white paper

Best Practices for Underwriting and Monitoring Multi-Level Marketers

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ELECTRONIC TRANSACTIONS ASSOCIATION

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Executive Summary

In today's ever changing business environment, merchant underwriting can be as challenging as it is important. Success in the critical role as an underwriter or underwriting department manager can contribute to increased revenues and decreased loss rates. The merchant segment of Multi-Level Marketing (MLM) creates an even more difficult and unique challenge than other merchant segments. This white paper will act as a best practice guide and assist you in better understanding the unique mindset, strategies and business structure of these merchants.

DEFINITION

Multi-level Marketing (MLM) is a designation that describes a company's marketing and sales structure rather than the actual product sold. It is also known as "direct marketing," "network marketing," "distribution marketing," "referral marketing" and "home-based businesses" to name a few. Examples of well known, well run, national MLM companies are Amway and Herbalife.

MLM is a way of selling products or services through independent sales people who are often called "members" or "distributors." A new member recruited by an existing member is referred to as a "downline member or distributor." MLMs not only pay commissions for the direct sales of the individuals who sign up to sell the MLM's products or service, they also receive commissions based on the sales of their downline members. The design of the downline can be as simple as a single downline or as complex as several layers of downlines. Understanding how these commissions are paid is an important part of underwriting the MLM.

The product sales and resulting commission payment structure are important factors in determining the risk level of the MLM organization. If there are greater incentives paid for recruitment of the downline member than product sales, the program should be viewed as one that carries more risk. These programs are usually marked by high "buy in" or "sign up" fees that must be paid by the member. Simply earning commissions from the recruitment of new members or new downlines without a product purchase may be viewed as a pyramid or Ponzi scheme. Wikipedia defines a Ponzi scheme as a scheme that pays returns to members from their own money or money paid by subsequent members, rather than from any actual profit earned. The FTC site states that the key element of a pyramid scheme is compensation obtained primarily from recruitment activities, rather than from actual sales to end users who are not in the network of participants in the sales device or scheme. Another pyramid like scheme is seen when an MLM requires the member to purchase more product or service than they are likely to sell.

It is important to review both the compensation plan to determine how members are obtaining commissions and the membership requirements for all members to understand if they are required to continuously purchase product or services to maintain their standing in the program. This is one of the keys to determining the risk level of the MLM during the underwriting process. The requirement of purchasing product does not make an MLM illegitimate; it is simply one factor that must be taken into account in the overall review of the MLM and its marketing and compensation programs.

MLMs can have a variety of compensation plans. It is important to know which plan the company under review uses. The basic plans are listed below:

- Uni-level Plans: This type of plan is often considered the simplest of compensation plans. As the name suggests, the plan allows a person to sponsor one line of distributors, called a "frontline." Every distributor the person sponsors is considered to be on that sponsor's frontline and there are no width limitations, meaning there is no limit to the amount of people one can sponsor in the frontline. The common goal of this plan is to recruit a large number of frontline distributors and then encourage them to do the same. This is due to the fact that commissions are normally paid out on a limited depth, which typically means sponsors can earn commissions on sales between 5 and 7 levels deep.

- Stairstep Breakaway Plan: This type of plan is characterized as having representatives who are responsible for both personal and group sales volumes. Volume is created by recruiting and by retailing product. Various discounts or rebates may be paid to group leaders and a group leader can be any representative with one or more downline recruits. Once predefined personal and/or group volumes are achieved, a representative moves up a commission level. This continues until the representative's sales volume reaches the top commission level and "breaks away" from their upline. From that point on, the new group is no longer considered part of his upline's group and the multi-level compensation aspect ceases. The original upline usually continues to be compensated through override commissions and other incentives.

- Matrix Plan: This type of plan is similar to a Uni-level plan, except there is also a limited number of representatives who can be placed on the first level. Recruits beyond the maximum number of first level positions allowed are automatically placed in other downline positions. Matrix plans often have a maximum width and depth. When all positions in a representative's downline matrix are filled (maximum width and depth is reached for all participants in a matrix), a new matrix may be started. Like Uni-level plans, representatives in a matrix earn unlimited commissions on limited levels of volume with minimal sales quotas.

