

Difficulties in the Legal Qualification of Fraud: Financial Pyramids and Multi-Level Marketing*

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Abstract:

This article examines the legal challenges involved in identifying and qualifying fraudulent schemes, particularly classic financial pyramids and commodity-based financial pyramids. Using a comparative legal approach, the study explores how these schemes frequently disguise themselves as legitimate business activities, most notably through multi-level marketing (MLM) structures. Such similarities often create difficulties for regulators and law enforcement agencies in distinguishing lawful commercial practices from criminal conduct. The analysis highlights several criteria for differentiating legitimate MLM operations from illegal pyramid schemes, including misleading investment promises, the absence of genuine economic value creation, excessive reliance on recruitment, and the continuous need to attract new participants to generate returns. The findings reveal that financial pyramids are inherently dependent on unsustainable growth and typically collapse when recruitment declines, causing significant financial losses to participants. Furthermore, the study demonstrates that many jurisdictions lack clear and uniform legal standards for defining and prosecuting pyramid schemes. This legal inconsistency complicates the qualification of criminal offenses and hinders effective consumer protection and regulatory enforcement.

Keywords: Classic Pyramid Scheme; Commodity Pyramid Scheme; MLM; Criminal Offenses; Investment.

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A. INTRODUCTION

Financial pyramids (FPs) have been causing significant losses to investors around the world for many years. The main mechanism of their operation is widely known and is primarily based on exploiting human naivety and the belief in risk-free super-profits (Bratash & Emelyanenko, 2024). Despite this, FPs continue to deceive investors by employing increasingly creative and fictitious business models designed to disguise criminal activity (Gallyamova, 2024; Petrov et al., 2024).

Depending on the fraudulent scheme used, the creators of FPs attempt to make them resemble legitimate multi-level marketing systems or banks/parabanks. Therefore, the focus of our study is on identifying different FP schemes and distinguishing their characteristics that allow us to identify FP models in line with the paradigm accepted in the literature. In addition, the goal is to identify key (common and distinct) factors contributing to the emergence of these types of fraud and to draw clear boundaries between criminal activity and legitimate business.

Literature Review

According to the US Federal Bureau of Investigation, a financial pyramid is a business scheme in which money is collected from newly recruited individuals and used to fulfill obligations to earlier creditors, thereby reducing the risk that clients will suspect the institution of insolvency or illegal activity (Bosley & Knorr, 2018).

The literature identifies various types of financial pyramids. The classic (chain) FP is a form of investment fraud in which investment returns are paid to investors using their funds or the funds of subsequent investors, rather than profits generated through investment or economic activity (Lewis, 2013, p. 284). New investors are attracted by an appealing but fictitious investment concept (a façade business model) and above-average profits, whose size does not depend on the number of newly recruited investors (Hanoch & Wood, 2021).

The creators of classic FPs act with criminal intent, using, among other things, deception and unrealistic business assumptions (Hidajat, 2018), as well as treating investors as providers of non-repayable capital (Krige, 2012; Toria, 2024). However, the final phase of a classic FP has the same economic consequences as the bankruptcy of a legitimate enterprise caused, for example, by the realization of credit or market risks (Fomin et al., 2021; Shkhagapsoev, 2024). For this reason, it is especially important to prove the criminal intent of the creators of classic FPs (Tajti, 2019).

Another type of FP is the commodity FP, which involves franchise fraud or referral chains. These are marketing and investment scams in which individuals are offered distributorship or franchise to promote a particular product. The actual profit does not come from selling the product, but from selling new distributorships (Hardy et al., 2020). According to G. Curtis, commodity FP is any plan, program, scheme, or process in which a participant, in exchange for payment, receives the right to promote the company's products or services and earn compensation based on the payments made by new members recruited into the commodity FP. These payments are not connected to the sale of products or services to end consumers (Almuflih et al., 2024; Curtis, 2012).

The organizational structure of commodity FPs resembles a triangle: the founder is at the top, and the subsequent lower levels consist of subordinates, each with their subordinate networks. The commission for recruiting a new participant is shared between the recruiter and all their superiors. This commission model strongly motivates participants of commodity FPs at all levels and leads to rapid growth in membership during the initial development phase. However, growth eventually slows due to demographic limits, which prevents exponential expansion of the participant base (Bosley & McKeage, 2015). For this reason, the potential lifespan of commodity FPs is limited and generally shorter than that of the classic FP.

