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November 6, 2014

Pamela Jones Harbour
Senior Vice President,
Global Member Compliance & Privacy
Herbalife Ltd.

Dear Ms. Jones Harbour:

As you know, Pershing Square has been a vocal critic of the Company. Based on our extensive investigation over the past three years, we believe Herbalife operates the largest and best-managed pyramid scheme in the world.

The challenge before you is immense. The press release announcing your arrival set ambitious goals:

> Leading a global member compliance team across 91 markets, Harbour will develop and enhance policies and infrastructure that ensure effective education, training and mentoring programs for the nearly 4 million independent Herbalife members worldwide, underpinned by robust and consistent monitoring and enforcement procedures.[1]

Your job will be an enormous undertaking, especially given the lax attitude toward compliance that has existed at Herbalife in the past.

<u>Compliance versus Recruitment</u>

Under scrutiny by regulators and Wall Street, Herbalife may face a choice: **Compliance – OR – Recruitment.** The more clearly the Company conveys the stark unlikelihood of success in the business, the less likely that people will enroll. Consider what would happen if, in all meetings with potential recruits, the recruiters were required to remind the audience clearly of certain key facts, for example:

- 88% earn nothing from the Company;
- Most money goes to the top 1%;
- Members churn rapidly and leave the system;

[1] http://ir.herbalife.com/releasedetail.cfm?ReleaseID=874595.

- Most distributors suffer net losses after accounting for time and money spent;
- Herbalife does not track retail sales;
- Millions of recruits have come and gone in recent years.

Or, consider what would happen if the recruiters at Herbalife meetings were not permitted to show pictures of their mansions and cars, or if recruiters were not allowed to tell 'income stories,' as the Company calls the personal rags-to-riches tales that are shared with recruits.

You may find yourself at the fulcrum of choosing between protecting consumers or protecting the Company. Based upon our research, we do not believe you can do both.

Herbalife-friendly analysts are tying together the Company's revised business practices with its recent financial set-backs. In the face of the company's weak quarterly results and just before the collapse of the stock price, Tim Ramey of Pivotal Research Group, the most aggressively supportive analyst of Herbalife's stock, released an updated report on HLF, dated November 4, 2014 (copy enclosed). Having set a price target of $110 just a couple of weeks ago, Mr. Ramey lowered his target by almost one-third to $75. In his report, Mr. Ramey includes bullet points about his discussion with management (copied below).

Notes from our discussion with management

- VZ was 300bp drag on volume and sales; 3Q net sales without VZ would have been +7%
- VZ percent of sales in the 4Q is 1.5% of volume; about 0.5% of sales. Volume is down – less than half of LY to the point where VZ will not be a factor in 2015 – except in the comps. $0.43 headwind from VZ in 2015.
- Substantial changes to marketing plan – first order limits
- Field sales do not count for supervisor qualification
- Those who qualify for supervisor over 3-12 months are 57% more active 12 months later and 62% more likely to be retained. The incentive to hit 4,000 volume points in one month has been taken away.
- Everything done in the U.S. to the marketing plan is being done globally
- 18 markets were deployed – Russia, China India, others are small
- Mexico did a lot of field sales – will take some training to get them on direct purchase from the company.
- Last year 12% of sales leaders qualified in two months; YTD it is 9%. It may be 6% next year; 3% would be better – slower qualification creates more stickiness and long-term success. "Creating a pathway that works better."
- China – tremendous consumption statistics – very strong foundation. EMEA doing tremendously well – 2/3 of sales leaders come in through the 5K method. 5k was 30% LY this year is 48%.
- Softness in Brazil – unique situation to Brazil – some distractions in distributor leadership re compliance.
- Members in the U.S. down – Lawyers are "having an impact on the business." Will require training and better compliance efforts
- Small asset impairment of $1.6 mm. Bought some equipment that didn't work – they should get it back – Aloe equipment.
- Share repurchase – none done in the 3Q; assume none in guidance. Free cash flow of $470 - $500 million in 2015.

