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SECURITIES EXCHANGE ACT OF 1934
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APPLICABILITY OF THE SECURITIES LAWS TO MULTI LEVEL DISTRIBUTORSHIP AND PYRAMID SALES PLANS

The Securities and Exchange Commission has considered the applicability of the securities laws to multi-level distributorship and other business opportunities that are being offered to prospective participants through pyramid sales plans. The Commission believes that the operation of such plans often involves the offering of an "investment contract" or a "participation in a profit sharing agreement," which are securities within the meaning of Section 2(1) of the Securities Act of 1933. In such cases the security involved--the agreement between the offering company and the investor--must be registered with the Commission unless an exemption is available. In the absence of registration or an exemption, sales of these securities violate Section 5 of the Securities Act.

Moreover, any person who participates in the distribution of these securities may be a broker as defined in Section 3(a)(4) of the Securities Exchange Act of 1934 and, unless an exemption is available, would be required to register as such pursuant to Section 15(a)(1) of that Act. For example, this might include, among others, persons who, for a finder's fee, commission, bonus or other compensation, induce others to become participants in the plans for the purpose of recruiting still other participants.

In addition, where deceptive acts and practices are committed in connection with the offer or sale of these securities, those responsible violate the antifraud provisions of Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Securities Exchange Act and Rules 10b-5 and 15c1-2 under that Act.

The common element of the various forms of pyramid promotions is a sales pitch which stresses the amount of money a participant can make on the recruitment of others to participate in the plan. This may serve to obscure the nature of the basic relationship being created between participants in the plan and the offering company. A discussion of two of the more prominent forms of promotions follows. The description of these programs should not be taken to indicate that promotions taking different forms may not also be within the purview of the following discussion.

In the typical form of multi-level distributorship that has been established through pyramid promotions, the company represents that it intends to manufacture, or to sell under its own trade name, a line of products and it purports to be offering franchises for the distribution of those products which appear to follow established forms of franchise-distributorships. Normally several types of distributorship agreements are said to be available to the public which are described more or less as follows. At the lowest level for a relatively small fee the participant is provided with a sample inventory and will be authorized only to make retail sales to the public. For a larger fee, the participant is supposed to receive a wholesale inventory that he in turn supplies to salesmen whom he supervises. This participant may also be authorized to make retail sales of his own. For an even larger fee, a more substantial wholesale inventory is obtained and responsibility is assumed for supervision of lower-level participants. At the highest level of distribution, for a very substantial fee, a purported right to be the link between the company and the distribution chain is acquired. If the distribution program should actually go into effect, under such plans, in accordance with a predetermined schedule, each distributor would pay less for products to those from whom he gets them than he would receive when he passes the products on through distribution channels to the consumer. Where in these circumstances prospective participants are led to believe that they may profit from participation in these distribution programs without actually assuming the significant functional responsibilities that normally attend the operation of a franchise, in the Commission's opinion there is the offer of a security. Even where a specific offer is not made, if in the actual operation of a distributor-ship program profits are shared with or other forms of remuneration are given to persons who have provided funds to the enterprise--purportedly for a franchise or other form of license--but those persons do not in fact perform the functions of a franchisee, there would appear to be an investment contract.

It must be emphasized that the assignment of nominal or limited responsibilities to the participant does not negative the existence of an investment contract; where the duties assigned are so narrowly circumscribed as to involve little real choice of action or where the duties assigned would in any event have little direct effect upon receipt by the participant of the benefits promised by the promoters, a security may be found to exist. As the Supreme Court has held, emphasis must be placed upon economic reality. See Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293 (1946). While the Commission has not taken the position that a franchise arrangement necessarily involves the offer and sale of a security, in the Commission's view a security is offered or sold where the franchisee is not required to make significant efforts in the operation of the franchise in order to obtain the promised return.

A different program that has frequently employed a pyramid sales promotion involves the solicitation of capital from a limited number of "founders" to construct a local retail store that will be owned and operated by the promoters. Under these plans the "founders" typically make a payment of money to the promoters (which may nominally involve the purchase of some product) and the "founders" are provided with some form of identification card that they are required to distribute to prospective customers of the store in advance of the store's opening. Once the store is in operation the "founder" is to receive a "commission" on sales made to those persons having the identification cards that the "founder" has provided. In the Commission's view, these programs involve the offer and sale of investment contracts. The basic promotional efforts that "founders" are required to make in advance of the store's opening --distribution of cards to prospective customers--even if required to continue after the store's opening, do not involve the kind or degree of participation in the management of an enterprise that might negate the inference of an investment relationship.

