Fordham Law Review

Volume 88 | Issue 5 Article 17

2020

Using a Hybrid Securities Test to Tackle the Problem of Pyramid Fraud

Corey Matthews
Fordham University School of Law

USING A HYBRID SECURITIES TEST TO TACKLE THE PROBLEM OF PYRAMID FRAUD

*Corey Matthews**

This Note examines federal securities law as a tool to deter and regulate illegal pyramid schemes. Pyramid schemes are among the most prevalent forms of consumer fraud in the United States and they victimize thousands of individuals every year. The rise of the internet and social media has made it even easier for pyramid promoters to target potential recruits, often those who are already particularly vulnerable to consumer fraud. The federal securities laws have proven to be robust regulatory tools against pyramid schemes. However, the test used by federal courts to determine whether a scheme meets the definition of a security has produced uncertainty and inconsistency in the law. This Note proposes that when pyramid schemes are alleged, federal courts should apply a hybrid securities test that incorporates aspects of risk capital analysis. In so doing, courts will be better equipped to focus on the economic reality of pyramid schemes and to draw a more principled line between illegal pyramid fraud and legitimate enterprises.

* J.D. Candidate, 2021, Fordham University School of Law; B.A., 2016, Cornell University. I would like to thank Professor Caroline Gentile for her invaluable guidance and insight, the editors and staff of the *Fordham Law Review* for their input and diligence, and my family and friends for their unwavering support and encouragement.

INTRODUCTION

In April 1987, the *New York Times* published an article warning readers about the rising popularity of illegal "airplane" games cropping up in communities across the United States.[1] Participants in the game paid an entrance fee, usually $1500, which entitled them to "passenger" status on the metaphorical "airplane."[2] A full airplane typically consisted of a pilot or captain, two copilots, four flight attendants, and eight passengers.[3] Once the "airplane" was assembled, the pilot received the $12,000 collected from the passengers' entrance fees and rotated out.[4]

Subsequently, the two copilots became pilots of their own "airplanes," taking half of the passengers with them as flight attendants.[5] The flight attendants from the original flight became copilots, two on each new flight, and the game continued.[6] As a player moved up the ranks, he or she was

1. Elizabeth Neuffer, *'Airplane': High-Stakes Chain Letter*, N.Y. TIMES (Apr. 7, 1987), https://www.nytimes.com/1987/04/07/nyregion/airplane-high-stakes-chain-letter.html [https://perma.cc/XTW6-6HG2]; *see also* Lawrence Kilman, *Newest Illegal Pyramid Scheme Going Up and Up, but Not Away*, AP NEWS (Mar. 23, 1987), https://apnews.com/7894d03521da555b7ea45e6f78323fbb [https://perma.cc/73PM-4WA2].

2. *See, e.g.*, Sheehan v. Bowden, 572 So. 2d 1211, 1211–12 (Ala. 1990); State v. DeLuzio, 643 A.2d 535, 536–37 (N.J. 1994) (Ohern, J., dissenting); People v. Riccelli, 540 N.Y.S.2d 74, 74 (App. Div. 1989).

3. *See* Kilman, *supra* note 1; Neuffer, *supra* note 1.

4. Neuffer, *supra* note 1.

5. *Id.*

6. *Id.*

responsible for recruiting at least one passenger behind them.[7] After several rounds, a passenger would eventually earn the pilot's seat—a return of $12,000 on the $1500 initial payment—often in a matter of days.[8] The only problem? The game was a classic pyramid scheme: "airplanes" needed a constant influx of new passengers in order to generate returns.[9] This demand became harder to fill as ever-increasing "airplanes" branched off to form new ones.[10] To illustrate: for one pilot to receive a return on his investment, participants needed to recruit eight passengers.[11] For those eight passengers to earn pilot status and receive a return, the crew would need sixty-four new passengers.[12] For those sixty-four passengers to generate a profit, they collectively needed to bring in 512 additional players.[13] Despite these odds, for many people, the "airplane" game represented quick and easy money; a victimless crime so long as recruitment was sustained.[14]

Such "get rich quick" schemes have a seductive allure: small investments, modest effort, and astronomical rates of return.[15] But while many get rich quick models are easily detected and quickly fade from popularity, others have proved enduring and obstinate. Illegal pyramid schemes are one such fraud.[16] An illegal pyramid scheme rewards participants primarily for recruiting new individuals to join.[17] However, unlike the "airplane" game, most schemes incorporate the sale of a sham product to disguise the true nature of the fraud.[18] Despite widespread public awareness and concerted governmental efforts, illegal pyramid schemes continue to regularly enter the marketplace.[19]

Pyramids have proliferated in the digital age, thanks in great part to the internet and the ubiquity of social networking.[20] It is easier now, more than

---

7. *Id.*

8. *See* Kilman, *supra* note 1; Neuffer, *supra* note 1.

9. *See* David Enscoe, *Pyramid Scheme Takes Off, Thousands Invest in "Plane Game,"* SUN SENTINEL (Mar. 26, 1987), https://www.sun-sentinel.com/news/fl-xpm-1987-03-26-8701190859-story.html [https://perma.cc/N4V4-RYH9].

10. *See id.*

11. *Id.*

12. *Id.*

13. *Id.*

14. *See id.*; Neuffer, *supra* note 1.

15. *See infra* Part I.B.

16. *See* Andrew Ceresney, Dir., Div. of Enf't, Sec. & Exch. Comm'n, Address at UIC-SEC Joint Symposium to Raise Public Awareness: Combating Pyramid Schemes and Affinity Frauds Opening Remarks (Mar. 2, 2016), https://www.sec.gov/news/speech/ceresney-remarks-joint-symposium-raise-public-awareness-03022016.html [https://perma.cc/VU6Q-3H6Y].

17. *See* United States v. Gold Unlimited, Inc., 177 F.3d 472, 475 (6th Cir. 1999).

18. *See* Jeffrey A. Babener, *Network Marketing and the Law*, OR. ST. B. BULL., May 1997, at 23, 24.

19. *See* Ceresney, *supra* note 16.

20. *See* James Walsh, Note, *"Tis the Time's Plague When Madmen Lead the Blind": How the IRS Can Prevent Pyramid-Scheme Formation (and Why It Should)*, 67 CASE W. RES. L. REV. 577, 585 (2016); Debra A. Valentine, Former Gen. Counsel, Fed. Trade Comm'n, Address at the International Monetary Funds Seminar on Current Legal Issues Affecting Central Banks (May 13, 1998), https://www.ftc.gov/public-statements/1998/05/pyramid-schemes [https://perma.cc/53DK-34VQ]) (opining that the growth of internet marketing has

ever, for companies to enlist distributors to sell products like vitamins, beauty supplies, and home goods through their personal networks.[21]

Unfortunately, all illegal pyramids are structurally doomed to fail.[22] Pyramid schemes fundamentally rely upon the continuous recruitment of new distributors.[23] The enterprises generate revenue not from the sale of goods to end users but from new distributors' entrance fees and inventory purchases.[24] Those distributors are then rewarded with either a bonus or commission on the purchases made by those they have recruited.[25] All such schemes, however, inevitably collapse once a given market for new distributors becomes saturated.[26]

Two federal agencies shoulder the main responsibility for regulation and enforcement in this area: the Federal Trade Commission (FTC) and the Securities and Exchange Commission (SEC).[27] The FTC typically brings complaints against pyramids for engaging in unfair and deceptive practices,[28] a violation of section 5 of the Federal Trade Commission Act (FTCA).[29] The FTC has had some success in shutting down illegal pyramids with this approach.[30]

Under the SEC's ambit, when courts find that pyramid schemes constitute securities offerings, various other tools are available to federal regulators and private litigants.[31] The SEC may pursue pyramids for offering unregistered

---

been the most significant contributor to pyramid scheme growth in the United States because electronic commerce allows fraudsters to target victims quickly and cost-effectively).

21. *See* Walsh, *supra* note 20, at 585.

22. *See* Webster v. Omnitrition Int'l, Inc., 79 F.3d 776, 781 (9th Cir. 1996); Ziven Scott Birdwell, *The Key Elements for Developing a Securities Market to Drive Economic Growth: A Roadmap for Emerging Markets*, 39 GA. J. INT'L & COMP. L. 535, 561 (2011); Adam Epstein, *Multi-level Marketing and Its Brethren: The Legal and Regulatory Environment in the Down Economy*, 12 ATLANTIC L.J. 91, 104 (2010); *Investor Protection Guide: Pyramid Scheme*, LEGAL INFO. INST., https://www.law.cornell.edu/wex/investor_protection_guide_pyramid_scheme [https://perma.cc/A4DX-7EXU] (last visited Mar. 17, 2020).

23. Clinton D. Howie, *Is It a Pyramid Scheme?: Multilevel Marketing and Louisiana's "New" Anti-pyramid Statute*, 49 LA. B.J. 288, 289 (2002); *see also* Rhonda Bundy, Note, *Federal Securities Regulations: Do They Adequately Serve Their Prescribed Purpose of Protecting Investors from Pyramid Schemes?*, 21 MEM. ST. U. L. REV. 123, 125 (1990).

24. Howie, *supra* note 23, at 289.

25. *Id.*; Bundy, *supra* note 23, at 127.

26. *See* SEC v. Int'l Loan Network, Inc. (*Loan Network II*), 968 F.2d 1304, 1308–09 (D.C. Cir. 1992); Sergio Pareja, *Sales Gone Wild: Will the FTC's Business Opportunity Rule Put an End to Pyramid Marketing Schemes?*, 39 MCGEORGE L. REV. 83, 85–87 (2008); *see also* Bundy, *supra* note 23, at 128 (noting that market saturation frustrates the ability of late-entering participants to recoup investments).

27. *See* Note, *Pyramid Schemes: Dare to Be Regulated*, 61 GEO. L.J. 1257, 1257 (1973).

28. *See* Heidi Liu, *The Behavioral Economics of Multilevel Marketing*, 14 HASTINGS BUS. L.J. 109, 117–18 (2018); *see also* Epstein, *supra* note 22, at 101–02.

29. 15 U.S.C. § 45 (2018).

30. Walsh, *supra* note 20, at 587–88.

31. *See, e.g.*, Birdwell, *supra* note 22, at 562–63 (discussing the SEC's role in shutting down pyramid schemes); Bundy, *supra* note 23, at 124 (noting that of the available avenues of redress for victims of pyramid fraud, securities law seems to be the most viable solution for curtailing the problem of high-pressure, fraudulent investment schemes).

securities, a violation of the Securities Act of 1933,[32] or for violating section 10(b)[33] of the Securities Exchange Act of 1934 and Rule 10b-5[34], which prohibit individuals from making materially false or misleading statements in connection with the sale or purchase of a security.[35] Further, violators who run afoul of the federal securities laws can also face criminal liability under federal mail and wire fraud statutes.[36] Additionally, private litigants may bring suit under the Private Securities Litigation Reform Act of 1995 (PSLRA).[37] Moreover, state-specific securities laws may apply to illegal pyramids.[38] Both SEC and state security enforcement, however, are necessarily contingent upon the classification of a pyramid scheme as a security.[39] Finally, state antipyramid or chain distribution statutes may prevent and prohibit pyramid schemes.[40]

In Part I, this Note explores the various federal and state regulatory and enforcement regimes targeting pyramid schemes. This Part also considers the benefits and obstacles of those regulatory approaches. In Part II, this Note suggests that the federal securities law are viable and useful tools for shutting down and deterring formation of pyramids schemes. Part II thereafter analyzes two different tests used to determine whether an illegal pyramid scheme involves the sale of a security. In Part III, this Note argues that the final prong of the risk capital test used by some state courts more accurately captures the economic realities of a pyramid scheme. Further, Part III argues that in the context of pyramid schemes, incorporating this last prong of the risk capital test into the current federal test for investment contracts will better serve the purposes of the federal securities law and provide stronger tools to protect against pyramid-based fraud.

I. CLASSIFICATION AND REGULATION OF PYRAMID SCHEMES

Part I explains what a pyramid scheme is and how various governmental actors approach regulation, enforcement, and prevention of illegal pyramid fraud. Part I.A provides an overview of the broad distribution model known as multilevel marketing (MLM) and distinguishes between legitimate MLM programs and illegal pyramids. Part I.A further explores why illegal pyramids are doomed to fail, and Part I.B gives an overview of the harmful effects of pyramid fraud in the United States. Part I.C describes federal- and state-level governmental regulation of pyramid schemes, while analyzing the costs and benefits of the various regulatory approaches.

32. *See generally* 15 U.S.C. § 77e.
33. *Id.* § 78j.
34. 17 C.F.R. § 240.10b-5 (2019).
35. 15 U.S.C. §§ 78a–78b.
36. *See generally id.* §§ 77a–77aa.
37. *See id.* § 78u-4.
38. *See* Liu, *supra* note 28, at 116.
39. *See* Bundy, *supra* note 23, at 124.
40. Epstein, *supra* note 22, at 118–19.

A. Separating Fraud from Fair Play

Legal MLM companies and illegal pyramid schemes both use a similarly tiered organizational structure.[41] The following section describes the general characteristics of MLM selling that may be present in both legal enterprises and illegal pyramids. MLM selling is a subset of a larger universe of "direct sales" models.[42] Direct sales companies sell products or services directly to the end user, typically through independent distributors,[43] without using a retailer.[44] MLM companies, in particular, tend to incentivize distributors to recruit new participants by offering recruitment bonuses or commissions.[45]

MLM companies almost invariably use an upline/downline structure.[46] Every member has a distributor above them and at least one below that they have recruited into the plan.[47] The "upline" members earn both direct income based on their own sales of goods or services and residual income from their "downline" participants' sales.[48] Thus, as a distributor's downline grows, with each downline participant recruiting his or her own downline members, the upline receives commission from a greater number of sellers.[49] Accordingly, the company takes on a pyramid organizational shape through geometric progression as more members are needed below to support the income of members above.[50] Nonetheless, as discussed more thoroughly below, not all MLM programs are illegal pyramid schemes.[51]

---

41. *Id.* at 92.

