



2020

## Reintroducing International Direct Sales Companies to Chinese Regulatory Compliance: Navigating National Distrust, Social Unrest & Colliding National Policies

Grace Garbee

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### Recommended Citation

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# Reintroducing International Direct Sales Companies to Chinese Regulatory Compliance: Navigating National Distrust, Social Unrest & Colliding National Policies

Grace Garbee<sup>†</sup>

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## I. Introduction

*Do you want to work from home and make money quickly? Interested in being your own boss?* Familiar to many, these questions are exemplary of the “network marketing” techniques often relied upon by direct sales companies, particularly multi-level marketing companies (“MLMs”), to sell products and recruit new participants.<sup>1</sup> MLMs, which employ a multi-level commission structure, are commonly conflated with their illegal counterpart, the pyramid scheme, since both models bear verticalized, multi-level structures.<sup>2</sup> Direct selling, including the MLM business model, holds a longstanding global economic position which remains alive and well today.<sup>3</sup>

Despite China’s 2005 regulatory regime barring all companies

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<sup>1</sup> See Adam Epstein, *Multi-Level Marketing and its Brethren: The Legal and Regulatory Environment in the Down Economy*, 12 ATLANTIC L. J. 91, 91 (2010).

<sup>2</sup> See *id.* at 102, 104–06 (describing the “upline-downline structure” as the key distinction between “a legitimately successful MLM” and an illegitimate, illegal pyramid scheme, and providing an overview of the factors used by the Federal Trade Commission (“FTC”) when deciding which category a business falls under); see also *Multi-Level Marketing Businesses and Pyramid Schemes*, FED. TRADE COMM’N, (Oct. 2019), <https://www.consumer.ftc.gov/articles/0065-multi-level-marketing-businesses-and-pyramid-schemes> [<https://perma.cc/K8Y9-422Y>].

<sup>3</sup> Yuexin Miao, *The Dilemma of Direct Selling in China*, 37 ADVANCES IN ECON., BUS., & MGMT. RSCH. 393, 393 (2017) (“As an industry, globally, direct selling has a history nearly 100 years [old], but in fact the concept of direct selling is not clear.”). See also *infra* Section III-A-1 (recounting the historical context and progression of China’s relationship with international direct sales). Direct selling is a \$193 USD billion industry worldwide that encompasses 118.4 million independent representatives. WORLD FED’N OF DIRECT SELLING ASS’NS, FACT SHEET 1 (2019), <https://wfdsa.org/wp-content/uploads/2020/04/Fact-Sheet-page-1.pdf> [<https://perma.cc/3GUZ-4YXX>] [hereinafter FACT SHEET].

with multi-level business models from market entry, certain societal and economic factors put Mainland China<sup>4</sup> among the most desirable markets for international direct selling companies.<sup>5</sup> Various enforcement actions and investigations demonstrate the level of risk these companies assume to gain Chinese market access without abandoning the customary multi-level business model or acquiescing to other compliance burdens.<sup>6</sup>

As a matter of positive law, MLMs are commonly confused with their illegal counterparts, pyramid schemes.<sup>7</sup> Nevertheless, MLMs maintain a secure position in the global economy, primarily due to “legitimate direct selling business opportunities for non-salaried, independent business owners in the United States and around the world.”<sup>8</sup> In reality, direct selling and MLMs are notorious for corruption and deceit, resulting in financial losses for their “employees.”<sup>9</sup> In China, there is longstanding suspicion towards direct selling.<sup>10</sup> In 2017, this suspicion increased again when

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<sup>4</sup> While finalizing this Note, the Standing Committee of China’s National People’s Congress passed a national security law for Hong Kong (theretofore a Special Administrative Region of China). *China: National Security Law Must Not Become a Weapon of Fear*, AMNESTY INT’L (June 30, 2020), <https://www.amnesty.org/en/latest/news/2020/06/china-national-security-law-weapon-of-fear/> [<https://perma.cc/E3JR-3KK7>]. Because the economic effects of this law remain unseen, “China,” as used in this Note, refers only to Mainland China: the geographic area under rule of the People’s Republic of China, excluding Hong Kong. *See id.*; *see also* Emily Feng, *5 Takeaways from China’s Hong Kong National Security Law*, NPR (July 1, 2020), <https://www.npr.org/2020/07/01/885900989/5-takeaways-from-chinas-hong-kong-national-security-law> [<https://perma.cc/AWZ2-6BRT>].

<sup>5</sup> Ryan Mcmorrow & Steven Lee Myers, *Amway Made China a Billion-Dollar Market. Now it Faces a Crackdown.*, N.Y. TIMES (Jan. 8, 2018), <https://www.nytimes.com/2018/01/08/business/amway-china.html> [<https://perma.cc/8SFC-MDAA>].

<sup>6</sup> *See id.*

<sup>7</sup> *See* Epstein, *supra*, note 1, at 92.

<sup>8</sup> *See id.* at 91 (internal footnote omitted).

<sup>9</sup> *See, e.g., id.* at 92, 97–98 (“MLMs, including their founding members, have drawn scrutiny for decades from federal and state regulators who have . . . questioned their legitimacy altogether more akin to a pyramid scheme.”) (internal footnote omitted); *see also* Miao, *supra* note 3, at 394 (“[E]thical problems [in China] aroused by multilevel marketing . . . give a bad name to the direct selling as a whole in its market.”). *See generally* JON M. TAYLOR, *MULTI-LEVEL MARKETING UNMASKED: WHY MULTILEVEL MARKETING IS UNFAIR AND DECEPTIVE* ch. 1–2 (Consumer Awareness Inst. ed., 2017) (ebook) (providing a more skeptical perspective of direct selling).

<sup>10</sup> *See, e.g.,* Mcmorrow & Myers, *supra* note 5; Yu Tian, *On the Legal and Market Analysis of “Direct Selling” in China*, 3 INT’L J. BUS. & MGMT. 86, 89–90 (2008).

Chinese media linked deaths of college graduates hoping to earn money after graduation to joining domestic pyramid schemes.<sup>11</sup>

Due to a deeply engrained national relationship culture, known as *guanxi* in Mandarin,<sup>12</sup> and unique economic conditions resulting in less consumer experience with privately-owned enterprises,<sup>13</sup> Chinese consumers prove more susceptible to being taken advantage of through schemes associated with direct selling.<sup>14</sup> In 2005, China acceded to the World Trade Organization (“WTO”) and passed the *Regulations on Direct Selling Administration*<sup>15</sup> and *Regulation on Prohibition of Pyramid Selling*<sup>16</sup> (collectively, “Regulations” or “2005 Regulations”) in an effort to combat corruption and the detrimental societal effects of direct selling enterprises. These Regulations effectively limit market entry for foreign direct sales companies to single-level commission structures and impose stringent procedural requirements on direct marketing companies.<sup>17</sup>

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<sup>11</sup> He Huifeng, *The Perils of Pyramid Schemes: A Dark Corner of China’s Economic Miracle*, S. CHINA MORNING POST (Sept. 29, 2017), <https://www.scmp.com/news/china/policies-politics/article/2108031/perils-pyramid-schemes-dark-corner-chinas-economic> [<https://perma.cc/L6HX-BJ3P>]; see also Han Rubo, *Inverting the Pyramid*, WORLD OF CHINESE (Sept. 21, 2019), <https://www.theworldofchinese.com/2019/09/inverting-the-pyramid/> [<https://perma.cc/GM8L-FFJ3>].

<sup>12</sup> See *infra* Section IV-B (describing the interrelationship of *guanxi* and network marketing techniques).

<sup>13</sup> Previously a planned economy, China is a more recently developed into a market economy with extraordinary growth. See, e.g., State Council Info. Off., China, *China’s Efforts and Achievements in Promoting the Rule of Law*, 7 CHINESE J. INT’L L. 513, 526–29 (2008) (providing an overview of China’s efforts to strengthen economic legislation since its decision to adopt “opening-up policies in 1978” and “transition from a planned economy to a market economy”). The official English translation from the Chinese State Council Information Office is available at [http://www.china.org.cn/government/whitepaper/node\\_7041733.htm](http://www.china.org.cn/government/whitepaper/node_7041733.htm) [<https://perma.cc/PW2V-8UY9>]; see also Miao, *supra* note 3, at 396; Tian, *supra* note 10, at 90.

<sup>14</sup> See Tian, *supra* note 10 at 89–90; Mcmorrow & Myers, *supra* note 5.

<sup>15</sup> See Zhixiao Guanli Tiaoli (直销管理条例) [Regulations on Direct Selling Administration] (promulgated by the St. Council of the People’s Republic of China, Aug. 10, 2005, effective Dec. 1, 2005) ST. COUNCIL GAZ., Sept. 3, 2005 (China).

<sup>16</sup> Jinzhi Chuanxiao Tiaoli (禁止传销条例) [Regulation on Prohibition of Pyramid Selling] (promulgated by the St. Council of the People’s Republic of China, Aug. 10, 2005, effective Nov. 1, 2005) ST. COUNCIL GAZ., Sept. 3, 2005 (China).

<sup>17</sup> See *China – Commercial Guide: Direct Marketing*, INT’L TRADE ADMIN., <https://www.trade.gov/knowledge-product/china-direct-marketing>

This Note explores the international implications of the 2005 Regulations by assessing events both preceding and following their promulgation, including enforcement actions against direct sales enterprises seeking to obtain or maintain Chinese market entry. Specifically, this Note explores the asymmetric interrelations between the legal allegations contained in such enforcement actions and China’s unique socioeconomic conditions. For instance, this Note addresses a significant misalignment between widespread global anti-corruption efforts—often prohibiting bribery and gift-giving—and the practical necessity for foreign companies to participate in Chinese gift-giving practices to succeed in Chinese business culture.

Part I provides a broad overview of this Note’s primary foci. Part II summarizes the legal frameworks and nomenclature of global direct selling, addressing the asymmetrical definitions of “direct selling” in the United States and China. Part III outlines direct selling’s historical relationship with China: namely, China’s transition from a planned to a market economy and its 2001 accession to the WTO. Part IV explores direct selling’s heightened impact on Chinese consumers due to the nation’s unique economic and cultural conditions such as *guanxi* and a jarring national wealth gap. Part V analyzes enforcement actions pertaining to non-compliance with the Regulations and explores pertinent patterns therein. Part VI briefly surveys the global direct selling industry’s modern economic status in China. Part VII concludes, considering the potential impact of international uniform direct selling standards and recommending best practices for foreign direct selling enterprises doing business in China to resolve latent tensions between the Regulations and the Foreign Corrupt Practices Act (“FCPA”).

## **II. International Direct Selling and the Implications of Industry Norms**

The direct sales industry encompasses MLMs, which employ multi-leveled commission structures, specifically upline-downline structures, in which downline member performance determines the uplines’ compensation.<sup>18</sup> The MLM structure holds a fairly secure

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[<https://perma.cc/6LHQ-LREU>] (last updated Oct. 13, 2019).

<sup>18</sup> Epstein, *supra* note 1, at 102–04.

position in international direct selling.<sup>19</sup> However, MLMs are best known, perhaps notoriously, for word-of-mouth recruitment and/or sales techniques called “network marketing.”<sup>20</sup> Overall, MLMs and their direct selling practices garner suspicion, often from consumer protection advocates, as to their legality, validity, and financial viability.<sup>21</sup>

For instance, many network marketing<sup>22</sup> tactics used in direct sales “can be extremely intense and sometimes misleading.”<sup>23</sup> “Concerns over fanatic, cult-like pressures preying upon potential recruits in order to persuade them to join or remain within the MLM membership ranks are quite common.”<sup>24</sup> These concerns may increase due to hyperbolic economic claims made during recruitment or sales, such as boasting extreme, unrealistic (though undeniably desirable) income claims in recruitment efforts (i.e., growing the upline-downline).<sup>25</sup> Additionally, high-profile incidents of corruption contribute to the widespread, negative perception of the MLM business structure.<sup>26</sup>

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<sup>19</sup> See *id.* at 91, 103–07 (explaining the differences between pyramid schemes, Ponzi schemes, and MLM structures of direct selling); Miao, *supra* note 3, at 394.