In Securities and Exchange Commission v. C. M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943), the Supreme Court observed that the nature of securities that are subject to the federal securities laws does not stop with the obvious and commonplace: "Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a "security"'." Similarly in Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293, 301 (1946) the Court described the purported sales of orange groves as a kind of investment contract. In that context it stated: "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." It has been contended that, since it is an element of some promotions of the kind here considered that the prospective investor must make some efforts himself, the contracts do not fall within that definition. But in the Commission's view a failure to consider the kind and degree of efforts required of the investors ignores the equally significant teachings of Howey, id. at 299, that form is to be disregarded for substance and that the investment-contract concept

> "embodies a flexible rather than a 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."

These words compel the conclusion that the Howey decision itself may not be permitted to become a "static principle" easily avoided by ingeniously-devised variations in form from the particular type of investment relationship described in that case.

The term "security" must be defined in a manner adequate to serve the purpose of protecting investors. The existence of a security must depend in significant measure upon the degree of managerial authority over the investor's funds retained or given; and performance by an investor of duties related to the enterprise, even if financially significant and plainly contributing to the success of the venture, may be irrelevant to the existence of a security if the investor does not control the use of his funds to a significant degree. The "efforts of others" referred to in Howey are limited, therefore, to those types of essential managerial efforts but for which the anticipated return could not be produced.

Nor is it significant that the return promised for the use of an investor's money may be something other than a share of the profits of the enterprise. The Court in Howey described an investment contract providing the investor with an equity interest in the common enterprise; where the interest offered is of a different nature the promised return will necessarily vary. Thus, for example, market-price appreciation in value--not profits in a commercial sense--was significant in the investment contracts recognized by the Supreme Court in Securities and Exchange Commission v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) and Securities and Exchange Commission v. United Benefit, 387 U.S. 202 (1967). The expectation of "commissions" for the use of investor's money, when not linked to services of the kind or degree for which commissions are normally paid in non-investment contexts, is also consistent with the existence of an investment contract.

In a recent decision, the Supreme Court of Hawaii has considered the meaning of the term "investment contract" as used in a state-statute definition of the term "security" that is substantially similar to the definitions contained in the federal securities laws. State v. Hawaii Market Center, Inc., 485 P.2d 105 (1971). The Hawaii Market Center through a pyramid promotion had offered participation in a retail-store enterprise of the kind described above. While embracing interpretive principles of the kind laid down by the United States Supreme Court in Howey and Joiner, the Hawaii court rejected a literal adherence to the language that the Supreme Court found appropriate in describing the specific type of investment contract that was before it in Howey, where profits were, indeed, to come "solely from the efforts" of others. In doing so, that court noted the danger that "courts [might] become entrapped in polemics over the meaning of the word 'solely' and fail to consider the more fundamental question whether the statutory policy of affording broad protection to investors should be applied even to those situations where an investor is not inactive, but participates to a limited degree in the operation of the business." Id. at 108 (footnote omitted). For purposes of the Hawaii Securities Act, therefore, the court held (id. at 109) that an investment contract exists where:

> "(1) An offeree furnishes initial value to an offeror, and
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> "(2) a portion of this initial value is subjected to the risks of the enterprise, and
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> "(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
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> "(4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise."

The Commission believes that the court's analysis of the investment-contract concept in the Hawaii Market Center case is equally applicable under the federal securities laws. While the conclusion of the Hawaii court encompasses types of investment contracts that the Supreme Court of the United States has not yet specifically considered, the Commission believes that its conclusion is fully consistent with the remedial approach repeatedly stated by the Supreme Court to be appropriate in interpreting the federal securities laws. See Tcherepnin v. Knight, 389 U.S. 322 (1967) (Securities Exchange Act); Securities and Exchange Commission v. Capital Gains Research Bureau, 375 U.S. 180 (1963) (Investment Company Act); Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293 (1946) (Securities Act); Securities and Exchange Commission v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943) (Securities Act).

It further appears to the Commission that the pyramid sales promotions that are often employed in connection with the sale of securities of the types described above may be inherently fraudulent. Under these programs, various cash fees and percentage incentives are offered to those willing to participate as an inducement for the recruitment of additional participants. This aspect of the promotion is often given great emphasis at "opportunity meetings" at which movies may be shown and speeches made concentrating on the allegedly unlimited potential to make money in a relatively short period of time by recruiting others into the program. Since there are a finite number of prospective participants in any area, however, those induced to participate at later stages have little or no opportunity for recruitment of further persons. It is patently fraudulent to fail to disclose these factors to prospective investors. Even where some disclosure of these practicalities is made, moreover, it may be made in a manner that misleadingly fails to note the significance to the participants of the facts disclosed. In the Commission's view, use of this inherently fraudulent device to induce investment in any enterprise offering securities to the public is a violation of the antifraud provisions of the securities laws.