Herbalife

Ponzi Scheme – Market Maker

Endless chain, concealed data, bogus
business opportunity, retailing facade, fixed pricing,
bottom-to-top money transfer, analogous to a classic penny stock scheme

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Date: September 28, 2007
To: Barry Minkow, Fraud Discovery Institute
From: Robert L. FitzPatrick
Re: Analysis of Herbalife Business Model and Business Practices

To prepare this analysis for Fraud Discovery Institute I studied the Herbalife 10K filings from 2004-2006 and the Herbalife website, including related links that are password protected and available only to qualified prospects. I reviewed various confidential letters that I have received over several years from consumers reporting their Herbalife experiences. I carefully read a current class action lawsuit brought by distributors (Minton vs. Herbalife and the Freedom Group). I reviewed various documents available on the Internet from other consumers, such as chat rooms and discussion threads. I conducted in-depth interviews with current- and ex-Herbalife distributors regarding the details of the marketing plan and their direct experience.

As an overview, I characterize Herbalife as an international pyramid scheme that is duping millions of people into buying its products based on the deceptive lure of an endless chain reward system. Not only are huge numbers of individual consumers tricked out of thousands of dollars but many are cheated out of unrecoverable time and effort pursuing the untenable business proposition that has been disguised as a "home based business" or "direct selling." The total number of people and the full amount of dollars that are lost due to Herbalife's calculated program of deception are astonishing. They far exceed a million people each year and reach into 64 countries worldwide.

Plotted over a five-year period, the rate of all consumers that have participated and lost money exceeds 99%. Of those recruited each new year, their loss rates as a group approach the same figure. By Herbalife's own data in the 2006 10K, over 80% of the entire sales channel is classified as failing to "re-qualify" or "turned over" each year, euphemisms for failed and quit. The average "incomes" of the others – when weighted by level on the sales chain – show that almost none earned enough to recover their investments in the "business opportunity."

A tiny group of promoters in the top three ranks of the chain that carries out the deceptive recruitment system gains extravagantly from these large-scale consumer losses. This is accomplished through Herbalife's complex pay plan. Commissions paid to the sales channel by Herbalife amount to 36% of Herbalife's net revenue. Of all that money, 84% is transferred to less than one percent (.76) of the entire distribution channel, the group positioned each year at the top of the pyramid.

Herbalife's business, therefore, and the value of its stock, rely entirely upon recruiting more than one million consumers who are doomed-by-design to financial loss. The business has no sustainable customer base or sales force. It essentially collapses each year but is sustained through its deceptive recruitment program that rebuilds its infrastructure and revenue base. The losses to consumers are inevitable, well designed and pre-determined, based on the multi-tiered structure of the plan, its practice of gaining a large front-end investment, its recruiting and purchase requirements on new recruits, and its top-loaded reward system.

While the "overrides" and "royalties" are concentrated into the hands of less than 1%, the other supposed income source for distributors – retail profit – is largely non-existent. Herbalife's SEC filings and its promotional literature offer an elaborate pretense that nearly a billion dollars is "earned" by the 1.5 million person sales organization from retail sales. Abundant evidence shows that this sales activity does not and could not occur. While claiming to be a direct selling company, Herbalife maintains no records and carries out no system to monitor retail sales. Its pay plan is based entirely upon the purchases of the distributors, not their retail sales to end-users. The business model is based upon recruiting and expanding the sales channel, not carrying out retail selling. The investments of the distributors into a bogus "business opportunity" are falsely portrayed as Herbalife's "sales."

The lack of a retail sales base represents the most extensive area of deception. It also constitutes the clearest evidence that Herbalife is in violation of federal laws regarding the operation of a pyramid scheme. When the test used by the FTC regarding required levels of retail sales is applied, it shows that Herbalife's distributors would have to retail 70% of all the inventory purchased from the company. The actual rate of retailing would not come close to this required level.

In my view, therefore, if Herbalife is investigated by the Federal Trade Commission or the SEC and criteria are applied that have been used in many previous prosecutions of similar multi-level marketing companies, Herbalife would be found in gross violation of the FTC Act, Section 5, covering "unfair and deceptive trade practices."

The most fundamental fact that Herbalife conceals from shareholders and consumers – the fact that reveals the true nature of the business, rather than the false one of "direct selling – is that the company's "revenue" consists of the *capital* lost by these home-based business investors. The company does not generate sales revenue as generally understood since fair value is not exchanged. The consumers invest in a grossly misrepresented business opportunity – which is Herbalife's actual product, not weight loss pills – and Herbalife gains its money without delivering on its offer, claims or promises for an income opportunity. The failure rates are nearly total, making the term "opportunity" a sham.

Herbalife's sales of "pills, potions and lotions", the standard offering of many other multi-level marketing schemes, is only incidental to the sale of the false business opportunity. In this respect, Herbalife is closely analogous to a "pump and dump" scheme of penny stock promoters that solicits investments in an essentially worthless or virtually non-existent company whose stock, the promoters say, is poised to dramatically increase.

Year after year, Herbalife solicits consumers to invest in a non-existent or virtually worthless business – retail-based "direct selling" of Herbalife products. The value of the Herbalife distributorship, like the penny stock, is based upon drawing in new investors whose capital investments are transferred to the earlier ones. The pyramid recruiting is orchestrated by Herbalife's "upline" like a "boiler room" phoning consumers about a "hot" new stock that is "going to be big." The Herbalife Upline, like the Boiler Room, makes its money on the "spread" between the manipulated transactions of buying and selling at fixed prices.

The equity value of the Insiders of the stock scheme coincides with that of Herbalife's top shareholders and executives whose worth is actually a "bubble" produced each year by kiting up the number of "distributors" lured into making capital investments. By the end of the year, these investors are "dumped" and replaced.

The theft of consumer investments of money, time, talent and hope can have far reaching consequences for consumers – damaging relationships, family, careers and self-esteem. Herbalife's fraud upon the public is compounded by its association with groups of Herbalife promoters such as, My Success System, Newest Way to Wealth, On-Line Business Systems and

The Freedom Group. Working collaboratively with the Herbalife Corporation these rapacious recruitment scams add to consumer losses by luring them into buying their marketing materials and incurring other costs with the false claim that they will help them gain success within the Herbalife business.[1]

Herbalife's business deliberately inflicts large-scale consumer losses. It therefore requires an elaborate system of diversion, deception and disguise. Much of this trickery includes the manipulation or concealment of financial data and calculations regarding numbers of people involved and their incomes or losses. For this reason, this analysis required careful scrutiny of financial disclosures and other mathematical calculations. A reader seeking the truth behind the Herbalife disguise must, to some extent, be willing to examine the math and the data. Like a puzzle whose parts have been scrambled, Herbalife's true nature as a predatory pyramid scheme becomes apparent when the parts are properly organized. None of the math is advanced in complexity, but is a crucial component of the investigation. In the end, all pyramid schemes are math tricks.

Selling the "Business Opportunity" to Induce Product Purchases

From even a cursory review of the Herbalife operation, the most striking characteristic is its great reliance on the enrollment of consumers into the "Supervisor" level of the distributor chain. In 2006, members of this group represented 27% of all distributors. The thrust of the entire recruitment program is to induce consumers to purchase enough inventory to a gain this position on the sales chain.

Every consumer who becomes a Herbalife distributor participates in the Herbalife "business opportunity" by becoming authorized to sell the products and to recruit other distributors. All new investors in the business opportunity purchase "starter kits" and sign contracts as "contractors" of Herbalife. However, those that join at the Supervisor level make the largest, most overt and direct investment in pursuing Herbalife's advertised money-making opportunity.