We note particularly Mr. Ramey's comments: "Softness in Brazil – unique situation – some distractions in distributor leadership re compliance" and "Members in the U.S. down – Lawyers are 'having an impact on the business.' Will require training and better compliance efforts." The internal quotation seems to come directly from management, attributing the downturn in

Membership to the impact of the lawyers. Similarly, Mr. Ramey reports that, in Brazil, there are "distractions in distributor leadership re compliance."[2]

On Herbalife's recent quarterly conference call, Mr. Ramey challenged the Company's management to explain why its earnings guidance failed to predict accurately the growth-limiting effect of its rule changes.[3]

Another analyst, Meredith Adler of Barclays, who has been supportive of HLF, issued a new report dated November 5, 2014, in which she lowered her price target by 15% from $94 to $80 (copied enclosed). She ties the recent business slowdowns to Herbalife's recent changes in its recruiting and marketing practices:

> HLF has been taking a variety of important steps to make involvement in its business less risky for a potential distributor. Changes that have been contemplated for a long time, and even tested in a few countries, are being rolled out globally now and over the next several months. These changes include limits in the size of a first order and new standards to qualify as a sales leader. **Not surprisingly they are dampening volume and sales growth in the short run, though to a greater extent than the company had anticipated.** Yet management remains confident that these changes build a healthier and more sustainable

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[2] In the quarterly conference call held yesterday, management acknowledged, in euphemistic terms, that recent changes have hurt performance in the short term, while, they hope, the long term will be more favorable. For example:

- "We are making changes to the business model that will not only improve our way of doing business but also improve our results. This period of transition for the company is an important chapter in our history and one that will make us stronger. Some of these changes, however, take time to be digested and implemented by our members and as a result, this has affected our performance for the short term, yet we manage for the long term, and we firmly believe that the changes we are making are all the right ones for the healthy growth of our company, and they give us tremendous confidence for our future" – Michael Johnson, 11/4/2014

- "We've implemented a number of build-it-better initiatives. We haven't had a build-it-better program for many years but recently, we've accelerated that partially in response to some of the outside noise. So when you got things like the nomenclature change, and then you follow that with the simplified pricing, and then you follow that with a greater level of claims training and enforcement, and then you roll in these marketing plan changes, I think it's the accumulation of efforts that's just causing a temporary reset as we have -- as our members out there just get used to the new situation and just a new game plan." – Des Walsh, 11/4/2014

[3] Mr. Ramey's questions on the conference call include the following:

So easy to play Tuesday morning quarterback here, but the new marketing initiatives all appear to have an impact of slowing growth or sales in the near term, and yet obviously you were surprised versus your guidance, number one, and it's not consistent necessarily with a holistic view of those changes that you bought back as much stock as you did earlier in the year. How do you make us more comfortable with that kind of fact pattern that we bought back stock, we gave guidance, and then we implemented these changes, which are well thought out and logical but made the previous decision somewhat suspect?

> business, and evidence from test markets shows that retention of sales leaders is higher and their productivity improves. [Emphasis added]

Ms. Adler draws a connection between the public criticism of Herbalife's business model and the Company's efforts to change its practices.

> It is not exactly clear why these changes are being made so quickly, but the negative publicity around HLF's business model probably provided a strong incentive to take action now.

For a rebuttal to Ms. Adler's comments, we enclose an article by Matt Stewart, an articulate critic of HLF, published November 5, 2014 on Seeking Alpha. If you want to understand the risks and liabilities at Herbalife, we believe you need to absorb the negative views, not just the views of cheerleaders. Mr. Stewart has published trenchant articles on HLF over the past year and a half. We urge you to heed them.

We believe Herbalife is changing its practices not simply because of "negative publicity around HLF's business model" (Ms. Adler's phrase), but because of genuine legal infirmities in its practices. Herbalife recent changes, however, are largely window-dressing – or worse, as they allow Herbalife and its top distributors to keep misleading consumers while claiming to clean up their practices.

Herbalife has been immodestly praising itself for having the "Gold Standard" of consumer protection, an accolade which we think can only be awarded by consumers or regulators. Many of the Company's recent changes, however, actually create greater opportunities to mislead recruits. For example, as we showed in our presentation on July 22, 2014, the new 90-day waiting period before a recruit is permitted to open a Nutrition Club is used by the Company to require 'training.' The 'training,' as we showed, violates consumer and labor laws by leading recruits to spend substantial time and money being 'taught' how to make shakes, clean tables and hand out flyers – all without compensation and without meaningful long-term prospects of running a profitable business.

