commission, decided to sue Amway because they thought that the growth of the company is suspicious and the activity is illegal. The FTC doubted that Amway might be involved in a Pyramid scheme. As Amway was the biggest MLM selling company at the time, the Federal Trade Commission thought that if the court finds Amway involved in illegal activity, it should become a precedent and other companies operating in the same business model should stay away from such activity.

The complaint by the FTC was based on the FTC act, and it was assumed that Amway made five violations. The FTC claimed the following counts against Amway Corporation:

Count I of the complaint alleges that respondents engage in resale price maintenance.

Count II alleges that respondents allocate customers among distributors and restrict the distributors' source of supply as well as the retail outlets through which they may resell.

Count III alleges that respondents restrict the distributors' advertising.

Count IV alleges that respondents misrepresent that substantial income may be obtained from geometrical increases in the number of distributors in the chain recruiting operation of the Amway distribution plan.

Count V alleges that respondents misrepresent the profitability of a distributorship and the potential for recruiting new distributors and fail to disclose the substantial business expense involved and the high turnover of distributors.<sup>8</sup>

For four years Amway fought in the courts to prove that MLM was a legitimate business finally winning the case in 1979. This paved the way for many more MLM companies to enter the industry. Several different pyramid schemes sprang up with the advent of MLM.

When it was found that Amway is not an illegal pyramid scheme, FTC gave certain orders to Amway. They were the following:

- Stop allocating customers from the distributor base.

---

<sup>8</sup> <https://www.mlmlaw.com/library/cases/mlm/ftc/amway.htm>

- Stop misrepresenting profits or sales. Stop implying anything other than average results, and the average results must be shown in a conspicuous manner.
- Stop retail price fixing.
- Print a disclaimer on suggested retail price lists.<sup>9</sup>

In 1986, Amway violated the ruling of 1979. Amway exaggerated distributors' earnings in advertisements, and it was fined 100.000\$. Amway has been following this rule until now.

It has become widely understood that the 1979 FTC vs Amway case has become the standard in the USA in judging if multilevel marketing companies are legal or illegal.

The wise MLM start-ups research Amway and imitate their pattern, so they stay within the law. And, the FTC uses this case in further determinations.<sup>10</sup>

## **CHAPTER II**

### **FINANCIAL PYRAMIDS.**

#### **§ DEFINITION AND CHARACTERISTICS**

As it is seen from the name, pyramid schemes are business models which have a hierarchic structure established by certain individuals, who try to involve in that scheme as many people as possible to gain money.

According to the article 189.1 of the Criminal Code of RA “Financial pyramid is an activity (except for the activities performed with a special permit (license)) aimed at the

---

<sup>9</sup> <https://onlinelmcommunity.com/ftc-vs-amway/>

<sup>10</sup> <https://onlinelmcommunity.com/ftc-vs-amway/>

involvement of property, in which the proposed material benefit of the investors of the property or the persons paying for the property or the service offered in the pyramid, is solely determined by the property involved by the new investors without an intention to use it in real business activities”.

At each level of the scheme, new people transfer money to those who are at higher levels and receive investments from those who are at lower levels of the pyramid, in that manner creating a unique system for redistribution of money. Only growth of the number of newly joined members in geometrical progression may allow the scheme to work properly. It means that every joined member should bring other people in a certain number after him in the scheme.

Pyramid schemes have a specific characteristic, which, in members' opinion, is that when the scheme is newly formed, everything goes on as they expected and were told. It means that at early stages the members earn some money, which motivates them and this motivation is a good advertisement to inspire the others to join the scheme. Afterwards, the pyramid gets bigger by snowball effect and includes more people, then comes the moment when the scheme includes so many people that it is practically impossible and very difficult for a member to recruit new members. As a result, the members who are at the top of the pyramid due to the people's credulity and the attractiveness of the idea to get rich within a short period of time manage to make money, and the people who are at lower levels of the scheme cannot make money because of the unexpected and inevitable collapse.