According to (Liu, 2018), multi-level marketing (MLM), also known as network marketing, is a form of direct selling whose defining feature is the method of calculating and distributing compensation to sellers. Higher-level sellers receive payment not only from their own (direct) sales but also from (indirect) sales made through their network of lower-level sellers whom they have personally recruited and trained. This hierarchical sales structure visually resembles a triangle (a pyramid), which is why scholars (Koliev, 2024; Muncy, 2004) argue that the connection between MLM and commodity FPs is evident.

The objective of this study is to identify the legal characteristics of FPs and their differences from MLM, which would support more accurate qualification of this type of illegal activity as fraud. The tasks of the study are as follows: 1). To determine the main differences between various types of FPs; 2). To identify the features that classify FPs as forms of activity prohibited by law in international practice; 3). To define the key differences between MLM as a legal business activity and an FP.

B. METHODS

The study of the legal characteristics of FPs and MLM was conducted through desk research by analyzing information sources related to the topic. At the first stage of the research, the source base was established, consisting of articles and monographs focused on the analysis of the features of FPs and MLM.

At the second stage, by analyzing the source base using methods of theoretical generalization, comparative analysis, and synthesis, answers were obtained to the following research questions: 1). What are the main differences between commodity and classic FPs? 2). What features define classic FPs and commodity FPs as forms of activity prohibited by law in international practice? 3). What are the main differences between MLM as a legal business activity and a commodity FP?

C. RESULTS

The analysis of the scientific literature on the research problem allows us to identify the main differences between commodity and classic FPs (Table 1).

Table 1. Comparative analysis of commodity and classic FPs

Criteria	Commodity FPs	Classic FPs
Essence of the activity	Selling pseudo-goods or pseudo-services (less often) Attracting new participants who can create their own sales networks Paying bonuses and rewards to participants	Accepting funds ("deposits") from clients with a stated but unrealized goal of investing with a high return
Type of participants (except creators)	Participants/agents/brokers	Clients/investors
Capital obligations of participants	Entry fee (for the right to promote products or services or for a "starter package") Purchase of pseudo-products (loading inventory)	Contribution of any amount
Source of resemblance	Franchise/referral chain of an MLM company	Parabanks
Organizational structure	Structured hierarchy (pyramid). Participants earn income from recruitment and sales by their subordinates	Flat structure. The founder exerts direct influence over all clients
Specific features	Pressure to recruit and sell. Profit depends on the sales of pseudo-products or pseudo-services, as well as fees from newly recruited members lower in the pyramid structure. May report revenue from internal sales to participants acting as independent businesses	Poses as a banking legal entity. Returns to early clients are generated from the contributions of new clients. Emphasis on investment safety or capital guarantees. Negative capital balance. Electronic access to the account is usually restricted
Main reason for collapse	Cessation of new recruitment/halt in sales	Loss of financial liquidity due to the lack of incoming capital

Common characteristics Concealment of the fictitious nature of activity: no economic rationale and value creation. Deception of investors typical of fraud, unfair market practices, or unfair competition.

Source: own research

The analysis of academic literature has also revealed that both commodity and classic FPs are considered criminal offenses as they mislead investors (Asnis, 2024; Volevodz et al., 2024). In the Criminal Code of the Republic of Kazakhstan, due to the particularly dangerous nature of these unlawful acts and to simplify enforcement, specific articles have been introduced: Article 217 “Creation and leadership of a financial (investment) pyramid” and Article 217-1 “Advertising of a financial (investment) pyramid” (Grinenko et al., 2025). In Russia, criminal liability for similar activity is regulated by Article 172.2 of the Criminal Code of the Russian Federation, “Organization of activities involving the collection of funds and/or other assets.” However, in many European countries (e.g., Germany, Poland), the criminalization of FPs is based on several legal acts and does not establish a distinct category of crimes for organizing and conducting activities in the form of financial (investment) pyramids. Therefore, in international practice, such offenses are generally treated as fraud, unfair market practices, unfair competition, or conducting banking activities without a license (Table 2). These characteristics may provide a sufficient evidentiary basis for prosecuting such violations.