Similarly, a new rule prohibits recruits from purchasing 4000 Volume Points to qualify as Supervisors on their first order on Day #1 – but they can do so on their second order on Day #2. There is a change of form, not substance. On occasion, Herbalife has described itself as going "deeper," which suggests enticing poorer and poorer people into the network. Reducing the Supervisor qualification level from 5000 Volume Points to 4000 Volume Points allows Herbalife to "go deeper."

When Herbalife tells credulous consumers that it has the "Gold Standard" of consumer protection, they may actually believe the phrase, without realizing the enormous opportunities for deception still inherent in the business.

Even if Herbalife wanted to clean up its improper practices, Herbalife faces an inherent conflict with its top distributors who continue to profit massively from recruiting, not retailing. In order to make substantive changes to the marketing plan, Herbalife needs a vote of the distributors (as evidenced by the July 2014 vote that management described on its recent conference call). Top distributors' self-interest dictates that they would want to continue their most aggressive recruitment methods without impediment. The compliance department will have to navigate these issues, as even Herbalife does not fully control its own rules.

Given the clear tension between compliance and recruitment, there may be pressure on you, as Chief of member compliance, to soften compliance requirements in order to accommodate continued growth. You will be in the spotlight. Regulators, consumer advocacy groups, Latino community organizations, investors and others will be watching closely to see how you respond to this tension and any management pressure.
In light of these challenges, in this letter, we address the following topics:

A. The need for an independent, well-funded, robust compliance system that can monitor almost 4 million distributors in 91 countries
B. The need for Herbalife's compliance professionals to have the authority to examine top executives and top distributors' conduct
C. The well-documented record of abusive and deceptive practices that are pervasive among top distributors and which have not been adequately sanctioned
D. Seven priority areas in need of investigation:
    1. Nutrition Club "Training" Programs
    2. Herbalife's Compensation Statements
    3. Deceptive Income Claims
    4. Sales of Recruiting Materials
    5. Lead Generation
    6. Product Claims
    7. Rules Purportedly Designed to Incentivize Retail Sales

To discuss these challenges, we would like to meet with you. In light of the critical importance of independence in your role, and the undue influence that senior distributors and senior management have exerted over compliance efforts in the past, we propose a meeting without other executives of the Company. We will meet with you anytime, anywhere.

Compliance in a System with Massive Recruitment and Turn-Over

Like all pyramid schemes, Herbalife depends for its survival on the constant recruitment of new participants, nearly two million per year at current rates. Herbalife and its senior distributors work closely together in developing "Business Methods" (Herbalife's phrase) and marketing strategies to maximize recruitment in existing markets and to penetrate new markets where they can find new pools of potential recruits. In public filings, Herbalife touts its programs to monitor methods being used around the world and to propagate the most effective methods. Lead generation, Nutrition Club "training" programs, questionable "University" qualifications with "graduations" and "certifications," and Wellness Coaching are just a few of the most successful

Business Methods and marketing strategies that Herbalife and its senior distributors have developed and proliferated.

None of these methods is geared toward promoting true retail sales. If there were genuine retail demand for Herbalife products as branded consumer packaged goods, it is difficult to explain the enormous annual turn-over of both Supervisors and non-Supervisors and their pronounced lack of brand loyalty. Des Walsh has stated that customers leave because they 'reach their goals,' but one doesn't reach a 'goal' when taking vitamins. Formula 1, according to Herbalife's own Dr. David Heber, is supposedly effective for weight loss, weight gain and weight maintenance; on this basis, there is no reason ever to stop using it. Yet customers overwhelming flee within a short period. Moreover, to whatever limited extent there may be retail sales, the vast majority of distributors making retail sales are nonetheless losing money on a net basis after taking into account their time, expenses and opportunity costs.

Only the very few who develop these Business Methods and marketing strategies, and place themselves at the top of a large downline, have any hope of succeeding with Herbalife. As years go by, the likelihood of scaling the heights of the pyramid grows more remote. Even in that tiny group of those who start to ascend, most fail. Yet they continue to promote an appearance of extraordinary financial success, even as some go through personal bankruptcy because of Herbalife—taking to the extreme Mark Hughes' exhortation to "fake it 'til you make it." Of course, these senior distributors sit atop huge organizations of downline distributors, and it is the image (true or not) of their financial success that motivates existing distributors to continue investing time and money, and arms these top distributors with an essential deception that they use to lure new recruits into the scheme. Meanwhile, at the bottom, nearly two million people per year churn through the system.