The working principle of pyramids is the following: the initiator persuades a person to join the scheme by investing, for example, 1000 Armenian Drams. This amount is transferred to the initiator, while the newly joined member to recoup and to earn some money has to convince others, in the same way, to pay entrance fee amounting 1000 Armenian drams and involve them in the scheme. If the newly joined member manages to involve ten new members, he may gain, for example, 5000 Armenian drams while he invested 1000 Armenian drams and the other 5000 Armenian drams would be transferred to the organizer of the scheme.

Each of the ten newly involved members should involve another ten new members as well and so on. The process continues until it becomes impossible for the pyramid which is increasing in a geometrical progression to involve new members because of some objective

and subjective reasons (for example the population is not enough to be involved, people start not to trust). This scheme at its 10th level exceeds the number of world population by 3 billion ( $10^{10}=10\text{billion}$ ,  $10-7=3$ ).

There are many types of pyramid schemes, and some of them are discussed below.

## § TYPES OF PYRAMIDS

### 1. Schemes Using the “Eight Ball” Model

The “eight balls” model has a relatively simple structure and working principle in a variety of other pyramid schemes. The number of involved members is limited in this model. The scheme composed of 1 captain, two co-pilots, four crew members and eight passengers. Every crew member has to involve two passengers, and each of them is to pay, for example, 1.000 Armenian Drams. The captain takes the collected sum(8.000 Armenian drams) and leaves the game. Then the "staff" is being reorganised or being divided into two. Co-pilots become the captains of the newly formed groups; crew members become co-pilots (2 in each group), passengers become crew members (4 in each group), and new passengers are recruited (8 in each group).<sup>11</sup>

While this scheme seems rather limited at first sight, but if the scheme implements successfully it can be transformed into two schemes, the latter into four and so on. Unlike other pyramid schemes, where the number of involved members is multiplied in geometrical progression, in case of eight ball model and such kind of schemes the number of schemes themselves is multiplied in geometrical progression until they stop being divided and become “dead” cells.

Without face-to-face relationship the “eight ball” model may be simulated by the following way: the captain would add imaginary members with phoney names on the levels between him and passengers.

The captain is acting instead of them to take the money which should go to the real members. The varieties of the "eight balls" model are specific in a sense that at a certain moment the captain leaves the scheme ceding his place to other captains,

---

<sup>11</sup> [https://www.cba.am/Storage/AM/downloads/FDK/Annual%20Reports/Analysis\\_on\\_pyramids\\_arm.pdf\\_page\\_4](https://www.cba.am/Storage/AM/downloads/FDK/Annual%20Reports/Analysis_on_pyramids_arm.pdf_page_4), 1<sup>st</sup> paragraph

who earn an eight-times more money against their initial entrance fee. It may seem that they get astronomic profits, but they are tiny compared to those earned by organisers of successful classic types of pyramids.

## **2. Financial Pyramids Using the Network Marketing Model**

This kind of pyramid schemes is hidden behind the veil of network marketing when the sale of some products through the distributors. That is, the distributors become members in this scheme and get certain profits from the involvement of new members selling the product to them.

As it is discussed above network or multi-level marketing is a rather widespread business scheme in nowadays world, which is specifically effective when used in the virtual environment through modern telecommunication technologies. <sup>12</sup>Taking into account this factor, the advertised product is used by perpetrators to hide the pyramid nature of the scheme organized by them. Particularly, they sell products which have no or low value and put on them inadequately high prices. To enter the scheme, they should purchase the products. So, in this case, the price of the product replaces "entrance fee" or "investment" which is used in classic schemes. The buyer becomes a distributor and should recruit new members by selling the high-priced product to them. To eliminate the doubts about overpriced products and justify the price, they attribute some material and non-material characteristics to the product, the existence of which buyers cannot check in advance.

Nowadays, some pyramid companies provide services. To use that services a person should pay in advance and he even doesn't know that service exists or not and what quality it has.

A financial pyramid having some typical characteristics of network marketing has advantages for organisers in contrast to classic pyramid schemes:

- It allows the organisers to bypass legal ban of “illicit economic activity” which is typical for pyramid schemes and gives them the opportunity to present themselves as legal trading or service providing company;
- It seems more trustworthy for the potential members because it provides the participants with an impression that they own some product or have an opportunity to use some services even though they have low quality or low value.