Consumers that are persuaded to sign up at this Supervisor level invest approximately $3,000 (the figure can often be as high as $3,500 or more) in a one or two month time frame. (This amount of actual investment translates to at least 4,000 "volume points" including shipping and taxes)

The initial high investment is very unusual in the multi-level marketing field, which often defines itself as a business that consumers can begin with a very small initial capital investment, often advertised as under $100. Herbalife's emphasis on an initial investment in the thousands of dollars, in combination with other factors such as recruiting new investors in order to rise in positions on multi-tiered chain is a classic hallmark of a pyramid scheme. This hallmark is further highlighted in Herbalife by the fact that the scheme awards the Supervisor status to anyone that makes a cash investment and is unrelated to retail sales.

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[1] In a previously settled class action lawsuit brought by consumers against Herbalife and associated marketing companies, 2,700 former distributors filed claims with aggregate losses totaling approximately $19 million. The suit charged Herbalife and the related recruitment groups with operating a pyramid scheme and using false and misleading claims about income to lure investors. (Nancy Jacobs, Individually on behalf of herself and all others similarly situated, and on behalf of the General Public, Plaintiff, vs. Herbalife International, Inc., Herbalife International of America, Inc., Dream Builders & Associates International, Inc., et. al., Class Action Complaint, Feb. 15, 2002 filed before the United States District Court for the Central District of California Los Angeles Division)

Though the title of Supervisor clearly indicates a managerial role, no training at all or any experience is required. For each Supervisor the Herbalife sales channel has less than three non-supervisors that would need to be "supervised." When the pay plan and other factors of the operation are understood, it becomes obvious that the Supervisor is nothing more than a key recruiter for the pyramid, and the initial investments of the Supervisors are the company's largest single revenue source.

After reviewing the devastating financial returns of the vast majority of those who invest in the Herbalife "business opportunity" I conclude that Herbalife is engaging in extraordinary, systematic deception to induce these Supervisor investments and to enroll others who join at lower levels. In plain terms, Herbalife tricks consumers into buying positions on its endless chain. In exchange for a large cash payment, Herbalife offers what appears to be highly lucrative incentives to profit from soliciting others to invest.

Unknown to most participants, the pyramid design of the plan and the extreme requirement for ongoing investments result in only a small fraction, less than 1% of all distributors, ever being able to gain revenue even minimally. The prime incentive employed by Herbalife is the mirage of the "endless chain". For those in the top three levels of the pyramid, Herbalife pays commissions based on investments from "infinite levels" of the (endless) chain. Herbalife's distribution chain is potentially "endless" since each new recruit is authorized and rewarded to recruit others who can do the same *ad infinitum*. Millions of new people are thereby lured into the scheme by Herbalife and its promoters that are positioned in the top 1% of the chain. These promoters have advance knowledge that virtually all new recruits are doomed to losses and that nearly every new investor will quit the "opportunity" in less than a year after suffering losses.

Recruiting Supervisors to Recruit Supervisors to Recruit Supervisors

The consumers that make the large initial investments and purchase the Supervisor position account for the majority of Herbalife "sales." Those lured into the business opportunity are then further lured to recruit others.

In 2006, Herbalife reported to the SEC that it had 408,000 Supervisors enrolled for the year. These Supervisors, therefore, account personally or for directly recruited downlines that provide between 65% to 80% of Herbalife's net revenue of $1.886 billion (408,000 multiplied by the minimum investments required to become a Supervisor). Only Supervisors can earn royalty overrides, and only 3% of the Supervisors can earn Production Bonuses, the most lucrative part of the "business opportunity."

Herbalife offers the Supervisor position immediately to those that make an investment of approximately $3,000 or more in one month or a larger amount over two months. Herbalife does not disclose how many Supervisors gain the position with one-time personal investments. However, it disclosed in its 2006 10K report to the SEC that only 42% of its Supervisors remain in their positions for more than a year. Accounting for replacements of the dropouts and net growth, about 70% of all Supervisors each year must, therefore, be recruited that same year. The majority of Herbalife's gross revenue each year is, therefore, directly tied to the annual recruitment of replacements and new enrollments of Supervisors.

Additionally, in its 2005 10K, Herbalife reports, "more than 90% of all non-Supervisor distributors quit within a year.[2] This shows that the great majority achieves the Supervisor status immediately or within the first 12 months when they first enroll into the business, rather than beginning at a non-Supervisor level and working gradually. Herbalife literature refers to the outright purchase of inventory to gain the Supervisor positions as a way to "Jump Start your Business."

The Supervisors are immediately entitled to a 5% "royalty" on purchases of their downlines up to three levels below. By definition, the incentive is to recruit other Supervisors who can profit from recruiting other Supervisors, etc.

Each level can be "infinitely" wide. They are also given the maximum margin when purchases are made by new recruits. Supervisors are entitled to a 50% margin while the Supervisors' recruits purchase at a 25-35% margin. The difference in margin on each purchase made by newly recruited non-Supervisor is transferred to the recruiting Supervisor. The payment to the recruiting Supervisor is, *de facto*, a reward for recruiting a new investor into the "business opportunity". Herbalife disguises the process as a "wholesale commission."

The Herbalife pay plan – based upon rewards for recruiting – offers the appearance of a strong financial incentive to each new recruit to make a large up front investment in order to "jumpstart the business" and gain a Supervisor position on the endless chain. The extreme loss ratio of those at the lower levels to those a the top which is inherent in the closed recruitment system and the market limits on the number of possible new Supervisors are not disclosed in the Herbalife marketing literature or website.[3]

The initial investment is only the first requirement to gain access to 5% "royalties" on a 3-level genealogy of new recruits. Each Supervisor must also maintain at least 2,500 volume points each month (including their own purchases) in order to collect.

The quickest and surest way to achieve the monthly group volume is to recruit more Supervisors whose large upfront investments exceed the monthly volume requirement. The right to receive the 5% royalty would be maintained and, more importantly, income could also be gained from the efforts of the new Supervisors as they seek to recruit their own chain.

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[2] Herbalife 2005 10K: "For the latest twelve month re-qualification period ending January 2005, approximately 60 percent of our Supervisors did not re-qualify and more than 90% of our distributors that are not Supervisors turned over."

[3] To get a sense of the mathematical trickery of this "royalty" incentive, in North America in 2006, Herbalife reported that it had 45,778 Supervisors. Supervisors are 27% of the total distribution channel. So there were about 125,000 non-Supervisor salespeople in North America. If just 10% of the Supervisors (4,578) would recruit three new Supervisors (Supervisors can receive royalties on three levels) and these three did the same and that group repeated the process (a downline of just 39 new people), there would an immediate growth of approx. 180,000 (39 x 4,578) new Supervisors and a proportionate growth of about 650,000 non-supervisor sales, a 400% explosion in the Herbalife organization. If 10% of that newly recruited group would also build their 39-person downlines, Herbalife's North American force of "Supervisors" would approach one million and proportionately there would be 2.7 million more sales people many of whom are trying to reach the Supervisor level! Soon, every American would become a Herbalife "distributor."

The hidden reality is that Herbalife is luring consumers into pursuing a recruiting scheme in which the market for investors is already saturated. It is mathematically impossible for any but a small few to successfully recruit enough new recruits to recoup their investments. Market saturation will doom nearly all new recruits to failure, but the *overall* market for their replacements remains for Herbalife to exploit, with necessary deception employed to accomplish the task.

The pay plan, therefore, not only offers an extreme enticement to make a large initial investment to gain the Supervisor position, but it also places a large requirement on the new Supervisor to rapidly recruit others in order to gain the full advantages that the position offers in "overrides."

Other provisions of the reward system are similarly based upon recruitment but are relevant only to an extremely small group that is strategically positioned at the top of the Herbalife pyramid. These are incentives and rewards to accelerate the recruitment process. Once a Supervisor's recruitment activity generates a group volume of 20,000 volume points the Supervisor gains the G.E.T. (Global Expansion Team) level and is eligible for the largest source of payments, Performance Bonuses.