42. Liu, *supra* note 28, at 111.

43. Participants in MLM companies may go by several different titles, including consultants, owners, contractors, and distributors, despite performing substantially similar functions. *See* Wesley K. Dagestaad, Note, Day*'s Pyramid Ignores Sturdy Severability Foundation, Builds off* Granite Rock, 2014 J. DISP. RESOL. 349, 349 n.2. Therefore, this Note uses such terms interchangeably. Independent distributors differ from traditional retailers in that distributors work for themselves and usually "set their own hours, create their own marketing plans, determine whether to build a sales team and how to mentor those within it and serve their customers." *What Is Direct Selling?*, DIRECT SELLING ASS'N, https://dsa.org/about/direct-selling [https://perma.cc/M7MG-5RL6] (last visited Mar. 17, 2020).

44. *See* Peter J. Vander Nat & William W. Keep, *Marketing Fraud: An Approach for Differentiating Multilevel Marketing from Pyramid Schemes*, 21 J. PUB. POL'Y & MARKETING 139, 140 (2002).

45. Liu, *supra* note 28, at 111.

46. *See* Epstein, *supra* note 22, at 102–04.

47. *Id.* at 102.

48. *Id.* at 102–03.

49. *Id.* at 103. For a detailed description of a typical MLM reward system, see William W. Keep & Peter J. Vander Nat, *Multilevel Marketing and Pyramid Schemes in the United States: An Historical Analysis*, 6 J. HIST. RES. MARKETING 188, 195 (2014).

50. For a diagram illustrating geometric progression in a sales-recruitment context, see Vincent G. Ella, Comment, *Multi-level or Pyramid Sales Systems: Fraud or Free Enterprise*, 18 S.D. L. REV. 358, 361 n.8 (1973).

51. Liu, *supra* note 28, at 115.

1. Fair Play: Legal MLM Selling and Its Advantages

Legal MLM companies are commonly confused with, or categorized as, illegal pyramid schemes because of organizational similarities.[52] Further, there is no clear dividing line in the law that separates legitimate MLM programs from illegal pyramid schemes.[53] Currently, there is no federal statutory definition of an illegal pyramid scheme and the courts have been inconsistent in how they distinguish pyramid schemes from MLM companies, which exacerbates confusion.[54] Nonetheless, there are several hallmarks of legitimate MLM businesses that set them apart from illegal schemes.

The first, and arguably most important, hallmark is that legitimate MLM companies focus primarily on real sales of marketable[55] products to real consumers outside of the plan.[56] The FTC has broken this principle down into four guideposts: (1) sales must be to real customers; (2) sales must be profitable and verifiable; (3) program targets or thresholds should not be satisfied by product purchases alone; and (4) compensation must be based on genuine retail sales.[57] Second, legitimate MLM companies tend to accurately represent the potential income or profits that their distributors can expect and the degree of time or effort required to achieve success in the plans.[58] Further, legal MLM programs rarely require distributors to make minimum inventory purchases to participate.[59] Finally, legitimate MLM programs typically maintain a buyback policy through which the company will repurchase inventory and sales kits from distributors wishing to leave the program.[60]

Legitimate MLM selling has benefits as a business model. For instance, direct selling through multilevel channels has low fixed costs, particularly

52. *See* United States v. Gold Unlimited, Inc., 177 F.3d 472, 475 (6th Cir. 1999).

53. *See* Walsh, *supra* note 20, at 583.

54. *Compare* SEC v. Glenn W. Turner Enters. (*Glenn Turner II*), 474 F.2d 476 (9th Cir. 1973) (taking into account the mathematical probability of market saturation in finding the scheme fraudulent), *with* Ger-Ro-Mar, Inc. v. FTC, 518 F.2d 33 (2d Cir. 1975) (noting the mathematical impossibility that continuous recruitment could be sustained, yet declining to conclude that the challenged scheme was deceptive).

55. Marketable products are those with competitive pricing and genuine demand in the marketplace. Babener, *supra* note 18, at 24. Illegal pyramids masquerading as legitimate MLM companies may sometimes claim substantial revenue from product sales, yet charge far above reasonable retail value for such products. *See, e.g.*, FTC v. BurnLounge, Inc., 753 F.3d 878, 883 (9th Cir. 2014).

56. *See* Ceresney, *supra* note 16.

57. Edith Ramirez, Chairwoman, Fed. Trade Comm'n, Keynote Remarks of FTC Chairwoman Ramirez: DSA Business & Policy Conference 5–6 (Oct. 25, 2016), https://www.ftc.gov/system/files/documents/public_statements/993473/ramirez_-_dsa_speech_10-25-16.pdf [https://perma.cc/U752-AQNT].

58. *Id.*

59. *Id.*

60. Babener, *supra* note 18, at 24. *But see* Whole Living, Inc. v. Tolman, 344 F. Supp. 2d 739, 742 (D. Utah 2004) (finding an MLM company to be legitimate and legal despite the absence of a buyback policy because its products were perishable and because the program's structure did not incentivize large purchases of inventory unrelated to demand for product).

when compared to the price of operating traditional retail outlets.[61] Further, in an MLM program, the existing sales force is responsible for training and recruiting new participants.[62] The MLM model also emphasizes entrepreneurship by encouraging social relationships between customers and distributors, rewarding personal selling through commission, and offering participants the independence and autonomy to build their own businesses and "downline."[63] Successful direct selling can be difficult because it requires strong personal sales skills and a substantial investment of time and social capital.[64] However, it does offer participants an opportunity to earn supplemental income and, in rare cases, more substantial profit.[65]

2. Fraud: Illegal Pyramid Schemes

In contrast to MLM companies, pyramid schemes are inherently fraudulent.[66] The term "pyramid scheme" has both a broad and specific meaning.[67] Broadly, a pyramid scheme is a kind of money-transfer arrangement that relies on perpetual recruitment.[68] Each participant pays a fee to enter the program and, in turn, receives the right to earn a portion of the fees paid by those recruited below them.[69] However, "[a]s recruitment continues, the number of people at or near the base of the recruitment structure grows very rapidly, often at an exponential rate for as long as a successful recruitment pattern is maintained."[70] Accordingly, those at the bottom struggle to recruit enough new members to recoup their investment.[71] Only the very few at the top earn a profit because the base necessarily represents the vast majority of participants.[72]

---

61. Vander Nat & Keep, *supra* note 44, at 140.

62. *Id.*

63. *Id.* Legitimate MLM distributors do earn a commission on sales of products by those whom they have recruited or sponsored. However, such a structure does not, on its own, render the program an illegal pyramid scheme. *See Whole Living*, 344 F. Supp. 2d at 745–46.

64. *See* Vander Nat & Keep, *supra* note 44, at 140–41.

65. *See* Ramirez, *supra* note 57, at 2–3.

66. Birdwell, *supra* note 22, at 561.

67. Keep & Vander Nat, *supra* note 49, at 196.

68. *Id.* The terms "pyramid scheme" and "Ponzi scheme" are often grouped together or used interchangeably. *See, e.g.*, Orlick v. Kozyack (*In re* Fin. Federated Title & Tr., Inc.), 309 F.3d 1325, 1327 (11th Cir. 2002). However, they are related, yet distinct concepts. *See* Eberhard v. Marcu, 530 F.3d 122, 132 n.7 (2d Cir. 2008). Pyramid schemes funnel money to participants by rewarding them for recruiting others, while Ponzi schemes pay initial investors directly with money contributed by later investors. United States v. Gold Unlimited, Inc., 177 F.3d 472, 475 (6th Cir. 1999).

69. *See* Keep & Vander Nat, *supra* note 49, at 196–97.

70. *Id.*

71. *See id.*

72. *Id.* at 197; *see also* Koscot Interplanetary, Inc., 86 F.T.C. 1106, 1132–33, 1181 (1975) (observing that an illegal pyramid scheme is really just an elaborate chain letter device in which most individuals who hope to regain their initial payment are bound to be disappointed); J. L. Gastwirth & P. K. Bhattacharya, *Two Probability Models of Pyramid or Chain Letter Schemes Demonstrating That Their Promotional Claims Are Unreliable*, 32 OPERATIONS RES. 527, 530 (1984) (reporting the statistical probabilities of expected returns for pyramid scheme participants based on time of entry into the program).

The specific definition of "pyramid scheme" is an organization that masks a perpetual recruitment chain with the sale of a product or service through a traditional MLM model.[73] However, in an MLM-based pyramid scheme, while products are bought and sold by participants, compensation is still derived chiefly from recruitment rather than market-based retail activity.[74]

There are several consistent attributes of MLM-based pyramid schemes. For instance, such schemes typically use a system of graduated product prices.[75] In this system, each distributor purchases products at a lower price than what he charges the public and what he charges if he sells to participants below him in the distribution chain.[76]

For example, a distributor at the lowest participant level, Distributor A, may be entitled to purchase product from the parent company, for sale to the public, at a 40 percent discount on the retail sales price.[77] However, Distributor B, having achieved membership in the tier directly above Distributor A, may be able to purchase product at a 55 percent discount.[78] Distributor B, further, has rights to sell both to the public and to Distributor A. Distributor B, therefore, earns up to a 15 percent override on A's sales *and* may offer her customers a lower price for the product yet enjoy the same profit margins as Distributor A.[79]

As such, if both Distributors A and B operate in the same geographic or social market, Distributor A is at a significant competitive disadvantage because he must pay more for inventory. Accordingly, Distributor A has a strong incentive to move up in the chain. If Distributor A rises in the program, he will earn a larger wholesale discount along with the right to recruit and sell to participants below him.[80] In such a system, therefore, moving up in the scheme is the easiest and most effective way for Distributor A to earn income.[81]

These graduated price arrangements typically lead to another common practice of MLM-based pyramid schemes known as inventory loading.[82] In many illegal pyramids, participants may advance in the program solely by

73. Stacie Bosley & Maggie Knorr, *Pyramids, Ponzis and Fraud Prevention: Lessons from a Case Study*, 25 J. FIN. CRIME 81, 82 (2018); Keep & Vander Nat, *supra* note 49, at 196–97.

74. Bosley & Knorr, *supra* note 73, at 82; *see also Koscot Interplanetary*, 86 F.T.C. at 1181 (noting that the presence of "recruitment with rewards unrelated to product sales" is the sine qua non of a pyramid scheme).

75. *See* Note, *supra* note 27, at 1258–59.

76. *Id.*

77. *See* Ella, *supra* note 50, at 362.

78. *See id.*

79. *See id.*

80. *See id.*

81. *See id.* at 362–63.

82. *See Business Guidance Concerning Multi-level Marketing*, FED. TRADE COMM'N, https://ftc.gov/tips-advice/business-center/guidance/business-guidance-concerning-multi-level-marketing [https://perma.cc/U9VD-CUUU] (last visited Mar. 17, 2020); *see, e.g.*, Webster v. Omnitrition Int'l, Inc., 79 F.3d 776, 782–83 (9th Cir. 1996) (citing the scheme participant's testimony that distributors would purchase excessive quantities of product that were entirely unrelated to actual market demand).

meeting a threshold for minimum wholesale product purchases.[83] Distributor A, for instance, may move up to the same tier as Distributor B by purchasing a large quantity of inventory in bulk.[84] Importantly, in illegal schemes, there is no requirement that Distributor A later prove that he has resold any product to customers *outside* the program.[85] Rather, so long as Distributor A recruits someone below him, Distributor C, then Distributor A has a built-in market to offload the inventory to lower-level distributors at a profit.[86]

Thus, the system encourages internal sales through continuous recruitment and de-emphasizes sales to retail consumers outside of the plan.[87] As such, MLM-based illegal pyramids use products predominantly to conceal the fraud, and such products are frequently not competitive in a real-world marketplace.[88] Rather, existing participants are compensated by money coming in from new recruits and those below them in an endless-chain fashion.[89]

Expectedly, MLM-based pyramids must rely on the continuous enlistment of new participants.[90] As such, the payment of bonuses upon successful recruitment of a new member is another hallmark of such schemes.[91] These payments are not based on the recruited distributors' actual sales.[92] Instead, they represent a predetermined percentage of the fee a new distributor must pay or the cost of products they must purchase to enter the program.[93]

83. *See* Ella, *supra* note 50, at 362.

84. *See* Babener, *supra* note 18, at 24–25.

85. *See Omnitrition*, 79 F.3d at 782 (describing rewards that are not tied to product sales to end users because they are earned "based on the suggested retail price of the amount *ordered* from Omnitrition, rather than based on *actual sales* to consumers").

86. *See id.* (observing that lucrative rewards for recruitment induce participants to focus on that part of the business, "making it unlikely that meaningful opportunities for retail sales will occur" (citing Koscot Interplanetary, Inc., 86 F.T.C. 1106, 1132–33, 1181 (1975))). This is one of the reasons why the FTC focuses so heavily on determining whether products are sold principally to consumers outside of the program. Ramirez, *supra* note 57, at 5–10.

87. *See* Ramirez, *supra* note 57, at 6 ("When a product is tied to a business opportunity, experience teaches that the people buying it may well be motivated by reasons other than actual product demand.").

88. *See* Ger-Ro-Mar, Inc., 84 F.T.C. 95, 148–49 (1974) (noting that the presence of some retail sales does not impact the fundamentally unlawful character of pyramid schemes); *see also supra* note 55 and accompanying text. A related problem arises when new distributors are recruited so rapidly that supply outpaces demand to such a degree that most distributors have virtually no chance of retailing products. *See, e.g.*, People *ex rel.* Kelly v. Koscot Interplanetary, Inc., 195 N.W.2d 43, 52–53 (Mich. Ct. App. 1972) (finding that for all plan participants in Michigan to realize the promoters' stated income projections, the company as a whole would have needed to sell $300,000,000 worth of its cosmetics in that state in a year; this figure was $20,000,000 more than the estimated *total market demand* for such goods in the state).

89. *Fast Answers: Pyramid Schemes*, SEC. & EXCHANGE COMMISSION (Oct. 9, 2013), https://sec.gov/fast-answers/answerspyramidhtm.html [https://perma.cc/7V72-CDH2].