Table 2. Characteristics of commodity and classic FPs as forms of activity prohibited by law in international practice

Signs of crimes	Commodity FP	Classic FP
fraud	+	+
unfair market practices	+	+
unfair competition	+	+
conducting banking activities without a license		+

Source: own research

The comparative analysis also identified the key differences between MLM structures and commodity FPs (Table 3).

Table 3. Comparative analysis of MLM structures and commodity FPs

MLM	Commodity FP
Profit is earned from one's own sales and the sales of individuals in one's downline	Profit is earned solely from recruiting new participants
Low or no entry fee	High entry fee that burdens participants' budgets
High-quality products at competitive prices	No real product or overpriced pseudo-products of low quality
Product sales to end consumers	Pseudo-products sold only within the structure
Clear product return and refund policies	Lack of rules regulating returns or restocking of pseudo-products
Long operational lifespan; effectiveness depends on economic conditions and demand	Short-lived business activity due to the inevitable collapse of the structure
Transparent rules and operations	Unclear and opaque rules of operation

Source: own research

D. DISCUSSION

As the results show, both commodity and classic FPs share many similarities as they are illegal and follow a comparable life cycle: creation, expansion, slowdown (at which point the first accusations of illegal activity typically emerge, accompanied by exit fraud tactics, such as a smokescreen, intensive money laundering, and reassurances of full solvency), and eventual collapse (Yatselenko & Gurbanov, 2024). According to the findings (Table 3), in international practice, *fraud* provisions (Volkova et al., 2024) can be applied to combat classic or commodity FPs if their organizers deliberately concealed the criminal nature of the activity, acted with direct intent, pursued financial gain, and caused actual damage or financial losses.

The founder's desire to obtain financial gain does not necessarily have to be evident at every stage of the scheme's life cycle as organizers may begin to withdraw funds only shortly before the anticipated collapse of classic or commodity FPs. The absence of financial damage while the pyramid is still functioning prevents effective prosecution of its organizers for fraud. Individuals who publicly warn about a potential classic FP or commodity FP may even be held liable by the organizers, provided that the company continues to make payouts, and the defendant is likely to lose a civil case, thereby indirectly validating the pyramid's operations as a legitimate business.

The requirement of direct intent to mislead is also problematic since extraordinary events may occur during the operation of classic or commodity FPs: such as financial crises, epidemics, natural disasters, or legal changes. The organizers of such fraudulent schemes may justify their bankruptcy by attributing it to these external events rather than the collapse of the underlying scheme.

Unfortunately, the fact that the definition of fraud is not tied to a specific type of abuse contributes to numerous shortcomings in this provision (Smolin & Shigurov, 2024; Tajti, 2019). Practice shows that fraudulent enterprises often contain elements of both types simultaneously, making their clear classification difficult. However, we have identified the following distinguishing characteristics in the organization of commodity and classic FPs.

What is common to both commodity and classic FPs is, first and foremost, the fictitious nature of their activities (lack of economic rationale and value creation) and the need to maintain a constant inflow of capital. Commodity FPs collapse when no new members join the structure (i.e., no entry fees are paid, and no products are purchased), while classic FPs typically collapse due to a loss of financial liquidity. A specific feature of commodity FPs, which is rarely or not at

all present in classic FPs, is the payment of additional bonuses to “older” participants for recruiting “new” ones (Msosa, 2022). Both structures may also impose unjustified fees on their participants.

Another difference between commodity and classic FPs is that the latter allows for the investment of unlimited amounts of money, whereas in the commodity FP, cash flow is primarily generated through a fixed entry fee and the sale of the so-called pseudo-products (Matthews, 2020). Thus, classic FPs have the potential to attract larger sums and cause greater losses to investors, making it more dangerous than commodity FPs.

An important distinction between commodity and classic FPs is that while victims of classic FPs tend to blame the scheme’s creators for fraud, participants in commodity FPs often blame themselves, citing their own incompetence, ineffective sales performance, or lack of qualifications. They are often ashamed of having failed to meet their goals and, as a result, do not report to law enforcement that they have fallen victim to fraud in the form of the commodity FP (Nat & Keep, 2002).