Only those in the top three levels – having achieved at least the 20,000 Group Volume requirements – receive the Performance Bonuses, which range from 2-6%, increasing with volume growth. The Performance bonus is added to the Royalties on the volume of the first three levels, but the greatest advantage of these "bonuses" is that they are paid to "infinite" levels of the recruitment genealogy.

A Money Transfer from the Bottom Directly to the Top

In the classic pyramid structure, the vast majority of all the people – and the greatest percentage of total investments – are at the lowest levels (last ones in).[4] In 2006, the "bottom" of the Herbalife pyramid was massive:

- Approximately one million non-Supervisors, i.e., 90% of all non-Supervisors that join during the year. These are the newest recruits with the least advantages for profit as defined by the business opportunity.
- Approximately 386,000 Supervisors, i.e., 94.5% of all Supervisors that earned on average no more than $549 per year. Nearly one-quarter million Supervisors, or about 60% of all that are were counted in 2006, were enrolled in that same year. These newest Supervisors along with those with minimal earnings are among the "last ones in." At the Supervisor level, they have made the largest investments, but the vast majority earns nothing or next to nothing in "royalties" (5% of the volume points of new recruits.) and virtually none in this group is eligible for the most lucrative of all payments, the "performance bonuses."

The Herbalife Performance Bonus can be as high as 6% (based on the "retail" value of the purchases, which is a 100% markup over the distributors' actual dollar investment) and extends to "infinity" in depth of levels, thereby tapping into the huge base at the bottom, those entering each year. Those in the top three levels actually receive larger rates of commission, per sale, than

[4] To understand this basic mathematical paradigm of all pyramid schemes, consider a simple structure of 1 person recruiting 5 others, with each new recruit doing the same and the structure extending just 3 levels from the top. 1 + 5 + 25 + 125 = 156 in the pyramid. However, of the total, 125 are at the very bottom, which constitutes 80% of the total. No matter how much further the pyramid would extend in levels and how many new people it recruited, the bottom level would always constitute 80% of the total. Since the bottom level participants have no one below them, they can earn nothing. They are "doomed by design", that is, 80% of all who ever participate are doomed from the start. In most pyramids disguised as "direct selling", recruits must have more than one level below them before they can recoup their own investments. In practice, therefore, the bottom two levels, at least, are doomed. In the above model, the bottom two levels will always constitute 96% of the total!

those doing the recruiting, an extreme incentive to get into these top positions. The only way to get there is relentless recruiting.[5]

The following charts reveal the extraordinary money transfer from the latest group of investors to the earlier ones. The data charts are only for those investing at the "Supervisor" level that requires an initial investment of between $3,000 and $4,000.

The calculations are based only on data provided by Herbalife on its website. The document is entitled "Statement of Average Gross Compensation of U.S. Supervisors in 2006."[6]

The charts present the data that Herbalife offers to consumers, followed by an analysis of that data using a sample of 1,000 Supervisors. When actual numbers in a sample, rather than just confusing percentages, are applied, the data reveal a pattern of massive financial loss and an extreme money transfer.

The pay plan is a complex set of rules, purchase requirements, and varying rates of payments. In the end, 36% of all the money that the distributors pay to Herbalife to buy and to maintain their "distributorships" is transferred from the last ones in to the earlier investors in the Herbalife "business opportunity." More than half of all that money winds up in the hands of one-half of one percent of the total group of Supervisors. The Supervisors are the top 27% of the entire chain of 1.5 million investors.

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[5] According to Herbalife's Statement of Average Gross Compensation of U.S. Supervisors in 2006, the distributors in these top three levels – that receive the "performance bonuses" – represent less than 3%of all those in leadership positions or less than one percent of the entire distributor chain.

[6] Without careful analysis, Herbalife's "Statement of Average Gross Compensation", is virtually useless to consumers considering an investment in the business opportunity and can be dangerously misleading. Among the confusing and misleading elements:

- It states that the average payment to "all leaders" in 2006 ("leaders" defined as Distributors that reach the rank of Supervisor and above, which it says are over 25% of all distributors) was $2,200. However, that number multiplied by the number of Supervisors for 2006 reported in the 10K – 408,000 – is far higher than what the company paid out in total as Royalties and Overrides.
- The report also divides all leaders into Active and not-active. Yet, all of the Supervisors had invested thousands of dollars in a one or two month time frame. Those that failed to earn commissions are defined as not–active, as if they made no effort, after making this substantial investment.
- Further confusing to the readers, the report offers percentages of Supervisors at each level for the Actives" and for "All", however both are under the subhead of "Active Leaders." Offering percentage of the 'actives" at each level shows a total group as "100%" in one column and the same group as 43.5% in the next column. Though the "actives" account for only 43.5% of all Supervisors, the report does not disclose that the other 56.5% received no commissions at all. The zero income for the majority of all Supervisors is excluded from the calculations of averages.
- The averages are mean averages, rather than weighted or median, which would offer a truer picture. For example, the report offers the mean average of the "Active" Supervisors as $5,100. It does not note that that the mean average of the 93% of this group – those at the bottom – was less than $780 or only 15% of the number it offers as the "average."
- Finally, the report, in addition to misleadingly naming only those that made enough purchases to qualify for commission as "active", totally omits the 1.1 million distributors that did not invest enough to reach the Supervisor level. These are excluded as if they are not part of the "channel" and not salespeople that represent Herbalife's products. Yet, in the 10K report to shareholders, Herbalife states, "We sell our products in 63 countries through a network of over 1.5 million independent distributors." To shareholders, Herbalife made no distinctions of how many are "active."

Herbalife Data:
"Statement of Average Gross Compensation of U.S. Supervisors in 2006"

Earning Level	% of Total Leaders	% of Active Leaders	Average Earnings (USD)
Presidents Team	0.1%	0.3%	$ 611,094
Millionaire Team	0.4%	1.0%	$ 111,444
GET	2.3%	5.3%	$ 24,455
World Team	2.5%	5.8%	$ 4,219
Supervisor	38.1%	87.5%	$ 549
Total	43.5%	100.0%	$ 5,192

Note that the data omits the zero income of all those defined as not "active" and does not calculate how much of the total payments go to each level.

Using Herbalife Data
Calculations of Payments to All Herbalife Supervisors, on a per 1,000 Model

Earning Level	% of Total Leaders	Mean Average Earnings (USD) of Leaders	No. per 1,000 of All Leaders	Total Payout for Each Level per 1,000	% of Payout for Each Level per 1,000 Leaders
Presidents Team	0.1%	$ 611,094	1	$ 611,094	31.5%
Millionaire Team	0.4%	$ 111,444	4	$ 445,776	23.04%
GET	2.3%	$ 24,455	23	$ 562,465	29.08%
World Team	2.5%	$ 4,219	25	$ 105,475	5.45%
Supervisor	38.1%	$ 549	381	$ 209,169	10.8%
Supervisors no earnings	56.5%	–0–	565	–0–	N/A
Total	100%	$1,934	1,000 rounded	$1,933,979 Total Paid	100% rounded

When actual numbers are applied – a sample of 1,000, and <u>all</u> Supervisors are included – an enormous money transfer is revealed accompanied by financial losses suffered by the vast majority.

- For each 1,000 Herbalife Supervisors, 435 will earn some commission while 565 earn no commissions (did not purchase enough during the year – after making initial investments – to qualify for commissions).
- 0.5% (one-half of one percent) of the total group, that is 5 Supervisors at the top of the chain out of each 1,000, will get 55% of all Commissions paid out by Herbalife to the sample.
- The top 2.8% of the Supervisors (those eligible for the "Performance Bonus") receive 84% of all Commissions paid out by Herbalife to the sample.
- The bottom 56.5% of the chain will get no commissions at all.
- The bottom 41% that does earn some commission receives an average payment of $14.90 per week.

