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U.S. SENATE CLIMATE CHANGE CLEARING HOUSE

## United States Senate

January 23, 2014

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The Honorable Mary Jo White  
Chair  
U.S. Securities and Exchange Commission  
100 F St. NE  
Washington, DC 20549

Dear Chair White,

I am writing to ask that you look into the business practices of Herbalife, Ltd and its domestic subsidiary Herbalife International of America, Inc., (collectively "Herbalife"), which sell nutritional and weight-loss products via a network of individual distributors. I have also written Herbalife to request that they provide me with some statistics regarding their business practices; that letter is attached. According to the company's recent 10-K statement, Herbalife is a

global nutrition company founded in 1980 that sells weight management, healthy meals and snacks, sports and fitness, energy and targeted nutritional products as well as personal care products. Herbalife distributes and sells its products through a network of independent distributors, using the direct selling channel. As of December 31, 2012, we sold our products in 88 countries to and through a network of approximately 3.2 million independent distributors.<sup>1</sup>

The company's filings indicate that the majority of Herbalife products are designed to deal with weight management, though Herbalife also trades in products involving targeted nutrition and "energy, sports, and fitness."<sup>2</sup> Herbalife sells these products through a vast network of individual distributors rather than through stores or online vendor sales. Pursuant to the company's 10-K statement, "To become a distributor in most markets, a person must be sponsored by an existing distributor and must purchase an International Business Pack," which usually contains, among other items, product samples, training materials, details of the compensation plan, and rules of distributor conduct.<sup>3</sup> Distributors make money via two main methods: by selling Herbalife products purchased at wholesale prices to customers outside the distributor network as well as to other distributors, and by "sponsor[ing] other distributors and establish[ing] their own sales organizations."<sup>4</sup> According to the 10-K cited above, the first method is far more common, as "the majority of our distributors have not sponsored another

<sup>1</sup> Herbalife Ltd, 10-K Form for Fiscal Year 2012, filed with the Securities and Exchange Commission on February 19, 2013, at page 4, available at

<http://www.sec.gov/Archives/edgar/data/1180262/000119312513065327/d452887d10k.htm>

<sup>2</sup> *Id.* at 4.

<sup>3</sup> *Id.* at 7.

<sup>4</sup> *Id.*

distributor and do not earn compensation relating to products [sic] sales made by or to other distributors.”<sup>5</sup>

Yet, there appear to be significant pecuniary benefits available to those distributors who sponsor others and establish their own sales organizations. By creating a network of organizations under them, distributors can receive “additional compensation” – so-called “royalty overrides” – for developing, retaining, and managing other distributors.<sup>6</sup> These royalty overrides can reach 15% of “product retail sales in the aggregate.”<sup>7</sup> Additionally, these distributors can receive “production bonuses” of up to 7% of retail sales for purchases by persons “in their downline organizations,” i.e. people who are part of that distributor’s sales organization.<sup>8</sup> Further, distributors who create their own sales organization can also receive the “Mark Hughes bonus” of up to 1% of retail sales in the aggregate for “some of our most senior distributors.”<sup>9</sup>

As a result of the structure and operation of this distribution network, Herbalife claims that it is a multilevel marketing company,<sup>10</sup> a type of entity in which the sales force receives compensation for both the sales they directly generate and the sales generated by a distributor’s downline personnel. However, there have been suggestions that Herbalife may not, in fact, be organized as a multilevel marketing company, but instead may be a pyramid scheme, based on Herbalife’s business operations.<sup>11</sup> Multilevel marketing companies and pyramid schemes often involve networks of sellers and a compensation system that rewards sellers based in part on the involvement of people in a seller’s “downline,” who are the individuals that a seller “bring[s] into a company to generate sales, their recruits, and so on.”<sup>12</sup> However, there are significant differences between these two types of businesses. For example, while multilevel marketing companies, such as Tupperware, typically use compensation systems that are based on a member’s product sales to the general public, a pyramid scheme typically uses a compensation

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<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 55.

<sup>7</sup> *Id.* at 7.

<sup>8</sup> *Id.* at 7, 8 and 55

<sup>9</sup> *Id.* at 7, 8 and 55

<sup>10</sup> *Id.* at 20

<sup>11</sup> See Edward Pettersson, “Herbalife Loses Bid to Dismiss ‘Pyramid Scheme’ Lawsuit,” Bloomberg, October 15, 2013, available at <http://www.bloomberg.com/news/2013-10-15/herbalife-loses-bid-to-dismiss-pyramid-scheme-lawsuit-1-.html> (Herbalife “lost a bid to dismiss a lawsuit by a former California distributor of its nutrition products who alleged the company’s business model is a ‘pyramid scheme’ that didn’t allow him to make a profit.”); Svea Herbst-Bayliss, “Latinos Urge California Attorney General to Probe Herbalife,” Reuters, October 18, 2013, available at <http://www.reuters.com/article/2013/10/18/us-herbalife-demonstration-idUSBRE99H14Z20131018> (“Some prominent Wall Street investors as well as certain civil rights groups have accused Herbalife, which relies on thousands of independent distributors to sell its products, of being a pyramid scheme, something the company denies.”); Duane Stanford, “Herbalife: Pyramid Scheme or Juggernaut? CEO Michael Johnson Fights Back,” Business Week, May 23, 2013, available at <http://www.businessweek.com/articles/2013-05-23/herbalife-pyramid-scheme-or-juggernaut-ceo-michael-johnson-fights-back>;

<sup>12</sup> Herb Greenberg, “Don’t Call Me a Multi-Level Marketer,” CNBC, January 9, 2013, available at <http://www.cnbc.com/id/100366770>.

system that is “based on the number of people you recruit and your sales to them.”<sup>13</sup> In effect, the main difference is whether sales are aimed inward at other members of a company or outward to the general public.