<sup>20</sup> See, e.g., Epstein, *supra* note 1, at 96–98. For instance, network marketing techniques often employ questions like: Do you want to work from home and make money fast? Do you want to quit your job and be your own boss? See *id.*; see also *supra* Section I (defining “network marketing”).

<sup>21</sup> See, e.g., Epstein, *supra* note 1, at 97 (explaining that state and federal regulators are also critical of MLMs); TAYLOR, *supra* note 9, at ch. 5; *Multi-Level Marketing Businesses and Pyramid Schemes*, *supra* note 2.

<sup>22</sup> “Network marketing” is a form of mouth-to-mouth or grassroots marketing commonly used in direct selling. See, e.g., *Multi-Level Marketing Businesses and Pyramid Schemes*, *supra* note 2; Epstein, *supra* note 1, at 96–97.

<sup>23</sup> Epstein, *supra* note 1, at 97 (describing MLM recruitment techniques); see also *Multi-Level Marketing Businesses and Pyramid Schemes*, *supra* note 2. MLMs have been known to make “outrageous claims[,]” and some have even employed “religious component[s] . . .” Epstein, *supra* note 1, at 98.

<sup>24</sup> Epstein, *supra* note 1, at 97 (internal footnote omitted).

<sup>25</sup> See *id.*; TAYLOR, *supra* note 9, at ch. 1–2, 2–12, 2–13 (“Prospects are typically lured into MLM[s] with exaggerated product and income claims.”); *Business Guidance Concerning Multi-Level Marketing*, FED. TRADE COMM’N (Jan. 2018), <https://www.ftc.gov/tips-advice/business-center/guidance/business-guidance-concerning-multi-level-marketing> [<https://perma.cc/SEC5-83CG>].

<sup>26</sup> See *Business Guidance Concerning Multi-Level Marketing*, *supra* note 25; Epstein, *supra* note 1, at 92–93, 104–06; TAYLOR, *supra* note 9, at ch. 2–12, 2–13.

*A. Positive Law Doctrine: Internationally Inconsistent  
Nomenclature in Direct Selling*

Besides the common conflation of MLMs and pyramid schemes,<sup>27</sup> nomenclature in the international direct selling industry remains further disjointed, especially between the United States and China.<sup>28</sup> Minimal legal research<sup>29</sup> on MLMs, especially transnationally, also contributes to the industry’s lacking legal uniformity.

*1. Direct Selling in the United States: MLMs versus  
Pyramid Schemes*

In the United States, the Federal Trade Commission (“FTC”) defines direct selling as “a blanket term that encompasses a variety of business forms premised on person-to-person selling in locations other than a retail establishment, such as social media platforms or the home of the salesperson or prospective customer.”<sup>30</sup> Thus, U.S. direct selling, or direct sales, encompasses two distinct multi-level selling structures: (1) a legally legitimate, *sales-based* MLM<sup>31</sup> and (2) an illegal, illegitimate, *recruitment-based* pyramid scheme that

<sup>27</sup> See *Business Guidance Concerning Multi-Level Marketing*, *supra* note 25; *Multi-Level Marketing Businesses and Pyramid Schemes*, *supra* note 2; Epstein, *supra*, note 1, at 92.

<sup>28</sup> See Tian, *supra* note 10, at 88–90; Miao, *supra* note 3, at 395–96; see also TAYLOR, *supra* note 9, at ch. 2, pp.6–10 (advocating for “[a] more accurate, research-based definition of MLM that addresses structural flaws”).

<sup>29</sup> Epstein, *supra* note 1, at 92.

<sup>30</sup> *Business Guidance Concerning Multi-Level Marketing*, *supra* note 25. In the United States, most “direct selling” definitions include MLMs as a sub-category of direct selling, but the individual definition of MLM varies. See, e.g., Epstein, *supra* note 1, at 95–104; TAYLOR, *supra* note 9, at ch. 2–12, 2–13 (offering his own, more skeptical, definition of MLM).

<sup>31</sup> See *Business Guidance Concerning Multi-Level Marketing*, *supra* note 25. The FTC defines MLM as a sub-category of direct selling:

Multi-level marketing is one form of direct selling. Generally, a multi-level marketer (MLM) distributes products or services through a network of salespeople who . . . may earn income depending on their own revenues and expenses. Typically, the company does not directly recruit its salesforce, but relies upon its existing salespeople to recruit additional salespeople, which creates multiple levels of “distributors” or “participants” organized in “downlines.” A participant’s “downline” is the network of his or her recruits, and recruits of those recruits, and so on.

*Id.*

is financially reliant on recruitment or establishing an upline-downline structure.<sup>32</sup> In other words, the legality of MLMs in the United States depends upon the compensation scheme.<sup>33</sup> An MLM must “pay compensation that is based on *actual* sales to *real* customers, rather than . . . mere wholesale purchases or other payments *by its participants*.”<sup>34</sup> A company’s compensation scheme, *not* the mere presence of an upline-downline structure, bears most upon legitimacy under U.S. law. If compensation derives primarily from *actual sales* to *third-party* customers, the MLM is likely legitimate.<sup>35</sup>

However, while illegal pyramid schemes in the United States “can look remarkably like legitimate MLM business opportunities,”<sup>36</sup> pyramid schemes pose the risk of significant financial loss. The following warning signs are characteristic of pyramid schemes as defined by U.S. law: promoters making “extravagant promises about your earning potential”; emphasizing “recruiting new distributors for your sales network as the real way to make money”; and playing on your emotions or using high-pressure sales tactics.<sup>37</sup> Nonetheless, these warning signs may also be found in legal MLMs in the United States.<sup>38</sup> Thus, even within the United States, distinguishing legitimate MLMs from illegal pyramid schemes proves to be a challenging and complex task.<sup>39</sup> This complexity only increases on an international scale.

## 2. *Direct Selling in China Under the 2005 Regulations*

China’s 2005 Regulations comprise the primary legal

<sup>32</sup> See, e.g., *id.*; Epstein, *supra* note 1, at 100; *Multi-Level Marketing Businesses and Pyramid Schemes*, *supra* note 2.

<sup>33</sup> See, e.g., *Multi-Level Marketing Businesses and Pyramid Schemes*, *supra* note 2.

<sup>34</sup> *Business Guidance Concerning Multi-Level Marketing*, *supra* note 25 (emphasis added); see also Epstein, *supra* note 1, at 91, 103–04.

<sup>35</sup> *Business Guidance Concerning Multi-Level Marketing*, *supra* note 25; Epstein, *supra* note 1, at 103; *Multi-Level Marketing Businesses and Pyramid Schemes*, *supra* note 2.

<sup>36</sup> *Multi-Level Marketing Businesses and Pyramid Schemes*, *supra* note 2. (“Eventually, most [pyramid scheme] distributors find that no matter how hard they work, they can’t sell enough inventory or recruit enough people to make money . . . . In the end, most people run out of money, have to quit, and lose everything they invested.”).

<sup>37</sup> *Id.*

<sup>38</sup> See, e.g., Epstein, *supra* note 1, at 95–100.

<sup>39</sup> *Id.* at 123–24; see also TAYLOR, *supra* note 9, at ch. 11–38, 11–39.

instrument governing Chinese market entry for foreign direct selling enterprises and contradict U.S. direct selling law in several ways.<sup>40</sup> Most notably, the Regulations make no distinction between MLMs and pyramid schemes, and thus legalize only single-level direct selling subject to procedural market entry requirements, prohibiting all multi-level marketing structures.<sup>41</sup>

Defining direct selling as “a type of business mode, in which direct selling companies recruit door-to-door salesmen to sell products directly to ultimate consumers . . . outside the companies’ fixed places of business[,]”<sup>42</sup> the Regulations contradict U.S. law insofar as they exclude any businesses with multi-leveled structures from the market, regardless of their legality elsewhere.<sup>43</sup> Using U.S. legal terms, both legal MLMs and illegal pyramid schemes are illegal under China’s Regulations, which only permit direct selling by *single-level* companies.<sup>44</sup> Under China’s Regulations, *any* multi-level, pyramid-like business structure, including the United States’ legal MLM,<sup>45</sup> is *illegal* “pyramid selling,”<sup>46</sup> regardless of legitimacy elsewhere.<sup>47</sup> Thus, practically, the Regulations mandate significant structural change for legitimate U.S.-based MLMs.

<sup>40</sup> See Zhixiao Guanli Tiaoli, *supra* note 15, art. 3; Jinzhi Chuanxiao Tiaoli, *supra* note 16, art. 2.

<sup>41</sup> See Tian, *supra* note 10, at 86–87; Zhixiao Guanli Tiaoli, *supra* note 15; Jinzhi Chuanxiao Tiaoli, *supra* note 16.

<sup>42</sup> Zhixiao Guanli Tiaoli, *supra* note 15, art. 3; *see also id.* art. 13; Jinzhi Chuanxiao Tiaoli, *supra* note 16, art. 2.

<sup>43</sup> See *id.*; Tian, *supra* note 10, at 86–87; Miao, *supra* note 3, at 394–96; *supra* Section I.

<sup>44</sup> Zhixiao Guanli Tiaoli, *supra* note 15 arts. 3 & 13; Jinzhi Chuanxiao Tiaoli, *supra* note 16, art. 2.

<sup>45</sup> Miao, *supra* note 3, at 395; *supra* Section I.

<sup>46</sup> See Zhixiao Guanli Tiaoli, *supra* note 15, art. 3; Jinzhi Chuanxiao Tiaoli, *supra* note 16, art. 2. The 2005 Regulations define prohibited “pyramid selling” by reference to various notorious characteristics of MLMs and direct selling enterprises:

The term “pyramid selling”...refers to such an act whereby an organizer or operator...disturbs the economic order and affects the social stability by recruiting persons, calculating and paying remunerations to recruiters on the basis of the number of persons a recruiter has directly or indirectly recruited or the sales performance, or asking the recruiters to pay a certain fee for obtaining the qualification for participation.

Jinzhi Chuanxiao Tiaoli, *supra* note 16, art. 2.

<sup>47</sup> See Jinzhi Chuanxiao Tiaoli, *supra* note 16, art. 2; Miao, *supra* note 3, at 395.

To further their underlying policy goal of adequate consumer protection, the Regulations require more than just structural change for market entry.<sup>48</sup> For instance, they explicitly prohibit practices commonly associated with MLMs such as (1) basing commission upon recruitment instead of sales; (2) requiring a fee, direct or indirect, for membership; and (3) any pyramid-like internal structure, such as upline-downlines.<sup>49</sup>

Lastly, the Regulations mandate procedural requirements for foreign direct sellers to enter the market. Most notable is the requirement to obtain a direct selling license, which proves both tedious and demanding.<sup>50</sup> Even when companies meet application requirements, Chinese governmental approval of foreign applications remains limited and arbitrary.<sup>51</sup> In 2018, only one new direct sales company received a license, exhibiting a governmental effort to limit industry growth.<sup>52</sup> Overall, China's direct selling industry "remains closely watched and tightly regulated at both the central and local levels."<sup>53</sup>

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<sup>48</sup> See, e.g., Zhixiao Guanli Tiaoli, *supra* note 15, art. 11. See *FAQ on Direct Sales in China*, LEHMAN, LEE & XU, <http://www.lehmanlaw.com/resource-centre/faqs/banking-finance/faq-on-direct-sales-in-china.html> [<https://perma.cc/TY7D-BP7J>] (last visited Nov. 1, 2019). For instance, the Regulations require all direct sales companies to formally contract with sellers and give notice of employment rights. *Id.*; see also Zhixiao Guanli Tiaoli, *supra* note 15, art. 16.