- Each Supervisor in the list has invested the same to join and to remain qualified. The difference in income is based not on the amount of investment or on "sales" but on position on the chain and recruiting activity.

Herbalife makes a distinction of the "active" Supervisors, those that generated 2,500 volume points after becoming Supervisors. Since *all* Supervisors invested more than $3,000 and were entitled to the Royalty Overrides based on 3-levels of new recruits, it cannot be argued that *only* the "actives" were participating in order to earn income. However, as the chart below reveals, even if the calculations excluded those that Herbalife termed "not active", the money transfer pattern remains extreme.

Using Herbalife Data

Calculations of Payments to "Active" Herbalife Supervisors, on a per 1,000 Model

Earning Level	% of Leaders	No. per 1,000 of Leaders	Average Earnings of Leaders	Total Payment to Each Level	%of Payment to Each Level
Presidents Team	0.3%	3	$ 611,094	$ 1,833,282	36.9%
Millionaire Team	1.0%	10	$ 111,444	$ 1,114,440	22.4%
GET	5.3%	53	$ 24,455	$ 1,296,115	26.1%
World Team	5.8%	58	$ 4,219	$ 244,702	4.9%
Supervisor	87.5%	875	$ 549	$ 480,375	9.7%
Total	100.0%	1,000 rounded	$ 5,192 Actives	$ 4,968,914 rounded	100%

From a Sample of 1,000 "Active" Supervisors in 2006:

- **Out of 1,000, just 3 would get 37% of all the money.**
- **13 of them at the top got about 60% of all the money**
- **The top 7% of the "Actives" got over 85% of all the money**
- **The mean average payments to the bottom 93% are less than $15 a week.**

In summary, the revenue of the company depends almost totally upon the recruitment of Supervisors. This involves persuading consumers to invest more than $3,000 initially. The program then powerfully induces them to recruit other Supervisors by requiring an ongoing monthly volume before they can gain the rewards. Finally, the reward system accelerates the recruitment process by top loading the pay plan with an enormous bonus available only to the top 1% (3% of the Supervisors). Recruiting is the only feasible way to reach these top positions

The pyramid pay formula, in conjunction with scheme's rules, results in the transfer of the great majority of all money to the very top of the pyramid, leaving virtually all others with financial losses.

The Herbalife Lure: False, Misleading Representations, Missing Data

The first encounter a consumer will likely have with a presentation of the Herbalife "Business Opportunity is the company video at the "business opportunity" link at Herbalife's official website.
(http://www.herbalife.com/dsassign/business_opportunity_landing.jsp?_requestid=1931827)

The video begins with disparaging testimony on the frustrations and futility of traditional corporate, trade, and professional occupations. Long hours, little time for family, low pay and job insecurity are among the ills of the traditional workplace, the video dramatically explains. From these dreary reports and complaints, the music picks up in pace and the stories of satisfied and excited Herbalife distributors are offered as the solution to widespread economic pain. The reports and the theme of the presentation are not only on earning income but clearly on *very large incomes.*

"Big cars, big homes"

"It's all about making money."

The testimonials are supported with images of large homes, luxury cars and stylishly dressed people. Then the featured Herbalife participants share their actual incomes.

"$1,500 - $2,000 per month"

"$300 a month, then $800, then $2,700 and I quit my job."

"First month - $1,500"

"$2,800 in the first month."

"$16,000 in one month"

"$10,000 in a month, then $15,000, $20,000, 30,000, $40,000 in one month."

"$25,000 in one month. I'm kind of excited!"

"First nine months that I got going, $250,000"

The video asks the viewer if they want to change their financial future and reach their financial dreams.

It would be understandable that the viewer might believe that these claims are typical or generally achievable by large percentages of the Herbalife sales force. The only cautionary or qualifying information appears just before the video has begun, a silent script on screen for exactly 6 seconds. It reads in part: *"Examples are not necessarily typical or average. There is no guarantee. And some examples are those in the top 1% of all distributors."*

Even if a consumer had carefully read the disclaimer, it did not indicate that the examples were not representative, valid or applicable to the new recruit personally, but only that they are not "necessarily" typical (literally meaning that they could be) and that there was no "guarantee" of matching these reported incomes (seeming to indicate that it could be likely, just not "guaranteed – but who would expect a guarantee?).

Unless someone understood Herbalife's actual income data – for example, that there were 1.5 million people in the chain and that each year, perhaps as many as 99%% of all who join during one year will quit within that same, and that each year 98.5% of all distributors earn less than $10.50 a week on average, then the disclaimer note has little meaning. The advisory that "some" of the testimonials come from distributors in the top 1% would mean nothing unless one could understand what it would take and what the odds would be of getting into that tier.

How well do the Supervisors actually do financially compared to that promotional video? According to Herbalife disclosure document 97% would not earn in commission on average even the amount needed to pay for qualifying inventory purchases. The odds of making a profit for those below the Supervisory level are so low they could not be meaningfully charted

Confusing the Shareholders

Since the Supervisors represent the vast majority of all company revenue, their financial condition, how they earn income, their rate of turnover and the precise number of them that are recruited – and need to be recruited each year for the company to sustain itself – would be crucial for an investor or analyst to know.

Yet, the Herbalife 10Ks offer confusing and contradictory data on these questions.

The 2005 10K reported, *"For the latest twelve month re-qualification period ending January 2005, approximately 60 percent of our Supervisors did not re-qualify and more than 90% of our distributors that are not Supervisors turned over."*

This clearly states that between the end of 2004 and the beginning of 2005, 60% of the Supervisors were eliminated. Yet, the same report offers the following charts:

	As of December 31,					
	2003	% Change	2004	% Change	2005	% Change
The Americas	110,165	4.4%	124,605	13.1%	160,878	29.1%
Europe	84,665	10.5	102,203	20.7	95,628	(6.4)
Asia/Pacific Rim	55,564	(14.7)	55,460	(0.2)	64,286	15.9
Japan	24,485	(23.3)	16,860	(31.1)	13,566	(19.5)
Worldwide	274,879	(1.5)%	299,128	8.8%	334,358	11.8%

Number of Supervisors by Geographic Region as of Requalification Period

	As of February,		
	2003	2004*	2005
The Americas	67,921	75,359	87,925
Europe	51,290	70,239	65,104
Asia/Pacific Rim	35,637	31,790	38,524
Japan	18,287	13,946	9,547
Worldwide	173,135	191,334	201,100

While the 10K said that 60% of all Supervisors did not "re-qualify" each year, the chart offers different data. It shows that, for example, in Dec. 31, 2004 there were 299,128 Supervisors. Then at the end of February 2005, when Herbalife determined how many "re-qualify," based on the required level of purchasing, there were 201,100. This would be only 33% loss rate. (299,128 - 201,100 = 98,028) and (98,028 ÷ 299,128 = 33%)

If 60% failed to re-qualify, then the number of survivors would be 119,651. (299,128 x 40%). Where did the 81,449 others come from? (201,100 who were reported active in Feb. '05 minus the 119,651 that would have been active if just 40% survived.)

Herbalife's data is particularly puzzling because it omits two months (January and February) in which the company recruited new people. But, if the missing two months of recruiting activity accounted for the discrepancy, it would mean Herbalife recruited 81,449 new Supervisors in just two months, or 40,725 a month. This would be an annualized recruitment of 488,700 (40,725 x 12) and would be added to the 40% that stayed active (119,651). This should then be a total at the end of the year of 608,351 (119,651 + 488,700). In fact, Herbalife reported that just 334,358 were on the books at the end of 2005.

While the 2005 10K offers conflicting data, the key about "re-qualifying and "turning over", euphemisms for failure and quitting, this data is missing entirely from the 2006 10K. The 2006 Herbalife 10K does not include the monthly data showing how many were accounted for at the end of each year for three years and how many were accounted for in February of those years when the lists were purged of those that did not re-qualify.