## **3. Ponzi Schemes**

---

<sup>12</sup> [https://www.cba.am/Storage/AM/downloads/FDK/Annual%20Reports/Analysis\\_on\\_pyramids\\_arm.pdf](https://www.cba.am/Storage/AM/downloads/FDK/Annual%20Reports/Analysis_on_pyramids_arm.pdf)

Charles Ponzi organises these schemes, that is why these schemes are named Ponzi. Ponzi decided to make huge profits using price differences of postal reply coupons in various countries. He promised involved investors high profits in a short period. It turned out that the project cannot come true. Despite this fact, Ponzi was able to persuade potential investors to be involved. He paid early investors promised income and their initial investment from the budget formed by the investments of new investors. Ponzi managed to gain a reputation of a trustworthy and successful businessman, and the scheme was enlarged by the snowball effect. Several years later this process ended with the collapse of the scheme and the investors suffered huge losses. So the perpetrator involves new members in a Ponzi scheme by promising high profits in a short time, and it seems that the profit comes from real investments and business efforts. However, instead of paying real profits, the perpetrator creates an illusion of such profits by paying the investors from their initial investments or from those who joined later and the latter become the victims of the fraud. This kind of schemes collapse when the amount of new investments is not enough to pay the promised amounts to early investors. There are some differences between classic pyramid schemes, which are:

- The organiser of the scheme (sometimes, the small group of informed individuals) mostly works hard to involve new members;
- The members make investments transferring the money directly to the organiser without intermediaries, in a non-hierarchic way;
- The members are not able to realise the pyramid nature of the scheme.

In spite of these differences, Ponzi schemes are considered to be a variation of pyramid schemes, since their viability depends on the constant influx of financial resources from new investors as a means to fund payouts to early investors. In some cases, the funds collected through Ponzi schemes may be partially channelled to real investment projects; however, the clue here is that no real investment project may ever provide for the profitability promised to the investors.<sup>13</sup>

---

<sup>13</sup> [https://www.cba.am/Storage/EN/FDK/Annual%20Reports/Analysis\\_on\\_pyramids\\_eng\\_08062017.pdf](https://www.cba.am/Storage/EN/FDK/Annual%20Reports/Analysis_on_pyramids_eng_08062017.pdf) page 6 para 6

## **§The Economic Consequences of Financial Pyramids.**

During the last two decades, developing countries were favourable for pyramid schemes to develop, where the population never aware of such kind of frauds before. The example of Albania is already described in the Introduction. In Israel, thousands of investors lost their money in the pyramid scheme which was created in the 1980s. In this classic pyramid scheme, banks were putting forth their shares available to be sold promising that the cost on them will just go up (in some cases by 2% daily). The banks utilised the last cent of contributors' cash, their capital and benefits to guarantee this undesirable and incomprehensible promise. This particular fraudulent business model, seemingly, the longest ever, kept going seven years. On one day in 1983, all the banks in Israel were found insolvent. The government confronted such polite turmoil that it was compelled to expand compensation plans which endured nine years. The total indirect damage is almost impossible to evaluate, yet the direct damage evaluated up to 6 billion US dollars.

Because of the activity of pyramid schemes, besides the population and the state, may suffer big and new established little companies engaged in fair trading or service providing activities. Nowadays, since Amway case in 1979 when the public and the state understood that it is possible to do legal business by creating a network or involving distributors, many companies started to work in the principle of Amway and many companies were established on the base of network or direct selling. Day by day this sphere of business is being developed, and this business has proved its efficiency. Therefore, the reputation of financial pyramids often is attributed to legal companies. As a result, they suffer difficulties and try to prove that their activity is legitimate.