<sup>49</sup> See Jinzhi Chuanxiao Tiaoli, *supra* note 16, arts. 2 & 7; Zhixiao Guanli Tiaoli, *supra* note 15, arts. 13 & 14.

<sup>50</sup> See *China – Commercial Guide: Direct Marketing*, *supra* note 17; see also Zhixiao Guanli Tiaoli, *supra* note 15, art. 7–12 (enumerating the requirements to apply for and obtain a direct sales license in China). Licensed products must fall within enumerated categories. *Id.*; see also *FAQ on Direct Sales in China*, *supra* note 48.

<sup>51</sup> *China – Commercial Guide: Direct Marketing*, *supra* note 17.

<sup>52</sup> TMO GROUP, INDUSTRY REPORT: HEALTH & FOOD SUPPLEMENTS: CHINA MARKET – 2020, AT 20 (2020), available at <https://www.tmogroup.asia/downloads/china-health-supplements-industry-report/> [<https://perma.cc/Y68P-5W8U>]; see also Gao Feng, Spokesperson, Ministry of Com. of China (MOFCOM), Regular Press Conference of the Ministry of Commerce (Feb. 14, 2019) (transcript available at <http://english.mofcom.gov.cn/article/newsrelease/press/201902/20190202835091.shtml> [<https://perma.cc/8JEN-ALCV>]) (answering a question as to likelihood of direct sales license issuance for 2019); *infra* Sections IV & V-B.

<sup>53</sup> *China – Commercial Guide: Direct Marketing*, *supra* note 17; see also Mark Schaub & David Hong, *China Crackdown – How Does it Impact International MLMs?*, CHINA L. INSIGHT (Aug. 23, 2017), <https://www.chinalawinsight.com/2017/08/articles/compliance/china-crackdown-how-does-it-impact-international-mlms/> [<https://perma.cc/M9VZ-2SUY>]; Mark Schaub, Atticus Zhao & David Hong, *A Castle Built on Sand: Challenges and Opportunities for Network Marketing in China*, CHINA L.

Non-compliance with the Regulations may result in civil and/or criminal liability under Chinese law, bearing significant consequences in either case. If Chinese governmental authorities determine that direct selling conduct constitutes an illegal pyramid scheme under the Regulations, such violation may constitute “a criminal offense” under Chinese law.<sup>54</sup> Even if conduct does not comprise criminalized pyramid selling, non-compliance with the Regulations may subject direct selling companies to significant administrative sanctions.<sup>55</sup> Therefore, to avoid any liability under the Regulations and/or Chinese criminal law, direct selling companies, international and domestic alike, must comply with the single-level structural mandate and licensure requirements.

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INSIGHT (June 21, 2017), <https://www.chinalawinsight.com/2017/06/articles/corporate-ma/a-castle-built-on-sand-challenges-and-opportunities-for-network-marketing-in-china/> [<https://perma.cc/6FRJ-M5G4>] (discussing potential consequences for non-compliance with the Regulations). See generally Peter J. Wang, Yizhe Zhang, & Qiang Xue, *Looking Ahead: The Integration of Chinese Anti-Monopoly Enforcement Authorities*, ANTITRUST SOURCE (Aug. 2018), [https://www.americanbar.org/content/dam/aba/publishing/antitrust\\_source/2018-2019/at-source-august2018/aug18\\_wang\\_8\\_16f.pdf](https://www.americanbar.org/content/dam/aba/publishing/antitrust_source/2018-2019/at-source-august2018/aug18_wang_8_16f.pdf) [<https://perma.cc/8P4N-26NK>] (recounting that, as of 2018, China’s antitrust reform gave enforcement power for the Regulations to a new state agency: the State Administration for Market Regulation).

<sup>54</sup> David Hong & Mark Schaub, *China 2019: Still Open for Network Marketing Businesses*, MLM.COM (Jan. 14, 2019), <https://mlm.com/china-2019-still-open-network-marketing-businesses/> [<https://perma.cc/7N5N-VJ6S>]. “[I]nternational MLM companies which operate in China must change their compensation model for that specific market[,]”, for if “such companies continue operating the same compensation model of multiple levels of commission within the borders of China as they do in their home market, they can be hit with criminal liability under Chinese law.” *Id.*; see also Jinzhi Chuanxiao Tiaoli, *supra* note 16, arts. 13, 24, 28-29.

<sup>55</sup> For instance, potential repercussions for companies non-compliant with the Regulations may include being “branded as illegal pyramid schemes [which] will face official [criminal] investigation . . . often result[ing] in the arrest of person-in-charge of affiliates within China and company executives who travel to China[,]” and/or “the non-compliant company will quickly find out how fragile its business in China is – the Chinese authorities can quickly move to shut down the company’s website and all social media channels – [and] given the importance of social media and the internet in most network marketing companies this effectively shut[s] down a company’s operations overnight.” See Schaub & Hong, *supra* note 53.

### III. Chinese Governmental Intent Underlying the 2005 Regulations: Consumer Protection, Governmental Market Control, and China's WTO Accession

In the modern socio-political context,<sup>56</sup> the global narrative underlying the Regulations characterizes them as a condition for China's 2001 accession to the WTO.<sup>57</sup> On the whole, China's unique economic conditions and contentious history with direct selling engender a distrust of the industry, both domestically and internationally.

#### A. *China's Economic Reform, 1990s MLM Movement, and Subsequent 1998 Blanket Ban on Direct Selling*

The normative underpinnings of China's 2005 Regulations go as far back as 1978, when China began major economic reforms. The reforms carried significant socioeconomic implications as China transitioned from a planned economy, associated with its socialist era, to a modern market economy.<sup>58</sup>

Within China, economic reform brought rapid industrialization, urbanization,<sup>59</sup> and an "influx of transnational culture, capital, and people" which must be understood "from a cultural and economic framework more complex than the simple adoption of Euro-

<sup>56</sup> The extent of the political and economic implications of China's WTO accession extend beyond this Note's scope. See, e.g., *How Influential is China in the World Trade Organization?*, CHINAPOWER, <https://chinapower.csis.org/china-world-trade-organization-wto/> [<https://perma.cc/69AV-GJKL>], (last updated June 18, 2020).

<sup>57</sup> See *China and the WTO*, WTO, [https://www.wto.org/English/thewto\\_e/countries\\_e/china\\_e.htm](https://www.wto.org/English/thewto_e/countries_e/china_e.htm) [<https://perma.cc/2MBT-G27W>] (last visited June 13, 2020) (noting that China's accession occurred on Dec. 11, 2001); Press Release, WTO, WTO Ministerial Conference Approves China's Accession (Nov. 10, 2001), available at [https://www.wto.org/english/news\\_e/pres01\\_e/pr252\\_e.htm](https://www.wto.org/english/news_e/pres01_e/pr252_e.htm) [<https://perma.cc/PTP9-RGBR>].

<sup>58</sup> See, e.g., State Council Info. Off., China, *supra* note 13, at 526–29; CHINA URBAN: ETHNOGRAPHIES OF CONTEMPORARY CULTURE 2 (Nancy N. Chen, Constance D. Clark, Suzanne Z. Gottschang & Lyn Jeffery eds., 2001) [hereinafter CHINA URBAN]; U.S. TRADE REPRESENTATIVE, 2018 REPORT TO CONGRESS ON CHINA'S WTO COMPLIANCE 19-20 (2019), <https://ustr.gov/sites/default/files/2018-USTR-Report-to-Congress-on-China%27s-WTO-Compliance.pdf> [<https://perma.cc/3ARU-A3D2>] (discussing the benefits China gained by joining the WTO).

<sup>59</sup> The extent of socioeconomic implications stemming from China's economic reform and subsequent urbanization goes beyond this Note's scope. For a broad overview of its implications and for thirteen ethnographies examining "the urban" and urbanization processes in 1990s China, see generally CHINA URBAN, *supra* note 58.

American neo-liberal capitalism.”<sup>60</sup> The Chinese state and the Chinese market “are sometimes mutually constitutive, . . . [i]n other instances, these categories are more ambiguous, more explicitly oppositional, and less state initiated.”<sup>61</sup> This framework may account for China’s often contradictory values: socialist-era underpinnings inextricably tied to modern market economy values and reality.<sup>62</sup>

On the whole, governmental motivation behind the 2005 Regulations may be understood best by looking first to China’s underlying motivations. These include, first, China’s 1998 direct selling ban, and second, its joining the WTO in 2001, conceding to the Regulations in return for an ultimately modern global economic reign.

### 1. *China’s 1990s MLM Movement and Subsequent Direct Selling Blanket Ban*

Because of China’s economic reform and delayed opening of its economy, direct selling arrived in China later than nations like America, Taiwan, and Japan.<sup>63</sup> Yet direct selling’s profitability proved immediately apparent. By 1997, fewer than twenty years after the nation’s first encounter with direct selling, China had 2,300 direct selling firms, employing up to 20 million citizens, and boasted a \$2 billion USD sales volume.<sup>64</sup> Further, by 1997, most

<sup>60</sup> CHINA URBAN, *supra* note 58, at 2.

<sup>61</sup> *Id.* at 10, 10–12 (providing an overview of these often contradictory values and/or motivations). “While much has been written about the disempowerment of the nation-state in the face of increasingly flexible and mobile capital, in China we see a process of negotiation between the state and new kinds of economic actors.” *Id.* at 10. “The equivocal and contradictory position of the state, where officials increasingly find themselves representing the interests of capital, is ironic . . . given . . . the nature of relations between labor and capital . . . [as a] founding moral narrative[] of the entire socialist era.” *Id.* at 11.

<sup>62</sup> *See id.* at 12.

<sup>63</sup> *See* Miao, *supra* note 3, at 394–96, 398 (noting that foreign direct selling firms entered China in the early 1980s–90s); *see also* State Council Info. Off., China, *supra* note 13, at 515, 517, 522, 526–29 (tracing the economic development that led to the modern entrance of direct selling firms into China’s markets); Lyn Jeffery, *Placing Practices: Transnational Network Marketing in Mainland China*, in CHINA URBAN: ETHNOGRAPHIES OF CONTEMPORARY CULTURE 23, 23–24, 28 (Nancy N. Chen; Constance D. Clark; Suzanne Z. Gottschang; Lyn Jeffery eds., 2001).