Further, in 2006, the reference in the 2005 10K that "more than 90% of our distributors that are not Supervisors turned over." was not repeated. Investors reading the 2006 10K would not know that, combining the 90+% turnover of non-supervisors with a 60% failure rate among the Supervisors equates to an overall failure rate of more than 80%. They would therefore not know that just to maintain 2006's level of distributors, Herbalife would have to recruit 1.2 million new distributors in 2007. (80% of its roster of 1.5 million distributors at the end of 2006.)

In summary, Herbalife presents a grossly misleading appeal to consumers to invest in its "business opportunity." The misleading appeal includes the omission of key data, the presentation of absurdly irrelevant testimonials, and the confusion or distortion of historical data on loss rates, failure rates or market saturation.

The misrepresentation continues beyond consumers also to shareholders who are similarly presented a false picture of "direct selling", and "financially rewarded" salespeople. Omitted are the facts that reveal a pyramid recruitment scheme that merely transfers investments from the newest recruits to a small group of recruiters positioned at the top of the chain, leaving virtually all with a financial loss and resulting in virtually all that join during the year quitting the scheme the same year and never buying the products ever again.

The Great Retailing Charade

Reading the Herbalife 10K submitted to the SEC and shareholders, one would conclude without doubt that Herbalife's business model is a straightforward direct selling business that uses independent distributors to reach its customers. From the 2006 10K:

> *"The Company's products are manufactured by third party providers and then sold to independent distributors who sell Herbalife products to retail consumers or other distributors."*
>
> *"We believe that the direct-selling channel is ideally suited to marketing our products, because sales… are strengthened by ongoing personal contact between retail consumers and distributors."*

Indeed, the word "retail" shows up over 100 times in the Herbalife 2006 10K. Yet, it is also disclosed that Herbalife does not sell any products at all on a retail basis. It only sells to distributors. Any retail sales that would occur would be carried out by the distributors themselves

As to how much of their products the distributors resell to retail customers, Herbalife actually offers what seems to be a dollar amount of what the distributors would earn. It is called the "distributor allowance." Along with the royalties and overrides, Herbalife claims in the 10K that the distributors rewards amount to 73% of the retail price, 50% gained from reselling to retail customers and 23% from Herbalife in the form of royalties, overrides and bonuses, based on "group volume." These are payments made by Herbalife to the distributors. For the distributors who receive them – a small minority of the total – these payments are primarily based on the purchases of other distributors who are linked in the chain below them, i.e., "later ones in."

In 2006, Herbalife listed the amount that the distributors gained from retailing (the "allowance") at more than $1.4 billion ($1,472,527,000), nearly $1,000 for each distributor (based on 1.5 million distributors.) This figure is actually much larger than the company paid out in overrides, royalties and bonuses (approx. $675 million).

In further support of this figure, which is supposedly gained by the distributors from retailing, Herbalife even lists $3,100,205,000 as its "retail sales" revenue. This would be the amount of all its sales to the distributors marked up 100% and resold in the open market to the general public. This is a remarkable figure in that it indicates that 100% of all products were resold and they were sold at the manufacturer's suggested price, without discounting or giving any away as samples.

In the history of direct selling, this would be considered a sales achievement of monumental proportions!

Retail Reality

A conventional market and sales analysis, however, immediately and unquestionably reveals that Herbalife distributors do not – and could not possibly – retail a substantial amount of their inventory purchases.

1. **The market for Herbalife's weight loss and nutrition products is highly competitive and price-driven, while:**
   - The Herbalife brand name is not advertised and is unknown to most consumers.
   - The similar products are abundantly and more conveniently available to consumers from multiple sources, including mail order and retail stores or even many other multi-level marketing companies.
   - The company provides little or no marketing support in sales leads and in generating market awareness.
   - Prices of some Herbalife products appear higher than competitive products available in stores.
   - Many of the products are nutrition-based and potentially therapeutic, yet Herbalife salespeople are legally prohibited from making any therapeutic claims and the company has no formal training program in nutrition.
   - More than 80% of Herbalife entire sales force quits the business within a year, not nearly enough time to build a retail customer base.
2. **The unlimited recruiting policy of the company is totally contrary to sustaining retail selling.**
   - Profitable retailing requires some limitation on the number of retailers in any given area. Herbalife's policy of authorizing and incentivizing each distributor to recruit more distributors is contrary to a retail sales model. Each new recruit in an area dilutes the market potential of all existing ones. More new distributors that buy at wholesales levels not only dilute the market but force downward pressure on retail pricing. No sustainable retail-based sales organization could survive a company's policy of authorizing an unlimited number of new retailers in all market areas.
3. **The entire reward system works against retailing.**
   - The vast majority of all Herbalife salespeople are allowed only 25% gross profit, a rate too small to cover the high costs of direct selling. The 25% is further eroded by the distributors having to pay shipping and taxes based on the suggested retail price.

- While the amount of inventory purchased by the non-Supervisor distributors is too small to provide a net profit, the distributors at the Supervisor level are prevented from significant retailing by *high* inventory purchase requirements. Recruiting other distributors becomes the only feasible way to recoup the investments and gain the overrides. They must find new distributors, and preferably more Supervisors to meet their high purchase requirements.
- The incentives to the Supervisors reward recruiting over retailing. These include incentives based on a three-level genealogy of other supervisors and a 25% "allowance" when they sign up new distributors at the starter level. Recruiting a new distributor, rather than a single retail sale to an end-user, provides a larger sale and offers the potential of ongoing recruiting.
- Overrides and Commissions are only paid on downline *purchases*, not retail sales. This basic fact is disguised by Herbalife's payment of overrides based on "volume points" that equate to retail prices. Though a retail price point is used for commission calculations and sales taxes, the actual commission is driven by a *wholesale* purchase, never a retail sale.
- Bonus payments are based on depth of the downline – the result of recruiting, not retailing – and increase in rate as volume grows. This overwhelmingly induces recruiting activity to mazimize the formula.
- The net result of the pay formula sends the majority of all commission payments to the top levels. Recruiting is the only feasible strategy for reaching the top levels where the highly promoted "big incomes" are available.

4. Marketing and promotions of the company – contrary to some of the rhetorical references in SEC filings – overwhelmingly emphasize recruitment over retailing.

- Promotional presentations often used "exponential expansion" of downlines as the means to achieve high income (5 get 5 who each get 5 more, etc.) and the literature emphasizes the returns based on building a downline (achieved by recruiting).

5. Two more compelling factors from within the company itself reveal that the distributors themselves are the "customers" and the company has no true retail base.

- **The Distributors** anecdotally report that they do not retail, that the entire pay plan and business model make retailing unprofitable and that the company and its top promoters focus on recruiting, not retailing.
- **Herbalife** acknowledges in its 2006 10K that the vast majority of its distributors, those at the levels below the Supervisors, do not earn income from retailing.

> *Many of our non-supervisor distributors join Herbalife to obtain a 25% discount on our products and become a discount consumer or merely have a part-time income goal in mind. Consequently, non-supervisor earnings tend to be relatively low and are not tracked by the Company.*

The "non-supervisors" constitute 73% of the sales force. Their prime financial incentive, though it is minimal, is to retail Herbalife products. They can sponsor other distributors, but they are not entitled to receive royalty overrides. This sector constitutes the bulk of the sales organization – the "feet on the street" – that is positioned to retail, yet Herbalife does not track their activity or earnings, which is to say, does not monitor their retail sales activity. Herbalife does not even assert that these people ever earn any net income, only that some have a "part-time income goal in mind."