So the economic consequences of pyramid schemes are the following:

- Damages caused to the real sector – material losses of the members lead to the diminution of the population's consuming potential and ability to save (and, therefore, to invest) of the given country. Usually, the authors of such kind of frauds spend the collected investments or invest in foreign countries to escape from being caught and possible legal consequences in future. The consequences of this process are that, the money collected in pyramid schemes which sometimes makes up astronomical



amounts directly and negatively influences on the GDP of the country and may cause fatal consequences;

- Damages caused to the financial system – pyramid schemes there are two ways through which pyramid schemes may affect negatively on the financial sector. First, savings of the population are absorbed by pyramid schemes, which otherwise should be invested in the financial industry in various ways, for example, investing in deposits, bonds, other securities, fund startups, etc. Second, the originators of pyramid schemes in some cases deliberately distribute obscene and lascivious information about the financial system and discredit it by presenting their offers as the best investment option in terms of profitability and other conditions in contrast to those offered by banks, investment companies or other financial institutions.
- Damages caused to the business sector: As pyramid schemes use a network marketing model to hide their illegal nature, it influences the reputation of legal network marketing companies. Usually, due to the unawareness of differences between pyramid schemes and legal network companies, people get confused and think that they are the same. Solely the name of pyramid schemes can spread horror amongst people, and they are spotting some common characteristics of the pyramid in legitimate companies, they try to avoid all that kind of companies. Besides, the distributors also suffer because of this. They have to convince the people that their activity is legal to manage to earn money.

## **CHAPTER III**

### **DIFFERENCES BETWEEN MLM SCHEMES AND FINANCIAL PYRAMIDS**

#### **§LEGAL DEFINITIONS AND DISTINCTIVE FEATURES**

If we attentively examine the schemes and understand all the details of it, we can spot the differences between Pyramid schemes and legal MLM Schemes.

MLM Schemes have legal process governed by rules and contractual obligations for distributorship as well as regarding inventory holding, training and sales etc. Pyramid selling, on the contrary, is based on very loosely constructed, vague rules promise without any legal or contractual obligations and more importantly without any substantial product range.<sup>14</sup>

The aim of pyramid schemes is to make quick and easy money by attracting funds in the scheme as fast and much as it is possible. Whereas, the goal of MLM business is to establish and enlarge distribution networks mainly by selling products or services and doing them more preferable for customers. So the income of MLM business is generated out of the sale of products and services.

MLM Schemes don't expect you to make any speculation except a pitiful cost spent on purchasing a startup kit or some marcom materials or a little membership fee and the amounts are insignificant. But in the case of pyramid schemes, the only source of income are investments, that's why they invent and require various kinds of payments such as membership fees, entrance fees and they are usually very high. At any convenient moment, they stipulate and charge unjustified high fees. Pyramid schemes operate on an uncertain and

---

<sup>14</sup> <https://managementstudyguide.com/multi-level-marketing-and-pyramid-selling.htm>

distorted business plan. There are fixed unrealistic and ambiguous goals, which don't have any economic base. The so-called business prospers on the base of motivation. The organisers motivate the members to pay unreasonable fees and recruit new members to have a luxury lifestyle and make the dreams come true, etc. In case of pyramid schemes members don't know much about their company, how much income was generated, how their income is estimated, and whenever members become interested in them, the organisers somehow try to deceive and confuse them.

Pyramid schemes, in general, have spoiled the image and reputation of legitimate MLM schemes in the eyes of the public. At first sight, MLM schemes and pyramid schemes seem the same, because both of them have common concepts of operation which are at the top of the iceberg, but the public is not able to immediately spot the differences which are in the bottom. That's why the negative opinion spreads on the MLM schemes, too.

To distinguish them, we should lift all the differences in the legal aspect and identify which characteristics make the schemes legitimate.

So the distinctive features of legitimate schemes are the following:

- The information about the company and its activity, also the reports are accurate and available for the public.
- The right information about products and services are available on the website in details and characteristics, offered to the public
- The initial joining kit is offered to the already joined distributors at a lower price or free. In the joining kit are included all the necessary tools to promote business, like samples, catalogues, flyers, joining forums. Usually, the managers organise training directed to develop marketing skills.
- The companies have policies for distributors explaining the details of the business and guiding them.
- More legitimate companies have contracts, which may include terms and conditions, rules of conduct and privacy policy, and the distributor should agree with them and sign to join the business.
- The main goal and concern of the company are sales, but not the recruitments. Commissions are generated from sales of product and services.

- The company provides enough time for distributors to learn and earn, in comparison with the pyramids, where the organisers are very strict and set requirements difficult to follow.
- The company takes care of its consumers and distributors. It doesn't neglect the consumer protection rights, provides product guarantees because their goal is to sale, prosperity and they intend to have long-lasting activity.

