



THE CHAIR

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

March 4, 2014

The Honorable Edward J. Markey  
United States Senate  
218 Russell Building  
Washington, DC 20510-2107

Dear Senator Markey:

Thank you for your January 23, 2014 letter requesting that the Securities and Exchange Commission (the "Commission" or "SEC") investigate the business practices of Herbalife, Ltd. to determine whether it is acting in accordance with the federal securities laws. In particular, you raised concerns over reports that Herbalife may be a pyramid scheme.

The Commission's investigations are confidential, and the Commission generally neither confirms nor denies the existence of an inquiry or investigation unless and until made a matter of public record in proceedings instituted before the Commission or in court. We do this to protect the integrity and effectiveness of our investigative process and to preserve the privacy of the individuals and entities involved. Accordingly, we cannot comment on whether SEC staff has investigated, or is currently investigating, matters related to Herbalife. Nonetheless, we appreciate your letter and the concerns you raised. I can assure you that we are giving your concerns every consideration.

In your letter, you asked for information in response to several questions. While specific responses are provided below, it is important at the outset to note some general information regarding the Commission's authority to enforce the federal securities laws as they relate to illegal pyramid schemes and legitimate multi-level marketing ("MLM") companies.

The Commission's Division of Enforcement is responsible for investigating possible violations of the federal securities laws, including unregistered offers and sales of securities and false and misleading statements in connection with the offer, purchase, and sale of securities. The antifraud provisions of the federal securities laws prohibit fraud, in the offer or sale, or in connection with the purchase or sale, of securities. "Securities" include, among other things, a company's stock and investment contracts offered by a company or promoters. Generally, the Commission's jurisdiction is limited to investigating and prosecuting misconduct involving securities as defined by the law and interpreted by the courts.

The Division of Enforcement regularly investigates the accuracy of disclosures by companies that offer or sell securities. In these cases, Enforcement staff reviews corporate statements, whether found in SEC filings, in statements by corporate officers, or elsewhere, to investigate whether such statements are materially false or misleading. For example, the Division may investigate whether a company or others misrepresented the company's business as having attributes of a legitimate MLM company when, in fact, the company does not have those attributes.

The Division of Enforcement also regularly investigates whether promoters offer or sell securities, and, if so, whether the offerings of securities are registered with the Commission in accordance with federal securities laws and regulations. In these offering cases, SEC staff reviews the representations made by the promoters to determine whether the interest offered is a security. For example, the Division may investigate whether promoters offered and/or sold to investors securities in the form of investment contracts. Under certain circumstances, an interest in a pyramid scheme may be an investment contract, and, therefore, a security subject to the Commission's jurisdiction. Whether an interest is an investment contract depends on the particular facts and circumstances as applied to the law. The Supreme Court has defined an "investment contract" to include the investment of money in a common enterprise, with the expectation of profits derived solely from the efforts of others. *SEC. v. W.J. Howey Co.*, 328 U.S. 293, 298-299 (1946).

In the securities law context, a so-called "pyramid scheme" is not a defined term, but rather generally refers to a type of scam in which fraudsters may pitch as legitimate a business opportunity in the form of MLM programs. SEC staff has issued an investor alert to warn the public of these scams, titled *Beware of Pyramid Schemes Posing as Multi-Level Marketing Programs*, available at [www.sec.gov/investor/alerts/ia\\_pyramid.htm](http://www.sec.gov/investor/alerts/ia_pyramid.htm). In this alert, the staff warns that pyramid schemes masquerading as MLM programs may violate the federal securities laws, such as laws prohibiting fraud and requiring the registration of securities offerings and broker-dealers. The alert explains that, in a typical pyramid scheme, money from new participants is used to pay recruiting commissions to earlier participants — just as in classic Ponzi schemes, where money from new investors is used to pay fake "profits" to earlier investors. Recently, the Commission has sued alleged operators of large-scale pyramid schemes for violating the federal securities laws by falsely representing these scams to be legitimate MLM programs. For example, in *SEC v. CKB168*, 13 Civ. 5584 (E.D.N.Y. 2013), Lit Rel. No. 22846 (Oct. 17, 2013),<sup>1</sup> the Commission filed charges to stop an alleged pyramid scheme. In addition, in an adjudicated settled action, *SEC v. Rex Venture Group*, 12 Civ. 519 (W.D.N.C. 2012), Lit Rel. No. 22456 (Aug. 22, 2012),<sup>2</sup> the Commission shut down a \$600 million fraud that duped approximately one million Internet customers through a complex investment scam involving a Ponzi scheme promoted as a daily profit-share pool and a pyramid scheme pitched as a legitimate MLM company.