90. Babener, *supra* note 18, at 24.

91. *Id.*; Walsh, *supra* note 20, at 582 (observing that the most significant common characteristic of all illegal pyramid schemes is payments in exchange for the right to recruit others into the scheme).

92. *See* Keep & Vander Nat, *supra* note 49, at 198.

93. *See id.* at 196–97.

B. Pyramid Fraud and the Harm to Consumers

As Part I.A demonstrated, the fundamental flaw in any pyramid scheme is the inescapable reality that only a finite number of investors can ever recoup their initial investments.[94] Pyramids are deliberately designed to grow exponentially and rapidly.[95] When the schemes inevitably grow too large, it becomes impossible to recruit enough new members to pay back existing ones.[96] As a result, the large majority of participants lose money simply because they enter the scheme after it has already become unsustainable.[97]

Because pyramids require continuous recruitment, they employ misrepresentations and unrealistic promises of success or potential earnings.[98] First, the schemes intentionally use convoluted reward structures and sale plans to mask the fraudulent nature of the program.[99] Second, pyramid schemes frequently look very similar to legitimate MLM plans, making it even more difficult for the average distributor to distinguish fraud from fair play.[100]

Third, pyramid schemes historically capitalize on potential participants' lack of financial knowledge or expertise.[101] Scheme promoters often target populations that are most susceptible to deceptive promises and those who lack the necessary financial experience or expertise to identify the flaws in the program.[102] For instance, communities or social networks with high levels of underemployment and unemployment are particularly susceptible to pyramid fraud victimization.[103] There is also a documented correlation

94. Gastwirth & Bhattacharya, *supra* note 72, at 528; Joseph P. Whitford, Note, *Pyramid Scheme Regulation: The Evolution of Investment Contracts as a Security Under the Federal Securities Laws*, 25 SYRACUSE L. REV. 690, 694 (1974).

95. *See Fast Answers: Pyramid Schemes*, *supra* note 89.

96. *See id.*

97. *See id.*

98. *See* Note, *supra* note 27, at 1259 (commenting on the widespread use of high-pressure sales tactics, misleading presentations, and deceitful enthusiasm, which create an expectation of dazzling financial returns in exchange for modest effort and time).

99. *See* Vander Nat & Keep, *supra* note 44, at 141.

100. *See* Lauren Bell, *Pyramid Dream*, BALT. MAG. (June 2018), https://www.baltimoremagazine.com/2018/6/12/multi-level-marketing-companies-evolve-with-21st-century [https://perma.cc/MNQ5-X2BE] (discussing the growth of the MLM business, the allure of MLM selling, and the difficulty participants have in identifying and assessing the risk that what appears to be a legitimate MLM company is in truth a pyramid scheme); *see also* Bosley & Knorr, *supra* note 73, at 82 (noting the growth of more sophisticated pyramid offerings set within the context of purportedly legitimate MLM companies).

101. *See* Note, *supra* note 27, at 1261 (commenting that pyramid plans are aimed at the general public and often employ recruitment tactics designed to make it difficult for potential investors to come to intelligent or thoughtful decisions).

102. Whitford, *supra* note 94, at 694. *But see* Stacie A. Bosley et al., *Decision-Making and Vulnerability in a Pyramid Scheme Fraud*, 80 J. BEHAV. & EXPERIMENTAL ECON. 1, 5 (2019) (reporting more recent data that may contradict the stereotype of fraud victims as older, less sophisticated, and uneducated).

103. *See* Bosley & Knorr, *supra* note 73, at 84, 87; Stacie Bosley & Kim K. McKeage, *Multilevel Marketing Diffusion and the Risk of Pyramid Scheme Activity: The Case of Fortune Hi-tech Marketing in Montana*, 34 J. PUB. POL'Y & MARKETING 84, 93 (2015) (finding that counties in Montana with higher unemployment and greater economic contractions were more

between lower levels of educational attainment and membership in pyramid schemes.[104] The schemes also frequently appeal to those with fewer opportunities in the mainstream job market[105] because the schemes are often billed as a supplementary and flexible income source that require only a small initial outlay of capital.[106]

Fourth, because recruitment requires leveraging community ties and social networks, there is significant overlap between affinity fraud and pyramid fraud.[107] Affinity fraud "refers to investment scams that prey upon members of identifiable groups, such as religious or ethnic communities, the elderly, or professional groups."[108] Such schemes can be particularly harmful to individuals and communities because they exploit group trust, friendship, and commonality.[109] Affinity fraud can also be especially difficult to detect and stop because the close relationships among groups often make victims reluctant to report the fraud or seek legal redress.[110] This problem is particularly acute when scheme promoters have convinced respected group members or community leaders to promote the fraud and encourage others to join.[111]

---

susceptible to recruitment efforts of a particular pyramid scheme); Ralph E. Stone & Jeffrey M. Steiner, *The Federal Trade Commission and Pyramid Sales Schemes*, 15 PAC. L.J. 879, 892 (1983) (noting that pyramid sales schemes are more popular during periods of economic uncertainty).

104. Bosley & Knorr, *supra* note 73, at 90.

105. *See id.* at 84; Kathy Peiss, *"Vital Industry" and Women's Ventures: Conceptualizing Gender in Twentieth Century Business History*, 72 BUS. HIST. REV. 218, 235–36 (1998) (discussing the ways that pyramid sales have appealed to working mothers as flexible job opportunities).

106. *See* Bosley & Knorr, *supra* note 73, at 84.

107. *See* Lisa M. Fairfax, *The Thin Line Between Love and Hate: Why Affinity-Based Securities and Investment Fraud Constitutes a Hate Crime*, 36 U.C. DAVIS L. REV. 1073, 1082 (2003); Lisa M. Fairfax, *"With Friends Like These . . .": Toward a More Efficacious Response to Affinity-Based Securities and Investment Fraud*, 36 GA. L. REV. 63, 72 (2001). Even where affinity groups are not involved, the importance of social networking, combined with the high-pressure sales and recruiting tactics typical of direct selling, may make distributors reluctant to leave programs even when they have incurred substantial financial losses. *See, e.g.*, Amelia Tait, *'They Have You in a Cultish Grip': The Women Losing Thousands to Online Beauty Schemes*, GUARDIAN (June 1, 2019), https://theguardian.com/fashion/2019/jun/01/online-beauty-schemes-selling-social-media-younique-arbonne [https://perma.cc/EV3H-P2R7].

108. *Affinity Fraud: How to Avoid Investment Scams That Target Groups*, SEC. & EXCHANGE COMMISSION (Oct. 9, 2013), https://www.sec.gov/investor/pubs/affinity.htm [https://perma.cc/TDR6-MEDC] (noting that affinity scams frequently involve Ponzi or pyramid schemes).

109. *Investor Alert: Affinity Fraud*, SEC. & EXCHANGE COMMISSION (June 18, 2014), https://www.sec.gov/oiea/investor-alerts-bulletins/ia_affinityfraud.html [https://perma.cc/4JBM-HSYP]; *see also* David E. Austin, Comment, *"In God We Trust": The Cultural and Social Impact of Affinity Fraud in the African American Church*, 4 U. MD. L.J. RACE RELIGION GENDER & CLASS 365, 365 (2004) (observing that affinity fraud can be especially effective among minority groups with a documented history of oppression, such as the African-American community, because the trust implicit among members is often particularly strong when the group has experienced social marginalization).

110. *Investor Alert: Affinity Fraud*, *supra* note 109.

111. *Id.*

Several factors complicate enforcement and prevention, making it difficult to gauge the precise amount of money that victims in the United States lose to pyramid schemes each year.[112] Settlements with both the FTC and SEC commonly reach tens of millions of dollars.[113] Additionally, the FTC's most recent survey indicates that around 1.5 million people fall victim to pyramid scheme fraud in the United States in any given year.[114] Unfortunately, of all monitored consumer fraud victim groups, pyramid scheme victims are the least likely to make formal reports to government authorities.[115] This may be because, when compared to Ponzi schemes—in which there are usually fewer victims who each lose larger sums[116]—pyramids tend to involve a greater number of victims who each lose a smaller amount.[117] There is also evidence that pyramid promoters stigmatize those who leave the program, announcing that participants who fail do so because of a lack of skill or dedication.[118] Finally, researchers have identified that guilt is a strong deterrent to victim reporting, a phenomenon that is unique to pyramid scheme fraud.[119] As participants feel regret and embarrassment for bringing in friends, family members, or colleagues, they are less likely to speak up about the experience.[120] Because of such low reporting rates and high social connectivity among pyramid scheme victim groups, prevention and enforcement are particularly important in this area.[121]

---

112. *See* Keep & Vander Nat, *supra* note 49, at 203–05 (noting the dearth of verifiable data regarding MLM and pyramid sales).

113. *See* Terrell McSweeney, *Congress Should Crack Down on Predatory 'Pyramid Schemes,' Not Look Away*, HILL (Aug. 3, 2017, 8:00 AM), https://thehill.com/blogs/pundits-blog/finance/345073-congress-should-crack-down-on-predatory-pyramid-schemes-not-look [https://perma.cc/WJL7-68NA] (reporting two FTC settlements with Herbalife and Fortune Hi-Tech Marketing totaling a combined $210 million and the $17 million lost by victims of the BurnLounge scheme).

114. FED. TRADE COMM'N, CONSUMER FRAUD IN THE UNITED STATES, 2011: THE THIRD FTC SURVEY 18–19 (2013), https://www.ftc.gov/sites/default/files/documents/reports/consumer-fraud-united-states-2011-third-ftc-survey/130419fraudsurvey_0.pdf [https://perma.cc/22AR-BE3S].

115. Bosley et al., *supra* note 102, at 1–2.

116. *See, e.g.*, Scott Cohn, *Want to Work at Home?: Take a Lesson from This $3 Billion Pyramid Scheme*, CNBC (June 22, 2018, 8:00 AM), https://www.cnbc.com/2018/06/21/want-to-work-at-home-take-a-lesson-from-this-3-billion-pyramid-scam.html [https://perma.cc/A9JV-LTTT] (comparing the TelexFree pyramid scheme, which defrauded an estimated 1.8 billion victims worldwide out of $3 billion, with Bernie Madoff's Ponzi scheme, which victimized several thousand people but generated $17.5 billion in losses).

117. *See* FED. TRADE COMM'N, *supra* note 114, at 39 (reporting that 50 percent of pyramid scheme victims who provided information on payments reported paying at least $200).

118. *See* Bosley et al., *supra* note 102, at 11.

119. *Id.* ("This last factor is unique to pyramid scheme fraud as it is the only form of fraud that, by definition, incentivizes person-to-person recruitment.").

120. *See* Bosley & Knorr, *supra* note 73, at 83.

121. *See* Bosley et al., *supra* note 102, at 2.

C. The Landscape of Existing Laws and Regulations

Hundreds of thousands of Americans participate in MLM-based direct sales every year.[122] While many work within legitimate MLM companies, a great number of people unknowingly sign up for illegal pyramids.[123] The overwhelming majority of these people lose money in the process.[124] Both state and federal agencies have worked hard to educate the public on how to spot and avoid fraudulent schemes.[125] However, it is difficult for the public to identify fraudulent programs effectively when government actors themselves have trouble separating the legitimate from the illegal.[126] As a result, government intervention has focused more on detection of, and enforcement against, illegal pyramids.[127]

However, one of the reasons pyramid schemes are so difficult to detect and stamp out is that they exist in a legal gray area.[128] On the federal level, MLM programs—both the legitimate enterprises and MLM-based pyramids—fall outside the FTC's definition of a franchise.[129] Accordingly franchise regulations and disclosure requirements do not apply to pyramids.[130] Moreover, as discussed more thoroughly below,[131] FTC enforcement actions charging unfair and deceptive practices have thus far not proved especially effective at deterring pyramid scheme formation.[132] Further, with the exception of the Ninth Circuit,[133] the federal courts have been unwilling to

122. *See Direct Selling in the United States: 2018 Industry Overview*, DIRECT SELLING ASS'N 1, https://www.dsa.org/docs/default-source/action-alerts/2018industryoverview-06032019.pdf [https://perma.cc/TEC7-Q7QW] (last visited Mar. 17, 2020).

123. Pareja, *supra* note 26, at 84–85.

124. FED. TRADE COMM'N, *supra* note 114, at 13 (reporting that often 90 percent or more of participants in pyramid schemes do not recoup their initial investment).

125. *See, e.g.*, *Business Guidance Concerning Multi-level Marketing*, *supra* note 82; Dana Nessel, *Consumer Alert: Multi-level Marketing or Illegal Pyramid Scheme?*, MICH. ATT'Y GEN., https://www.michigan.gov/ag/0,4534, 7-164-177337_20942-208400--,00.html [https://perma.cc/PZ34-BFDX] (last visited Mar. 17, 2020).

126. *See* Walsh, *supra* note 20, at 583 (noting that courts, legislators, and enforcement agencies have all struggled to adequately define the term "pyramid scheme").

127. *See* Note, *supra* note 27, at 1266, 1274.

128. *See* Bosley & Knorr, *supra* note 73, at 81 (explaining that pyramid schemes operate in a complicated practical and legal environment); Walsh, *supra* note 20, at 583.

129. *See* Business Opportunity Rule, 76 Fed. Reg. 76,816 (Dec. 8, 2011) (to be codified at 16 C.F.R. pt. 437) (noting that because of the minimum investment and inventory exemptions to the franchise rule, pyramid schemes are not covered); W. MICHAEL GARNER, FRANCHISE AND DISTRIBUTION LAW AND PRACTICE § 1.11 (2019) (noting that sales distributorships differ from franchises in that (1) distributors do not pay franchise fees for the right to resell a product or use the trademark of a supplier; (2) the supplier in a distributorship will rarely provide a marketing system or plan; and (3) the distributor has no rights to the supplier's trademark).

130. *See Business Guidance Concerning Multi-level Marketing*, *supra* note 82, ¶ 10.