There are some features which alert that the scheme may be a pyramid:

- The company provides high profits in a short period as promises.
- They are focusing more on recruitment rather than product selling. Organisers teach the joined members to recruit new members in any way no matter circumstances.
- Companies may have a product, but it with its nature is formal, serving as a veil of selling the company.
- There is no possibility to refund and get back the money.
- A large amount should be paid for the initial package as an entrance fee to be involved in the business.
- Organisers force and press distributors to recruit new members.

Checking these points in the given company, a person can discover it is a pyramid scheme or not.

The issue is different when we speak about pyramid schemes using the network marketing model. As it is discussed above, there are pyramid schemes which act in a network marketing model, and it is very difficult to differentiate them. But there are certain characteristics, due to which we can discern network marketing businesses from illegal pyramid schemes. The Central Bank of RA has returned to this issue in its analysis made by Financial Monitoring Center. According to the analysis

- In pyramid schemes, the real value of the sold product is significantly lower from the sales price, and this difference is “compensated” by attributing to it certain nonexistent material and non-material characteristics;
- The goods in their proposed form and product features are not available for sale at public service and trade places;
- Pyramid schemes are likely to sell to the new participant's such quantities of goods (without buy-back options), which cannot be sold within a reasonably short period;

Whereas:

- Network marketing involves goods with certain trading efficiency and potential for making a profit due to recurrent/ regular sales to customers;
- Members at any level of a network marketing scheme may make profits through the sale of goods and services, without the need of recruiting new members;
- Members at any level of a network marketing scheme may outperform the member who had once recruited them, without the need of making mandatory hierarchic contributions from their profits to that member.

The FTC also returned to this issue, which includes almost the same statements done by the CBA. For example, FTC in its guidance posted on its official website says the following about the products:

Many companies that market their products through distributors sell quality items at competitive prices. But some offer goods that are overpriced, have questionable merits, or are downright unsafe to use. Find out what will you be selling. Are similar products on the market? Is the product priced competitively? Is it safe? Can your sponsor — the distributor who is recruiting you — support the claims about the product’s performance?<sup>15</sup>

So FTC, too, considers that the most important element is the product to determine whether the company is legal or illegal.

But the best version of the definition, which covers all the differences between pyramids using network marketing model and pure network marketing is given by Competition Act of Canada, according to which "55.1 (1) For this section, a scheme of pyramid selling means a multi-level marketing plan whereby

- a) a participant in the plan considers the right to receive compensation because of the recruitment into the plan of another participant in the plan who considers the same right;
- b) a participant in the plan gives consideration, as a condition of participating in the plan, for a specified amount of the product, other than a specified amount of the product that is bought at the seller’s cost price for the purpose only of facilitating sales;

---

<sup>15</sup> <https://www.ftc.gov/tips-advice/business-center/guidance/multilevel-marketing>

- c) a person knowingly supplies the product to a participant in the plan in an amount that is commercially unreasonable; or
- d) a participant in the plan who is supplied with the product
  - does not have a buy-back guarantee that is exercisable on reasonable commercial terms or a right to return the product in saleable condition on reasonable commercial terms, or
  - is not informed of the existence of the guarantee or right and how it can be exercised.

This is stipulated to clearly define the differences between network marketing and pyramid schemes.

Similar provisions stipulate legal acts of France and Great Britain. Furthermore, Section 327 of California Penal Code defines as any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant.<sup>16</sup>

As to the legal mechanisms available in Armenia for combating pyramid schemes, the Criminal Code of the Republic of Armenia, besides article 189.1, defines the following offences:

a) Swindling – the promises which eventually cannot be kept provide the basis for attributing characteristics of swindling to pyramid schemes. This can be considered as embezzlement of property through the abuse of confidence.

b) Illegal entrepreneurial activity – the promises for certain yields and payout of gains imply that this is an entrepreneurial activity aimed at making a profit using attracting investments.<sup>17</sup>

---

<sup>16</sup> <https://codes.findlaw.com/ca/penal-code/pen-sect-327.html>

<sup>17</sup> [https://www.cba.am/Storage/EN/FDK/Annual%20Reports/Analysis\\_on\\_pyramids\\_eng\\_08062017.pdf](https://www.cba.am/Storage/EN/FDK/Annual%20Reports/Analysis_on_pyramids_eng_08062017.pdf)

## **§SUPERVISING INSTITUTIONS: DSA**

As it is very difficult to do determine the company is legal MLM or pyramid operating in the model of MLM, besides legislative amendments, the developed states established Direct Selling Associations, and as a result, World Federation of Direct Selling Association was formed. The goal of such kind of institutions is to establish such criteria for direct selling companies, which would protect both the consumers and companies' rights. At the same time existence of such institutions makes states' work easier.