In addition to the SEC's efforts, other federal agencies also seek to combat illegal pyramid schemes. See, e.g., [www.consumer.ftc.gov/articles/0065-multilevel-marketing](http://www.consumer.ftc.gov/articles/0065-multilevel-marketing) (describing the FTC's use of federal consumer protection laws to combat pyramid schemes) and <http://www.fbi.gov/scams-safety/fraud> (listing pyramid schemes as a common scheme that the FBI investigates).

With this general information in mind, below are responses to your specific 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**

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<sup>1</sup> See <http://www.sec.gov/litigation/litreleases/2013/lr22846.htm>.

<sup>2</sup> See <https://www.sec.gov/litigation/litreleases/2012/lr22456.htm>.

**more than a 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%?**

Response

The SEC does not maintain specific data regarding the typical number of compensation levels or turnover rates at either MLM companies or pyramid schemes. As stated above, the Division of Enforcement's investigations include disclosure and offering cases, and each investigation depends on its particular facts and circumstances. In disclosure cases, we investigate whether any statements made about the business are materially false or misleading, including statements regarding the compensation levels or the turnover rates. In offering cases, we investigate whether the interest acquired by the investor was a security, and the compensation level and/or turnover rate might be relevant to that analysis. However, compensation and turnover rates would be but two of multiple facts and circumstances used to determine whether Enforcement should conduct an investigation.

- 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 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?**

Response

Whether a firm is operating an illegal pyramid scheme in violation of the federal securities laws depends on the particular facts and circumstances, including the complexity of its structure and its disclosures concerning the structure. Although we do not have detailed information on the minimum amount of time for distributors to rise through compensation levels, the following Commission enforcement actions exemplify pyramid schemes involving limited complexity: *SEC v. Universo Foneclub Corporation*, 06 Civ. 109040 (D. Mass.), SEC Lit Rel. No. 19715 (Jun. 1, 2006) (two levels);<sup>3</sup> *SEC v. Lane*, 07 Civ. 1920 (M.D. Fla.), SEC Lit Rel. No. 20393 (Dec. 11, 2007) (four levels);<sup>4</sup> and *SEC v. West*, 09 Civ. 1419 (M.D. Fla.), SEC Rel. No. 21182 (Aug. 21, 2009) (four levels).<sup>5</sup> In each action, the defendants purported to operate legitimate MLM companies.

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<sup>3</sup> See <http://www.sec.gov/litigation/litreleases/2006/lr19715.htm>.

<sup>4</sup> See <http://www.sec.gov/litigation/litreleases/2007/lr20393.htm>.

<sup>5</sup> See <https://www.sec.gov/litigation/litreleases/2009/lr21182.htm>.

- 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"**
  - 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?**

Response

As stated above, the Commission's investigations are confidential and the Commission generally neither confirms nor denies the existence of an inquiry or investigation unless and until we bring charges against someone involved. Accordingly, we cannot comment on whether the Commission has investigated, or is currently investigating, matters related to Herbalife.

Thank you again for your letter. Please do not hesitate to contact me at (202) 551-2100, or have your staff contact Tim Henseler, Director of the Office of Legislative and Intergovernmental Affairs, at (202) 551-2010, if you have any questions or comments.

Sincerely,



Mary Jo White  
Chair