131. *See infra* Part I.C.2.

132. *See* Pareja, *supra* note 26, at 94–97 (noting the difficulty in gathering evidence of unfair or deceptive acts and reporting that, between January 1997 and December 2005, consumers submitted 17,858 complaints regarding pyramid schemes but the FTC only brought twenty cases against such schemes under the FTCA between 1990 and 2008).

133. *See Glenn Turner II*, 474 F.2d 476, 479 (9th Cir. 1973).

hold that pyramid schemes are per se securities.[134] Moreover, state-level regulation has been problematic for two reasons. First, predatory pyramid schemes are able to move easily across state lines to avoid disclosure requirements or limit liability in future enforcement actions.[135] Second, for legal MLM companies, inconsistent state laws and regulatory regimes complicate risk assessment, and this unpredictability may discourage the growth of legitimate businesses.[136]

1. The States

Though there is no federal antipyramid scheme statute, many states have passed laws targeting pyramid schemes and other kinds of chain promotion or distribution plans.[137] Typically, state statutes either target pyramids specifically or handle them within broader statutes prohibiting deceptive trade practices.[138] These laws vary greatly, as do the individual state definitions of the term "pyramid scheme."[139] However, many states do at least prohibit the sale of business opportunities[140] unless the seller provides the prospective participant with a presale disclosure document that has been filed with the relevant state agency.[141] Nonetheless, twenty-one states have antipyramid scheme laws that define pyramid fraud and distinguish the practices of such schemes from those of legitimate businesses.[142]

---

134. *See, e.g.*, Davis v. AVCO Fin. Servs., Inc., 739 F.2d 1057 (6th Cir. 1984); Ranieri v. AdvoCare Int'l, L.P., 336 F. Supp. 3d 701, 713–14 (N.D. Tex. 2018); Kerrigan v. ViSalus, Inc., 112 F. Supp. 3d 580, 598–99 (E.D. Mich. 2015).

135. Note, *supra* note 27, at 1265.

136. *See id.* at 1257, 1265–66.

137. Epstein, *supra* note 22, at 118–19. For decades, commentators have called on Congress to pass a specific antipyramid statute. *See, e.g.*, Ella, *supra* note 50, at 392–93; Note, *supra* note 27, at 1293. Further, proposed antipyramid legislation has been introduced in the U.S. Senate twice but has never successfully passed. Valentine, *supra* note 20. This may be the result of difficulty in crafting an appropriate definition for illegal pyramid schemes that is both precisely targeted but not excessively narrow so as to encourage circumvention. *See infra* note 150 and accompanying text.

138. DEE PRIDGEN & RICHARD M. ALDERMAN, CONSUMER PROTECTION AND THE LAW § 3.14 (2019–2020 ed.).

139. *Compare* CAL. PENAL CODE § 327 (West 2020) (prohibiting "[a]ny 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"), *with* MICH. COMP. LAWS § 445.2582(h) (2020) ("'Pyramid promotional scheme' means any plan or operation in which an individual gives consideration for the opportunity to receive compensation that is derived primarily from recruiting other individuals into the plan or operation rather than from the sale of products or services to ultimate users or from the consumption or use of products or services by ultimate users.").

140. Federal and state authorities both similarly define a business opportunity as an "arrangement[] where a seller solicits a prospective buyer to enter into a business, the prospective purchaser makes a required payment, and the seller—expressly or by implication—makes certain kinds of claims." *Selling a Work-at-Home or Other Business Opportunity?: Revised Rule May Apply to You*, FED. TRADE COMMISSION (Nov. 2011), https://www.ftc.gov/tips-advice/business-center/guidance/selling-work-home-or-other-business-opportunity-revised-rule [https://perma.cc/BZP7-GV7K].

141. Pareja, *supra* note 26, at 105.

142. Sean Reyes, *Learning from the States: Feds Should Adopt Anti-pyramid Scheme Law*, HILL (Nov. 19, 2017, 12:30 PM), https://thehill.com/blogs/congress-blog/judicial/362235-

Additionally, all fifty states have their own securities laws,[143] under which state regulators have targeted pyramid schemes for securities fraud or violations of state disclosure provisions.[144]

However, enforcing state laws against multistate companies is difficult because these laws vary widely.[145] As a result, companies that might face greater liability or disclosure requirements in one state may easily transfer their operations across borders.[146] This is particularly true given the increasing role of technology and the internet in pyramid scheme promotion.[147] Further, variation among state antipyramid statutes and business opportunity laws has produced an uncoordinated regulatory effort.[148] For legitimate MLM programs, this inconsistency creates unpredictability and discourages the growth of economically productive businesses.[149] Finally, state statutes that narrowly define the term "pyramid scheme" may unwittingly provide a roadmap that allows promoters to design programs that specifically skirt the definition.[150]

Use of state securities laws against pyramids is similarly difficult.[151] The variation that weakens antipyramid statutes as regulatory tools similarly reduces the efficacy of state securities laws in this area.[152] Furthermore, in 1996, the National Securities Markets Improvement Act of 1996[153] (NSMIA) explicitly preempted state securities laws in many ways.[154] For instance, NSMIA barred the states from imposing registration or reporting requirements on issuers of covered securities.[155] Subsequently, the

learning-from-the-states-feds-should-adopt-anti-pyramid-scheme [https://perma.cc/SB97-GJ9Y].

143. Adam J. Gana & Michael Villacres, *Blue Skies for America in the Securities Industry . . . Except for New York: New York's Martin Act and the Private Right of Action*, 19 FORDHAM J. CORP. & FIN. L. 587, 596 (2014).

144. *See* Liu, *supra* note 28, at 116.

145. Pareja, *supra* note 26, at 104.

146. *Id.*

147. *See* Valentine, *supra* note 20.

148. *See* Epstein, *supra* note 22, at 118; Stone, *supra* note 103, at 893–94; *see also* Eric Witiw, *Selling the Right to Sell the Same Right to Sell: Applying the Consumer Fraud Act, the Uniform Securities Law and the Criminal Code to Pyramid Schemes*, 26 SETON HALL L. REV. 1635, 1643–44 (1996).

149. *See* Howie, *supra* note 23, at 289–90 (noting the ambiguity and uncertainty in the application of various state statutes to multilevel marketing plans).

150. *See* CAROLYN L. CARTER, CONSUMER PROTECTION IN THE STATES: A 50-STATE REPORT ON UNFAIR AND DECEPTIVE ACTS AND PRACTICES STATUTES 11 (2009), https://www.nclc.org/images/pdf/udap/report_50_states.pdf [https://perma.cc/R75W-7MC8]; Frank Mays Hull, Comment, *Pyramid Marketing Plans and Consumer Protection: State and Federal Regulation*, 21 J. PUB. L. 445, 454 (1972).

151. Pareja, *supra* note 26, at 104–05.

152. *See* Witiw, *supra* note 148, at 1640–42.

153. Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 and 29 U.S.C.).

154. 15 U.S.C. § 77r (2018); THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.24 (7th ed. 2019).

155. 15 U.S.C. § 77r.

Securities Litigation Uniform Standards Act of 1998[156] also removed most securities class actions involving publicly traded securities from state courts.[157] Moreover, even where these statutes do not explicitly preempt state law, courts have frequently held that state laws that conflict with federal securities law may be impliedly preempted.[158] Accordingly, states currently play a greatly diminished role in securities regulation and enforcement.[159] In sum, while state-level regulation may be useful for targeting localized pyramid fraud within state borders, on the whole, it is not a particularly effective tool for combatting this national problem.

2. The FTC

On the federal level, the FTC began robust enforcement against pyramids in the 1970s, when modern MLM companies began to take shape and proliferate.[160] Two important cases, *Koscot Interplanetary, Inc.*[161] and *Amway Corp.*,[162] helped develop the criteria that the FTC would use to define illegal pyramid schemes and to distinguish them from legitimate MLM programs.[163]

In *Koscot*, the FTC alleged that the company's realization of profit was predicated upon inducing others, through misrepresentations of potential profits, to join the plan.[164] However, due to high market saturation and exceedingly low market demand for the actual products, those who joined after the first few rounds of recruitment were all but guaranteed to lose any money they had invested in purchasing the products for resale.[165]

The FTC successfully showed that Koscot's business model was false, misleading, and deceptive, and therefore it constituted an unfair act and practice.[166] The administrative law judge thus held that unlawful pyramids are characterized by payments by participants "in return for which they receive (1) the right to sell a product *and* (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to

156. Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.).

157. HAZEN, *supra* note 154, § 1.24.

158. *Id.*

159. *See* Rutherford B. Campbell, Jr., *The Role of Blue Sky Laws After NSMIA and the JOBS Act*, 66 DUKE L.J. 605, 613–14 (2016). State regulation may nonetheless still be useful for more localized fraud, and states still retain some jurisdiction over certain securities actions. HAZEN, *supra* note 154, § 1.24. For instance, class actions implicating securities that are not publicly traded may still be heard in state court. *Id.*

160. Jessica Sweeb, *Health Multi-level Marketing: Robbing People of Their Money and Their Health*, 27 ANNALS HEALTH L. ADVANCE DIRECTIVE 223, 228 (2018).

161. 86 F.T.C. 1106 (1975).

162. 93 F.T.C. 618 (1979).

163. Sweeb, *supra* note 160, at 228–30.

164. *Koscot*, 86 F.T.C. at 1112.

165. *Id.*

166. *Id.*

the sale of the product to ultimate users."[167] The FTC continues to use this definition today.[168]

In stating that the program was not a pyramid and did not engage in deceptive business practices, the *Amway* decision provided guideposts for distinguishing between illegal pyramids and legitimate MLM programs.[169] The decision emphasized three of Amway's company policies and concluded that such policies provided sufficient consumer protection safeguards. First, Amway had a policy of buying back goods of distributors leaving the program.[170] Second, Amway required that distributors make sales to at least ten unique customers each month.[171] And third, distributors were required to sell 70 percent of the product they purchased each month to customers outside the Amway program.[172]

In the years since *Amway*, those three policies have become known as the Amway safeguards rule.[173] Legitimate MLM companies have generally been able to limit much of their potential FTC liability by incorporating Amway's policies into their business models.[174] The FTC's regulatory approach to pyramid schemes has also remained consistent in the decades since *Koscot* and *Amway*.[175] The agency continues to rely heavily—if not exclusively—on case-by-case adjudication and enforcement.[176]

Though the FTC has had some success in taking down large pyramid schemes, several major obstacles prevent effective FTC regulation and enforcement. First, shutting down a scheme under the Federal Trade Commission Act of 1914 is difficult, time-consuming, and costly.[177] Proving, for instance, that a company affirmatively misrepresented its earning potential is a highly fact-intensive process that requires significant agency resources.[178] Moreover, pyramids and fraudsters have proven capable of adapting and innovating to evade detection, which has made the FTC's cases even harder to prove.[179] Additionally, by the time pyramid schemes achieve the size and visibility necessary to attract FTC attention,

---

167. *Id.* at 1180.
168. *See Business Guidance Concerning Multi-level Marketing*, *supra* note 82.
169. *See* Amway Corp., 93 F.T.C. 618 (1979).
170. Pareja, *supra* note 26, at 95.
171. *Id.*
172. *Id.*
173. Babener, *supra* note 18, at 24.
174. *See id.*
175. *See* Pareja, *supra* note 26, at 88–90.
176. *See Business Guidance Concerning Multi-level Marketing*, *supra* note 82 (explaining that the commission engages in case-by-case enforcement and adjudication, rather than prescriptive rulemaking).
177. Walsh, *supra* note 20, at 588.
178. *See* Note, *supra* note 27, at 1272 n.99; *see also* Pareja, *supra* note 26, at 95–96 (explaining that companies are careful to protect against claims of misrepresentation by trumpeting the success of the few at the top of the pyramid while including generic and bare disclaimers); Walsh, *supra* note 20, at 591 (observing that FTC adjudication requires "lengthy and complicated factual analyses that use balancing tests, percentages, and somewhat arbitrary ratios").
179. *See* FTC v. BurnLounge, Inc., 753 F.3d 878, 883 (9th Cir. 2014) (citing the district court's description of the BurnLounge bonus system as a "labyrinth of obfuscation").

most stakeholders have already incurred significant losses that they are unlikely to recoup.[180]

Finally, the FTC only has the authority to bring civil charges against pyramid operators.[181] Accordingly, the consequences of FTC violations, though sometimes significant, are limited to financial loss.[182] Because enforcement actions are lengthy and not guaranteed,[183] the overall deterrent effect of FTC enforcement has been somewhat weak.[184]

3. The SEC

The SEC became concerned about pyramid schemes around the same time that the FTC did.[185] In November 1971, the agency issued a landmark release, which detailed its view that the operation of a pyramid scheme may involve the offering of a security under the Securities Act of 1933.[186] Where pyramid schemes are classified as securities, there are several important consequences.[187] First, promoters of pyramid securities are required to register any agreement between the company and potential investors with the SEC.[188] Second, investors recruiting or soliciting others in exchange for a commission or other compensation need to be brokers, as defined by the 1934 Securities Exchange Act.[189] Third, deceptive acts or practices connected to the sale or offer to participate are subject to securities antifraud provisions.[190] Further, under the ambit of the federal securities laws, pyramid profits may be subject to disgorgement.[191] Although the SEC has no authority to require a violator of the securities laws to make restitution, in injunction actions, the agency has frequently been successful in securing orders requiring disgorgement of profits as ancillary relief.[192] These funds are then held in a depository and distributed to victims entitled to recovery.[193] The SEC may

---

180. *See FTC Action Leads Court to Halt Alleged Pyramid Scheme*, FED. TRADE COMMISSION (Jan. 28, 2013), https://www.ftc.gov/news-events/press-releases/2013/01/ftc-action-leads-court-halt-alleged-pyramid-scheme [https://perma.cc/XLE8-2576] (reporting that, by the time the FTC's complaint was filed, more than 100,000 consumers had been victimized by the scheme and more than 90 percent of those who bought in had lost their money).

