

Multi-level Marketing and Pyramid Schemes

Copenhagen, September 2004 revision

Introduction

1.1. Background and objective of this guideline

In recent years the Danish Consumer Ombudsman [DCO] has channelled considerable resources into investigation of various marketing concepts known as pyramid schemes, multi-level marketing and network marketing, among other things.

This guideline is a result of requests from journalists, public authorities and advisers in general who call for a clear position on schemes that they have encountered in different contexts. Promoters of various schemes have likewise expressed a wish for advice as to the legality of their schemes, as have consumers contemplating participation in these schemes. The DCO has also conducted investigation into matters on his own initiative.

The aim of this guideline is to establish a DCO standard procedure for conduct and practises. It is the result of the experience gathered by the DCO in this area, and is available in hardcopy as well as on the websites www.forbrug.dk, www.consumerombudsman.dk, www.forbrugerombudsmanden.dk.

In the following a number of general issues relating to the legality of the different schemes are being explained. Further, some special legislation provisions pertaining to this area have been included.

This guideline is not an exhaustive account of all aspects surrounding the schemes. Schemes present in the market are often greatly diversified and frequently change. Hence, circumstances surrounding the individual scheme, even if not explicitly touched upon here, may nevertheless give rise to concern. It follows, then, that this guideline is not an approval of some schemes as opposed to others.

Special legislation may also be relevant; although not included here, it may have to be observed in order to ensure a scheme's compliance with the law.

The translation of this guideline has been abbreviated for reasons of clarity. Three dots indicate that information has been left out.

1.2 The schemes and their features

Schemes that have come to the DCO's attention can be categorised in 3 groups:

1. Schemes that involve trade of products of real value. Revenue is actually created on basis of a turnover. The distributor network is often built up to generate profit for participants who, apart from collecting revenue from their own sales, also benefit from sales made by 'downline' participants. These schemes are called Multi-level Marketing or Network Marketing.

2. Schemes that involve trade of products of insignificant or no value. Turnover is based on payments made by participants while revenue generated by actual sales of products is illusory or very slim. These schemes are sometimes – erroneously - called Multi-level Marketing or Network Marketing.
3. The last group of schemes is traditionally known as pyramid schemes or chain letters, schemes that operate exclusively with money transactions.

The purpose of these schemes is to recruit new participants. Having paid a considerable amount of money, one has in effect ‘bought’ the right to recruit new members – and the pyramid scheme takes form. Money gradually moves up the scheme as more participants join in.

In the following, the guideline only distinguishes between illegal pyramid schemes and legal Multi-level Marketing and Network Marketing concepts.

2. Illegal pyramid schemes and chain letters

The 1990s saw a number of pyramid schemes in operation in which many people lost large sums of money. The schemes proved difficult to clamp down, however, as they were not dealt with in the legislation in force at the time. This induced the Danish parliament to introduce a ban on pyramid schemes, cf. the Danish Public Collections and Pyramid Schemes Act (lov om offentlige indsamlinger og pyramidespil).

2.1 How to recognise a pyramid scheme

A pyramid scheme is not a lottery in the usual sense of the word, as chances of benefiting from the scheme do not depend on either coincidence or skill; rather, the number of incoming participants determines one’s success in the scheme.

Pursuant to the Danish Public Collections and Pyramid Schemes Act (lov om offentlige indsamlinger og pyramidespil), a pyramid scheme is construed as a scheme with a pyramid form where:

participation requires money or other kind of financial investment;

participants are promised financial rewards;

the reward primarily stems from investments made by incoming participants below.

A pyramid scheme involves payment of money that flows from the bottom to the top of the scheme; the turnover may have only little or nothing to do with sales of actual goods and services. Turnover is generated by sales of ‘distribution rights’ and allocation of rewards; hence, recruitment of new participants to the scheme is of crucial importance as revenue is generated in this way only.

In theory, the scheme can expand infinitely. However, in practise the supply of potential investors eventually dry up, leaving participants on the last level with considerable losses.

It will be considered a pyramid scheme only when financial rewards *primarily* are based on payments made by new participants. Other trading schemes such as Multi-Level Marketing concepts may take a pyramid form, but should not necessarily be regarded as pyramid schemes, see

below.

To distinguish between a pyramid scheme and Multi-Level Marketing is often difficult and must be subject to individual assessment; however, where exchange of goods or services is not involved, this will usually turn out to be an illegal pyramid scheme.

If a participant tries to evade the ban by disguising payments or bonuses as e.g. stock schemes where 'personal shares' are traded, the law will, depending on the circumstances, cover this as the turnover then in actual fact is generated by payments (contributions) and not sales of goods or services.

2.2. Offenders will be prosecuted

Promoters of pyramid schemes, e.g. people who recruit new participants to a scheme, may be fined or imprisoned for a period of up to 4 months, and where more aggravating circumstances are present, imprisonment for a period of up to 2 years may be imposed.