As a model, we take the DSA of the USA. The mission of DSA is to protect, serve and promote the effectiveness of member companies and the independent business people they represent. To ensure that the marketing by member companies of products and the direct sales opportunity is conducted with the highest level of business ethics and service to consumers.<sup>18</sup>

The DSA gives membership opportunity for network marketing companies which operate direct, but not all companies can be members. All the legal companies which want to prosper and have long-lasting activity, try to be a member of DSA. There is a strict and clear

---

<sup>18</sup> <https://www.dsa.org/> DSA mission

procedure of membership. DSA has its own Code of Ethics, and all the current members and pending applicants must meet the requirements of it. No, any pyramid scheme can be a member of DSA, which is specially mentioned in the Code of ethics: particularly, according to section 6 “pyramid or endless chain schemes shall be considered actionable under this Code. The DSA Code Administrator (appointed under Section C.1) shall determine whether such pyramid or endless chain schemes constitute a violation of this Code by applicable federal, state and local law or regulation”. “Member companies shall remunerate independent salespeople primarily based on sales of products, including services, purchased by any person for actual use or consumption. Such remuneration may include compensation based on purchases that are not simply incidental to the purchase of the right to participate in the program”.<sup>19</sup>

The Code of ethics also covers all the problematic issues to protect consumers' rights. It also regulates the relationships concerning inventory loadings, purchase fees, training, guarantees, buy-back policies, etc. A company which wants to be a member, must apply and fill the application form and pay the fee. A company gets examined, and the Board of Directors decides to start the compliance procedure or not. DSA gives time to a pending application to eliminate non-compliance. When the company is meeting all the requirements, it becomes a member and DSA allows to use its logo. There are already up to 200 member companies, and there are thousands of companies which fail to become a member. Membership of DSA is already a safe guarantee that the company is legal and a consumer doesn't concern that it may be a pyramid. DSA annually examines all the members' activity and can seize the membership in case of breach of the Code. Besides annual inspections, DSA allows consumers to apply with a complaint.

---

<sup>19</sup>

[https://www.dsa.org/docs/default-source/code-of-ethics/dsa-code-of-ethics-december-2018.pdf?sfvrsn=5598cda5\\_10](https://www.dsa.org/docs/default-source/code-of-ethics/dsa-code-of-ethics-december-2018.pdf?sfvrsn=5598cda5_10)



## **CHAPTER IV**

### **REGULATIONS IN THE REPUBLIC OF ARMENIA: SUGGESTIONS**

#### **LEGAL ISSUES IN RA**

Until 2018 there was no definition of financial pyramids in RA. But after the amendments of the Criminal Code of RA legislator defined what means financial pyramid and provided a separate article about it. 189.1 article of the Code financial pyramids defines as

activity (except for the activities performed with a special permit (license)) aimed at the involvement of property, in which the proposed material benefit of the investors of the property or the persons paying for the property or the service offered in the pyramid, is solely determined by the property involved by the new investors without an intention to use it in real business activities.<sup>20</sup>

This definition is incomplete. Many types of financial pyramids are out of the scope of this definition, and this could be enough to define pyramids hundred years ago. Nowadays, new schemes and plans are being invented which can avoid criminal punishment with their such kind of characteristics which law enforcement authorities cannot detect and define. Also, this definition doesn't cover pyramids operating in network marketing model. They can avoid the punishments, proving that during their activity the income of members isn't "solely determined by the property involved by the new investors". They can ground that they sell products and the income is generated out of the sales. Nowadays, the law must define the definition so that it covers all the characteristics of complicated pyramids. Now, the new bill of Criminal Code suggests almost the same definitions, except the part which says "without an intention to use it in real business activities". This may be progressing, because it only makes the work of enforcement bodies harder and it is almost impossible in practice to clear the intention, which is subjective side.