MLM and commodity FPs. As the results of the study show, MLM is often viewed with skepticism because many companies operating “under the guise” of MLM enterprises have turned out to be disguised commodity FPs. The legality of such activity has been questioned in court (Lyubushkin, 2024), but these proceedings have been complicated by the many overlapping characteristics that connect MLM structures to commodity FPs. In addition, the false (façade) business models used by commodity FPs are constantly evolving, making them increasingly difficult to detect and more effective in attracting new investors (Muncy, 2004).

This last point demonstrates the effectiveness and foresight of Kazakhstan’s legislation (Mussali, 2024) which introduced Article 217 and Article 217-1 into the Criminal Code of the Republic of Kazakhstan. For instance, TOO “QI-Trade Kazakhstan” offered its investors the opportunity to invest in what it claimed was trading on Amazon with the promise of guaranteed returns. About 100 residents of Almaty reported being victims of this FP. Later, two directors of the company were detained by law enforcement. They were charged under Clause 3 of Article 217 of the Criminal Code of the Republic of Kazakhstan, “Creation and management of a financial (investment) pyramid.”

In February 2025, a money laundering scheme involving proceeds from the operation of the LiveGood FP was uncovered in Astana. According to the investigation, between 2023 and 2025, the suspect headed a structural division of

the pyramid which was disguised as a network marketing business selling dietary supplements. The scheme was based on a binary system in which participants were placed on different levels depending on the number of new recruits they brought in. The primary income was not generated through product sales but through the entry fees paid by new members. Lured by promises, over 6,000 people purchased a \$50 subscription with monthly payments to LiveGood, hoping to earn up to \$2,000 per month in bonuses based on their level in the system.

The main difference between MLM and commodity FPs (Table 3) lies in the sources of income for their participants. Firstly, a legitimate MLM business must be based on actual product sales. Secondly, recruitment in MLM should aim to expand market share, rather than being the sole purpose of the business as is the case with commodity FPs, where new participants are recruited by older (higher-level) members solely to maintain the scheme. However, identifying the true source of income is not always easy as commodity FPs often introduce pseudo-products into their operations to disguise their fraudulent nature (Msosa, 2022) and make them resemble legal MLM businesses.

Pseudo-products are typically low-quality goods, though assessing their quality can be challenging especially in the case of product prices based on discretionary or psychological factors, such as luxury items or trendy goods. Another issue in evaluating pseudo-products lies in verifying their alleged “miraculous” properties, such as claims of improving health or well-being.

Prices for pseudo-products often exceed their actual market value (Pareja, 2008), meaning the only viable way to sell them is to require participants in the commodity FP to purchase them themselves. This obligation, known as inventory loading, is a condition for becoming an active member of the commodity FP and for gaining access to a downline network (Pareja, 2008). Thus, commodity FPs generate income by selling pseudo-products to its own distributor network, who due to the inflated prices, poor product quality, or lack of adequate sales skills are unable to sell the products to end consumers, in line with the core structure of commodity FPs. Revenues in such schemes are derived almost exclusively from inventory loading by independent contractors who bear the costs and risks of these ineffective sales. In essence, they serve as providers of non-refundable capital to the scheme (Moturenko, 2023). Inventory loading becomes merely a quasi-entry fee for participation in the pyramid scheme. In conclusion, a legitimate business must generate income primarily from sales to external customers (end consumers), rather than relying on internal sales (inventory loading). A lawfully operating MLM company must meet two key criteria: 1) Tangible financial benefits gained from the MLM system must arise

from the purchase or sale of goods and services at prices close to their actual market value; 2) An individual who leaves the system must have the opportunity to resell all purchased goods or services back to the organizer for no less than 90% of the original purchase price.

Compliance with these principles confirms the company's focus on external consumers and provides sellers with a chance to reassess their decision to join the MLM system that may have been made under emotional influence at a reasonable cost. Failure to meet these conditions clearly indicates a prohibited scheme classified under international unfair competition laws as a snowball-type (or endless chain) sale. This model offers goods or services by promising material benefits to buyers in exchange for recruiting others to make the same purchases, who receive similar benefits by attracting more participants (Krainova et al., 2024; Matytsin, 2022).