People who live in Denmark, but promote pyramid schemes abroad, are also liable to punishment.

2.3. Where to direct enquiries

The police and the prosecution service undertake investigation of potential pyramid schemes as well as bringing potential cases before the court.

Have you received an invitation to join a pyramid scheme, or has the existence of one such come to your knowledge in any other way, you should hence inform the police.

2.4. The legislation on lotteries etc.

Recently, other kinds of schemes with a pyramid form involving money have emerged. They deal with lotteries, shares and casino.

They may not show all the typical features of a pyramid scheme, nor are they necessarily dealt with in the Danish Public Collections and Pyramid Schemes Act (lov om offentlige indsamlinger og pyramidespil).

The schemes will nevertheless often conflict with the law, as the legislation on lotteries etc. requires that permission from the relevant authorities be obtained. Otherwise, a scheme should not be promoted. Contravention of the law is punished with a fine or imprisonment for a period of up to 1 year.

Persons who illegally assist promoters of a lottery/casino/stock scheme by for instance recruiting new participants may incur liability for complicity and presentation of the scheme. Both offences are punishable under the law in the same way as promotion of pyramid schemes is.

For more information about the legislation on lotteries etc., see the website www.spillemyndigheden.dk (NB: the site is in Danish)

3. Multi-Level Marketing, Network Marketing or other trading schemes with a pyramid form

Multi-Level Marketing, Network Marketing or other similar trading schemes are in general legal as opposed to pyramid schemes.

However, the DCO holds the opinion that some aspects surrounding these trading schemes may cause concern. Likewise, a number of rules applying to Danish businesses make it difficult for the schemes to flourish in the Danish market.

The most important provision in this connection is the ban on doorstep selling/telephone selling.

One should also know the relevant legislation before joining a Multi-Level Marketing scheme. The most important ones are dealt with further below; however, as this account is not an authoritative statement of the law, we recommend that independent and impartial business advice be sought elsewhere before joining a scheme.

3.1. Recruitment of new traders

3.1.1. Recruiting friends

Many Multi-Level Marketing promoters encourage participants to recruit new members through their personal network, e.g. family, friends, colleagues, parents of their children's playmates etc. This is popularly known as recruitment of friends.

The DCO holds the view that recruitment of friends in general violates the principles of good marketing practises - especially if recruitment primarily serves one's own financial interests.

A person who is contacted by a friend or family member with a view to persuade him or her to join a scheme will often take a more favourable attitude than if the same enquiry had been made by a business or trader unknown to this person. However, an enquiry, irrespective of personal relations, will always have the same objective: to meet financial obligations as well as get a reward.

In cases where a larger pyramid scheme is based on the participants' recruitment of friends, the whole scheme is most probably violating the principles of good marketing practises.

3.1.2. Potential new traders and marketing

Independent traders involved in Multi-Level Marketing schemes are themselves responsible for acting according to law and with it, the Danish Marketing Practises Act [DMPA].

Traders must act according to the principles of good marketing practises, cf. section 1 of the DMPA. The law also makes it an offence to use misleading, incomplete or incorrect statements, cf. section 2 (now section 3) of the above Act. Infraction of the latter provision is punishable by fine.

Needless to say, the other provisions of the Act must likewise be complied with.

Recruitment should be organised in a way as to do away with later doubt as to whether recruitment has actually taken place. A personal signature may be required.

3.1.2.1. Good marketing practises

The principles of good marketing practises should at all times be observed regardless of the marketing method used – this also applies to Internet-related marketing activities.

A Multi-Level Marketing scheme may not always appear as such at first sight when marketed through preliminary enquiries, advertisements or on the Internet. Often people are not made to realise it until well into the process. Examples of trader contracts in which it was stated that disclosure as to the true nature of the scheme should be avoided in the marketing have even come to the CO's attention. However, in the opinion of the DCO, withholding this kind of information, even in the initial stages, is a violation of the principles of good marketing practises.

It is also an instance of violation of the principles of good marketing practises when marketing material is deemed to be of a nature that is likely to violate the ban included in the Danish Consumer Agreement Act on unsolicited enquiries via telephone or unsolicited personal enquiries.

Nor should promoters use intrusive or aggressive marketing methods.

When a promoter encourages the use of after-sales marketing in order to follow up on buyers and their purchases, this activity may be in conflict with the principles of good marketing practises. Also, it violates the ban on intrusive conduct of business, cf. section 2(3) (now section 3(3) of the DMPA.

It is also considered improper to encourage participants to borrow money or open an overdraft account where the overdraft is gradually reduced in step with the introduction of new participants to the scheme.