The definition also should include such elements which can spot pyramids, providing services. When the pyramid's main activity is service provision, the members pay the in advance, unknowing what quality does it have and even it exists or not. It comes out that until the members use the service, the paid amount is being accumulated and in fact organisers pay the commissions from accumulated funds which are generated from members investments. On the other hand, the company may have useful services in high quality. However, our legislation doesn't cover this issue.

---

<sup>20</sup> <https://www.arlis.am/DocumentView.aspx?docid=125137> art 189.1

## **POSSIBLE SOLUTIONS**

Surely, the best definition of pyramids gives the Competition Act of Canada, which resembles the French version. It covers all features of pyramids, and it should be better than the Armenian legislator follows the model of Canada, which is introduced above.

Besides legislation, there is another preventive measure: that is establishing such kind of institutions which would be responsible for this sphere and defines requirements for direct-selling companies' activity. The example of this is DSAs discussed above.

As there are many network marketing companies in RA, there is a need to have such kind of institutions, for example, DSA of RA. This DSA would have a code of ethics, which should regulate this sphere in RA. The all legal network marketing companies would be members of DSA, and this means that they are already under the supervision and the rights of consumers are already protected. Being a member of DSA would inspire trust amongst people and the companies which are not members, would be unreliable for consumers and not having victims or consumer would make such kind of companies stop their activity or start matching procedure of Code of Ethics and become a member.

I would suggest that the Code of Ethics had provisions containing at least the following statements:

1. The product or service should have a reasonable and competitive price, have proper quality.
2. The product or service should be necessary for people, so they could use and be suitable for the needs of a wide range of the public.
3. Online transfers of money should be secured by TSL or SLS certificates.
4. There should be opportunity buy-back or refund and replacement of improper product.
5. There shouldn't be forced a trade. Thus, it's a person's right to buy product and purchase, and no has no right to force him to buy another product, as he has bought it for his needs and doesn't need any more.
6. There shouldn't be the concept of log out, flash out, max out, etc. It means that no matter how much the distributor managed to sell, he remains in the scheme.
7. For the distributor, there shouldn't be a connection between income and the time he joined. No matter when he joined, the more sells the more earns.
8. The company should have a contract, containing terms and conditions, privacy policy, rule of conduct, etc.

It would be better that besides the DSA another state body had guidance, such as FTC, and which should be periodically refreshed and published on the base of reports of DSA, which should contain points as mentioned above.

## CONCLUSION

Financial pyramids are a serious challenge for the economy not only of the specific country but also for the whole world.

Pyramid schemes are illegal scams in which large numbers of people at the bottom of the pyramid pay money to a few people at the top. Each new participant pays for the chance to advance to the top and profit from payments of others who might join later. For example, to join, you might have to pay anywhere from a small investment to thousands of dollars. In this example, \$1,000 buys a position in one of the boxes on the bottom level. \$500 of your money goes to the person in the box directly above you, and the other \$500 goes to the person at the top of the pyramid, the promoter. If all the boxes on the chart fill up with participants, the promoter will collect \$16,000, and you and the others on the bottom level will each be \$1,000 poorer. When the promoter has been paid off, his box is removed and the second level becomes the top or payoff level. Only then do the two people on the second level begin to profit. To pay off these two, 32 empty boxes are added at the bottom, and the search for new participants continues.

Each time a level rises to the top, a new level must be added to the bottom, each one twice as large as the one before. If enough new participants join, you and the other 15 players in your level may make it to the top. However, for you to collect your payoffs, 512 people would have to be recruited, half of them losing \$1,000 each.

Of course, the pyramid may collapse long before you reach the top. For everyone in a pyramid scheme to profit, there would have to be a never-ending supply of new participants.

In reality, however, the supply of participants is limited, and each new level of participants has less chance of recruiting others and a greater chance of losing money.<sup>21</sup>

Pyramids can have different forms and day-by-day they develop. Almost all states take measures to prevent their activity and stipulate strict punishment measures. At the same time, there is one type of business, MLM or network marketing, which with its some operational principles resembles the pyramid schemes.

