

SEC ADVISORY -18 April 2002

BEWARE OF PYRAMID AND PONZI SCHEMES MASQUERADING AS LEGITIMATE BUSINESS

These days, with the need to earn more income becoming more and more urgent, a number of "investment opportunities" are dangled before many individuals and families to help them tide over the economic crunch. Some of these offers are legitimate and viable, but some of them are fraught with danger to the unwary. This brochure is intended to help the innocent investor with some money to save distinguish between what is legitimate, and what is an area where even angels should fear to tread.

Pyramid Schemes

The most common of these schemes which have victimized many an eager investor is what comes under the generic heading of "pyramid" schemes. In a Pyramiding scheme the promoters, who are at the top, entice others down the line to bring in others in an ever-widening triangle, so that the base feeds those at the top. One might also liken a pyramid scheme to the familiar "chain letter" where a recipient of a letter is asked to send out a multiple of the letter he has received to others. To mask the scheme, promoters make it appear and name the "recruits" as "independent business owners", or some other nomenclature showing some form of independence. The independence is more often than not illusory since it is the promoter that controls the flow of the money and the giving of so-called credits or awards. Even business opportunity meetings mirror only the scheme of the promoter.

Another variation is where the Promoter offers investors "exclusive distributorship rights" to sell the distributorship to others for a specified amount, usually considered an "initial investment" to pay for a set of products which are "exclusively marketed" and not found in regular stores. Investors get a percentage or "commission" from the sales of the products of the other investors they have recruited. So Promoter gets the initial investment plus a share in the sale of the investors distributorships, and so on down the line. The investors recruited by the promoter, and the other investors recruited by the initial investors

are called "downlines." The come-on is that the more downlines you recruit, the more commissions you are able to earn from the sales of those who come after you. Downlines are recruited from the investor's circle of friends, co-employees, even family. The catch is, in order to keep the scheme afloat, the number of recruits has to increase geometrically, that is, you have to keep raising the number of recruits to the power of the original set recruited. In the end, if this scheme has to keep going, the number of recruits required may even have to exceed the population of the community, or even the country, to push it to its absurd limits!

Thus in a pyramid, the Promoter or those at the top would likely be able to get back their investment and then some, as the money flows upward from those down the line. The problem is, the unwary investor never really knows where he is in that pyramid.

a) Are Pyramid Schemes Legitimate

Pyramid schemes are illegal under Section 53 of the Consumer Act of the Philippines. Moreover, pyramid schemes also fall under the category of investment contracts insofar as it involved a solicitation of money that is pooled into a common fund with promises of profits through the efforts of others. Being in the nature of investment contracts these should be registered with the Securities and Exchange Commission pursuant to Section 8 of the Securities Regulation Code (SRC). Offering unregistered investment contracts is illegal and carries a penal sanction under Section 73 of the SRC. The recent "G. Cosmos" affair is an example- SEC ruled that they were selling investment contracts without the proper SEC registration and thus slapped the company with a "cease and desist" order.

Multilevel marketing organizations are legitimate types of pyramid operations whose primary purpose is to sell a product and not mainly to sell the distributorship itself. The entry fee is usually small and used to pay for an initial purchase of the products to be sold. They do not promise unbelievably high returns from the investment. Income is derived from the sale of the products being marketed.

b) Multi-Level Marketing

Multi-Level Marketing is a legitimate business strategy for achieving a wider distribution of products while lowering costs. The most well-known and probably considered the origin of multi-level marketing is the Amway Corporation, which started with its Nutrilite product line. To make a long story short, the Nutrilite product was a food supplement which was supposed to have unusual therapeutic value, and which were sold to the friends of the inventor, at a commission. Significant out of state distribution of Nutrilite supplements began in 1945 when a company, Mytinger, Casselberry and Rehnborg, and some 15,000 door to door salesmen were selling them with a booklet "How to Get Well and Stay Well." The company ran afoul of the law when outlandish claims (through testimonial letters in the booklet) about diseases responding to Nutrilite treatment were made and a permanent court injunction was issued forbidding the exaggerated importance of the supplements.

Amway's founders were friends who became Nutrilite distributors after high school graduation, and became extremely successful with a sales organization of over 2000 distributors. Fearing the collapse of Nutrilite products, they formed a new company, the American Way Association, later renamed Amway, and began marketing biodegradable detergent products and other household cleaning products, later diversifying their product line to include beauty aids, toiletry, jewelry, furniture, electronic products, and other items. 2/

Distribution of these items were done through multi-level marketing plans, also known as "network" or "matrix" marketing. These plans typically promise that if you sign up as a distributor, you will receive commissions - for both your sales of the plan's goods and services, and through the sales of the people you recruit as distributors. Typically, a multi-level marketing plan usually promises to pay commissions through two or more levels of recruits, known as the distributor's "downline."