<sup>64</sup> *See* Miao, *supra* note 3, at 394–95; Jeffery, *supra* note 63, at 23–24. “From 1990 to its official ban in 1998, the Chinese [MLM] movement offered millions of Chinese the opportunity to . . . partially replace or subvert conventional social geographies . . . . By

urban Chinese citizens had at least heard of MLMs (*chuanxiao*),<sup>65</sup> and “many had friends or family who had tried it if they had not done so themselves.”<sup>66</sup> However, in 1998, China issued a blanket ban on direct selling<sup>67</sup> in the name of consumer protection and social stability.<sup>68</sup> Governmental interest underlying China’s 1998 blanket ban appears ambiguous, oscillating between genuine concern for consumer protection and desire for state control over a rapidly-growing, unexplored industry in China’s newfound market economy.<sup>69</sup>

Chinese officials insisted the 1998 ban was intended to primarily prevent abuse by domestic Chinese pyramid schemes taking advantage of China’s recently-liberalized laws against private business and harming consumers, denying any exclusionary targeting of foreign enterprises.<sup>70</sup> Acknowledging China’s genuine need to safeguard consumers from deceptive domestic pyramid schemes,<sup>71</sup> legitimate U.S. direct selling firms doing business in China (e.g., Amway, Avon, and Mary Kay)<sup>72</sup> nevertheless felt that the ban was overreaching.<sup>73</sup> This contention may prove more

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1997, the multilevel marketing [] industry, introduced to China by American, Taiwanese, and Japanese companies, had sold an estimated U.S. \$7 billion . . . through networks with some 10 million participants.” *Id.*

<sup>65</sup> Jeffery, *supra* note 63, at 23; *see also* Tian, *supra* note 10, at 88–90 (providing an overview of the translation of this term and potential causes for confusion).

<sup>66</sup> Jeffery, *supra* note 63, at 41 n.5.

<sup>67</sup> Miao, *supra* note 3, at 394–95; Jeffery, *supra* note 63, at 24, 39–40.

<sup>68</sup> Miao, *supra* note 3, at 395.

<sup>69</sup> *See* John Pomfret, *China Bans Direct Marketing to Attack Scams*, WASH. POST (Apr. 28, 1998), <https://www.washingtonpost.com/archive/business/1998/04/28/china-bans-direct-marketing-to-attack-scams/b1178e4a-02cb-49d2-81d8-93b0fffb6b0c/> [<https://perma.cc/77K5-MAET>].

<sup>70</sup> *See, e.g., id.*; *see also* Debevoise & Plimpton LLP, *Avon’s FCPA Investigation in China and Beyond*, 10 FCPA UPDATE 7, 7-8 (2011); Jeffery, *supra* note 63, at 28. Domestic Chinese direct selling scams “mimic American direct marketing operations in that participants buy products to sell to other consumers[. H]owever, in the scams, the products are often worthless.” Pomfret, *supra* note 69.

<sup>71</sup> *See* Pomfret, *supra* note 69.

<sup>72</sup> The descriptor “legitimate” conveys here that the named enterprises were considered legal MLMs under U.S. law and, in the 1990s, conducting business in China legally. *See* Pomfret, *supra* note 69; Debevoise & Plimpton LLP, *News from the BRICs: China: Avon Suspends Four Executives in Anti-Bribery Investigation*, 1 FCPA UPDATE 5, 5-6 (2010) (reporting that Avon was the first direct selling company to enter China, legally conducting business until its executives faced bribery charges in 2010.).

<sup>73</sup> *See* Pomfret, *supra* note 69.

reasonable considering that direct selling within networks of personal connections makes an industry less susceptible to governmental penetration.<sup>74</sup> This is particularly relevant to 1990s China, which was then transitioning from a state-controlled market with Chinese citizens becoming individual market participants with subjective consumer interests and market practices different from the state's.<sup>75</sup>

China's purported rationale for the 1998 ban, primarily corruption by domestic pyramid schemes, is difficult to reconcile with the reality that the ban practically and normatively manifested a desire to maintain state market control by limiting foreign market influence and exposure in direct selling.<sup>76</sup> The multi-faceted governmental intent underlying China's 1998 blanket ban translates almost directly to the 2005 Regulations. Both purport to protect consumers from immediate potential harm from direct selling, both domestic and international, while still maintaining a degree of state control over consumer lifestyles and market practices.

*B. The 2005 Regulations: A Condition for China's WTO Accession*

The 2005 Regulations constitute one of multiple concessions made for China's 2001 WTO accession,<sup>77</sup> which endowed China with "access to new trading partners[,] . . . better rates with current ones, rais[ed] prospects for improved living standards domestically and . . . a seat at the table in a globalizing" international economy.<sup>78</sup> Despite China lifting the 1998 blanket ban and re-opening its

<sup>74</sup> See Jeffery, *supra* note 63, at 39–40; see also Michele A. Wong, *China's Direct Marketing Ban: A Case Study of China's Response to Capital-Based Social Networks*, 11 WASH. INT'L L.J. 257, 257 (2002) (discussing China's 1998 blanket ban on direct selling and the potential of direct selling organizations as "self-motivated political force[s]").

<sup>75</sup> See Jeffery, *supra* note 63, at 39–40; see also Wong, *supra* note 74, at 272.

<sup>76</sup> See Jeffery, *supra* note 63, at 39–40; see also Wong, *supra* note 74, at 260, 276–77.

<sup>77</sup> See generally, *China's Long March to WTO Entry*, CNN.COM (Dec. 10, 2001), <https://edition.cnn.com/2001/WORLD/asiapcf/east/09/18/china.wto.timeline/> [<https://perma.cc/LC4X-8YUL>] (providing a streamlined overview of China's lengthy, controversial WTO accession).

<sup>78</sup> *What Happened When China Joined the WTO?*, WORLD101, <https://world101.cfr.org/global-era-issues/trade/what-happened-when-china-joined-wto> [<https://perma.cc/UNU8-GMPT>] (last visited June 14, 2020); see also Miao, *supra*, note 3, at 395; Tian, *supra* note 10, at 86; State Council Info. Off., China, *supra* note 13, at 529, 543.

economy in part to certain foreign enterprises, the Regulations remain an issue today for U.S.-China trade relations<sup>79</sup> and international direct selling.<sup>80</sup>

#### **IV. Direct Selling's Unique Socioeconomic and Cultural Impact on China**

Economic and cultural factors make Chinese consumers particularly susceptible to direct sales techniques. This Section addresses two such factors. First, it analyzes China's extreme income gap and how this gap may leave already marginalized sub-groups most vulnerable to get-rich-quick techniques. Second, it addresses China's deeply-engrained *guanxi* culture, assessing heightened consumer reactivity to network marketing techniques employed in direct sales.

##### *A. China's Ever-Present Wealth Gap and Direct Selling's Marginalized Appeal*

In addition to the aforementioned factors lending to China's distrust of direct selling,<sup>81</sup> China today suffers from a jarring wealth gap. Chinese citizens on the lower end of the wealth gap and many

<sup>79</sup> Modern U.S.-China trade relations and disputes extend beyond this Note's scope. For more information, see generally U.S. TRADE REPRESENTATIVE, *supra* note 58; Philip Levy, *Was Letting China into the WTO a Mistake?*, FOREIGN AFF. (Apr. 2, 2018), <https://www.foreignaffairs.com/articles/china/2018-04-02/was-letting-china-wto-mistake> [https://perma.cc/C27Z-37HC]; U.S. CHAMBER OF COM. & AM. CHAMBER OF COM. IN CHINA, PRIORITY RECOMMENDATIONS FOR U.S.-CHINA TRADE NEGOTIATIONS (2019), <https://www.wsj.com/public/resources/documents/tradereport.pdf> [https://perma.cc/JX2A-LJJG]; Amanda Lee, *China Refuses to Give Up 'Developing Country' Status at WTO Despite US Demands*, S. CHINA MORNING POST (Apr. 6, 2019), <https://www.scmp.com/economy/china-economy/article/3004873/china-refuses-give-developing-country-status-wto-despite-us> [https://perma.cc/7JLX-JUKX]; Antara Ghosal Singh, *What Does China Want from WTO Reforms?*, DIPLOMAT (May 21, 2019), <https://thediplomat.com/2019/05/what-does-china-want-from-wto-reforms/> [https://perma.cc/4FZX-QUET]; Silvia Amaro, *'A Reform-or-Die Moment': Why World Powers Want to Change the WTO*, CNBC (Feb. 7, 2020), <https://www.cnbc.com/2020/02/07/world-powers-us-eu-china-are-grappling-to-update-the-wto.html> [https://perma.cc/SUC6-5FC7].

<sup>80</sup> See, e.g., U.S. TRADE REPRESENTATIVE, *Appendix to 2019 REPORT TO CONGRESS ON CHINA'S WTO COMPLIANCE* A-1, A-95 (2020), [https://ustr.gov/sites/default/files/2019\\_Report\\_on\\_China's\\_WTO\\_Compliance.pdf](https://ustr.gov/sites/default/files/2019_Report_on_China's_WTO_Compliance.pdf) [https://perma.cc/4KKF-HH8R]; U.S. CHAMBER OF COM. & AM. CHAMBER OF COM. IN CHINA, *supra* note 79.

<sup>81</sup> See *supra* Section III (addressing these economic factors, both historically and contextually).

others in financially precarious situations are more often victims of the predatory practices often associated with direct selling.<sup>82</sup>

As of 2018, China's income gap was larger than the United States'.<sup>83</sup> This gap must be assessed contextually, accounting for China's rapid and globally phenomenal \$11 trillion economic growth which, as of 2018, was still growing "by close to 7 per cent a year, [with] newly minted billionaires regularly mak[ing] headlines[.]"<sup>84</sup> Thus, Chinese citizens from lower income levels, heretofore excluded from China's highly publicized economic growth and success, prove particularly susceptible to predatory get-rich-quick techniques.<sup>85</sup> Reasons for this include these individuals' financial status and China's unique socioeconomic conditions, which make such techniques appear feasible and leave disadvantaged groups like agricultural workers and college graduates more vulnerable to direct sales practices.<sup>86</sup>

Rural and agricultural workers,<sup>87</sup> who almost always fall on the low end of China's wealth gap,<sup>88</sup> are one generalized example of Chinese citizens particularly vulnerable to predatory techniques in direct selling. China's economic disparities are particularly apparent "between urban and rural areas"<sup>89</sup> and this "urban-rural divide"<sup>90</sup> remains "a key driver behind [China's] rising income

<sup>82</sup> See, e.g., Huifeng, *supra* note 11; Stone Shi, *The Great Divide Between China's Rich and Poor*, ZHONGGUO INST. (Nov. 27, 2018), <https://zhongguoinstitute.org/the-great-divide-between-chinas-rich-and-poor/> [<https://perma.cc/57FR-RQRF>] ("[A]s far as income distribution goes, China is more unequal than some of the world's poorest nations[.]" ). Its wealth gap has been called "the great urban-rural divide." *Id.*

<sup>83</sup> Shi, *supra* note 82.

<sup>84</sup> Huifeng, *supra* note 11.

<sup>85</sup> See, e.g., *id.* ("[M]any of those left behind by the economic boom – fresh university graduates struggling to find a proper job, workers laid off from state factories where they toiled for decades, and migrant labourers – also yearn to get rich quick." ).

<sup>86</sup> See *id.* In some of China's most egregious instances of pyramid scheme corruption, participants attempting to escape were victims of physical beatings to coerce them to stay. Even those who managed to escape sometimes remain brainwashed or mentally affected by trauma. See, e.g., Rubo, *supra* note 11; Huifeng, *supra* note 11.

<sup>87</sup> See Huifeng, *supra* note 11; see also *infra* Section III and accompanying notes.

<sup>88</sup> See Huifeng, *supra* note 11; Shi, *supra* note 82. As of 2017, accelerated economic growth had transformed China "in just a generation from an egalitarian society into a country with one of the world's largest wealth gaps[.]" a gap still increasing today. Huifeng, *supra* note 11.

<sup>89</sup> Shi, *supra* note 82.