181. *See* 15 U.S.C. § 45 (2018).

182. *See id.*

183. *See supra* note 132 and accompanying text.

184. *See* Matt Stroud, *An Insider Explains Why the FTC Can't Put an End to Pyramid Schemes*, BLOOMBERG (Feb. 27, 2015, 1:39 PM), http://bloomberg.com/news/articles/2015-02-27/an-insider-explains-why-the-ftc-can-t-put-an-end-to-pyramid-schemes [https://perma.cc/YKS8-LXY8].

185. *See* Bundy, *supra* note 23, at 128.

186. Multi-level Distributorships and Pyramid Sales Plans, Securities Act Release No. 5211, Exchange Act Release No. 9387, 36 Fed. Reg. 23,289 (Nov. 30, 1971) [hereinafter Release].

187. *See* Bundy, *supra* note 23, at 129.

188. *See* 15 U.S.C. § 77e (2018).

189. *See id.* § 78c.

190. *See id.* § 77x.

191. *See* HAZEN, *supra* note 154, § 1.55.

192. *Id.*

193. *Id.*

also issue disgorgement orders against securities violators.[194] The application of these regulatory tools is, however, necessarily dependent upon pyramid schemes meeting the federal definition of "security."[195]

The history and background of the federal securities regime offer useful context for examining the interpretation and application of the federal securities laws to pyramid schemes. Federal securities regulation emerged in the wake of the infamous stock market crash of 1929.[196] In this period, Congress was particularly concerned that, due to unchecked fraud, investors had been duped into funneling money into spurious companies.[197] In response, it used state "blue sky laws"[198] as a model for a federal securities regime.[199]

With the aim of protecting the investing public, Congress devised a broad statutory definition for a security, which covers a variety of financial instruments and investment opportunities.[200] Accordingly, the U.S. Supreme Court construed the term "security" within the 1933 Securities Act to "include by name or description many documents in which there is a common trading for speculation or investment."[201] The Court recognized that some instruments, such as notes, bonds, and stocks, have well-settled meaning.[202] However, descriptive designations or catchall terms, such as "investment contract," may reach "novel, uncommon, or irregular devices" so long as the device generally involves a contribution of capital with the intention to earn income or profit from its use.[203]

Though pyramid schemes do not fall within the meanings of any of the well-settled statutory terms such as "stock" or "bond," the SEC has argued that pyramids are securities because they constitute investment contracts.[204] However, the term "investment contract," though included in the statutory list of instruments that may be securities, is not defined by statute.[205] Therefore, in *SEC v. W.J. Howey & Co.*,[206] the Supreme Court articulated a test for determining whether an investment contract exists within the

194. *Id.*

195. Bundy, *supra* note 23, at 124.

196. Ryan C. Farha, Comment, SEC v. Edwards*: An Opportunity to Knock on the Viability of the* Howey *Test as the Gatekeeper of Federal Securities Laws*, 31 OKLA. CITY U. L. REV. 161, 165 (2006).

197. *See* Farha, *supra* note 196, at 165.

198. The term "blue sky laws" refers to state statutes regulating securities markets. Gregory J. Pease, Note, *Bluer Skies in Tennessee—the Recent Broadening of the Definition of Investment Contract as a Security and an Argument for a Unified Federal-State Definition of Investment Contract*, 35 U. MEM. L. REV. 109, 111–12 (2004).

199. David K. Brown & Valerie D. Barton, *Securities Regulation*, 56 MERCER L. REV. 1341, 1352 (2005).

200. *See* Pareja, *supra* note 26, at 97–103.

201. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

202. *Id.*

203. SEC v. W.J. Howey & Co., 328 U.S. 293, 299 (1946) ("It embodies a flexible rather than static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.").

204. Release, *supra* note 186, at 23,289.

205. *See* Brown & Barton, *supra* note 199, at 1352–53.

206. 328 U.S. 293 (1946).

meaning of the federal securities laws.[207] The Court held that "an investment contract for purposes of the Securities Act means a contract, transaction, or scheme whereby a person," (1) "invests his money," (2) "in a common enterprise," and (3) "is led to expect profits solely from the efforts of the promoter or a third party."[208]

The *Howey* Court emphasized the need for flexibility in interpreting the term "investment contract" to ensure that the federal securities laws fulfilled their purpose of generously protecting investors.[209] For instance, the Court approved of the prevailing state court approach, which disregarded form for substance and emphasized economic reality.[210] Moreover, the Court noted that the federal securities regime was based on states' blue sky laws.[211] Therefore, the Court reasoned that Congress intended that the term "investment contract," under federal law, be given the same well-settled and flexible meaning it had under state laws.[212] Such state laws were primarily concerned with protecting investors from fraudulent securities schemes, not with precisely demarcating all possible variations that might arise in capital markets.[213]

As discussed more thoroughly below, the SEC has had varying success convincing courts that pyramids involve the sale of securities. Nonetheless, the SEC does regularly bring enforcement actions against pyramids, primarily alleging the use of materially false or misleading statements.[214]

II. WHEN A PYRAMID IS ALSO A SECURITY: DIFFERENT TESTS FOR FINDING AN "INVESTMENT CONTRACT"

When courts find that a pyramid involved the sale of securities, a variety of new enforcement mechanisms become available.[215] First, the scheme's top-level promoters may face liability for the sale of unregistered securities[216] or for material misrepresentations and omissions in the sale of such securities.[217] Further, as material misrepresentations constitute fraud, individuals may be subject to criminal liability under federal mail and wire fraud statutes.[218] Finally, classification as a security allows defrauded scheme participants to bring private actions against the pyramid's promoters

207. *Id.* at 299.
208. *Id.* at 298–99.
209. *Id.* at 301.
210. *Id.* at 298.
211. *Id.*
212. *Id.*; *see also* Brown & Barton, *supra* note 199, at 1352 (noting that Congress looked to the blue sky laws when drafting federal securities law in order to build an adaptable body of law that would protect the public).
213. *See* Farha, *supra* note 196, at 165.
214. *See* Pareja, *supra* note 26, at 96–97.
215. *See supra* Part I.C.3.
216. *See* 15 U.S.C. §§ 77e, 77*l* (2018).
217. *See id.* § 77x; 17 C.F.R. § 240.10b-5 (2019).
218. *See* 18 U.S.C. §§ 1341, 1343 (2018).

and organizers under the PSLRA.[219] Such penalties represent significant deterrents to the formation and operation of pyramid schemes.[220]

The enforcement mechanisms available under federal securities law, however, are not available in every case because the courts have employed inconsistent reasoning when determining the existence of an investment contract.[221] As explained above, the *Howey* test is the definitive rule for identifying an investment contract within the meaning of the federal securities laws.[222] On the state level, however, the risk capital approach has developed as an alternative to the *Howey* test.[223] Part II illustrates the development of these two different tests and the application of each test to pyramid schemes alleged to be securities.

A. Application of the Howey *Test to Pyramid Schemes*

For pyramid schemes, the third prong of *Howey* is usually the most difficult to satisfy.[224] The third prong asks whether the investor expected that profits would be derived "solely from the efforts of the promoter or a third party."[225] In the wake of *Howey*, some commentators noted that the use of the word "solely" was problematic because it provided a means for avoiding literal application of the test.[226] Because the *Howey* test ostensibly failed to protect investors who contributed a modicum of effort, schemes could implement a requirement of nominal participation and thus avoid securities laws.[227]

219. *See* 15 U.S.C. § 78u-4.

220. Spencer M. Reese, *Securities Law & MLM—What's the Deal?*, REESE POYFAIR RICHARDS PLLC (Sept. 24, 2018), https://www.mlmlaw.com/law-library/securities-law-and-mlm-whats-the-deal [https://perma.cc/SG28-X8AE].

221. *See infra* Part II.A.

222. *See infra* Part II.A.

223. *See infra* Part II.B.

224. *See* Pareja, *supra* note 26, at 99–100; Note, *supra* note 27, at 1277. *See generally* Bundy, *supra* note 23. On rare occasions, pyramid schemes have failed to satisfy the "common enterprise" prong. *See, e.g.*, United States v. Holtzclaw, 950 F. Supp. 1306, 1314–16 (S.D.W. Va. 1997). However, a discussion of the commonality element is unnecessary here because the federal courts overwhelmingly find that pyramid schemes satisfy this requirement. Pareja, *supra* note 26, at 99. For a thorough discussion of the common enterprise element and the split among courts as to its application, see Maura K. Monaghan, Note, *An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis*, 63 FORDHAM L. REV. 2135 (1995).

225. SEC v. W.J. Howey & Co., 328 U.S. 293, 299 (1946).

226. *See* Kyle M. Globerman, Casenote, *The Elusive and Changing Definition of a Security: One Test Fits All*, 51 FLA. L. REV. 271, 290 (1999); Note, *supra* note 27, at 1277–78 (arguing that the Howey Company could have required each investor to pick a single orange and thereby avoided literal application of the test).

227. *See* Note, *supra* note 27, at 1277–78.

1. Liberalization of *Howey*'s "Efforts of Others" Prong

In the years after *Howey*, several lower courts lessened the restrictiveness of the third prong of the test.[228] In *SEC v. Glenn W. Turner Enterprises, Inc.* (*Glenn Turner I*),[229] the SEC brought suit against Glenn Turner's company, Dare to Be Great, which sold self-improvement courses through MLM distribution.[230] The company defendants argued that the third prong of *Howey* was not met.[231] They pointed to the fact that at the initial sales meetings for the program, investors were given the opportunity to recruit others and were told of the importance of their efforts.[232] Accordingly, the defendants asserted, participants were not led to expect that profits would flow *solely* from the efforts of others.[233]

The court, nonetheless, found that the scheme constituted an investment contract for three reasons. First, any business skills an investor may have had were far less important than his or her ability to pay for the plan.[234] Second, the investor's primary, if not sole, responsibility was to bring new people to attend recruitment meetings.[235] Third, the success or failure of the program was entirely dependent on the business decisions of the high-level company managers.[236] In sum, because the company and its top-level organizers, not the individual participants, performed the essential managerial tasks, the court concluded that Turner's plan constituted an investment contract.[237]

In its analysis, the *Glenn Turner I* court approved of the approach developed by the California Supreme Court in *Silver Hills Country Club v. Sobieski*.[238] In *Silver Hills*, the state court focused on the economic reality of a security, finding that fundamentally, a security involves "investors [who] subject their money to the risk of an enterprise over which they exercise no managerial control."[239] The *Glenn Turner I* court reasoned, in the same vein, that because the parent company ultimately remained responsible for all managerial decisions and responsibilities, the investor-participants were entitled to the protections of the federal securities law.[240]

The Ninth Circuit affirmed, holding that Dare to Be Great indeed offered investment contracts under a properly liberal reading of the *Howey* test.[241]

---

228. *See* Douglas M. Branson & Karl Shumpei Okamoto, *The Supreme Court's Literalism and the Definition of "Security" in the State Courts*, 50 WASH. & LEE L. REV. 1043, 1050 (1993).
229. 348 F. Supp. 766 (D. Or. 1972), *aff'd*, 474 F.2d 476 (9th Cir. 1973).
230. *Id.*
231. *Id.* at 770.
232. *Id.*
233. *Id.*
234. *Id.* at 775–76.
235. *Id.*
236. *Id.*
237. Bundy, *supra* note 23, at 134.
238. 361 P.2d 906 (Cal. 1961).
239. Bundy, *supra* note 23, at 134.
240. *Glenn Turner I*, 348 F. Supp. at 774–75.
241. *Glenn Turner II*, 474 F.2d 476, 480 (9th Cir. 1973).

In *SEC v. Glenn W. Turner Enterprises, Inc.* (*Glenn Turner II*),[242] the court found that the "solely" requirement "should not be read as a strict or literal limitation on the definition of an investment contract."[243] Rather, the test should be read realistically "so as to include within the definition those schemes which involve in substance, if not form, securities."[244] This is particularly so in light of the remedial purposes of the federal securities laws, the policy of broadly protecting the public, and the Supreme Court's mandate that securities should be defined flexibly.[245] The Ninth Circuit thus relaxed the meaning of "solely," asking instead "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[246] Similarly, in *SEC v. Koscot Interplanetary, Inc.*,[247] the Fifth Circuit conducted a careful analysis of the *Howey* decision and the authority relied upon by the Supreme Court in developing the test.[248] It concluded that "solely" should not be read literally.[249] Importantly, the court recognized that too literal an interpretation of the *Howey* test would frustrate, rather than serve, the remedial purposes of the federal securities laws.[250]

This more functional approach to *Howey* is now the majority position.[251] Using this test, however, federal courts have come to varying conclusions about whether pyramids constitute securities.[252]

2. Differing Interpretations of Managerial Efforts

While the circuits have liberalized the last prong of *Howey*, the courts still differ with respect to the quantity and quality of efforts made by the investor that will preclude a finding of a security under the test.[253]

---

242. 474 F.2d 476 (9th Cir. 1973).

243. *Id.* at 482.

244. *Id.*

245. *Id.*

246. *Id.* (noting that a rule that precludes a finding of an investment contract based solely on the fact that investors were required to exert some efforts would frustrate, rather than serve, the purposes of the Securities Act of 1933).

247. 497 F.2d 473 (5th Cir. 1974).

248. *Id.* at 480.

249. *Id.*

250. *Id.* at 479.

251. *See* Farha, *supra* note 196, at 174; *see, e.g.*, SEC v. SG Ltd., 265 F.3d 42, 54–55 (1st Cir. 2001) (noting that the courts of appeals have universally declined to interpret "solely" literally in this context); Albanese v. Fla. Nat'l Bank of Orlando, 823 F.2d 408, 410–12 (11th Cir. 1987).

252. *See, e.g.*, Webster v. Omnitrition Int'l, Inc., 79 F.3d 776 (9th Cir. 1996); *Glenn Turner II*, 474 F.2d 476 (9th Cir. 1973); SEC v. Int'l Loan Network, Inc. (*Loan Network I*), 770 F. Supp. 678 (D.D.C. 1991), *aff'd*, 968 F.2d 1304 (D.C. Cir. 1992).