In its 2005 10K (not disclosed to shareholders in 2006), Herbalife also reported that 90% of these non-supervisors quit the company completely within one year. The extraordinarily high and quick turnover of the great majority of the sales force, coupled with their low purchase levels and Herbalife's own disinterest in their sales activity, demonstrate that little or no retailing is occurring. The rest of the channel – the Supervisor level – is economically compelled by the Herbalife incentives and inventory requirements to recruit other distributors rather than retail. Yet, whatever retailing this group might actually do is similarly not tracked by Herbalife

It is inconceivable that a legitimate direct selling company – that is based on retailing – would not take measures to know about its end-user market and the retailing success of its sales channel. Herbalife's behavior can only be accounted for by the glaring evidence that Herbalife is not a direct selling business at all. Its real business is to market a "business opportunity." As part of this opportunity, the investor must purchase inventory. The mission of the company is, therefore, to induce distributor investments in inventory.

What Herbalife reports to the SEC as "sales" are not sales at all. No legitimate direct selling company can report purchases made by the distribution channel as "sales" unless there is evidence that the channel can and will resell the goods to the end users. Herbalife only sells to the channel, which cannot profitably resell the goods. Market factors, the reward system, the purchase requirements and other costs and the unlimited expansion of the channel prevent any meaningful reselling.

Lacking a viable retailing opportunity, the distributors are compelled to pursue the other part of the "business opportunity" – seeking rewards from soliciting other investors into the business opportunity, that is, to promote the endless chain of distributor investment/purchases. This strategy, the only one available to the recruit, proves to be a futile and desperate measure, as 90-99% of all participants on the chain are doomed to be in the bottom positions where profit is not possible. Finding themselves trapped in this "failure" position, more than 90% of all who join each year will quit within the year. Herbalife and its top promoters then replace the "failures" by means of their highly developed and deceptive recruitment program.

Based on federal court rulings and precedents of prosecutions by the Federal Trade Commission, the non-retailing, recruitment-based business practices of Herbalife would be illegal.

Applying the FTC Test for Legality:
70% Retailing Required to Cover Herbalife Cost Structure and Recruitment Rewards

The FTC has prosecuted about 20 multi-level marketing companies that were similar in model to Herbalife. In nearly all cases, the FTC determined that lack of retail revenue was the key indicator of the operation of a pyramid scheme disguised as "direct selling."

One tool that the FTC used in making its evaluation is a retail business model "test" developed by FTC Senior Economist, Dr. Peter Vandernat, Ph.D. This tool does not determine legality, but it does determine how much retail revenue the multi-level marketing company must generate in order to be legal. When that figure is ascertained the FTC then can assess whether the company does, in fact, gain the necessary level of retail sales, or is primarily generating its revenue from endless chain recruiting, which is illegal under Section 5 of the FTC Act, covering "unfair and deceptive trade practices."

The test has been applied by the FTC in declarations against multi-level marketing schemes such as Equinox International, Trek Alliance, and SkyBiz among others, which the FTC charged were pyramid schemes disguised as direct selling companies. The test was described and presented in a peer-reviewed article in a respected academic journal. This article was also referenced in the FTC's Notice of Proposed Rule Making [7] to regulate business opportunity schemes, including multi-level marketing companies such as Herbalife.

To support the retail criteria for distinguishing pyramid schemes from legitimate direct selling companies, the FTC relied upon federal court rulings, such as Koscot, Omnitrition and Gold Unlimited, that have firmly established that a multi-level marketing company must source most of its commission payments along with other business costs from retail purchases, that is, from consumers *outside the chain*. If most of the money for costs and payments to recruits is coming from the recruits who are part of the chain, the scheme is an endless chain, which is an inherent fraud.

The test sets up a basic retail-based business model, using a base of $1,000 of net sales of the company. The retail model affirms the basic reality that if a company is in the direct selling business, it must have customers. If it gains all or most of its revenues only and ultimately from its sales force without end-user customers, how would the sales force earn a profit?

If the sales force is treated as the customer base then how does the company induce them to become customers? If the company rewards all the salespeople for recruiting other salespeople, then the plan is utilizing an "unfair and deceptive trade practice", that is, to offer rewards based on an "endless chain."

The endless chain is "unfair and deceptive" because:

- It cannot deliver its promised rewards to any but a few, since only a few can be positioned at the top of the chain. Though the scheme, by design, must cause most to be in the bottom positions where no profit is possible, the scheme will claim that profit is available to all. This is deceptive and the harm caused is unfair.
- It is unsustainable since it is based on offering the same reward proposition to each group based on endless expansion of new recruits, which is impossible.
- It must lead to saturation while continuing to recruit new people and promising them the opportunity to recruit others, which is deceptive and causes financial losses to nearly all.

In short, an endless chain proposition used to induce product purchases is a classic fraud. Part of the disguise of endless chain scams is to present themselves as "sales companies" and imbed the money transfer in the product purchase price and in other related fees for the "business." In Herbalife's case, 36% of the base price paid by the distributors is transferred from purchaser/investor to the recruiters. The FTC, therefore, pursued questions aimed at uncovering such disguised pyramid schemes.

- Does the scheme have a true customer base in the open market?

[7] The Notice of Proposed Rule Making references the article by Peter J. Vandernat and William W. Keep, *Marketing Fraud: An Approach to Differentiating Multilevel Marketing from Pyramid Schemes*, 21 J. of Public Policy & Marketing (Spring 2002), at 139– 151. (Federal Register / Vol. 71, No. 70 / Wednesday, April 12, 2006 / Proposed Rules, 19060

- Or, does it "make its own market" by using the endless chain lure that promises profit from joining the chain and having the right to recruit others, with the participants having to purchase the products as part of the "opportunity"?

Legality, the FTC asserted, requires that the MLM pay for its basic business costs and at least 51% of its payments to the recruiters from retail revenue. Dr. Vandernat wrote,"(In legitimate MLMs)… "commissions," or whatever the rewards paid to distributors may be called, are ultimately to be paid out of retail revenues… In pyramid analysis the core requirement for a legitimate business is that the rewards paid in connection with recruitment are to be tied to the sales of goods and services to the public (Koscot test)."

The test that the FTC's Dr. Vandernat developed and which the FTC applied in numerous prosecutions is based on the logic that if less than 51% of the recruiters' commissions come from retail revenue, but rather are sourced from the investments/purchases of the recruits, they are, *de facto*, payments for recruiting, the hallmark of the pyramid scheme. The 51% threshold is used in order to ensure that the rewards are "primarily" retail-based. This is the requirement established by federal court rulings. The FTC does not require that *all* rewards come from retail, just most of them. Consumption of some of the products by the distributors and product giveaways are accounted for.

When the test is applied to Herbalife it calculates that at least 70% of all purchases by the distributors would have to be sold to the public on a retail basis at full retail price (100% markup).

As has been shown, there is abundant evidence that Herbalife's distributors do not retail any amount even approximating this rate. Herbalife itself, though it claims to be a "direct selling" business, has no mechanism or system for measuring levels of retail selling. It has no record of who or how many people ultimately purchase its products. It has no sustainable sales force to survey since, according to its 10K filings, more than 80% of all its salespeople fail and quit the business within a year.