<sup>90</sup> *Id.*

inequality.”<sup>91</sup> As a result, agrarian workers frequently fall victim to get-rich-quick fantasies. Likewise, recent college graduates, who may be in financially dubious situations, are another demographic easily captivated by get-rich-quick techniques.<sup>92</sup> On the whole, job-searching college graduates from local higher education institutions (versus “prestigious key universities”) experience significant difficulty obtaining post-graduate employment, which heightens susceptibility to predatory practices associated with the direct selling industry.<sup>93</sup>

In 2017, Chinese social unrest about the industry<sup>94</sup> culminated in a “three-month national campaign to crackdown on illegal

<sup>91</sup> *Id.*

<sup>92</sup> See Rubo, *supra* note 11; Huifeng, *supra* note 11.

<sup>93</sup> See Rubo, *supra* note 11; Huifeng, *supra* note 11; ORG. FOR ECON. CO-OP. AND DEV. (OECD), CHINA IN THE GLOBAL ECONOMY: GOVERNANCE IN CHINA 554-56 (2005) (ebook). As of 2005, “an average of 20% of [] university graduates and 50% of [] graduates from non-degree colleges cannot find jobs” in China despite China’s overall shortage in university graduates and continued need for a skilled workforce. OECD, *supra* note 95, at 555 (noting that, between 2001 and 2004, “[t]he number of higher education graduates [in China] seeking employment increased from 1.15 million . . . to 2.80 million . . . , more than doubling in just three years”). “[I]t is not only the graduates living in the economically depressed areas who have [employment] difficulties....About 10% of the university graduates in Shanghai, one of the most prosperous coastal cities, are unemployed in the first 12 months after graduation.” *Id.*; see also *id.* at 554-55 (noting “a growing problem of the labour market structure and the imbalance of demand and supply of qualified human resources” in China, as of 2005). Relatedly, the Chinese direct selling industry has been described as “provid[ing] [] low-threshold and flexible opportunities of starting a business and employment for a large number of people who are short of professional skills with lower education degree.” Shen Danyang, News Spokesman, Ministry of Com. of China (MOFCOM), Press Conference of the Ministry of Commerce (Nov. 4, 2015) (transcript available at <http://english.mofcom.gov.cn/article/newsrelease/counseloroffice/westernasiaandafriacereport/201511/20151101165802.shtml> [<https://perma.cc/U45X-697S>]) (answering the eighth question posed regarding what role the 2005 Regulations played in “the development of [China’s] direct selling industry”).

<sup>94</sup> See, e.g., *China to Step Up Crackdown on Pyramid Schemes*, XINHUANET (Apr. 10, 2018), [http://www.xinhuanet.com/english/2018-04/10/c\\_137100941.htm](http://www.xinhuanet.com/english/2018-04/10/c_137100941.htm) [<https://perma.cc/ZE5N-BK7F>]. As recently as 2019, China has demonstrated hostility towards foreign direct sales companies. See, e.g., Li Lei, *91 Direct-Sellers Ordered to Review their Management and Marketing Practices*, CHINA DAILY.COM (Jan. 30, 2019), <http://global.chinadaily.com.cn/a/201901/30/WS5c50f518a3106c65c34e7360.html> [<https://perma.cc/2HG9-HEV9>]; *China Suspends Registration and Approvals of Direct Selling*, XINHUANET (Feb. 14, 2019), [http://www.xinhuanet.com/english/2019-02/14/c\\_137821994.htm](http://www.xinhuanet.com/english/2019-02/14/c_137821994.htm) [<https://perma.cc/XAW6-7F3W>].

pyramid schemes in China[.]”<sup>95</sup> This crackdown can largely be attributed to the deaths of recent college graduates in “suspicious pyramid scheme related circumstances”<sup>96</sup> and public uprisings in July 2017 against a corrupt Chinese Ponzi scheme.<sup>97</sup> The 2017 public protests focused on the “cult-like activities”<sup>98</sup> of unlawful pyramid schemes, escalating existing outrage in the media about the college graduates’ deaths.<sup>99</sup>

China’s economic conditions, including its extreme income gap, engender the high likelihood of sub-groups like agrarian workers and college graduates falling for unlawful, predatory direct selling practices. China’s uniquely contentious, personal relationship with direct selling may offer some justification for the stringent consumer protection policies latent in the 2005 Regulations.

*B. Guanxi: The Unique Susceptibility of Chinese Consumers to Network Marketing*

China’s national relationship culture, *guanxi*,<sup>100</sup> makes Chinese

<sup>95</sup> Schaub & Hong, *supra* note 53.

<sup>96</sup> *Id.*; see also Huifeng, *supra* note 11; Rubo, *supra* note 11 (revealing the extreme corruption of certain Chinese pyramid schemes). One of the first cases involving the death of a college graduate was twenty-three-year-old Li Wenxing, whose body “was found in a pond on the outskirts of Tianjin on July 14, two months after . . . arriv[ing] in the city” as a recent college graduate. Huifeng, *supra* note 11.

<sup>97</sup> See Schaub & Hong, *supra* note 53. For a general overview of the legal distinctions between Ponzi schemes, MLMs, and pyramid schemes, see Epstein, *supra* note 1, at 106–09.

<sup>98</sup> See Schaub & Hong, *supra* note 53.

<sup>99</sup> See *id.*

<sup>100</sup> *Guanxi* literally means “personal connections, relationship or social networks” and “implies trust and mutual obligations between parties, and [] operates on personal, familial, social, business and political levels[:] Having good, bad or no *guanxi* impacts one’s influence and ability to get things done.” Michael C. Wenderoth, *How a Better Understanding of Guanxi Can Improve Your Business in China*, FORBES (May 16, 2018), <https://www.forbes.com/sites/michaelcwenderoth/2018/05/16/how-a-better-understanding-of-guanxi-can-improve-your-business-in-china/#5c7b8cde5d85> [https://perma.cc/3KLM-5F98]. *Guanxi* requires mutual trust and “friendship or familial feelings[.]” paying homage to “China’s implicit “traditional rule of virtue[.]” Mary Szto, *Chinese Gift-Giving, Anti-Corruption Law, and the Rule of Law and Virtue*, 39 FORDHAM INT’L L.J. 591, 593, 610 (2016) (“China’s traditional rule of virtue is a tenet of Confucianism that a government’s promotion of virtue is superior to governance by legal measures. Virtue is cultivated through ritual [e.g., gift-giving].”).

*Guanxi* “is widely acknowledged as essential for successful business dealings in China.” Szto, *supra*, at 593; see also Wenderoth, *supra* (noting that a study performed on 700 Chinese entrepreneurs about the impact of social networks on business success

consumers uniquely susceptible to network marketing,<sup>101</sup> bolstering direct selling's influence in China. *Guanxi*'s interrelation with the direct selling industry likely furthers the governmental desire to limit the industry's presence (especially via foreign influence) to ensure a high degree of state-market involvement and oversight.<sup>102</sup>

Essential to direct selling's success in China in the 1990s, *guanxi* complements the essence of direct selling: the proliferation of personal relationships to increase sales volume.<sup>103</sup> Despite being "a key reason why network marketing is such big business in China[,]"<sup>104</sup> some scholars nonetheless advocate against excessive profiting in China via *guanxi* and network marketing, warning of

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suggested "higher trust and being strategically connected (having *guanxi*, or broker networks) was *correlated* to business success"). In Chinese business, "effective *guanxi* requires *ganqing* and *renqing*, or friendship or familial feelings[.]" Szto, *supra* at 593, and "foster[s] familial ties among business partners that lead to trust[.]" *id.* at 611. *Renqing* "may be translated as human warmth, favor, or sympathy" and *ganqing* "may be translated as affection" or "a present feeling based on past treatment; it creates *guanxi*, or an obligation for the future." *Id.* at 611, 620 ("Having *guanxi* means having reliable people who can help when one is in need.").

Gift-giving is argued as essential for cultivating *guanxi*, both traditionally and in modern Chinese business. *Id.* at 593, 620-26; *but see* Wenderoth, *supra* (pointing out "the downsides of *guanxi*" such as the common association "with corruption" and the potential to "lead to dangerous reciprocal obligations and collective blindness"). Gift-giving cultivates *guanxi* by "creat[ing] future obligations[.]" Szto, *supra*, at 620. A gift's value is "directly tied to *ganqing*: obligation, strength of feeling, and dependability." *Id.* Likewise, "the lapse of time between a gift and its return gift[] heighten[s] the moral stance of the gift." *Id.* (noting that "giving a return gift of equal value within a day or two was considered an insult"). Simultaneously, "[g]iving a gift demonstrates one's economic power[.]" *Id.* (internal quotations and footnote omitted); *see also Id.* at 592, 620-21 (expanding upon the concept of *mianzi*).

To keep up with China's recent economic growth, "*guanxi* must be expressed through gifts of increased value." *Id.* There remains a distinction between virtuous gift-giving and bribery in the *guanxi* system: "whether the payment is to develop a relationship or to achieve an immediate gain." *Id.* at 621 (emphasizing that "immediate gain" resulting from gift-giving indicates bribery). In sum, "[g]*uanxi* is about increasing resources through repeated reciprocal acts of favor and *ganqing* and *renqing*, or familial affection." *Id.* at 626.

<sup>101</sup> *See supra* Section II (providing a brief summary of network marketing strategies and normative implications).

<sup>102</sup> *See, e.g., supra* Section III-A. *See generally* Jeffery, *supra* note 63 (proposing that China's 1998 blanket ban on direct selling was tied to, at least in part, a governmental desire to maintain market and consumer control).

<sup>103</sup> *See* Jeffery, *supra* note 63.

<sup>104</sup> Hong & Schaub, *supra* note 53.

potential “damage [to] the foundation of Chinese society[.]”<sup>105</sup> Both *guanxi* and network marketing depend upon “interpersonal relationships.”<sup>106</sup> However, traditional *guanxi* departs from U.S. networking, especially in business relations.<sup>107</sup>

As opposed to the contractual style of U.S. business, which depends upon “strong codified laws[.]”<sup>108</sup> Chinese business success depends upon effective *guanxi*, relying upon personal networking or trust<sup>109</sup> and requiring mutual trust, or similar “friendship or familial feelings.”<sup>110</sup> These contrary cultural dispositions heighten susceptibility of Chinese consumers to transnational network marketing because it “sells interpersonal relationships[.]”<sup>111</sup> emphasizing relational opportunities.<sup>112</sup> “Word-of-mouth [network] marketing has a much higher conversion rate [in China] than traditional forms of marketing because of the importance which the Chinese place upon trusting their close friends and family. This nurturing of relationships is what drives the prevalence of network marketing businesses in China.”<sup>113</sup>

*Guanxi* remains essential for successful business in China today,<sup>114</sup> and, since China’s economic transition from planned to

<sup>105</sup> Miao, *supra* note 3, at 397 (reasoning that “relationship management is a product of social culture”).

<sup>106</sup> *Id.*

<sup>107</sup> See Wenderoth, *supra* note 100; Miao, *supra* note 3, at 397; State Council Info. Off., China, *supra* note 13, at 514, 517.

<sup>108</sup> See Wenderoth, *supra* note 100.

<sup>109</sup> See *id.* (identifying “networks of trust and mutual obligations” as important to Chinese business success); Miao, *supra* note 3, at 397 (explaining that China’s economy remains highly “dependen[t] on social stability”); State Council Info. Off., China, *supra* note 13, at 514, 517; see also Zhu Wenqian, *Culture as a Pillar of the Nation’s Economy*, CHINADAILY ASIA (Apr. 18, 2016), [https://www.chinadailyasia.com/business/2016-04/18/content\\_15417941.html](https://www.chinadailyasia.com/business/2016-04/18/content_15417941.html) [<https://perma.cc/BWT3-G9NP>].

<sup>110</sup> Szto, *supra* note 100, at 593.

<sup>111</sup> Miao, *supra* note 3, at 397.

