

COMMITTEES:

COMMERCE, SCIENCE, AND TRANSPORTATION
SMALL BUSINESS AND ENTREPRENEURSHIP
FOREIGN RELATIONS

CHAIRMAN:

SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT AND
FOREIGN ASSISTANCE, ECONOMIC AFFAIRS,
INTERNATIONAL ENVIRONMENTAL PROTECTION, AND
PEACE CORPS

U.S. SENATE CLIMATE CHANGE CLEARING HOUSE

United States Senate

January 23, 2014

SUITE SR-218
RUSSELL BUILDING
WASHINGTON, DC 20510-2107
202-224-2742

975 JFK FEDERAL BUILDING
15 NEW SUDBURY STREET
BOSTON, MA 02203
617-565-8519

222 MILLIKEN BOULEVARD, SUITE 312
FALL RIVER, MA 02721
508-677-0523

1550 MAIN STREET, 4TH FLOOR
SPRINGFIELD, MA 01101
413-785-4610

Mr. Michael O. Johnson
Chairman and Chief Executive Officer
Herbalife International of America, Inc.
800 W. Olympic Blvd., Suite 406
Los Angeles, CA, 90015
310-410-9600

Dear Mr. Johnson,

I am writing to request information regarding Herbalife, Ltd and its domestic subsidiary Herbalife International of America (collectively, "Herbalife"), which sells nutritional and weight-loss products via a network of individual distributors. According to Herbalife's 10-K statement filed with the Securities and Exchange Commission ("SEC"), the company 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.¹

The company's SEC 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."² Herbalife sells these products through a vast network of individual distributors rather than through stores or online vendor sales. Pursuant to your 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.³ 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."⁴ According to the 10-K cited above, the first method is far more common, as "the majority of our distributors have not sponsored another

¹ 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>

² *Id.* at 4.

³ *Id.* at 7.

⁴ *Id.*

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

Although the majority of Herbalife’s distributors apparently do not utilize this sales channel, 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.⁶ These royalty overrides can reach 15% of “product retail sales in the aggregate.”⁷ 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.⁸ 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.”⁹

As a result of the structure and operation of this distribution network, Herbalife claims that it is a multilevel marketing company,¹⁰ 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.¹¹ 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 individuals that a seller “bring[s] into a company to generate sales, their recruits, and so on.”¹² 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

⁵ *Id.*

⁶ *Id.* at 55.

⁷ *Id.* at 7.

⁸ *Id.* at 7, 8 and 55

⁹ *Id.* at 7, 8 and 55

¹⁰ *Id.* at 20

¹¹ 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>.

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

sales to the general public, a pyramid scheme typically uses a compensation system that is “based on the number of people you recruit and your sales to them.”¹³ 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.”¹⁴ 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.’”¹⁵ 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 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.”¹⁶ 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

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

¹⁴ 79 F.3d 776, 781 (9th Cir. 1996).

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

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

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.”¹⁷

I take no position on the merits of these allegations. However, to better understand Herbalife’s business practices and their impact on my constituents in Massachusetts, I request that you answer the following questions:

- 1) There is a great deal of opacity surrounding Herbalife’s system of compensation.
 - a. Can you explain, in simple terms, how the Herbalife compensation system works? How exactly does a new distributor earn commissions? What metrics or milestones must a new distributor reach in order to advance through each level of the compensation system? How do you ensure first-time, unsophisticated business operators understand the system?
 - b. How many compensation system levels (e.g. Founder’s Circle, Chairman’s Club, President’s Team, Millionaire Team, GET Team, World Team, Supervisor, Non-Sales Leaders, etc.) does Herbalife currently have, and what is required to attain each system level?
 - c. How many people have entered and exited each level of the Herbalife compensation system for each quarter since 2007?
 - d. How much profit (net earnings after expenses) can the average distributor expect to make from retailing to non-distributors (i.e. people who are not directly involved in Herbalife themselves)? How much profit can the average distributor expect to make from retailing to distributors?
 - e. How much profit (net earnings after expenses) can the average distributor expect to make from purchases of products by their downline (i.e. people under a distributor in Herbalife whose sales and membership lead to bonuses and other compensation for that distributor) sales organization?
 - f. On your October 28, 2013 earnings call, a spokesman for your company stated that “we have added our statement of average gross compensation as part of our membership application, ensuring that all new participants are provided this information before they join.” What is the average net compensation, once average expenses and average losses are accounted for, and why is this figure not also included on the application?
- 2) How a company structures its operations typically provides insight into whether a company is a pyramid scheme, and I would like more information on this subject.
 - a. For each fiscal quarter for each of the past five years, how many persons have i) become Herbalife distributors and ii) exited Herbalife’s distributor program?
 - a. Exactly how many people who became an Herbalife distributor at the most basic compensation system level in the first fiscal quarters of 2007, 2009 and 2012 are

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

in each of the compensation levels now? Please include precise numbers about how many of those three classes of people are currently in each separate compensation level

- b. What is the minimum number of years it would take for a distributor who became a Herbalife distributor at the most basic compensation system level in January 2013 to reach each of the distinct compensation system 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) Why have your 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) For each of the past five years –
 - i) What's the correct number of sales outside the network as a percentage of total sales?
 - c) Please provide information about the percentage of your retail sales outside the distributor network
 - i. by product
 - ii. by quantity
 - iii. by total retail sales in dollars

Please provide me with data to support those numbers.
 - d) The New York Times reported in February 2013 that Herbalife “does not collect comprehensive data on sales to people outside its network,” but that it does “require its sales representatives to keep records of their transactions.”¹⁸ This data would be helpful in determining the extent of sales outside the distributor network.
 - i) Why do you require distributors to create detailed retail receipts?
 - ii) Why do you mandate that these retail receipts must be retained for two years and produced to the Company upon request?
 - iii) Why don't you collect the retail receipts regularly from all distributors? How many times have you requested that a distributor provide you with retail receipts? What percentage of these requests was not fulfilled by the distributors? What happened to those distributors who refused to provide retail receipts?

¹⁸ Peater Eavis, “Seeking a Company's Elusive Sales Data,” Dealbook, *New York Times*, February 4, 2013, available at <http://dealbook.nytimes.com/2013/02/04/seeking-a-companys-elusive-sales-data/>.

Chairman Johnson
January 23, 2014
Page 6 of 6

- 4) According to the Attorney General of New York, pyramid schemes often target specific religious or social groups.¹⁹
- a. Does Herbalife specifically target members of any minority community, including the Hispanic, African-American, and Asian communities, to become distributors? Does Herbalife target members of low income communities to become distributors?
 - b. If so, how much money has Herbalife spent in each of the last four fiscal quarters marketing to each of those communities? Please also provide details about how Herbalife advertises to any groups it targets, including the names of the media organizations used for the top 10 ad buys in 2012.

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

¹⁹ See Attorney General of New York, "Don't Get Caught in a Pyramid Scheme," available at <http://www.ag.ny.gov/consumer-frauds/pyramid-schemes> ("Pyramid promoters often target closely knit groups such as religious or social organizations").