The FTC Test Applied to Herbalife, Using 2006 10K Data:

70% of Herbalife Products Must Be Retailed to Actual Consumers for Herbalife Legality

FTC Retail Test: Basic Costs and 51% of Rewards to Recruiters Must Be Retail-based

- Projections are on a base of $1,000 of distributor purchases
- Production costs were 20.2% of all purchases by distributors Upline
- Overhead costs were 30.4% of all purchases by distributors
- Payout was 35.8% of all purchases by distributors
- Distributor margin on retail sales was 50%

Retail-base Cost Projections:

✓ Production (from 2006 10K)	$202
✓ Overhead: (from 2006 10K)	$304
✓ FTC Test Figure of 51% of Royalties/Overrides	$183[1]
✓ Retail Profit if 70% of Goods were Retailed to Public	$700[2]
Total Costs:	**$1,389**

[1] 35.8% of net sales are paid out to the recruiters as "royalties and overrides." $1,000 of sales x 35.8% x 51% = $183

[2] At a 50% Gross Profit, $1,000 of goods purchased by the distributors would be resold for $2,000, yielding a $1,000 Gross Profit. ($1,000 x 70% = $700)

Retail-base Revenue Projection:

Total Revenues from Retail Sales if 70% of all product purchased by the distributors were retailed to the public:
Total Revenue: $1,400[3]

[3] $1,000 of distributor purchases retailed with a 50% gross profit would be sold for $2,000 (70% of $2,000 = **$1,400**)

For Herbalife to be a legal sales company, not a pyramid recruitment scam, at least 70% of all Herbalife products would have to be retailed to consumers by Herbalife distributors

- The 70% figure is arrived at by testing other lesser amounts until a retail revenue level is reached that would cover all the basic business costs, including the retail profit margin for the matching amount of retail sales, and 51% of the royalties/overrides. When different retail levels are tested, the Projected Retail Profit amount changes on the left side and the projected total retail revenue changes correspondingly on the right side. All other variables on the left side would remain unchanged. They are derived from the 2006 10K are fixed amounts based on each $1,000 of purchases by the distributors.
- For example if a 65% were tested, the retail profit figure under projected costs on the left side of the column would $650 and the Total Costs would $1,339. On the right side the projected revenue at a 65% retailing level would only be $1,300 ($2,000 of potential retail revenue x 65% = $1,300) making it less than the costs and failing the test.

The Penny Stock Ponzi Scheme Analogy
Making Its Own Market

At the price charged and sold to revolving group of untrained salespeople, is there really a market for Herbalife's virtually unknown brand of weight loss, food supplements and skin care products? Herbalife provides its distributors with no sales leads, no national advertising. It charges them heavily for marketing materials in addition to freight and taxes that it calculates on the suggested retail price which is 33-100% above the distributors' pricing, depending on their rank.[8]

When all relevant marketing and sales factors are reviewed, it is obvious that the distributors do not – and cannot – resell Herbalife goods on a retail basis on the open market. There is no demand and the sales model does not support channel "pushing" based on the product itself.

Herbalife does not have a system to measure or account for any retail sales and no company rewards are offered for retailing. Distributors anecdotally report that little or no retailing is occurring. Herbalife acknowledges that 73% of its sales force purchases Herbalife products only "to obtain a 25% discount on our products and become a discount consumer or merely have a part-time income goal in mind" and that any earnings, if they exist at all, "are not tracked by the Company."

Though Herbalife suggests that some of these distributors purchase the products based on discount pricing, the sales were made to them only as part of their enrollment in a money-making plan. They did not buy the products straightforwardly but as part of their participation in the Herbalife "business opportunity." Therefore, many in this group, were just seeking not products but had an "income goal in mind."

Herbalife "sold" more than $1.886 billion of goods to consumers in 2006. This was not done by distributors reselling the goods or due to any market demand for the goods. It was done in a classic Ponzi scheme manner by "making its own market." Herbalife utilizes a version of the "pump and dump" system utilized by stock manipulators, often called "penny stock" promoters.

In the penny stock model, a "boiler room" of stock promoters, representing a small group of Insider financial backers, sells a worthless stock at an arbitrary price to select consumers that are solicited usually by telephone. Each consumer is told that the stock is for a company, unknown to the consumers and the general public, that is poised for explosive growth and profitability. In a short time, after selling the initial offering of stock, the penny stockbrokers develop a later group of buyers, also through direct solicitation. They arbitrarily set the stock at a substantially higher price and convince the new group to buy the stock from the original group, giving them the very same story that the stock is destined to grow further. This process is repeated successively.

On each transaction, the prices are fixed by the promoters. The stock that the penny stock promoters offer does not compete with other stocks in the open market and is not listed on any major exchange (equivalent to Herbalife's product not being available in stores.) Each buyer is led to believe they have "inside information" and are "at the right place at the right time." They are buying a "future."

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[8] According to the 2006 10K Herbalife collects more than $100 million from its distributors for sales related company materials, approximately $250 for each distributor at the Supervisor level.

In fact, the stock would never sell in the open market when true facts about the company were known. The market for this stock is closed and controlled by the promoters who take a large percentage of the "spread." The story about the company's expected growth is false.

Though the share price is manipulated up by the promoters, often doubling quickly, the total price paid for the shares by each successive new group of buyers is usually about the same. The promoters have in mind a total investment threshold that the solicited investors will pay. This allows the promoters to standardize the sales pitch and the price and to focus on a target market that fits this purchase price level.

In this example, $2,500 is the price. This relatively low amount also protects the promoters when the stock price crashes and most investors – the last ones in – lose their money. Few will choose to legally pursue the promoters for fraud over a relatively low amount of losses when time and legal costs are factored. Most will often write off the loss as due to their own gullibility. Most will not even realize the stock was manipulated and will just assume they had bad timing or made a poor investment decision.

Therefore, with the price of the shares rising, but the average dollar price paid by each investor remaining about the same, the total number of new investors must grow successively. For example, the first group – usually uninformed and inexperienced investors that have been solicited by the stock promoters – pays $2,500, and each share is valued at one penny ($.01). Each investor receives 250,000 shares (250,000 shares x $.01 per share is $2,500). One hundred investors are found, raising $250,000. The total number of shares sold is 25 million (250,000 shares x 100 new shareholders). This will be only 20% of the total issued. The Insiders will hold 80%, 100 million shares. That enormous block will have value and will grow in value only to the degree that the promoters can pump up the stock and find more investors.

All of the public shareholders that are solicited are told the stock will soon grow in price and they can sell at a good profit. They are asked to imagine what they might do "if the stock goes to a dollar – converting their $2,500 investment to a quarter million dollars!"

The stock price is then doubled and a new group of investors is solicited to buy the originally issued shares now at two cents ($.02). The first group nearly doubles their investment and most happily sell their shares. Members of the new group will also be sold $2,500 blocks of shares each, since this is an amount most can afford and is the "block" that is promoted. For $2,500 they will each receive only 125,000 shares, half of what the first group got for the same investment amount. To move the entire block of shares, the promoters, therefore, need to find nearly 200 new buyers, twice as many as they brought in earlier.

The process continues. The stock price is manipulated higher. More people must be found. Some will continue to ride the wave. They will take their gains and reinvest them in the stock again and perhaps add more capital, at higher share prices. But, even as the price per share rises dramatically, the total amount paid by each person in each new group will usually remain about the same as earlier groups. The total number of shares they receive will be reduced from earlier buyers who paid the same amount. For each group to unload its stock a much larger group of new buyers must be found.

Whatever the amount paid, the value is determined strictly by the ability of the promoters to find new buyers. The market is closed. Without the promoters' false story about the company's imminent growth, the stock is worthless. And even if the promoters can find new people, each successive level of buyers is paying more money for a stock that has virtually no intrinsic value.

In number of investors, each new level will always account for the majority of all shareholders that have ever owned the stock. The bottom level will always be more than 50% of all that ever bought in.

Herbalife's Pump and Dump Ponzi

In Herbalife, analogously, each new investor pays about $3,000, the cost of becoming a Supervisor. The real value of this "distributorship" is based almost entirely upon new investors/Supervisors joining. They will all pay the same for the their Supervisor distributorships, level after level. If enough new investors are found, the original group can recoup its money. The value of the distributorship is based on "projected growth" of new investors. The story that the distributorship's value is based on the consumer demand for the Herbalife product, and that there is a viable opportunity to retail the product is as false as the penny stock promoters' story about their company's expected growth and profitability.