3.1.2.2. Misleading marketing

As mentioned above, marketing should not make use of incorrect, misleading or unreasonably incomplete statements, including unrealistic statements about possibilities of profit-making cf. section 2(1) (now section 3(1) of the DMPA.

Statements about possibilities of making profit should be regarded as real facts subject to substantiation, cf. section 2(4) (now section 3(4) of the DMPA. If it is not possible to substantiate the statements, they will, under the circumstances, be regarded as misleading and hence in conflict with section 2(1) (now section 3(1) of the DMPA.

Further, if a pyramid scheme appears to be non-transparent to the participant, and if the lack of transparency is aggravated by misleading marketing material, then it may conflict with section 2(1,3) (now section 3(1,3) of the DMPA.

In general, it may be in conflict with the ban on misleading statements included in section 2(1,3) (now section 3(1,3) of the DMPA to organise a trader network in a way which is likely to mislead as to the actual possibilities of making a profit.

3.1.3. Recruitment of vulnerable groups or children

Promoters who only look for new participants among children, young people, students or impressionable people may be acting socially irresponsible, and this conflicts with section 1 of the DMPA.

3.1.4. Recruitment meetings

During recruitment meetings, promoters must not use psychological triggers to fuel the impression that joining the scheme can make you rich quick. Psychological triggers of this kind may conflict with the principles of good marketing practises, cf. section 1 (now sections 1 and 2) of the DMPA.

If promoters organise meetings *primarily* for people below the age of 18, this may also be deemed socially irresponsible and in conflict with section 1 of the DMPA.

Invitations for such meetings should clearly state the objective of the meeting.

3.2. How products are sold

Retail points of sale as business premises are usually not that common in Multi-Level Marketing schemes.

The actual sale or contracts/agreements are therefore primarily regulated under the Danish Consumer Agreement Act.

Note, however, that this does not apply to sales of goods and services intended for resale. A new trader's purchase of goods and services for resale is therefore not considered a consumer purchase, sale or agreement.

3.2.1. Bans on doorstep selling and telephone sales

A Multi-Level Marketing trader must not direct enquiries to a consumer in his working place or at his address unless on request from the consumer himself.

It follows then, that unsolicited calls or visits to a consumer in his working place, at his address or in any other places outside public space conflict with the law, cf. section 6 of the Danish Consumer Agreement Act.

Some exceptions apply. Traders/sellers are allowed to call or visit without prior request in cases where the following goods and/or service are offered for sale:

- Insurance policies
- Books
- Periodical and newspaper subscriptions
- Evacuation and ambulance services

Non-compliance with the ban on doorstep selling will be fined, and agreements entered into in connection to this activity will not be binding on the consumer.

Consumers are also, in most cases, owners' associations, non-commercial sports clubs and other non-professional clubs or societies etc., cf. the Danish Consumer Agreement Act.

A trader is not allowed to direct enquiries to members of his own family or friends with a view to sell his services and goods without prior request. A trader is only allowed to call or visit for purposes of demonstrating and selling his products when specifically requested to do so.

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3.2.3. Home shopping parties – product demonstrations in private homes

An invitation for a home party should clearly state the objective of the session: to demonstrate products.

Pursuant to section 10 of the Danish Trade License Act (næringsloven), purchase and ordering of goods must take place in connection to the trader's permanent place of business. Goods must not be sold or ordered in private homes as the order itself is construed as a sale. Hence the trader is only allowed to introduce and demonstrate his assortment, and only when requested, see above. Order forms may be distributed at the session; however, the trader is not allowed to bring the completed forms with him.

Home shopping parties must not be intrusive or aggressive, cf. sections 1 and 2 (now section 3) of the DMPA.

3.2.4. Sales at trade fairs and exhibitions

Permission to sell goods and services at trade fairs and exhibitions must be obtained from the Danish Commerce and Companies Agency, cf. section 15 of the Danish Trade License Act (næringsloven).

3.2.5. The right to cancel a purchase

Consumers have the right to cancel a purchase or an agreement within the first 14 days of any event hosted or arranged by the trader in which an agreement was entered into or a purchase was made.

This also applies to agreements entered into in public places, at exhibitions and fairs as well as goods purchased here unless payment and delivery take place at the exhibition or fair, cf. section 2(2)(ii), paragraph a of the Danish Consumer Agreement Act.

In cases where a visit from a trader has not been requested, sale and conclusion of agreements in connection to this will be considered a violation of the law. In the event that sale and conclusion of agreements nevertheless take place, these actions are considered non-binding on the consumer. For both, see sections 6 and 7 of the Danish Consumer Agreement Act and 3.2.1. above.

The right to return goods in the first 14 days also applies where goods have been bought online on the Internet or via mail order, also known as distance selling, cf. sections 4 and 17 of the Danish Consumer Agreement Act.

The consumer must be informed of his right to cancel the agreement, cf. section 9 of the Danish Consumer Agreement Act.