<sup>112</sup> See *id.*; Wenderoth, *supra* note 100.

<sup>113</sup> Hong & Shaub, *supra* note **Error! Bookmark not defined.** “Network[] marketing is alive and thriving in China. This can be seen in the dynamic and innovative nature of the business in China. Wildly successful domestic and international networking marketing companies have tapped into China’s relationship culture, known in China as ‘*guanxi*.’” Yet “network marketing is not static in China – the market is still growing and innovative programs are constantly popping up . . . [Thus,] competitive companies need to innovate, whether in business model, compensation or reward mechanisms. Differentiation is key.” *Id.*

<sup>114</sup> Szto, *supra* note 100, at 625–26.

market economy, has expanded beyond the traditional, familial setting into capitalized business practices<sup>115</sup> via gift-giving.<sup>116</sup> In “urban [Chinese] business[,]”<sup>117</sup> “gift-giving among business associates and government officials”<sup>118</sup> is practically required for effective, successful business in China.<sup>119</sup> Further, China’s modern economic conditions require amplification of traditional *guanxi* gift-giving, which solidifies gifts in the Chinese business context as emblems of “privilege and status.”<sup>120</sup> Since a gift’s value is directly related to the extent of its returned obligation, effective *guanxi* and business in the modern Chinese economy require giving and receiving “gifts of increased value[,]”<sup>121</sup> thereby reinforcing gifts as longstanding symbolizations of one’s status,<sup>122</sup> and also emphasizing gift-giving as necessary for successful Chinese business ventures.<sup>123</sup> Thus, *guanxi* gift-giving constitutes a practical business requirement for success in China’s urban business sector.<sup>124</sup> This practical economic necessity exacerbates the economic plight of citizens at the lower end of the Chinese national wealth gap,<sup>125</sup> as China’s economic success via exclusionary, capitalistic *guanxi* gift-giving practices elude them.<sup>126</sup>

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<sup>115</sup> See Szto, *supra* note 100, at 593, 620, 626; Wenderoth, *supra* note 100. It has been suggested that one should assess one’s business *guanxi* in terms of three levels—personal, business, and sector or governmental—expanding *guanxi* beyond initial, personalized roots. Wenderoth, *supra* note 100.

<sup>116</sup> Szto, *supra* note 100, at 611.

<sup>117</sup> *Id.* at 620.

<sup>118</sup> *Id.* at 626.

<sup>119</sup> *See id.*

<sup>120</sup> *Id.* at 611; *see also Id.* at 620-21. Emphasizing the importance of virtuous gift-giving when doing business in China, “wise and faithful giving” is suggested for adhering to traditional *guanxi*, such as allowing time to pass before returning the gift in order to “heighten[] the moral stance of the gift” and/or giving a “return gift” at least equivalent in value to the original gift. *Id.* at 620-21 (internal footnote omitted).

<sup>121</sup> This correlation has been pointed out as directly related to Chinese consumers’ status as “the largest number of luxury goods consumers in the world.” *Id.* at 620, 626 (“It is also not an accident that today Chinese are the number one consumers of luxury goods in the world; and that officials may receive up to half of these goods.”).

<sup>122</sup> Szto, *supra* note 100, at 610.

<sup>123</sup> *See id.* at 611, 620-21, 625.

<sup>124</sup> *See id.* at 593, 620, 625.

<sup>125</sup> *See supra* Section IV-A (discussing the pertinence and extremity of China’s wealth gap).

<sup>126</sup> *See id.*; Szto, *supra* note 100, at 611, 620-21, 625 (discussing the capitalistic

Deeply-engrained in the national psyche, *guanxi* increases the direct selling industry's attraction to the already-desirable Chinese market by heightening consumer reactivity to network marketing.<sup>127</sup> In addition to China's unique economic conditions,<sup>128</sup> cultural susceptibility to network marketing contributes further to the need for consumer protection policies as exhibited in the Regulations.<sup>129</sup>

## V. Non-Compliance with the Regulations: U.S. Enforcement Standards and Patterns under the Foreign Corrupt Practices Act ("FCPA") for Chinese Subsidiary Conduct

Indirectly, China's 2005 Regulations often manifest in the United States regulatory system, either in actions brought under the Foreign Corrupt Practices Act ("FCPA" or "the Act")<sup>130</sup> by the United States Securities and Exchange Commission ("SEC"), and/or by the United States Department of Justice ("DOJ"). In these actions, U.S.-based direct sales companies allegedly violate (1) the Act's anti-bribery provisions,<sup>131</sup> and/or (2) the Act's accounting provisions,<sup>132</sup> including (a) the "books and records provision"<sup>133</sup> and (b) "internal controls provision[.]"<sup>134</sup> When intertwined with

development of *guanxi* gift-giving in the Chinese business context).

<sup>127</sup> See Miao, *supra* note 3, at 396; see also Schaub et al., *supra* note 53.

<sup>128</sup> See *supra* Sections III-A & IV-A.

<sup>129</sup> See Miao, *supra* note 3, at 397; see also Jeffery, *supra* note 63, at 37–40.

<sup>130</sup> See Foreign Corrupt Practices Act of 1977, as amended, 15 U.S.C. §§ 78dd-1, *et seq.* ("FCPA" or "the Act").

<sup>131</sup> See *id.* § 78dd-1 (prohibiting and sanctioning the bribery of foreign officials). The anti-bribery provisions "can apply to conduct *both inside and outside the United States.*" U.S. DEP'T OF JUSTICE, CRIM. DIV. & U.S. SEC. & EXCH. COMM'N, A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT 10 (2012), <https://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf> [<https://perma.cc/YVQ8-LPLZ>] [hereinafter RESOURCE GUIDE TO THE FCPA] (emphasis added).

<sup>132</sup> See *generally* 15 U.S.C. §§ 78m(b)(2)(A), (b)(2)(B) (containing the accounting provisions of the FCPA).

<sup>133</sup> The "books and records provision" of 15 U.S.C. § 78m(b)(2)(A) mandates that international direct sales companies "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the [company's] transactions and dispositions of [its] assets." RESOURCE GUIDE TO THE FCPA, *supra* note 131, at 39 (internal footnote omitted). See *generally* 15 U.S.C. § 78m(b)(2)(A) (containing the statutory text of the books and records provision).

<sup>134</sup> RESOURCE GUIDE TO THE FCPA, *supra* note 131, at 38 ("[U]nder the 'internal controls' provision" [15 U.S.C. § 78m(b)(2)(B)], international direct sales companies 'must devise and maintain a system of internal accounting controls sufficient to assure management's control, authority, and responsibility over the firm's assets.'"). See

China's Regulations, a recurring pattern appears in these FCPA actions. U.S.-based direct sellers, as parent companies of Chinese subsidiaries, are held liable under the Act (or otherwise used as a vehicle for liability) for the subsidiary's extraterritorial conduct in China, most often due to unlawful attempts to obtain, or maintain, Chinese market access under the 2005 Regulations.

For instance, in 2014, Avon (notably the first foreign direct sales company to obtain a license under the Regulations)<sup>135</sup> and its Chinese subsidiary, Avon China, both plead guilty to criminal violations of the FCPA anti-bribery provisions.<sup>136</sup> Avon China "made \$8 million worth of payments in cash, gifts, travel, and entertainment to gain access to Chinese officials *implementing and overseeing direct selling regulations* in China[.]"<sup>137</sup> The unlawful payments were made in an attempt to maintain both its direct sales license and the significant financial benefits accrued therefrom.<sup>138</sup> According to an SEC statement, after obtaining the direct selling license, "sales revenue in China then 'grew 44%[.]'"<sup>139</sup> Further, after receiving the license, Avon "achieved operating profits of \$3

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generally 15 U.S.C. § 78m(b)(2)(B) (containing the statutory text of the internal controls provision).

<sup>135</sup> Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Avon With FCPA Violations: Avon Entities to Pay \$135 Million to Settle SEC and Criminal Cases (Dec. 17, 2014), *available at* <https://www.sec.gov/news/pressrelease/2014-285.html> [<https://perma.cc/T777-J8VK>]. Avon "received the first direct selling business license in China in March 2006." *Id.*; *see also* Miao, *supra* note 3, at 394.

<sup>136</sup> Press Release, U.S. Dep't of Just., Avon China Pleads Guilty to Violating the FCPA by Concealing More Than \$8 Million in Gifts to Chinese Officials (Dec. 17, 2014), *available at* <https://www.justice.gov/opa/pr/avon-china-pleads-guilty-violating-fcpa-concealing-more-8-million-gifts-chinese-officials> [<https://perma.cc/8WE3-KY65>].

<sup>137</sup> Payments "include[d] paid travel for Chinese government officials[,] . . . gifts such as Louis Vuitton merchandise, Gucci bags, Tiffany pens, and corporate box tickets[.]" Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 135 (emphasis added); Complaint at 10–14, SEC v. Avon Products, Inc., No. 14-CV-9956 (S.D.N.Y. Dec. 17, 2014).

<sup>138</sup> "Avon's subsidiary . . . paid millions of dollars to government officials to obtain a direct selling license and gain an edge over their competitors, and the company reaped substantial financial benefits as a result[.]" Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 135 (internal quotations omitted). The payments were made also to "avoid fines or negative news articles" impacting "Avon's clean corporate image required to retain the license." *Id.*

<sup>139</sup> Robert Appleton & Kenton Atta-Krah, *Does Voluntary Disclosure Make More Sense After Goodyear?*, LAW360 (Mar. 4, 2015), <https://www.law360.com/articles/626656> [<https://perma.cc/2XCG-X6UD>].

million” after incurring “a \$1 million *loss*” the year before.<sup>140</sup> Both entities incurred criminal penalties<sup>141</sup> for these violations. Additionally, parent company Avon “agreed to implement rigorous internal controls, cooperate fully with the department and retain a compliance monitor for at least 18 months.”<sup>142</sup>

Similarly, the adjacent action against Avon under the FCPA accounting provisions<sup>143</sup> resulted in civil penalties of “more than \$67.36 million”<sup>144</sup> for each entity. In determining this penalty, the SEC considered various factors such as Avon China’s failure to fairly and accurately record the nature and purpose of the payments<sup>145</sup> and the parent company’s inadequate remedial efforts, such as missing correctional opportunities in its China subsidiary.<sup>146</sup>

In 2016, the SEC brought an action against Nu Skin Enterprises, Inc. under the FCPA accounting provisions for extraterritorial acts of its China subsidiary (“Nu Skin China”).<sup>147</sup> The unlawful payment that ultimately provoked the SEC action arose out of a Chinese provincial investigation against Nu Skin China for violation of the 2005 Regulations.<sup>148</sup> An internal Nu Skin China email evidenced the subsidiary’s unlawful intent underlying the improper payment by proposing an investigatory alternative where they were “*not charged* and . . . ‘*donate[d]* some money *instead of* a fine.’”<sup>149</sup> To execute this endeavor, the subsidiary obtained the influence of a

<sup>140</sup> *Id.* (emphasis added).

<sup>141</sup> Press Release, U.S. Dep’t of Justice, *supra* note 136 (reporting a total of “\$67,648,000 in criminal penalties”).

<sup>142</sup> *Id.*

<sup>143</sup> Press Release, U.S. Sec. & Exch. Comm’n, *supra* note 135.

<sup>144</sup> *Id.* (calculating this figure by totaling Avon’s agreed-upon disgorgement plus prejudgment interest).

<sup>145</sup> *See id.*

<sup>146</sup> *See* Press Release, U.S. Sec. & Exch. Comm’n, *supra* note 135; Appleton & Attakrah, *supra* note 139.