Like the penny stock victims, all successive levels of Herbalife investor/Supervisors are faced with a saturating market. The ability to find new investors declines as the base grows. So, though they paid the same as earlier investors, in fact, the "opportunity" shrinks. In Herbalife's case, the markets for new investors in most countries– in sufficient numbers for the latest ones to recoup their investments – were saturated many years ago. Distributors signing up now are doomed from the start.

The type of investors that are burned by the penny stock promoters closely resemble those that Herbalife targets, usually inexperienced and uninformed people regarding the stock market in the case of the penny stock or self-employment, direct selling or nutrition products in Herbalife's case. They are easily misled by the story of "changing your life" and "big incomes" from selling an unknown brand of vitamin pills, just as the penny stock victims swallowed the false story told by boiler room promoters about an unknown company that is going to grow explosively. And, in both cases, few will realize their plight even after they lose money. Most will never seek restitution or report the experience to authorities or even admit to friends they were duped. Most hide the losses in silence and shame.

The ability of the penny stock promoters to find new investors creates the illusion that the value of the stock is real. Earlier investors earn large returns. These "profits" are in fact capital gains that have been manipulated by transferring later investors' funds to earlier ones. The profit is unrelated to the activity of the company whose stock is being promoted. Yet a mirage of a sustainable and viable enterprise is created.

Similarly, in Herbalife, the incomes paid to earlier investors appear to verify the story that the Herbalife "business" has value. The Herbalife video and the personal testimonials of the Upline about "big incomes" support the illusion. The evidence that retailing is not feasible is overlooked and only the potential of capital gains is now pursued. The penny stock investors also do not look closely at the story about the business activity and promised "growth" of the phantom company whose shares they now own. They are distracted by the rising stock price, and the promises of much greater growth. Few understand that the stock price increase has been manipulated by the promoters and is dependent entirely upon their solicitation of new investors.

Comparing and Contrasting the Classic Penny Stock Scheme with Herbalife

1. The penny stock promoters "make the market" for their chosen stocks. The market is purely manipulated and is determined by their ability to find new investors. Share price is not

determined by the actual business activity of the company whose stock they represent or any product it offers or service it may perform. The price of the share is not market-based and is not comparable to anything else on the market. It is arbitrarily fixed, non-competitive and the purchases are driven by a false story about growth and profit.

Likewise, the value of the Herbalife distributorship is unrelated to its alleged purpose and business model – selling weight loss products to distributors that resell them to end-users. The price paid by the investors, which includes the price set for the inventory, is also fixed and non-competitive. In fact, the retailing of Herbalife products does not occur on any measurable scale and virtually no Herbalife distributor earns any money from doing this. The only value that is developed and the only returns that are gained are derived from the recruiting of new investors. Purchases are also driven by a false story of profit and growth. Herbalife products, therefore, do not compete in the normal way with other weight loss products sold in the open market. The price is fixed and is inextricably bound up with income promises and claims. Sold in this way, consumers do no "price shop" because they are buying not just "pills, potions and lotions", but an "extraordinary opportunity" that could "change their lives."

2. The money transfer that occurs and is manipulated by the penny stock promoters is carried out under the guise of "selling securities." No one actually pays the promoters or the Insiders directly. All the money is laundered as stock purchases and stock sales. The stock sales are said to be based on market demand. The boiler room and the price manipulation are invisible from the outside.

   Likewise, the Herbalife money transfer is hidden behind inventory purchases that are required by the pay plan and related fees for Internet services, training, shipping, etc. These investments are disguised as "direct selling" and are claimed to be based on demand for the products. The misleading income promises used to induce purchases and the associated reward system are invisible from the outside.

3. In both the penny stock and Herbalife the "last ones in" must ultimately lose. Those investors cannot ever recoup their money unless the schemes could expand forever, which cannot occur.

4. In both cases, the last ones in represent the majority of all that have ever been involved.

5. In both cases, the promoters – "boiler room" for the penny stock and Herbalife's "upline" – gained their rewards from a money transfer based on capital investments. They both make money on the "spread."

6. Neither the Penny Stock Boiler Room nor the Herbalife Upline delivers value because the stock and the distributorships respectively are inherently worthless.

7. The wealth of the Insiders in both schemes – the penny stock backers and the Herbalife Corporation – rests on the losses of the last ones in. There is no sustainable capital base. The value of the Insiders' stakes in both cases depends entirely on the ability of the schemes to find new investors that will pay the fixed and manipulated prices for "shares" (stock in the case of the penny stock scheme, a distributorship that includes inventory in the Herbalife scheme). The Insiders' wealth would evaporate immediately if new capital infusions were interrupted.

8. As the overall size of the penny stock scheme grows, the wealth of the Insiders grows correspondingly. The market capitalization of the penny stock scheme, for example, rose to $5 million when the shares went to 4 cents (125 millions total shares issued) The initial 25 million shares was sold to the public for $250,000 and was 20% of the total issued. When the stock reached four cents $.04 the same number of share were worth $1 million, making the Insiders value explode to $4 million. To accomplish this, the number of public investors grew from 100 initially to 800 when the stock reached 4 cents in price. Each "level" of investor doubled in size over the previous one. Insiders gained all their wealth simply by sponsoring the "kiting" of worthless stock and being properly positioned as major equity holders.

   Similarly, the Herbalife Corporation's value and the wealth of its largest shareholders are based on the facilitation of the money transfer in the sales of the worthless distributorships. The number of distributorships grows dramatically as it moves from country to country.

   The Herbalife Insiders' wealth, like the penny stock backers' is purely a "bubble" based on the purchases made by the last ones in. It would immediately collapse if a newer and larger group could not be found when that latest group and their distributorships are "dumped."

9. The penny stock scheme eventually "dumps" the stock it has kited to take the final reward from the scam. Often the insiders' stock is released to the closed market and the final group of buyers – representing the majority of all that have ever invested – is left with worthless shares. Some who rode the wave, and reinvested their money while adding new capital suffer larger losses. Many others at the end, having seen what appeared to be a verifiable record of rising stock, purchase much larger blocks of shares. They suffer the worst at the hands of the penny stock promoters and their insider backers.

   The penny stock scam appears to have ended but actually reconstitutes itself, sometimes under a different company name, and always with a new stock, another one promised to be "hot" and "going to be big." The very same process is carried out with the new "product." Often, many of the same investors that lost in the previous scheme, eager to recoup their losses and unaware of the scheme's machinations, are enrolled once again.

   Herbalife's similarly, "dumps" its losers and their worthless distributorships. It carries this out without interruption or needing to rename itself (though some multi-level marketing companies do rename themselves, as in Amway's new name, Quixtar, which was adopted when the Amway name had been widely sullied.

   Herbalife's "last ones in" lose *each year*. After the scheme has reached saturation points in most of its market regions – which occurred in most countries years ago – it continues to bring in more investors who face losses *immediately*. More than 90% of each new investing group discovers that it cannot pursue the publicized business of retailing and few can find enough new investors for them to recoup their own investments. They and their distributorships are "dumped", and then replaced by a new group that will be similarly dumped within the next year. Effectively, Herbalife "collapses" each year and, like the penny stock scheme, resurrects with a new set of victims, some of whom are carried over from the previous period, still hopeful and unaware of the nature of the plan.

10. The viability of both the penny stock enterprise and of Herbalife depend on three key factors:

    1) The ability to continuously gain new investors, since the company has no sustainable business and offers no value in exchange for investments.

2) The ability to maintain a disguise over the worthlessness of its alleged businesses – a "growth company" for the penny stock, and a retail-based "direct selling" distributorship for Herbalife. In both cases, news media investigations can be devastating and can trigger total collapse.
3) The lack of any government regulator bodies – SEC, FTC state Attorneys General or regulators in other countries – investigating the business models, sales practices, and financial consequences of the operations for consumers or enforcing anti-pyramid scheme and consumer or securities fraud laws.