One distinguishing feature of a Multi-Level Marketing plan is that there is a product or service of real value that is sold and that the commissions are primarily derived from the proceeds of the sale of such product or service.

c) How to Evaluate Pyramid-type Offers

Multi-level marketing plans should only pay for commissions against the retail sales of goods and services, not for recruiting new distributors. As long as the focus is the sale/distribution of tangible products, and not of the distributorship itself, such multi-level marketing "networks" are considered legitimate. Pyramiding is prohibited because plans that pay commissions for recruiting new distributors eventually collapse when no new distributors can be recruited. When such a scheme collapses, people, especially those at the base or lower levels of the pyramid, lose their money. The only way to win in this game is make sure that you enter early and become a master manipulator of those you enroll. There is a loser in this game, and the trick is not to let it be you. Obviously, there are ethical considerations here, but pyramid scammers are not bothered by these.

In order not to get hit, the investor has to rely on his good or common sense. However, the following seven tips were formulated by the US Federal Trade Commission when one is faced with a decision about whether to join a multi-level plan.

1. Avoid any plan that includes commissions for recruiting additional distributors.
2. Beware of plans that ask new distributors to purchase expensive inventory.
3. Be cautious of plans that claim you will make money through continued growth of your "downline.," rather than through sales of products you make yourself.
4. Beware of plans that claim to sell miracle products or promise enormous earnings. Ask the promoter of the plan to substantiate claims with hard evidence.
5. Beware of "shills" - decoy references paid by a plan's promoter to describe their fictional success in earning money through the plan.
6. Don't pay or sign any contracts in an "opportunity meeting" or any other high pressure situation. Insist on taking your time to think and consult others before deciding.
7. Check with your local business bureau and/or government regulator about any plan you are considering, especially when the claims about the product or your potential earnings sound too good to be true. 3 /

Remember, no matter how good a product is, and how solid a multi-level marketing plan may be, you must expect to invest "sweat equity" apart from the pesos you part with for your investment to pay off. If it sounds too good to be true, it must be.

Ponzi Schemes

The "ponzi" scheme was named after Charles A. Ponzi, an Italian immigrant to the United States who defrauded hundreds of investors in the 1920's. Ponzi traded in postal coupons by purchasing them in a weak currency country and exchanged them at a profit in the U.S. By itself, there was nothing wrong with that. He later raised funds from the public to purchase more coupons and promised them a 40% return on their investments. As his investors grew in number, and there were not enough coupons to be bought, he continued to solicit investors, paying off old investors from money raised from new investors. When he could no longer recruit new investors, the bubble burst.^{1/}

Ponzi schemes are one of the oldest tricks, and many unsuspecting investors have also been victimized in the Philippines. An example close to home is the Agrix scam of the late 1970's. Another of more recent vintage is the gold certificates scam which victimized a number of Forbes Park type people. There have been other similar scams which however have not been reported as victims are generally too embarrassed to admit that they have been fooled by con-artists.

How A Ponzi Scheme Works

Promoter recruits an Investor to invest an amount with the promise to repay the principal amount plus interest within a specified period of time, say thirty days. The interest is usually higher than what would be earned by say a savings or even time deposit in a bank. During this time Promoter also makes similar promises to other investors, receiving an amount from each of them, offering to pay the principal amount plus interest within a similar specified period of time. At the end of that period. Promoter offers to pay the Investor the principal and interest as promised, and invite the Investor to "reinvest" the amount for another period of time. Investor, seeing a good thing, is enticed to put back his money for another thirty days. He might even bring in his friends to share in his

"good investment." Promoter is able to collect a pool of money that he can use to pay those investors who wish a return of their money, and while the going is good, investors are able to happily recoup their investment plus! This encourages others to join and more money is pooled by the Promoter who can continue to operate this scheme for some time before "pulling the plug" - either by disappearing with all the investments, or claiming that the investments went bad, and everyone has to bear the loss. As with Ponzi in the US, and Agrix in the Philippines, for as long as the money kept coming in to cover those who want out, the scheme is feasible; however, eventually the bubble will burst.

What to Do if Victimized

If you have been victimized by a pyramid promoter, the Philippine regulatory authorities are: Securities and Exchange Commission
Department of Trade and Industry
Bangko Sentral ng Pilipinas

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- 1/ "Beware of Ponzi Schemes" by Atty. Enrique I. Quiason, Portfolio, June 1997
- 2/ "The Origin of Multilevel Marketing" by Stephen Barret, M.D., Multilevel Marketing, A Guide for Consumers and Investors, Uptrend Business Center
- 3/ "Multilevel Marketing Plans," Produced in Cooperation with the North American Securities Administrators Association, A Guide for Consumers and Investors, Uptrend Business Center