It is relatively easier to distinguish classical pyramid schemes from network marketing. Classic pyramids are already exhausted themselves, are very simple and easily

---

<sup>21</sup> <https://wfdsa.org/what-is-a-pyramid-scheme/>

detected. A new kind of pyramid schemes appeared, which is hiding behind the veil of network marketing. MLM or network marketing is a controversial marketing strategy where goods and services are sold through a network of distributors. Typically, members of an MLM company can make money from two (theoretical) revenue streams:

1. You can earn commissions by selling the company's products and services
2. You can earn commissions by recruiting new members and leveraging the MLM company's pyramid-style commission system

MLM companies sell their products and services through distributors. Mostly, these distributors are private people who are trying to make some extra income.<sup>22</sup>

The amount of this type of pyramids started to increase after the Amway case (1979) when network marketing was found by the court as a legal business. Pyramid schemes started to imitate the characteristics of network marketing which makes the pyramid scheme look legal. The big trouble with pyramid schemes is that they don't offer any meaningful products or services. Their business model is built on making money by recruiting new members.

When you join a pyramid scheme, the way you can make money with them is to lure unaware people into joining the system, then pressure them to do the same for others. A distributor can earn commissions from his downlines while his uplines take portions from his income.<sup>23</sup>

Day by day it's becoming harder to differentiate these two types of companies, and the victims of this are the states, people and legal companies.

To solve this problem, preventive measures should be taken, especially by RA, because as discussed above, the provision of Criminal Code is not enough and is very weak to prevent the spread of pyramid schemes.

The most effective measures against the activity of pyramids are:

- Amendment of Criminal Code so as the definition of pyramids includes all characteristics of modern and complicated pyramids.
- Establishing a state institution which will be responsible for this sphere of business. That institution may be DSA created on the base of international practice. Afterwards, membership of DSA to WFDSA.

---

<sup>22</sup> <https://egonsarvreviews.com/mlm-vs-pyramid-schemes>

<sup>23</sup> <https://egonsarvreviews.com/mlm-vs-pyramid-schemes>

- Analyse the market, bring out the problems and by the membership of operating network companies bring them under supervision; write a code of ethics for legal companies, which should have binding power. The Code of ethics should be based on singularities of RA and international practice.
- Posting and publishing guidance to inform the population about their differences and singularities in advance.
- Creating a mechanism due to which the quality and price will be checked and evaluated, which most probably should be done by DSA of RA.

Anyway, the first and most important factor in preventing the development of pyramids, is a social condition of the population, due to which they get attracted by promises of huge income. The second is the unawareness of the population. The state should pay huge attention to informing the population, as it does the USA by its state bodies, DSA and FTC.



## **BIBLIOGRAPHY**

1. Official Website of Federal Trade Commission of USA([www.ftc.gov](http://www.ftc.gov))
2. Official Website of Direct Selling Association of USA ( [www.dsa.org](http://www.dsa.org))
3. Official Website of the World Federation of Direct Selling Associations([www.wfdsa.org](http://www.wfdsa.org))
4. [www.investopedia.com](http://www.investopedia.com)
5. Analysis of Central Bank of Armenia on Pyramid Schemes  
[https://www.cba.am/Storage/AM/downloads/FDK/Annual%20Reports/Analysis\\_on\\_pyramids\\_arm.pdf](https://www.cba.am/Storage/AM/downloads/FDK/Annual%20Reports/Analysis_on_pyramids_arm.pdf)
6. The criminal code of RA
7. <https://www.thestreet.com/personal-finance/education/what-is-a-pyramid-scheme-14724861>
8. <https://www.commerce.wa.gov.au/sites/default/files/atoms/files/pyramidschemes.pdf>
9. [https://www.michigan.gov/ag/0,4534,7-359-81903\\_20942-208400--,00.html](https://www.michigan.gov/ag/0,4534,7-359-81903_20942-208400--,00.html)
10. <https://sso.agc.gov.sg/Act/MLMPSPA1973>
11. <https://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03035.html>
12. The Competition Act of Canada
13. The Competition Act of France
14. California Penal Code