- Binary Plan: This type of plan is a compensation plan which allows distributors to have only two frontline distributors. If a distributor sponsors more than two distributors, the excess are placed at levels below the sponsoring distributor's frontline. This "spillover" is one of the most attractive features to new distributors since they need only sponsor two distributors to participate in the compensation plan. The primary limitation is that distributors must "balance" their two downline legs to receive commissions. Balancing legs typically requires that the number of sales from one downline leg constitute no more than a specified percentage of the distributor's total sales.

- Hybrid Plan: This type of plan is a compensation plan that uses elements of more than one type of compensation plan.

UNDERWRITING

The typical credit and background checks on both the business and the principals (Google, FTC, Lexis/Nexis, etc.) should be performed during the underwriting process. For MLMs requesting larger processing volumes, a criminal check should also be performed. The next step of the review process is to determine the business type and commission structure. The MLM should also be reviewed based on their product, product delivery, refund policy and percent of the product available outside of the MLM structure without the intervention of the member (as seen on TV that is also available in stores). The results of these checks should be reviewed in conjunction with the merchant's past processing and financial condition.

The best practices listed below provide an outline of activities that include pre-screening, risk mitigation, risk monitoring and ongoing due diligence that should apply to the underwriting and ongoing maintenance of an MLM.

Items to be understood during the underwriting process:

1. Is an actual product available for sale or is the MLM relying on signing up downline distributors?
2. Is the product or service viable and does it have the worth to allow for the continuing sales of the product and growth of the MLM (i.e., cleaning products that need to be repurchased once used)? Will the product or service saturate the market (i.e., work out equipment that is purchased once and never again)?
3. Will there be adequate and continuous product availability?
4. Is the applying merchant the actual MLM company (i.e. the payer of commissions and controller of the product) or one of the downline members?
5. Does the MLM program have a strong infrastructure to manage the operation?
6. Who is the manufacturer of the product?
7. What is the distribution model for this product?
    - Where is the fulfillment house? (see below, this must be inspected)

- How is the product stocked?
- How is the product shipped?

8. Research the product
   - What is the product's worth as compared to the price?
   - Does the organization have a "quantity purchase requirement" for the product or service?
   - What is the billing process – auto-ship or trial? Are there recurring charges?

9. Member requirements
   - What are new member requirements related to their training, training materials and marketing materials?
   - Is the member required to purchase their own materials to pay or attend a seminar on how to sell the product and recruit additional downline members?
   - Is the member required to purchase a specific quantity of the product?
   - A simple test of the MLM is the 70 percent rule. This rule requires members to sell at least 70 percent of their product from their previously purchased inventory before placing new orders. Some understand this to be product sold to individuals not in the program, while others allow for product usage by the members. This prevents members from "inventory loading" in order to qualify for additional bonuses.
   - Is there an initial purchase requirement and/or are there recurring monthly product purchase requirements?
   - Is there a membership fee?
   - Is there a compensation plan based on downlines? How many payments and what is the percentage?

10. Is the product billed as part of an auto-ship or trial offer? (*Please note this paper does not speak to the Rockefeller commission mandates.*)

11. Investigate the potential merchant to ascertain if they are a member of certain organizations and/or use research websites that specialize in this industry. Some examples are:
    - http://www.mlmwatch.org/
    - http://www.npros.com/directory.asp
    - http://www.dsa.org/
    - http://www.consumerfraudreporting.org

12. Ensure domain registration matches the corporation on the application.

13. Ensure the owner is willing to endorse his company's ethics and sign a personal guarantee.

14. Ensure the online incorporation documents match what has been supplied.

15. Obtain a complete site survey from a reputable third party, not the sales representative.

16. Obtain a minimum of six months previous processing history from the same merchant account for all current processors and ensure all ratios are within guidelines.