<sup>147</sup> *SEC Charges Nu Skin Enterprises, Inc. with FCPA Violations*, SEC (Sept. 20, 2016), <https://www.sec.gov/litigation/admin/2016/34-78884-s.pdf> [<https://perma.cc/87NU-UYF3>]; *see also* In the Matter of Nu Skin Enterprises, Inc., Admin Proc. File No. 3-17556 (Sept. 20, 2016) at 2.

<sup>148</sup> *See In the Matter of Nu Skin*, *supra* note 147, at 4. The Chinese Administration of Industry and Commerce was investigating Nu Skin China for “unauthorized activities of its sales representatives” in violation of the Regulations, which threatened the subsidiary with a fine of \$431,088 U.S.D. and potential trouble maintaining its direct selling license. *See id.* at 2-4.

<sup>149</sup> *Id.* at 3 (emphasis added).

high-ranking Chinese official<sup>150</sup> via a \$154,000 “donation” to his charity.<sup>151</sup> This “charitable” donation resulted in a written donation agreement<sup>152</sup> and ceremony where the official spoke, praising Nu Skin China.<sup>153</sup> Two days after the ceremony, it was announced that Nu Skin China “was neither charged nor fined”<sup>154</sup> for the regulatory investigation. Provoking the SEC action, on an expenditure authorization form,<sup>155</sup> Nu Skin China unlawfully labeled the \$154,000 payment as a charitable donation.<sup>156</sup> In reality, the payment was made for the improper purpose of “influenc[ing a Chinese] Party Official to favorably impact the outcome of”<sup>157</sup> a provincial investigation against Nu Skin China for violating the Regulations.<sup>158</sup>

Like Avon, Nu Skin’s subsidiary committed the unlawful conduct, yet the parent company bore FCPA liability to the extent possible for:

[failing to] devise and maintain a reasonable system of internal accounting controls over its subsidiary’s operations in China to ensure that transactions were recorded as necessary to maintain accountability for assets . . . [G]iven the well-known corruption risks in China,<sup>159</sup> Nu Skin did not ensure that adequate due diligence was conducted by Nu Skin China with respect to charitable donations to identify links to government or political party officials and to prevent payments intended to improperly influence such persons in violation of the company’s anti-

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<sup>150</sup> *Id.* at 3–4.

<sup>151</sup> Further indicative of improper motive was Nu Skin China’s agreement to obtain “college recommendation letters for the Party Official’s child” from “an influential U.S. person[.]” *Id.* at 2–4.

<sup>152</sup> The final version of this agreement, between Nu Skin China and the charity (unbeknownst to, and against the advice of U.S. counsel) omitted the suggested anti-corruption language. *See id.* at 4.

<sup>153</sup> *Id.*

<sup>154</sup> *In the Matter of Nu Skin*, *supra* note 147, at 4.

<sup>155</sup> *Id.*

<sup>156</sup> *Id.* at 2, 4.

<sup>157</sup> *Id.* at 4.

<sup>158</sup> The Chinese Administration of Industry and Commerce was investigating Nu Skin China for “unauthorized activities of its sales representatives” in violation of the Regulations, which threatened the subsidiary with a fine of \$431,088 U.S.D. and potential trouble maintaining its direct selling license. *See id.* at 2-4.

<sup>159</sup> *See, e.g., Szto*, *supra* note 100, at 596–603, 609–12, 620–27.

corruption policy and the FCPA.<sup>160</sup>

Most recently, in 2019, the SEC brought an action against Herbalife under the Securities Act<sup>161</sup> and the Exchange Act<sup>162</sup> for unlawfully issuing false and misleading statements.<sup>163</sup> In the settlement agreement,<sup>164</sup> Herbalife agreed to pay a \$20 million punitive fine.<sup>165</sup> However, just six weeks after the SEC settlement, the DOJ indicted two former executives of an Herbalife subsidiary, Herbalife China<sup>166</sup> for violating the anti-bribery and accounting provisions of the FCPA.<sup>167</sup> Herbalife remains unnamed in the DOJ indictment, but circumstantial evidence and secondary sources indicate Herbalife as the MLM at issue that formerly employed defendants Yanliang Li and Hongwei Yang as high-level executives.<sup>168</sup>

Again, like Avon and Nu Skin, the charges alleged attempts to maintain direct selling licenses under the Regulations.<sup>169</sup> Specifically, the DOJ alleged that defendants corruptly influenced<sup>170</sup> Chinese governmental investigations and state-

<sup>160</sup> *In the Matter of Nu Skin*, *supra* note 147, at 4.

<sup>161</sup> *See* 15 U.S.C. §§ 77q(a)(2)–(3).

<sup>162</sup> *See* § 78m(a).

<sup>163</sup> The SEC found certain statements in Herbalife’s quarterly and annual SEC filings untrue because they claimed to use a different business model in China when, in fact, its “compensation model in China” was “similar . . . to the one it employed in every other country[.]” The SEC found the statements “false and misleading[.]” *See* Press Release, Sec. & Exch. Comm’n, Herbalife to Pay \$20 Million for Misleading Investors, (Sept. 27, 2019), available at <https://www.sec.gov/news/press-release/2019-195> [<https://perma.cc/FU3L-SUF4>] (emphasis added).

<sup>164</sup> Herbalife neither admitted to nor denied the findings. *See In the Matter of Herbalife Nutrition Ltd.*, Admin Proc. File No. 3-19536 (Sept. 27, 2019) at 1.

<sup>165</sup> *See, e.g., id.* at 11; Press Release, Sec. & Exch. Comm’n, *supra* note 163.

<sup>166</sup> Herbalife operates in China “through a group of wholly owned subsidiaries based in China” as Herbalife China. Bruce Zagaris, *2 Former Executives of Chinese Subsidiary of Herbalife Charged with Corruption*, 35 INT’L ENF’T L. REP. 407, 407 (2019). The two former Herbalife China executives were Yanliang Li and Hongwei Yang, “also known as Mary Lang[.]” *Id.*; Sealed Indictment at 3–5, *United States v. Li*, 19 Crim. 760 (S.D.N.Y. Oct. 22, 2019) [hereinafter *Herbalife Indictment*].

<sup>167</sup> *See Herbalife Indictment*, *supra* note 166, at 6–18.

<sup>168</sup> *See, e.g., Zagaris*, *supra* note 166, at 407–08; *Herbalife Indictment*, *supra* note 166, ¶¶ 1-7.

<sup>169</sup> Again, financial incentive appears plausible. As of 2016, “Herbalife China was responsible for approximately 20 percent of Herbalife’s worldwide net sales, which surpassed \$4 billion.” Zagaris, *supra* note 166, at 407.

<sup>170</sup> *Herbalife Indictment*, *supra* note 166, at 7.

controlled media via unlawful payments.<sup>171</sup> The alleged payments include, *inter alia*, round-trip airline tickets, a shopping trip and spa visit for a Chinese official, his daughter, and her classmates, an internship for a senior government official, and Herbalife China “receiving \$772,433 in reimbursement [from its parent company] for purportedly entertaining 4,312 gov’t officials at 239 meals . . . and providing fruits and vegetables for officials.”<sup>172</sup>

Additionally, defendants violated the FCPA accounting provisions by circumventing the parent company’s internal controls meant to prevent bribery and fraud.<sup>173</sup> Similar to Nu Skin, Herbalife’s failure as a parent company to “identify, investigate, stop the payments, [or] take remedial action”<sup>174</sup> indicated either “big flaws” in Herbalife’s international accounting procedures and controls, or that “persons in the parent organization also participated in the scheme.”<sup>175</sup> Despite having thus far evaded immediate FCPA legal liability, Herbalife’s actions demonstrate the incidental consequences for parent companies in similar situations adversely affecting Herbalife’s “reputation, financial situation, and stock value.”<sup>176</sup> Despite public disclosure and subsequent remedial action,<sup>177</sup> Herbalife’s share value went down shortly after the DOJ indictment.<sup>178</sup>

These FCPA enforcement actions exhibit the various forms of liability that parent companies may take on for a foreign subsidiary. These enforcement actions serve as warnings to foreign companies hoping to do business in China, calling for compliance with both the Regulations and the FCPA.<sup>179</sup> Yet also latent in these actions is the tension between the FCPA’s bribery prohibition and participation in *guanxi* gift-giving as a practical necessary for successful,

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<sup>171</sup> See Zagaris, *supra* note 166, at 408.

<sup>172</sup> *Id.*

<sup>173</sup> See Herbalife Indictment, *supra* note 166, at 14–16; see also Zagaris, *supra* note 166, at 407–08.

<sup>174</sup> Zagaris, *supra* note 166, at 409.

<sup>175</sup> *Id.*

<sup>176</sup> *Id.*

<sup>177</sup> See *id.*

<sup>178</sup> *Id.* Shortly after the indictment, Herbalife shares went down 30 cents (0.7%), from \$43.50. *Id.* at n.12. In addition to “substantial fines, penalties, and disgorge profits[,]” Herbalife “will likely have to have a monitor for years into the future, for which it will need to pay.” *Id.* at 409.

<sup>179</sup> See *id.*

effective business in China.<sup>180</sup> Lastly, these actions each allude implicitly (and undeniably) to an arbitrary, undefined degree of Chinese governmental involvement in China's direct selling industry.<sup>181</sup>

#### A. Enforcement Actions & Patterns in China

While harsh on their face, actual enforcement of the 2005 Regulations in China proves isolated and unpredictable.<sup>182</sup> Besides a few high-profile cases<sup>183</sup> imposing strict penalties or punishments for blatant corruption, more mundane enforcement remains arbitrary, isolated, and often haphazard.<sup>184</sup> The direct selling industry should remain aware of potentially arbitrary or selective enforcement of the Regulations in China.<sup>185</sup>

However, recent industry developments and current events in China may create harsher enforcement of the Regulations by Chinese governmental authorities.<sup>186</sup> For instance, as recently as September 2019, the Chinese government was conducting random compliance checks for direct selling companies.<sup>187</sup> Further, as of February 2019, the direct selling licensure system was suspended

<sup>180</sup> See, e.g., Szto, *supra* note 100, 592–93, 620, 626. (discussing Chinese gift-giving culture and the inherent risk of violating the FCPA and considering whether gift-giving of Chinese culture can be used simultaneously to fight corruption); see also *supra* Section IV-B (discussing the Chinese cultural value of *guanxi*).

<sup>181</sup> See, e.g., Jeffery, *supra* note 63, at 39–40; Pomfret, *supra* note 69; Wong, *supra* note 74, at 280–81.

<sup>182</sup> See, e.g., Rubo, *supra* note 11.

<sup>183</sup> See, e.g., *Leader of China's \$9 Billion Ezubao Online Scam Gets Life; 26 Jailed*, REUTERS (Sept. 12, 2017), <https://www.reuters.com/article/us-china-fraud/leader-of-chinas-9-billion-ezubao-online-scam-gets-life-26-jailed-idUSKCN1BN0J6> [<https://perma.cc/B7ZU-77CM>] (providing an overview of the Ezubao case).

<sup>184</sup> Rubo, *supra* note 11; McMorro & Myers, *supra* note 5.

<sup>185</sup> Rubo, *supra* note 11; see also Szto, *supra* note 100, at 592 (pointing out that “China is considered a high-risk business environment”); Ivan Franceschini, *Labour NGOs in China: A Real Force for Political Change?*, 281 CHINA Q. 474, 475–78 (2014) (suggesting heightened power in governmental enforcement of regulations and laws, no matter how selective or arbitrary); *supra* Section V. Without consistent enforcement, illegal domestic Chinese pyramid schemes and their often pervasive corruption will not disappear. See, e.g., Huifeng, *supra* note 11; Rubo, *supra* note 11; Jeffery, *supra* note 63, at 39–40; Pomfret, *supra* note 69; Wong, *supra* note 74, at 257–58.