253. *See* Stephen C. Hillard & Peter A. Ricciardelli, *Investment Contracts Under the Colorado and Uniform Securities Acts*, 49 U. COLO. L. REV. 391, 406 (1978) (observing that interpretation and application of *Howey*'s third prong has been somewhat elusive, with courts focusing on different aspects of the enterprise in question); Nancy K. Jones, Note, *Defining an "Investment Contract" for Purposes of Alaska Blue Sky Law: Have the Alaska Courts Stretched Their Test Beyond Meaningful Application?*, 2 ALASKA L. REV. 371, 391 (1985) (arguing that "neither the *Howey* test nor its progeny have quantified the amount of managerial

For instance, in *Kerrigan v. ViSalus, Inc.*,[254] the court focused extensively on the breadth of activities that the scheme promoters represented would be required of distributors who desired success in the program.[255] The case dealt with a multilevel retailer of powdered weight loss shakes and associated products.[256] The court began its discussion by concluding that, because of the emphasis that ViSalus placed on recruitment, the market for the products was saturated.[257] As such, nearly all of the distributors who had joined between 2010 and 2013 lost their money.[258] The court concluded that, because of the focus on recruitment and its compensation structure, the ViSalus program was a pyramid scheme.[259] However, in moving to the securities question, the court concluded that it could not find, as a matter of law, that the final *Howey* prong was satisfied.[260] In particular, the court looked to the company's statements, which detailed the various marketing, administrative, and sales activities distributors might engage in.[261] Moreover, in all of its promotional materials, ViSalus heavily emphasized the role that individual distributors would play in their own success.[262] Despite noting that ViSalus directly provided distributors with essential marketing materials and training, the court found it significant that ViSalus represented that it offered participants a great degree of freedom in choosing how to promote or sell the products or the program.[263] Accordingly, the court held that it was not clear that the distributors' efforts were insignificant and that, therefore, the *Howey* test was not met.[264] The *Kerrigan* court's reasoning exemplifies the approach to *Howey* that looks primarily to the amount of work expected of a potential investor, as represented to them by the program promoters and promotional or recruitment materials.[265]

Other courts, however, have focused more specifically on whether the work of participants is largely ministerial or managerial.[266] For example, in

---

control that an investor may exercise before a scheme will be deemed an investment contract").

254. 112 F. Supp. 3d 580 (E.D. Mich. 2015).

255. *See id.* at 598–99.

256. *Id.* at 586–87.

257. *Id.* at 588.

258. *Id.*

259. *Id.* at 593–95.

260. *Id.* at 599.

261. *Id.* at 598–99.

262. *Id.* at 599 ("These activities may include hosting events such as challenge parties; purchasing and using promotional materials; utilizing and paying for direct mail and print materials . . . purchasing inventory . . . and recruiting, training and mentoring customers and other individual promoters . . . .").

263. *Id.* at 598–99.

264. *Id.* The court nonetheless acknowledged that the allegations in the complaint did suggest that the distributors' chances of profit were substantially dependent upon the promotional work of ViSalus and its employee network. *Id.* at 598.

265. *Accord* Villeneuve v. Advanced Bus. Concepts Corp., 730 F.2d 1403, 1404 (11th Cir. 1984); Bitter v. Hoby's Int'l, Inc., 498 F.2d 183, 184–85 (9th Cir. 1974); United States v. Holtzclaw, 950 F. Supp. 1306, 1316–17 (S.D.W. Va. 1997).

266. *See, e.g.*, Martin v. T. V. Tempo, Inc., 628 F.2d 887, 890–91 (5th Cir. 1980); Miller v. Cent. Chinchilla Grp., Inc., 494 F.2d 414, 416–18 (8th Cir. 1974); Lytikainen v. Schaffer's

Mitzner v. Cardet International, Inc.,[267] the court acknowledged the role of the distributors and area managers in the company's MLM product delivery program.[268] Like in *Kerrigan*, the court further recognized that the participant agreements reflected an expectation that participants were responsible for recruiting others, distributing brochures, picking up orders, and delivering goods sold.[269] Nonetheless, the *Mitzner* decision turned on the court's conclusion that the participants' efforts were purely ministerial.[270] In particular, despite the fact that the participants' success was dependent upon their performance of certain tasks, the court underscored that the company was responsible for selecting the type, quality, and nature of goods sold, as well as providing marketing and advertising materials.[271] The distributors and area managers were therefore bound by the rules and procedures set by the company and not empowered to make meaningful or independent business decisions.[272]

Accordingly, even though the participants were told explicitly to expect to make significant efforts, the *Mitzner* court found that the third prong of *Howey* was not satisfied because such efforts were ministerial, not managerial.[273] However, the respective responsibilities of the company and of the distributors in *Mitzner* closely resembled the facts in *Kerrigan*. Nonetheless, the two courts came to opposite conclusions regarding the existence of a security.[274] Such cases reflect courts' inconsistent application of *Howey*'s third prong to pyramid schemes.

B. Risk Capital Analysis and the Hawaii Market Center *Test*

In response to the perceived rigidity of the *Howey* test, state courts began to formulate alternative investment contract tests.[275] One such alternative, the "risk capital test," has been articulated in several different ways by both federal and state courts.[276] However, all of the variations derive from a common notion that the "subjection of the buyer's initial value to the risks of an enterprise with which he is not familiar and over which he exercises no control seems to be the 'economic reality' which most clearly creates a need

---

Bridal LLC, No. CV-18-04685-PHX-DWL, 2019 WL 3890313, at *3 (D. Ariz. Aug. 19, 2019).

267. 358 F. Supp. 1262 (N.D. Ill. 1973).

268. *Id.* at 1267–68.

269. *Id.* at 1267.

270. *Id.* at 1267–68.

271. *Id.* at 1268.

272. *Id.* The court also gave weight to the fact Cardet emphasized to potential participants that no experience was necessary. *Id.*

273. *Id.* at 1268–69; *cf.* Ranieri v. AdvoCare Int'l, L.P., 336 F. Supp. 3d 701, 714 (N.D. Tex. 2018) (concluding that distributors' personal efforts to recruit new members were more than nominal or ministerial, precluding a finding that the scheme promoters were responsible for managerial efforts).

274. *See Mitzner*, 358 F. Supp. at 1268–69; Kerrigan v. ViSalus, Inc., 112 F. Supp. 580, 599 (E.D. Mich. 2015).

275. *See* Pease, *supra* note 198, at 119.

276. *See* Wiebolt v. Metz, 355 F. Supp. 255, 259 (S.D.N.Y. 1973) (commenting that the risk capital approach has not been applied uniformly).

for the special fraud procedures, protections, and remedies of the securities laws."[277]

1. The Development of Risk Capital Analysis

Justice Roger J. Traynor is generally credited with articulating the first risk capital analysis in *Silver Hills Country Club v. Sobieski*, which arose as an action under California's securities laws.[278] There, the defendants sought capital to develop and finance a country club by selling memberships in the club.[279] Under the developers' plan, the cost of a membership increased as the club grew and new facilities were added.[280] Members were responsible for monthly dues and had no rights to the club's income or assets.[281] Yet, membership entitled investors to use all club facilities, except for the golf course, and membership could only be transferred to individuals approved by the club's board of directors.[282] The club developers argued that memberships were simply contracts for the sale of personal recreational services.[283] Accordingly, they posited that the memberships did not fall within the scope of the securities laws because they were not purchased for investment.[284]

Nevertheless, Justice Traynor concluded that securities protection was intended "to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures."[285] The membership therefore constituted a security because the benefits of membership would only be realized if investors, along with other purchasers, subjected their capital to the risks of the enterprise.[286] Even though the interest was labeled a membership, the risk of loss was no different than that of a stock, bond, or note.[287] In sum, *Silver Hills* introduced the idea that, where capital solicited from investors is subjected to the risks of an enterprise, the risk of loss is shifted to members of the public, who are then entitled to the protections of the securities laws.[288]

The rationale from *Silver Hills* was further refined by the Hawaii Supreme Court in *State v. Hawaii Market Center, Inc.*[289] In *Hawaii Market Center*, the court faced a "founder-membership" plan similar to the one in *Silver Hills*: the defendants sought to open a retail store that would only sell goods

277. Ronald J. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367, 412 (1967).
278. Silver Hills Country Club v. Sobieski, 361 P.2d 906 (Cal. 1961).
279. *Id.* at 906–07.
280. *Id.* at 907.
281. *Id.*
282. *Id.*
283. *Id.*
284. *Id.*
285. *Id.* at 908.
286. *Id.*
287. *Id.*
288. *See* Hillard, *supra* note 253, at 409.
289. 485 P.2d 105 (Haw. 1971).

to individuals who had purchased authorization cards.[290] To finance the development of the store, the promoters recruited "founder-members."[291] To become a founder-member, one would purchase either a sewing machine or a cookware set, each with a $70 wholesale value, for $320.[292] In return, the member received: authorization to shop at the store once it became operational, fifty authorized buyer's cards to be distributed by the investor to others, the right to earn a 10 percent commission on any sale made by shoppers using one of the investor's distributed cards, as well as fees and compensation for bringing others into the program as founder-members or higher-level distributors.[293]

In determining whether the scheme constituted a security, the *Hawaii Market Center* court rejected the *Howey* test, arguing that it fostered a mechanical and narrow notion of investor participation.[294] Fundamentally, the court reasoned that, under the *Howey* formula, courts become entrapped in semantics and fail to consider the overriding question of whether the protection of the securities laws should apply to the enterprise in question.[295] Instead, the court held that, for purposes of the Hawaii Uniform Securities Act,

> [A]n investment contract is created whenever:
>
> (1) an offeree furnishes initial value to an offeror, and
>
> (2) a portion of this initial value is subjected to the risks of the enterprise, and
>
> (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
>
> (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.[296]

Particularly significant for the issue of pyramid schemes was the observation that courts should concentrate on the quality of participation and the degree of *control* over the enterprise exercised as a function of that participation.[297]

---

290. *Id.* at 107.
291. *Id.*
292. *Id.*
293. *Id.*
294. *Id.* at 108.
295. *Id.*
296. *Id.* at 109.
297. *Id.* at 111. This concept has been incorporated by case law or statute by several states. *See, e.g.*, NNN Durham Office Portfolio 1, LLC v. Grubb & Ellis Co., No. 10-CVS-4392, 2016 WL 7489690, at *15 (N.C. Super. Ct. Dec. 29, 2016); King v. Pope, 91 S.W.3d 314, 324 (Tenn. 2002) (concluding that the *Hawaii Market Center* test is preferable because, inter alia, it puts the requirement of managerial control in explicit, more easily comprehensible terms).

2. Reception by the Federal Courts

Although *Howey* remains the definitive rule, many federal courts recognize risk capital analysis as a useful tool for defining various forms of securities.[298] With respect to investment contracts and the "efforts of others" prong, the court in *SEC v. Aqua-Sonic Products Corp.*[299] observed that the theory underlying the *Silver Hills* and *Hawaii Market Center* risk capital tests could be used to further define or refine investor passivity or dependence under *Howey*.[300] Moreover, it concluded that the risk capital concept helped to distinguish between enterprises that appear more like a traditional offer to invest—because the risk of loss is dependent upon the competence of others—from those in which the investor buys the right to conduct a business and exercises practical control over his or her resources.[301]

Similarly, in determining whether the defendant's MLM business was a pyramid and an investment contract, the court in *In re Bestline Products Securities & Antitrust Litigation*[302] applied the *Howey* test but engaged in a lengthy discussion regarding the significance of risk that the individual distributors assumed as a function of their relationship to the company.[303] Significantly, in its analysis of *Howey*'s third prong, the court thoroughly considered the degree of *control* retained by distributors and the relationship of the distributor's control to their chances of success, as opposed to simply the nature or extent of their efforts.[304]

The concept of risk capital has also been employed to determine whether a promissory note may be classified as a security.[305] Some courts look to the degree of risk, subject to the entrepreneurial or managerial efforts of others, when distinguishing between promissory notes for ordinary commercial loans and investments that fall under the protection of the securities acts.[306] Additionally, the Fifth Circuit uses a risk capital approach when asking whether, under *Howey*, the efforts of general partners are insignificant enough to warrant finding a security.[307] Under that approach, the third prong

---

298. *See, e.g.*, Elson v. Geiger, 506 F. Supp. 238 (E.D. Mich. 1980); Mr. Steak, Inc. v. River City Steak, 324 F. Supp. 640 (D. Colo. 1970), *aff'd*, 460 F.2d 666 (10th Cir. 1972).

299. 524 F. Supp. 866 (S.D.N.Y. 1981).

300. *Id.* at 866, 878.

301. *Id.*

302. 412 F. Supp. 732 (S.D. Fla. 1976), *rev'd sub nom.* Piambino v. Bailey (*In re* Bestline Prods. Sec. & Antitrust Litig.), 610 F.2d 1306 (5th Cir. 1980).

303. *Id.* at 750–53.

304. *Id.* at 751–52 ("The class Plaintiffs are not manufacturers or producers of soap, and the terms and conditions of their participation in the Bestline National Marketing Plan are controlled by Bestline . . . . Bestline's failure would not only render its distributorships worthless, but would effectively put the distributor out of business as a separate or independent entity.").

305. *See, e.g.*, Great W. Bank & Tr. v. Kotz, 532 F.2d 1252, 1256–57 (9th Cir. 1976); C.N.S. Enters., Inc. v. G. & G. Enters., Inc., 508 F.2d 1354, 1249 (7th Cir. 1975).

306. *See, e.g.*, Danner v. Himmelfarb, 858 F.2d 515, 519 (9th Cir. 1988); *Great W. Bank*, 532 F.2d at 1256–57; Elson v. Geiger, 506 F. Supp. 238, 241 (E.D. Mich. 1980), *aff'd*, 701 F.2d 176 (6th Cir. 1982).