Multilevel marketing is a valid business operation, but pyramid schemes are inherently fraudulent. As the United States Court of Appeals for the Ninth Circuit stated in *Webster v. Omnitrition International*, “Operation of a pyramid scheme constitutes fraud for purposes of § 12(2) of the Securities Act of 1933, § 10 of the Securities Exchange Act of 1934, and various RICO predicate acts.”<sup>14</sup> According to the court, “pyramid schemes are said to be inherently fraudulent because they must eventually collapse. . . . Like chain letters, pyramid schemes may make money for those at the top of the chain or pyramid, but ‘must end up disappointing those at the bottom who can find no recruits.’”<sup>15</sup> As such, pyramid schemes are inherently a grave risk to consumers and regulators must be vigilant to prevent such schemes from appearing and growing.

I have seen reports from Massachusetts residents that suggest Herbalife is a pyramid scheme. For example, one family in Norton, MA reported that it lost \$130,000, including their entire 401(K), investing in Herbalife, and that involvement in Herbalife caused significant stress within their family. Another Massachusetts resident claimed that she was encouraged to recruit new members by approaching her family, a step that she refused to take. She also received pressure to spend money to buy more products so that she could qualify as a Supervisor in the Herbalife system. She also stated that she was encouraged to stay in the program even after she said she wanted out. The second resident also said that she “often wonders how many people have lost money on this...they are going to keep coming up with these ideas and people are going to keep going for it. I wonder if anyone has gone after them for being a pyramid scheme.”

Many of these allegations have been repeated by other groups. In a letter to the Federal Trade Commission (FTC), Mr. Jose Calderon, the President of the Hispanic Federation, claimed that “[a] particular concern to us about Herbalife is whether distributors make money selling products or recruiting others to sell products. The latter is an indicator of a pyramid scheme.”<sup>16</sup> In a separate letter to the FTC, Alma Morales Riojas, President of CEO of MANA, a National Latina Organization, stated that “According to Herbalife’s own 2012 data, 88 percent of their participants received no payments from the company at all. . . . On a personal level, I believe they prey on our most vulnerable, and I have seen some of my own friends in my home state of Texas fall victim to these terrible practices.”<sup>17</sup>

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<sup>13</sup> Bureau of Consumer Protection, Federal Trade Commission, “Multilevel Marketing,” available at <http://business.ftc.gov/documents/inv08-bottom-line-about-multi-level-marketing-plans>.

<sup>14</sup> 79. F.3d 776, 781 (9th Cir. 1996).

<sup>15</sup> *Id.* (quoting *In re Koscot Interplanetary, Inc.*, 86 F.T.C. 1106, 1181 (1975)).

<sup>16</sup> Hispanic Federation, Letter to FTC Chairwoman Edith Ramirez, May 17, 2013, available at <http://www.scribd.com/doc/142602752/The-Honorable-Edith-Ramirez-FTC>

<sup>17</sup> MANA, Letter to FTC Chairwoman Edith Ramirez, August 29, 2013, available at <http://www.scribd.com/doc/167326456/MANA-FTC-Herbalife>.

I take no position on the merits of these allegations. However, out of concern about Herbalife's business practices and their impact on my constituents in Massachusetts, I request that you investigate the company's business practices yourself to confirm that the company is acting in accordance with the federal securities laws under the authority of the Commission. I also request that you answer the following questions:

- 1) There is a great deal of opacity surrounding Herbalife's system of compensation.
  - a. Typically, how many compensation system levels do multi-level marketing companies have? Is it common to see a multi-level marketing company have more than half-a-dozen? Also, how many compensation system levels does the typical pyramid scheme have?
  - b. Hypothetically, if an entity had a turnover rate in excess of 5% each quarter in its lowest tier, would that be grounds for an investigation into whether the entity is a pyramid scheme? What if the turnover rate was in excess of 10%? What if it was in excess of 50%?
  
- 2) How a company structures its operations typically provides insight into whether a company is a pyramid scheme.
  - a. Is it accurate to state that the more complex a structure and the longer it takes to rise through it, the more likely it is that a company is a pyramid scheme?
  - b. Can you provide me with information about the pyramid schemes that the Commission has prosecuted with the least complex structures, including information about the minimum amount of time it took a distributor who entered an entity to rise through each of the entity's compensation levels?
  
- 3) There have been inconsistent estimates of sales outside Herbalife's distributor network (i.e. to people who are not distributors). Typically, the more sales occur within a distributor network in which the products are not purchased by those who would be expected to ultimately consume them, the more likely a company is to be a pyramid scheme.
  - a) Have you investigated the fact that Herbalife's statements changed materially over time about the percentage of sales outside the network?
    - i) May 1, 2012 Conference Call – Pres. Des Walsh: 70% or higher
    - ii) May 2, 2012 – 8K: We don't keep track.
    - iii) Dec. 19, 2012 – CEO Michael Johnson: 90% of customers are outside the network – “Absolutely”

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- b) Do you have any idea what the accurate number of sales outside the networks as a percentage of total sales was for each of the last five years?

I request that you respond to these questions by February 28, 2014. Thank you for your attention to this important matter. Please have your staff contact Justin Slaughter or Michal Freedhoff of my staff at 202-224-2742 with any questions.

Sincerely,



Edward J. Markey  
United States Senator