Another distinctive feature of commodity FPs, which resembles MLMs (Table 3), is the requirement of a high entry fee, often placing a significant financial burden on new participants. According to commodity FP organizers, this entry fee is framed as an investment expected to pay off over time through involvement in the program. In reality, it typically results in non-refundable losses for the individual. This payment often appears in the form of a "starter kit" (including promotional and training materials, samples of pseudo-products, etc.), a pseudo-license granting the right to sell, or simply a fee for joining the structure (Nat & Keep, 2002). While a high upfront payment is a red flag, it alone is not sufficient to prove the existence of the commodity FP. It is also necessary to evaluate whether the fee is justified by the real value of what is provided.

One more difference between MLMs and commodity FPs is the significantly shorter lifespan of the latter. By definition, MLM companies operate for an indefinite period, depending on factors such as macroeconomic conditions, sales trends, consumer preferences, etc. In contrast, the primary goal of commodity FPs is to rapidly build a sales network and cease operations once the growth momentum declines. To operate legally, an MLM company must emphasize the transparency of its business model. An example of the difficulties in correctly distinguishing between MLM structures and commodity FPs is the 1998 decision of the Chinese authorities to suspend the operations of all direct sales companies. This drastic measure was taken due to challenges in combating fraudulent schemes (Tajti, 2019). It remains the only instance globally where the problem of commodity FPs disguised as MLMs was effectively eliminated, although this step also caused significant damage to many legitimate enterprises (Butakova, 2024).

To more effectively differentiate MLM structures from commodity FPs, the US Federal Trade Commission introduced the so-called Koscot test in 1975. The test is named after Koscot Interplanetary, a company that was the subject of a prolonged legal case concerning pyramid scheme allegations. According to the test, if both of the following conditions are met, the structure qualifies as the commodity FP (Matthews, 2020): 1). The opportunity to earn profit is based solely on recruiting new participants; 2). The profit is not connected to actual sales of goods or services to end consumers.

History shows that companies, being aware of existing legal safeguards, often attempt to evade detection by designing commission systems that include bonuses for both recruitment and sales (Matthews, 2020). An example of such a company is WorldClassNetwork, which was initially presented as an MLM business offering travel packages. Sales were expected to be conducted by independent agents who had to purchase a training program for \$49,578 to join the structure. Revenue was supposedly generated through both the sale of travel services and the recruitment of new agents who, in turn, would also purchase the initial training program. However, in-depth analysis revealed that only 8% of income came from actual sales, while 92% was derived from recruitment activities. This case clearly illustrates how a company can introduce a pseudo-product to conceal its involvement in the commodity FP. The operations of such disguised pyramids have led to substantial financial losses for individuals globally (Liu, 2018). Therefore, even when courts have ruled in their favor, the legitimacy and ethical nature of their business practices remain under constant scrutiny in public discourse and the media.

F. CONCLUSIONS

Although commodity and classic FPs are not new phenomena in the financial market, investors remain vulnerable to their influence, primarily because the creators of these fraudulent structures constantly devise new and increasingly creative ideas to disguise their illegal activities. The operating principle of a commodity FP resembles that of an MLM-type company, as both structures rely heavily on recruiting new participants and building a personal network of sellers. A classical FP is similar to a parabank as it allows individuals to invest in products that resemble those offered by parabanks, and its creators exert direct influence over all depositors.

The common denominator of both prohibited structures is the deception of investors (with minor exceptions), the concealment of the fictitious nature of the activity (i.e., the lack of economic rationale and creation of added value), and their alignment with the characteristics of fraud, unfair market practices, unfair

competition, or the conduct of banking activities without a license. The existence of both structures depends on a constant inflow of new participants, which cannot be sustained in the long term. Therefore, the creators of classic FPs and commodity FPs must anticipate their eventual collapse.

The factors behind the creation of these schemes also differ slightly: both types of fraud are based on human greed and the desire to earn above-average profits. In the case of commodity FPs, the key elements are the aura of uniqueness, the image of the founders, word-of-mouth promotion, and recruitment combined with social engineering. In contrast, the creators of classical FPs focus on portraying low investment risk and building a solid reputation to maintain a steady inflow of investors. The most challenging task faced by the justice system and lawmakers is the effective identification of such fraudulent structures (i.e., distinguishing commodity and classic FPs from legitimate businesses that resemble them) to minimize potential investor losses and strengthen trust in the financial market.

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