If the agreement is not concluded at the trader's permanent place of business, the consumer must be given his rights in writing, cf. section 10 of the Danish Consumer Agreement Act.

Information about rights must also be available in writing or in another durable medium when the agreement is concluded via distance selling, cf. sections 11 and 12 of The Danish Consumer Agreement Act.

The period of cancellation begins when the consumer has been informed of his rights.

Even if the trader does not observe the information duty, the agreement will nonetheless be valid. However, this means that the period in which goods may be returned is extended so that it begins from the time on which information about the right to return goods become available in writing to the consumer.

As for distance selling, the period of cancellation may be extended no more than 3 months, beginning from the day on which the consumer receives the goods or, if a service, from the day on which the consumer is notified that the agreement has been made, cf. section 18(3) of the Danish Consumer Agreement Act.

3.2.6 Further obligations to be observed by the trader

When joining a Multi-Level Marketing scheme, one is no longer a consumer; instead, one assumes the legal status of trader, and provisions and rules included in The Danish Consumer Agreement Act, the Danish Contracts Act and the Danish Sale of Goods Act on consumer protection must be complied with.

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Pursuant to section 83 of the Danish Sale of Goods Act, it is possible to complain about defective goods for 2 years, i.e. the statutory guarantee period that comes with any purchase. The guarantee period cannot be shortened by additional agreements between the parties.

In case of defects found by the consumer, he may inform the trader in order to have it repaired, replaced or to receive a full or partial refund, cf. section 78 of the Danish Sale of Goods Act.

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Guarantees must always afford the consumer a considerably better legal position than otherwise provided by existing legislation, in this case the Danish Sale of Goods Act. It is a good idea to have a copy of the guarantee in writing. Any written guarantee must be in Danish, cf. section 4(2) (now section 12) of the DMPA.

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3.3. The trader contract

One of the special characteristics of Multi-Level Marketing schemes that causes problems is that traders often are recruited among ordinary pay earners with little experience when it comes to run a business.

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However, this does not change the fact that, as a basis, a person involved in Multi-Level Marketing acquires legal status as a trader with the duties and obligations this entail.

3.3.1. The parties' duties and obligations in the contract

Unreasonable terms in a contract may be set aside under section 36 of the Danish Contracts Act. Terms that are considered unreasonable are also generally in conflict with section 1 of the DMPA.

The contract drawn up between the promoter and trader should be in writing, and the duties and obligations of the respective parties should be balanced.

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The right to interpret the terms stated in the contract, i.e. to decide whether delivered goods meet these terms, should not be accorded unilaterally to one party.

The duty to fulfil contractual obligations can never be accorded unilaterally.

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A trader who fails to fulfil his obligations should not be under the duty to pay a disproportional remuneration to the other contracting party.

It must be possible for the trader to terminate the contract by giving a reasonable notice of no more than 3 months.

On trader's termination of the contract, the promoter should commit himself to take back goods bought by the trader.

The trader contract must not contain any unreasonable choice-of-law clauses or jurisdiction clauses, nor should it include far-reaching non-competition clauses, restrictive covenants or waivers of responsibility.

Unreasonable investment in equipment or goods must not be required. It is considered an unreasonable term of contract to require the trader to invest in equipment or goods before having been approved for the scheme by the promoter. Approval, on the other hand, may be conditioned by the trader's investment in equipment or goods provided that only a modest amount of money is needed for this end.

Whether collection of administrative fees, annual fees etc. is carried out must be clearly stated in the trader contract.

The promoter must not charge extra fees for assigning a better position to the trader in the scheme.

Information about product liability and defect liability should be included in the trader contract, cf. the Danish Sale of Goods Act.

To prevent a trader under the contract from contacting public authorities is a violation of the principles of good marketing practises.

3.4. Further regulation under public law

3.4.1. Prices, taxes and duties

A trader offering goods for sale in the retail business must when marking or displaying goods for sale clearly state the total price inclusive of VAT and other duties, cf. section 1 of the Danish Price Marking and Display Act.

This general rule does not apply to the sales of services. As for consumer agreements, VAT, whether explicitly stated or not, will often be assumed to be included in the stated price.

When marked goods and services are displayed in advertising or advertisements, the price must be inclusive of VAT and other duties, cf. section 5 of the Danish Marking and Display Act.

Failure to comply with the law may be fined.

Pursuant to sections 47(1) and 49(1) of the Danish VAT Act, VAT registration is obligatory if the annual turnover of goods exceeds DKK 50,000.

Traders who are liable to collect VAT are also obliged to keep accounts.

Profit made from the sale of goods must be declared to the tax authorities.

3.4.2. The legislation on foodstuffs and medicine

Traders of dietary products/supplements, herbal medicines, cosmetic products etc. must observe and comply with the public legislation pertaining to this area.

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