307. *E.g.*, SEC v. Arcturus Corp., 928 F.3d 400, 410–11 (5th Cir. 2019). For a discussion of the significance of the "efforts of others" prong in the context of general partnerships, see

of *Howey* is satisfied when: (1) the parties' agreement gives so little power to the partner that it in fact distributes power in the same way as a limited partnership; or (2) the partner so lacks experience and knowledge of business affairs that he is not capable of intelligently exercising his partnership powers; or (3) the partner so heavily depends on the unique entrepreneurial or managerial skills of the promoter or manager that he cannot replace that promoter or manager, or otherwise exercise meaningful partnership power.[308]

Further, the SEC has endorsed the risk capital formulation set out in *Hawaii Market Center* as applicable to the federal securities laws and consistent with the Supreme Court's emphasis on the remedial character of the federal securities acts.[309] Significantly, the SEC noted that a security exists where the responsibilities or powers of the investor have little direct effect on their receipt of promised benefits.[310] Further, the SEC urged that even the performance of financially significant duties, which manifestly contribute to the success of the venture, may not alter the security analysis if the investor lacks significant control over the use of his investment.[311]

Nonetheless, despite its acceptance on the state level and the use and discussion of risk capital analysis on the federal level, no risk capital test has formally been adopted to replace *Howey*.[312] Further, given the opportunity, in *United Housing Foundation, Inc. v. Forman*,[313] the Supreme Court declined to adopt a risk capital analysis.[314]

The Court did not, however, foreclose the possibility of adopting a risk capital test in a more appropriate case.[315] Rather, the Court observed that in the *Forman* fact pattern, it was clear that the plaintiffs had not taken on any significant risk because they were able to recover their investment in full at any time.[316] Therefore, if the Court were inclined to apply the risk capital test, it would not do so in the instant case.[317] However, as the Ninth Circuit

Douglas M. Fried, Note, *General Partnership Interests as Securities Under the Federal Securities Laws: Substance over Form*, 54 FORDHAM L. REV. 303 (1985).

308. Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir. 1981).

309. Release, *supra* note 186, at 23,290 (stating the commission's position that the conclusion of the *Hawaii Market Center* court is fully consistent with the Supreme Court's remedial approach to interpretation of the federal securities laws).

310. *Id.* at 23,289.

311. *Id.*

312. *See* Pareja, *supra* note 26, at 100. Further, there is some disagreement among the federal courts as to whether risk capital analysis should be employed only when assessing investments made as part of initial capitalization. HAZEN, *supra* note 154, § 1:55; *see also* Sec. Adm'r v. Coll. Assistance Plan (Guam) Inc., 533 F. Supp. 118, 123 (D. Guam 1981). The question may have arisen, however, because in many of the early state cases that developed and applied the risk capital test, including *Silver Hills* and *Hawaii Market Center*, the facts involved initial capitalization at the start of the enterprise. *See, e.g.*, Jet Set Travel Club v. Corp. Comm'r, 535 P.2d 109 (Or. Ct. App. 1975); State *ex rel.* Healy v. Consumer Bus. Sys., Inc., 482 P.2d 549 (Or. Ct. App. 1971).

313. 421 U.S. 837 (1975).

314. *Id.* at 857.

315. *See id.*

316. *Id.* at 857 n.24.

317. *Id.*

pointed out in *Great Western Bank & Trust v. Kotz*,[318] the Supreme Court has used a form of risk capital analysis to distinguish between annuity investment contracts, which are covered by the securities laws, and insurance contracts, which are exempt from registration requirements.[319]

III. JOINING FORCES: A COMBINED *HOWEY–HAWAII MARKET CENTER* TEST

As this Note has illustrated, pyramid fraud in the United States is substantial and difficult to regulate.[320] Victims' documented reticence to come forward also exacerbates the problem, impeding government actors from detecting and shutting down illegal pyramids.[321] The federal securities laws are fruitful and promising avenues for enforcement.[322] Classification as a security brings with it significant liability and regulatory costs, as well as the possibility of criminal penalties.[323] Therefore, where pyramid scheme promoters believe that their schemes will fall within the ambit of the federal securities laws, they are more likely to be deterred from forming such schemes in the first instance.[324] Additionally, the increased availability of securities enforcement actions would make it more likely that victims would recover their losses because the SEC may seek disgorgement of profits.[325]

Yet, despite the liberalization of *Howey*'s "efforts of others" prong, as the discussion in Part II demonstrated, there continues to be inconsistency among the federal courts as to how to categorize and analyze the efforts of pyramid scheme participants and distributors.[326] Accordingly, the application of the federal securities laws to pyramid schemes remains unsettled. Moreover, under *Howey*'s third prong, several pyramid schemes have escaped the reach of the federal securities laws, despite bearing the economic characteristics of securities.[327] As a result, pyramid scheme formation is not effectively deterred by the federal securities laws.

Part III.A argues that pyramid schemes bear the fundamental economic characteristics of securities and that pyramid fraud is precisely the kind of

318. 532 F.2d 1252 (9th Cir. 1976).

319. *Id.* at 1257 n.2 (first citing SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 211 (1967) (finding that the assumption of *some* risk by an insurance company cannot by itself bring an annuity contract within the insurance exemption); then citing SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65, 71–73 (1959) (finding that in the instant case, because the investment instrument saddled the investor with all of the risk, the annuity was classified as a nonexempt security which was required to be registered with the SEC)).

320. *See supra* Parts I.B, II.

321. *See supra* Part I.B.

322. *See supra* Part I.C.3. *But see* Pareja, *supra* note 26, at 102–03 (arguing that SEC enforcement is made more difficult by the agency's lack of resources and that the preclusion of punitive damages in securities class actions make private causes of action less desirable).

323. *See* Hillard, *supra* note 253, at 429; *supra* Part I.

324. *See* Bundy, *supra* note 23, at 124.

325. *See supra* Part I.C.3; *see, e.g.*, SEC v. DFRF Enters. LLC, 384 F. Supp. 3d 129, 131 (D. Mass. 2019).

326. *See supra* Part II.A.

327. *See, e.g.*, Ranieri v. AdvoCare Int'l, L.P., 336 F. Supp. 3d 701, 713–15 (N.D. Tex. 2018); SEC v. Int'l Heritage, Inc., 4 F. Supp. 2d 1378, 1383 (N.D. Ga. 1998); United States v. Holtzclaw, 950 F. Supp. 1306, 1313, 1317 (S.D.W. Va. 1997).

deceptive investment opportunity that securities law was designed to target. In Part III.B, this Note further argues that *Howey*'s third prong leads to both inconsistent and unprincipled results when applied to pyramid schemes and that it is not a useful analytical tool in that context. Part III.C urges the federal courts to replace the "efforts of others" prong from *Howey* with the final prong of the *Hawaii Market Center* test in cases involving alleged pyramids. Finally in Part III.D, this Note demonstrates why this combined *Howey*–*Hawaii Market Center* test produces more principled results that are consonant with the purposes, policies, and spirit of federal securities regulation.

A. Why Securities Protections Should Properly Be Applied to Pyramid Schemes

Congress enacted the securities laws to broadly protect the investing public from meaningful misstatements, omissions, and fraud.[328] The history of securities regulation reveals that the laws are most principally concerned with investor manipulation and victimization.[329] From the beginning, the aim was to require disclosure of material information, ensuring that both investors and the marketplace had sufficient information to make intelligent investment decisions.[330]

While the federal securities laws are not a broad remedy for all forms of fraud, pyramid schemes bear all of the hallmarks of the misleading investment fraud that these laws were designed to protect against. Pyramids are fundamentally money transfer schemes.[331] Thus, they do not generate genuine economic value because they do not produce revenue through the sale of goods or services.[332] Rather, they almost invariably involve fraudulent misrepresentations and cause financial losses to the great majority of those that sign up to participate.[333] Further, the convoluted and obfuscated nature and structure of such schemes makes it incredibly difficult for the average potential participant to adequately assess the risk of loss or the legality of the venture.[334] In sum, pyramids possess all of the evils that the federal securities laws were intended to cure: fraud, misrepresentation, deceptive and spurious investments, and inadequate disclosure.[335]

328. Bundy, *supra* note 23, at 124.

329. Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 534 (1999).

330. *Id.*; *see also id.* at 539 ("Congress enacted the securities laws to promote socially-directed values, such as fairness, equity, the protection of investors, the deterrence of fraud, and the promotion of ethical standards.").

331. *See* Keep & Vander Nat, *supra* note 49, at 196.

332. *See* Bosley & Knorr, *supra* note 73, at 82; Valentine, *supra* note 20.

333. *See supra* Parts I.A.2, I.B.

334. *See* Pareja, *supra* note 26, at 86–88; Bundy, *supra* note 23, at 123–28; Note, *supra* note 27, at 1261.

335. *See* Richard S. Hardy, Comment, *The New Gold Rush: The Last Frontier of the Securities Laws?*, 29 SANTA CLARA L. REV. 359, 364–65 (1989) (discussing why Congress's concerns about uninformed investors purchasing worthless and fraudulent investments motivated the creation of the federal securities regime).

B. The Relationship Between Investor Effort and Investor Control

The history and emphasis of the federal securities laws reflect the notion that governmental protection of investors is warranted where the investor is involved and, therefore, informed.[336] Securities law's heavy emphasis on disclosure is based on the notion that investors are adequately protected when all relevant aspects of an investment are fully and fairly communicated.[337] Such disclosure offers investors the means to evaluate the merits of an investment opportunity themselves.[338] It follows that the danger of fraud is considerably lessened when the investor subjects capital to an enterprise over which he exercises meaningful control because such an investor also inevitably remains informed of material information about his investment.[339]

Thus, the "efforts of others" prong does not separate passive from active investors for its own sake.[340] Rather, it is a means to identify investors who retain no direct control over the policy decisions affecting their funds, in which case the law should force disclosure of material information about the enterprise.[341] Where, on the other hand, the investor exercises meaningful control through participation, there is less of a need for governmental protection[342] and the need for forced disclosure of information to enable an investor to make an intelligent decision about the soundness of an enterprise is significantly reduced.[343]

The move away from the word "solely" in the *Howey* test reflects this notion.[344] As the Supreme Court has long recognized, Congress intentionally defined "security" in general terms.[345] Congress also acknowledged the boundlessness of possible schemes that might arise in capital markets.[346] The securities laws, therefore, include descriptive phrases, like "investment contract," that are broad and flexible enough to carry out the acts' remedial

336. *See* Joseph C. Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 171 (1971); *see also* Coffey, *supra* note 277, at 396.

337. HAZEN, *supra* note 154, §§ 1.16–1.18.

338. *Id.*

339. Coffey, *supra* note 277, at 396.

340. *See id.* at 398–400; Long, *supra* note 336, at 154–55, 170–72; Bundy, *supra* note 23, at 135.

341. *See* Bundy, *supra* note 23, at 135; *see also* Long, *supra* note 336, at 154–55, 170–72.

342. *See* SEC v. Galaxy Foods, Inc., 417 F. Supp. 1225, 1239 (E.D.N.Y. 1976) (noting that a flexible securities test "is consistent with the purpose of the securities laws 'to protect passive, uninformed investors'" (quoting Mr. Steak, Inc. v. River City Steak, Inc., 324 F. Supp. 640, 644 (D. Colo. 1970), *aff'd*, 460 F.2d 666 (10th Cir. 1972)).

343. Long, *supra* note 336, at 171 (noting also that securities are unique among investment vehicles because investors lose control and that this was one of the principal reasons for the emergence of securities regulation); *see* United States v. Leonard, 529 F.3d 83, 91 (2d Cir. 2008) (concluding that the essential question in making a security determination is whether an investor is able to exercise meaningful control over his investment); *Glenn Turner I*, 348 F. Supp. 766, 775 (D. Or. 1972) (noting that the cases considering the meaning of "investment contract" have consistently emphasized whether the investor has substantial control to influence the success of the enterprise), *aff'd*, 474 F.2d 476 (9th Cir. 1973).

344. *See* Monaghan, *supra* note 224, at 2137.

345. Welle, *supra* note 329, at 535–36.

346. *Id.*

purposes and afford full protection to the investing public.[347] A literal reading of the word "solely" is therefore inconsistent with the view that inquiries into the existence of a security should be flexible and centered on economic realities.[348] On the other hand, risk of loss without control is one of the essential characteristics of the economic reality of a security.[349] This notion can be traced back to *SEC v. C.M. Joiner Leasing Corp.*,[350] where the Supreme Court recognized that the degree to which the buyer's investment was tied to the success of the enterprise was critically relevant to the buyer's need for the protection of the federal securities laws.[351]

The economic reality of pyramid schemes is that participants make investments—sometimes substantial ones—and yet, returns are based on the continuous recruitment of new participants and mathematically unsupportable geometric progression.[352] Since participants have no control over the model, distributors' returns are based, to a substantial degree, on the decisions and efforts of others.[353] Accordingly, the extent, nature, and quality of a participant's efforts frequently have no bearing on the success of their investment.[354]

Howey's final prong, which courts have generally read to inquire into the quantity and quality of efforts, therefore, makes little sense in the context of pyramid schemes.[355] In illegal pyramids, a participant may devote himself tirelessly to the sale of a sham product and the development of a customer base and management of a business.[356] Yet, his returns still turn on market saturation and downline recruitment.[357] Thus in a pyramid scheme, an investor may very well contribute managerial or essential efforts, and yet, such efforts are no protection against the risk of loss inherent in the scheme or the lack of information about the true nature of the program.[358] Regardless

---

347. *Id.*

348. *See* SEC v. Arcturus Corp., 912 F.3d 786, 793 (5th Cir. 2019); Bailey v. J.W.K. Props., Inc., 904 F.2d 918, 920 n.3 (4th Cir. 1990); *Glenn Turner II*, 474 F.2d 476, 482 (9th Cir. 1973).

349. Coffey, *supra* note 277, at 375, 381.

350. 320 U.S. 344 (1943).