17. Obtain financials and ensure they support the processing volumes requested.

18. Obtain operating account bank statements to ensure commission payments are being made and trades are being paid.

19. Understand the commission tracking software being used.

20. Review all telemarketing scripts for reasonableness and all marketing material including the affiliate sales portals.

21. Join the MLM anonymously, read all communications, purchase the product, use it, return it. Test all aspects of the system.

Things to avoid during the underwriting process:

1. MLMs with an intangible or disreputable core product.

2. MLMs that incent members to bring on other members rather than sell product.
3. Merchants that may be selling an opportunity, educational program (i.e., training, coaching) or system.
4. Forced auto-shipment of products not based on the members' ability to resell.
5. Fee-based seminars.
6. Products in an unacceptable or excessive "high risk" category.
7. Start up products and businesses.
8. Principals, businesses or any related address that is on MATCH should be reviewed with closer scrutiny.
9. Incorrect MCCs.
10. Harsh downsells in the customer service scripts.
11. Harsh return policies.
12. Hidden purchases (*please note this paper does not speak to the Rockefeller commission mandates*).

RISK MONITORING

Once an account has been properly underwritten it must be monitored with greater diligence than other accounts. Some basic ongoing MLM monitoring tips are listed below.

1. Basic risk monitoring based on approved volumes and tickets is the first step and must be performed with diligence.
2. Transaction and monthly account limits should be set appropriately and closely monitored. Do not let them process more than you have approved them for, but allow sales growth as appropriate.
3. Monitor refund dollar levels and percentage rates. MLM's credit ratios should be between 5% and 10%.
4. Focus on "high risk" chargebacks, including non-receipt of merchandise, credit not processed, fraudulent purchase and non-response to retrieval requests
5. Develop a relationship with fulfillment houses that service a large segment of MLM companies. Frequently contact and visit the fulfillment houses to monitor inventory and discuss issues or concerns that may exist for a specific merchant or the industry in general.
6. Overall processing history including chargebacks and credits must be continually reviewed during the month and in arrears for six months.
   - Early identification and detection of high risk activity must occur via daily risk monitoring. Focus should be placed on retrieval requests, chargebacks and unusual spikes or declines in processing. These patterns should be tracked in monthly risk reports.
7. Operational and commission bank account statements should be reviewed monthly to ensure commission checks are being paid and not bouncing, trades are being paid and the funds flow is not changing. Large marketing costs may be associated with an increase in members or product sales. Ensure product distribution channels are being paid.
8. Conduct annual or semi-annual on-site reviews on business and fulfillment house.
9. Financial stability through business financials must be reviewed quarterly. This review should include cash, working capital and net income. The overall review will determine if any adjustments, such as processing limits, reserves, or other changes in terms are required.
10. Regular URL reviews should occur to monitor for a change in products or new product offerings. This review should include the sales portal to ensure products are consistent.

This should be combined with transaction monitoring as increasing or decreasing tickets could suggest a change in the offering.

11. Random calls should be made to the customer service number to determine the level of service provided. Pay attention to the time to answer, the recording while on hold, the ability to obtain a credit and similar customer service items.

CONCLUSION

When working in the MLM industry it is important to know who the MLM is prior to approving them and to have a consistent review of the MLM's business, business model and business practices. Therefore, when the MLM begins processing, monitoring tools must be in place to review their activity based on their transactions and volumes, including credits, declines and chargeback/retrieval statistics. Chargebacks and retrievals should be evaluated on both numbers and percentage of volume, as it provides a better understanding of the variances that may be encountered. In addition, it is recommended that the merchant's web presence be reviewed and scanned for any changes on a monthly basis at a minimum. Using an outsourced scanning company along with a manual review is recommended. Products should be reviewed to ensure that no changes have occurred, including additions or modifications to the product line. This would also include variances in pricing that might reflect changes in the business model or practices. Understanding the merchant's overall business model, commission structure, product and customer service philosophies will allow you to process for this detailed merchant segment.

The MLM model is profitable. Through knowledgeable and enhanced underwriting and monitoring, you will be able to increase revenues and decrease loss rates from this high risk segment.