<sup>186</sup> Heather Martin, *5 Events That Impacted Direct Selling in 2019*, JUFULLY MEDIA (Dec. 5, 2019), <https://www.zxfull.com/en/80-resources/focus/8825-5-events-that-impacted-direct-selling-in-2019> [<https://perma.cc/8TZV-NQKB>].

<sup>187</sup> *Id.*

pending a comprehensive national industry review, and Chinese authorities were discussing, *inter alia*, “establish[ing] a black list for discredited direct sellers and players, [and] increas[ing] the cost for violation of laws and dishonest behaviors[.]”<sup>188</sup> In light of potentially heightened enforcement of the Regulations in China, direct selling companies with business in China should consider and ensure compliance efforts accordingly, while remaining aware of potentially arbitrary or selective enforcement in China.

### **VI. Transnational Direct Selling in China—Current State of Affairs: 2018’s Record-Breaking Industry Figures and 2019 Fourth Quarter Declines for Industry Leaders**

Direct selling’s declining fourth quarter figures for industry leaders in 2019 were often linked to Chinese market performance or presence. In 2018, the industry remained lucrative and profitable. The global direct sales industry experienced \$192.9 billion in global retail sales for the 2018 fiscal year (ending December 31, 2018), demonstrating an annual 1.7% compounded increase for 2015-2018.<sup>189</sup> As of 2018, China was the largest direct selling market in the world (with the United States close behind in second), boasting \$35,731 billion USD in retail sales for 2018.<sup>190</sup> Likewise, direct selling’s global “sales force” broke records in 2018 with “a total of 118.4 million people involved in direct selling globally”<sup>191</sup> including “over 53 million Independent Representatives[.]”<sup>192</sup> However, looking at major direct sellers’ 2019 fourth quarter and 2019 growth performances,<sup>193</sup> which “give some significant

<sup>188</sup> Feng, Spokesperson, Ministry of Com. of China (MOFCOM), *supra* note 52.

<sup>189</sup> *WFDSA Announces Record-Setting 2018 Direct Selling Business Results*, WORLD FED’N OF DIRECT SELLING ASS’NS (June 3, 2019), <https://wfdsa.org/wfdsa-announces-record-setting-2018-direct-selling-business-results/> [https://perma.cc/P3PC-7MWU] [Hereinafter *Record-Setting 2018*]; FACT SHEET, *supra* note 3, at 1; see WORLD FED’N OF DIRECT SELLING ASS’NS, GLOBAL DIRECT SELLING 2018 (2019), [https://wfdsa.org/wp-content/uploads/2019/06/WFDSA-Fact-sheet-2018\\_F.pdf](https://wfdsa.org/wp-content/uploads/2019/06/WFDSA-Fact-sheet-2018_F.pdf) [https://perma.cc/R5ZA-HLUQ] [hereinafter GLOBAL DIRECT SELLING 2018].

<sup>190</sup> WORLD FED’N OF DIRECT SELLING ASS’N’S, WFDSA 2018/2019 ANNUAL REPORT 23 (2019), <https://wfdsa.org/initiatives-and-resources/publications/> [https://perma.cc/MGL6-V9LF]; GLOBAL DIRECT SELLING 2018, *supra* note 189. The United States was close behind China, with \$35,350 billion U.S. dollars in retail sales for the year of 2018. *See id.*

<sup>191</sup> GLOBAL DIRECT SELLING 2018, *supra* note 189.

<sup>192</sup> *See Record-Setting 2018*, *supra* note 189.

<sup>193</sup> Hakki Ozmorali, *2019 in a Few Major Companies’ Figures*, WORLD OF DIRECT

indications”<sup>194</sup> as to “the sentiment or the trends in the industry,”<sup>195</sup> the permanence of the industry’s record-breaking numbers in 2018 proves speculative, especially within China.

For instance, despite experiencing 2.8% growth compared to its 2018 fourth quarter figures, Herbalife experienced a 15% sales decline in China.<sup>196</sup> However, on the whole, Herbalife ended 2019 with a revenue figure very similar to its 2018 fiscal year.<sup>197</sup> Herbalife management has not offered “any guidance for 2020,”<sup>198</sup> yet it plans to update guidance “when they c[an] reasonably estimate . . . the extent of impact from the Coronavirus.”<sup>199</sup>

Alternatively, Nu Skin experienced a 10% annual revenue decline in 2019, due in large part to its China market.<sup>200</sup> While the company’s “customer base remained relatively strong”<sup>201</sup> in the fourth quarter, its “sales leader count was down . . . primarily driven by a decline in Mainland China.”<sup>202</sup> Nu Skin’s China sales “dropped by 29% or by \$63 million on a quarterly basis[.]” attributing 2/3 of Nu Skin’s overall sales decline to its performance in Mainland

SELLING (Mar. 30, 2020), <https://www.worldofdirectselling.com/2019-in-direct-sales-in-figures/> [<https://perma.cc/7LHG-SW93>].

<sup>194</sup> *Id.*

<sup>195</sup> *Id.*

<sup>196</sup> *Id.*

<sup>197</sup> Herbalife “ended the year with a revenue figure (\$4.877 b) very close to last year’s (\$4.892 b).” *Id.*

<sup>198</sup> *Id.*

<sup>199</sup> Ozmorali, *supra* note 193. The implications of COVID-19 for global direct selling exceed this Note’s scope and prove too recent for accurate prediction. For more information on how the COVID-19 pandemic could impact not only direct selling, but world trade as a whole. See, e.g., *COVID-19 and World Trade*, WTO, [https://www.wto.org/english/tratop\\_e/covid19\\_e/covid19\\_e.htm](https://www.wto.org/english/tratop_e/covid19_e/covid19_e.htm) [<https://perma.cc/8U93-MJ48>] (last visited Oct. 2, 2020) (providing an overview of current global trade status and links to further sources); *E-Commerce, Trade and the COVID-19 Pandemic: Information Note*, WTO 1, 1 (May 4, 2020), [https://www.wto.org/english/tratop\\_e/covid19\\_e/ecommerce\\_report\\_e.pdf](https://www.wto.org/english/tratop_e/covid19_e/ecommerce_report_e.pdf) [<https://perma.cc/AD6T-ZNPY>]; see also *WTO Report Looks at Role of E-Commerce During the COVID-19 Pandemic*, WTO (May 4, 2020), [https://www.wto.org/English/news\\_e/news20\\_e/rese\\_04may20\\_e.htm](https://www.wto.org/English/news_e/news20_e/rese_04may20_e.htm) [<https://perma.cc/HS76-JG24>].

<sup>200</sup> Ozmorali, *supra* note 193 (“Nu Skin’s [fourth] quarter global sales was \$583 million, down 15% from prior year [2018] same quarter. Together with this, company closed the year with \$2.420 b sales. This again, meant a 10% annual revenue decline.”).

<sup>201</sup> *Id.*

<sup>202</sup> *Id.* (internal quotations omitted).

China.<sup>203</sup> That said, besides for marginal growth in Japan, “none of Nu Skin’s other units posted growth in Q4[.]”<sup>204</sup> Nu Skin’s management foresees 5 to 10% *negative* growth in 2020, but predicts positive growth will return in the fourth quarter when it launches “a new beauty device.”<sup>205</sup> “Their projected sales *decline* in Mainland China for [2020] is 20 to 25%.”<sup>206</sup>

Lastly, USANA Health Sciences (“USANA”), a global direct selling company dependent upon China for “about half of [the] company’s global revenue[,] . . . basically does not have strong presence in markets outside of Asia.”<sup>207</sup> It experienced a 9% decline in the 2019 fourth quarter compared to the same quarter in 2018,<sup>208</sup> closing 2019 with an 11% decrease in total global sales<sup>209</sup> and a significant decrease in total active customers.<sup>210</sup> USANA management makes no predictions for significant growth in 2020.<sup>211</sup>

Already speculative, the viability of global direct selling, both in China and beyond, proves even more dubious in light of the potential impending effects of COVID-19. Thus, the industry, particularly transnational direct selling entities conducting business in Mainland China, must not assume that they will continue to experience monetary success in the future.

## VII. Resolving Dissonant National Policies in Transnational Direct Selling: Effective Legal Standards and/or Best Business Practices

Internationally-uniform legal standards in direct selling prove lacking yet necessary, but the industry remains legally complex, both in terminology and national customs.<sup>212</sup> Certain best practices

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<sup>203</sup> *Id.*

<sup>204</sup> *Id.*

<sup>205</sup> *Id.*

<sup>206</sup> Ozmorali, *supra* note 193 (emphasis added).

<sup>207</sup> *Id.* (“Total sales in Americas and Europe make up 20% of USANA’s total.”).

<sup>208</sup> This 9% decline in the fourth quarter was taken from USANA’s quarterly reporting of \$271 million, “9% less than Q4 of 2018.” *Id.*

<sup>209</sup> USANA “closed the year with \$1.061 billion sales, a decrease of 11%.” *Id.*

<sup>210</sup> USANA’s “total number of active customers at the end of the fourth quarter was 586,000, compared to 616,000 in the prior-year period[.]” *Id.*

<sup>211</sup> USANA expects “net sales between \$1.03 billion and 1.13 billion in 2020.” *See id.*

<sup>212</sup> *See supra* Section II (providing a legal overview of the global direct selling industry).

for transnational direct selling companies conducting business in China may prove more effective for dodging threats of enforcement until U.S. or Chinese national policy resolves existing tensions between the 2005 Regulations and the FCPA.

The direct selling industry must balance the interests of “enterprises, the consumers[,] and the regulators[.]”<sup>213</sup> Considering China’s national socioeconomic conditions<sup>214</sup> makes it clear that these three entities interact completely differently than they do within the United States. Chinese “regulators” often share interests or control with “enterprises” and the market post-China’s delayed economic liberalization engenders more stringent oversight of private business in opposition to the United States’ open economy policy and practices.<sup>215</sup> Similarly, as seen in the national history underlying the 2005 Regulations and 1998 direct selling ban, China’s “regulators” often maintain implicit control over “consumers.”<sup>216</sup> After considering such Chinese national conditions, and longstanding national tensions with the direct selling industry, a necessary, admittedly idealistic, industry goal: regaining Chinese national trust.

Internal anti-corruption safeguards prove immediately crucial for direct selling companies doing business in China, regardless of whether industry leaders incorporate broader, ideological suggestions tailored to Chinese national culture and history as related to direct selling. Implementation of internal anti-corruption practices proves most vital because gift-giving must not arise to unlawful bribery under Chinese or U.S. law, regardless of benefits accrued by foreign enterprises doing business in China from cultivating *guanxi* via gift-giving. Otherwise, enforcement is likely, and fair, in either country. U.S.-based parent companies must implement stringent internal anti-corruption policies, practices, and enforcement to avoid potential liability under the FCPA for their Chinese subsidiaries’ extraterritorial conduct. Unless and until legislative policy shifts adapts to reconcile underlying policy differences between the FCPA and Chinese best business practices, transnational direct selling companies must tread carefully when

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<sup>213</sup> Miao, *supra* note 3, at 396–97.

<sup>214</sup> *Id.*

<sup>215</sup> See, e.g., Jeffery, *supra* note 63, at 39–40; Pomfret, *supra* note 69; Wong, *supra* note 74.

<sup>216</sup> See *supra* Sections III & VI.

conducting business in China to ensure compliance with both the 2005 Regulations and the FCPA.