351. Coffey, *supra* note 277, at 381.

352. *See* Villeneuve v. Advanced Bus. Concepts Corp., 698 F.2d 1121, 1126 (11th Cir. 1983) (Kravitch, J., dissenting); Gastwirth & Bhattacharya, *supra* note 72, at 528; Valentine, *supra* note 20; *Fast Answers: Pyramid Schemes*, *supra* note 89.

353. *See Villeneuve*, 698 F.2d at 1126 (Kravitch, J., dissenting); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 485 (5th Cir. 1974); *see, e.g.*, Smith v. LifeVantage Corp., No. 2:18-CV-00621, 2019 WL 6616308, at *2–3 (D. Utah Dec. 5, 2019); Shuxin Li v. EFT Holdings, Inc., No. CV-13-8832, 2015 WL 12747812, at *2 (C.D. Cal. July 21, 2015).

354. *See* Gastwirth & Bhattacharya, *supra* note 72, at 528–30 (demonstrating "how dependent a participant's potential earnings are to their time of entry in the process"); Whitford, *supra* note 94, at 694 (observing that once pyramid schemes reach an inevitable point of saturation, "efforts of the investor are simply irrelevant, even if he spends all his time in futile efforts to sell the unsellable" (quoting *Glenn Turner I*, 348 F. Supp. 766, 776 (D. Or. 1972))).

355. *See supra* Part II.A; *see also* Coffey, *supra* note 277, at 395 (arguing that if the risk factor of an investment is not properly identified "certain transactions involving genuine risk to the buyer's initial value might escape security classification").

356. *See supra* Part II.A.

357. *See Loan Network II*, 968 F.2d 1304, 1308–09 (D.C. Cir. 1992).

358. *See, e.g.*, Mitzner v. Cardet Int'l, Inc., 358 F. Supp. 1262, 1267–68 (N.D. Ill. 1973).

of how much effort a pyramid scheme requires of distributors, those efforts rarely ever determine their returns; the primary factor that determines whether a pyramid participant earns money is the time at which they enter the scheme.[359]

C. Harmonizing Howey *and* Hawaii Market Center*: Incorporating Practical and Actual Control*

In the context of pyramid schemes, incorporating the fourth prong of the *Hawaii Market Center* test, which focuses on investor *control*, would bring the *Howey* test into accord with the purposes of the federal securities laws and would further the goal of investor protection.

The final prong of the *Hawaii Market Center* test requires that "the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise."[360] As applied, this test focuses on practical and actual managerial *control* as opposed to managerial *efforts*.[361] For instance, in *Wieboldt v. Metz*,[362] the district court discussed the application of the risk capital test to a franchise agreement.[363] The court noted that in a typical franchise, the franchisee has decision-making power over choices that affect the economic viability of his enterprise.[364] In contrast, under the risk capital test, where the franchisee exercises no meaningful control over his venture, an investment contract exists.[365] Similarly, in *Securities Administrator v. College Assistance Plan (Guam), Inc.*,[366] the court adopted the *Hawaii Market Center* test, reasoning that the test was more concerned with practical and actual control, recognizing the importance of weighing not just the degree but also the effect of investor participation.[367]

If courts evaluating an alleged pyramid scheme focus on whether the investor retained control to influence the success of his investment, they can avoid the danger of arbitrarily excluding certain schemes from the protection of the federal securities laws.[368] For many investment vehicles, such as the

359. *See* Whitford, *supra* note 94, at 694.
360. State v. Haw. Mkt. Ctr., Inc., 485 P.2d 105, 109 (Haw. 1971).
361. *See* Note, *supra* note 27, at 1286 (arguing that the *Hawaii Market Center* test overcame some of the limitations of the *Howey* test by examining investor control, rather than investor effort, in the production of profit).
362. 355 F. Supp. 255 (S.D.N.Y. 1973).
363. *Id.* at 259–60.
364. *Id.* at 260.
365. *Id.*
366. 533 F. Supp. 118 (D. Guam 1981).
367. *Id.* at 123. Some courts have commented that there is no longer a meaningful difference between the final prong of *Howey* and the final prong of the *Hawaii Market Center* test because *Howey* has been made more flexible subsequent to the *Koscot* and the *Glenn Turner* cases. However, the distinction between efforts or labor and control "does become important with the development of new plans specifically drafted to fall just beyond the *Howey* definition." Long, *supra* note 336, at 176.
368. *See* Long, *supra* note 336, at 145 (noting that after *Howey*, courts almost unanimously interpreted efforts to mean any effort by the investor, regardless of the bearing it had on control

one presented in *Howey* itself, efforts—or lack thereof—made by the investor are closely correlated to the control and knowledge of the investor.[369] However, in pyramids, investors may retain formalistic control and exercise significant efforts, yet these efforts do not influence their success in the scheme.[370] Therefore, with respect to alleged pyramids, it is more useful to ask not how significant the efforts were but rather whether those efforts had any impact on the investor's return or lack thereof.

Accordingly, a combined *Howey–Hawaii Market Center* test better serves the policies underlying *Howey*: emphasis on economic reality, flexibility, and protecting investors from fraudulent schemes that are not easily detected.[371] Because pyramids are subject to greater variation than other forms of investment contracts and not as easily categorized, it makes sense for courts to use a test that better captures the harm seeking to be prevented or remediated.[372]

This tailoring is already a common approach among lower courts when they are confronted with investment vehicles that are difficult to analyze or whose nature may be influenced by a number of variables.[373] There is evidence that courts already vary the focus of their analysis of *Howey*'s last prong, often emphasizing control over efforts, when the specific facts call for such an analytical departure.[374] For example, looking at a sale-leaseback program in *Albanese v. Florida National Bank of Orlando*,[375] the Eleventh Circuit found that a scheme whereby investors purchased ice machines, and then agreed to lease them back to the sellers, constituted a security.[376] In that case, the defendant-sellers pointed to the fact that the investors retained the right to: reject the selected locations, receive a regular accounting of expenses and collections, and terminate the agreements under specified conditions.[377] The defendants posited that as a result of the investors' rights and responsibilities, *Howey*'s third prong was not met.[378] The court, however, recognized that despite the investors having retained formal

of the enterprise); Note, *supra* note 27, at 1293 (commenting that "[s]ecurities regulation would benefit from substantial refinement of controlling efforts analysis").

369. SEC v. W.J. Howey Co., 328 U.S. 293, 299–300 (1946).

370. *See supra* Part III.B; *see also* Bundy, *supra* note 23, at 123–25.

371. *See* Wayne Klein, *The Idaho Securities Act: An Analysis of Idaho Courts' Securities Opinions*, 29 IDAHO L. REV. 95, 108 (1992) ("The use of the risk capital test, in addition to the *Howey* test, gives regulator additional flexibility and enforcement authority against certain types of fraudulent schemes."); Jones, *supra* note 253, at 392 (arguing that the risk capital test enables courts to find an investment contract where the economic realities of a security are present, even if the literal requirements of *Howey* cannot be met).

372. *See* Bell v. Health-Mor, Inc., 549 F.2d 342 (5th Cir. 1977) (serving as an example of the numerous possible variations on the classic pyramid model); Miller v. Cent. Chinchilla Grp., Inc., 494 F.2d 414 (8th Cir. 1974) (same).

373. *See, e.g.*, SEC v. Arcturus Corp., 928 F.3d 400, 409–11 (5th Cir. 2019); SEC v. Shields, 744 F.3d 633, 643–47 (10th Cir. 2014); Hocking v. Dubois, 885 F.2d 1449, 1460–61 (9th Cir. 1989); Williamson v. Tucker, 645 F.2d 404, 421–24 (5th Cir. 1981).

374. *See supra* note 373.

375. 823 F.2d 408 (11th Cir. 1987).

376. *Id.* at 412.

377. *Id.* at 410–12.

378. *Id.*

responsibilities by the terms of the agreement, their control was illusory.[379] Due to the nature of the arrangement, the investors had no realistic alternative to allowing the company to manage their investments.[380]

Finally, the combined test is consistent with the principles underlying the original *Howey* test.[381] *Howey* excluded the active investor from the disclosure and fraud protections of the securities laws, at least in part, because an investor does not need such protection where he exercises managerial control and therefore has access to information about the issuer.[382] In the case of pyramids, however, the fact that the investor participates does not in fact give him access to crucial information about the enterprise.[383] There is, therefore, little reason to exclude such an investor from the protection of the federal securities laws.[384]

D. Clarity and Consistency: Applying the Combined Test

The proposed test provides a clearer, more concrete, and consistent standard. It better captures the differences between legitimate MLM companies and illegal pyramids and also leads to more analytical harmony. Such consistency and predictability in the law benefits legitimate businesses and also better protects the public from illegitimate, fraudulent schemes.

First, the most principled distinction between legitimate MLM companies and illegal pyramids is whether or not revenue is based primarily on the continuous recruitment of new members.[385] Overall continuous recruitment is a factor almost entirely outside the control of the individual participant.[386] On the other hand, if there is an opportunity to earn income from the sale of a marketable product, the participant has substantial control over his success in the enterprise and thus does not subject capital to the common risk pool to the same extent.[387] Thus, adopting the control prong of the *Hawaii Market*

---

379. *Id.* at 412.

380. *Id.*

381. *See* Joseph C. Long, *State Securities Regulation—an Overview*, 32 OKLA. L. REV. 541, 571, 573 (citing *Glenn Turner I*, 348 F. Supp. 766, 776 (D. Or. 1972)). For instance, in *Howey*, the Supreme Court gave the term "investment contract" the meaning that it had under state law at the time the Securities Act was enacted. Long, *supra* note 336, at 141–42. The definition was derived principally from *State v. Gopher Tire & Rubber Co.*, 177 N.W. 937 (Minn. 1920). *Id.* Importantly in *Gopher Tire*, the investors were in fact required to devote substantial efforts to the enterprise, yet the court found the existence of an investment contract nonetheless. *Gopher Tire*, 177 N.W. at 937–38.

382. Hirsch v. DuPont, 396 F. Supp. 1214, 1222 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977).

383. *See* Pareja, *supra* note 26, at 86–88; Bundy, *supra* note 23, at 123–28; Note, *supra* note 27, at 1261.

384. *See* Coffey, *supra* note 277, at 396.

385. *See* Koscot Interplanetary, Inc., 86 F.T.C. 1106, 1181 (1975); Walsh, *supra* note 20, at 582.

386. *See supra* note 354 and accompanying text.

387. *See Koscot Interplanetary*, 86 F.T.C. at 1112 (observing that due to high market saturation and low product demand, participants had almost no chance to recoup their initial investments and were all but guaranteed to lose money); Whitford, *supra* note 94, at 694; *supra* note 55 and accompanying text.

Center test does a better job of incorporating this distinction between legitimate MLM companies and illegal pyramids into the law and draws a more useful line.

Second, the utility of the proposed test can be further demonstrated by reevaluating the two divergent cases introduced in Part II, *Kerrigan v. ViSalus, Inc.* and *Mitzner v. Cardet International, Inc.*[388] If the facts of both cases are evaluated using the combined test, the results and reasoning become concordant. In *Kerrigan*, the scheme would pass the final prong of the proposed combined test because, while the distributors were expected to actively recruit others, the facts show that the defendants controlled all relevant aspects of the program and structure.[389] The plaintiffs received no right to exercise actual or practical control because they were bound by the sales and recruitment structure and policies.[390] As the record reflected, a distributor could only generate at most a token income by retailing product, yet recruitment bonuses enabled the same distributor to earn hundreds of dollars simply by enrolling a new recruit in the program.[391] Therefore, each distributor, for all practical purposes, was only able to generate a return based on rewards for recruitment.[392] Unfortunately, that emphasis on recruitment quickly produced market saturation and made it impossible for the great majority of participants to earn such rewards, regardless of their extensive efforts or activities.[393] These facts precluded a return on investment, regardless of how hard each distributor worked to recruit new participants.[394] Therefore, ViSalus investors did not have the right to exercise practical or actual control under *Hawaii Market Center*, satisfying the final prong of the combined test.

Similarly, in *Mitzner*, the scheme would pass the final prong of the combined test, not because the participants' efforts were ministerial but rather because they were not entitled to exert any significant control over the managerial decisions of the enterprise.[395] In other words, the participants were not empowered "to make any meaningful or independent *business* decisions" that would impact the success of their investment.[396] Instead of focusing on the distinction between managerial and ministerial tasks, asking whether the participants lacked control over their investment's success

388. In both cases, the respective courts found that the programs at issue satisfied the first and second prongs of the *Howey* test. Kerrigan v. ViSalus, Inc., 112 F. Supp. 3d 580, 596–98 (E.D. Mich. 2015); Mitzner v. Cardet Int'l, Inc., 358 F. Supp. 1262, 1268 (N.D. Ill. 1973). Because the decisions diverged only with respect to the third prong, the discussion here is limited to the last prong of the proposed combined test.

389. *Kerrigan*, 112 F. Supp. 3d at 588.

390. *Id.*

391. *Id.* at 593.

392. *Id.*

393. *Id.* at 588.

394. *Id.*

395. Mitzner v. Cardet Int'l, Inc., 358 F. Supp. 1262, 1268 (N.D. Ill. 1973).

396. *Id.*

provides a clearer analytical frame that is easier to apply and produces consistent results between the two cases.[397]

CONCLUSION

The problem of pyramid fraud is only growing. Despite the investment of significant governmental resources, undeterred fraudsters continue to form new pyramid schemes with growing regularity. The federal securities laws were enacted to protect the public from precisely these kinds of unsubstantiated, misleading, and fraudulent investment opportunities. However, courts inconsistently applying the *Howey* test continue to draw unprincipled lines and exclude pyramid schemes from the ambit of the federal securities laws based on the red herring of investor efforts. This Note argues not that the federal courts should ignore the role played by distributors in pyramid schemes but rather that they should focus attention on the degree of control that investors may exercise as a function of that participation. By incorporating the language of the final prong of the *Hawaii Market Center* test, the courts may more directly identify the economic reality of an alleged pyramid scheme. In so doing, they can better effectuate the vital aim of protecting the investing public whenever the fundamental characteristics of a security are present.

397. *See id.* at 1264, 1267–68.