There is little retail demand for the Company's overpriced commodity products, which receive almost no advertising and promotion, and retail sales are typically at large discounts from the Company's artificially high Suggested Retail Prices. In the absence of material profits from retail sales, the Herbalife compensation system incentivizes distributors to (i) order large volumes of Herbalife products, (ii) focus on recruiting new distributors into the scheme, and (iii) push new recruits to order large volumes of products themselves. Importantly, commissions are paid to the upline upon the *purchase* of inventory by downline distributors regardless of whether the inventory is ever resold. These large initial orders—which allow the new distributor to qualify as a Supervisor and thus become eligible for commissions, royalties and bonuses on orders placed by that distributor's recruits—are the lifeblood of Herbalife.

Every day, new victims are sold on the "dream" of making substantial income working from home by selling protein shakes and diet powder to friends and family. The "dream" is an utter fantasy. The overwhelming majority of recruits lose thousands of dollars or more and drop out of the scheme rapidly. Millions of people have been fooled and have lost billions of dollars in the process.

Minimum Requirements for a Compliance Program

In your new role, you will need to build a new compliance system. Based upon our research, including conversations with multiple former employees and distributors, Herbalife's rules—given their bare enforcement—are ineffective. At a minimum, a genuine compliance program must include the following:

- An analysis of Herbalife's business and its compensation system to understand which incentives may encourage illegal or unethical practices—follow the money, as investigators say;
- Modifications to the compensation system to de-emphasize incentives for recruiting and increase incentives for achieving legitimate retail sales;
- Modifications to Herbalife's rules to allow free competition among online sellers and to allow price visibility so that distributors may sell at any discount they choose;
- A review of existing rules and revisions to those rules as needed;
- Publication and enforcement of rules in order to inform and convince employees and distributors throughout all levels of the organization that standards will be rigorously enforced;
- Appropriate compensation and protections for all compliance employees to allow them to function effectively and without fear;
- Independence of compliance from senior executives and senior distributors, such that top distributors are prohibited from inquiring about or inserting themselves into investigations, or enlisting senior executives to do the same on their behalf;
- Country-by-country and region-by-region systems for monitoring distributor conduct in real time;
- Adequate resources to create a credible compliance team commensurate with their duties and with the size and extent of Herbalife's distributor network;
- An anonymous procedure for receiving and investigating reports of wrongdoing;
- An extensive monitoring system to capture and analyze distributor promotional materials and to observe the conduct of distributors anonymously and without prior warning;
- Making top distributors responsible for the conduct of distributors in their downlines;
- Imposition of material financial sanctions on those who commit wrongs, profit from wrongdoing, or fail to enforce proper standards;
- Introduction of a pro-active system to collect, investigate and compensate consumer harm;
- Public announcement of the imposition of sanctions, so that all distributors understand the consequences of violating the rules and the law;
- Authority for the compliance department to engage separate legal counsel, where appropriate; and
- Authority for the compliance department to refer infractions to Federal, State and local regulators or prosecutors, where appropriate.

Under the Sales and Marketing Plan, Herbalife gives itself extensive power to investigate and remedy wrongs committed by distributors, but to date, we understand, these rules have been used only sporadically, ineffectively, and often simply to retaliate against disfavored distributors—all without deterring obvious violations of Herbalife's rules and applicable legal standards by top distributors.

The Work We Have Done So Far

We have shared our analysis with the public, beginning with a presentation at the Sohn Investment Conference on December 20, 2012. Since then, we have made several more presentations demonstrating the deceptive nature of Herbalife's business and the extraordinary harm Herbalife has caused, especially to economically vulnerable racial and ethnic minority groups. These presentations are available online at http://www.factsaboutherbalife.com/resource-library/, and we urge you to watch them:

"Who wants to be a Millionaire?"	December 20, 2012
"Robin Hood in Reverse"	November 22, 2013
"Herbalife in China"	March 11, 2014
"The Big Lie"	July 22, 2014

We have published a series of profiles covering 30 people so far, documenting the deceptive recruiting practices engaged in by senior Herbalife distributors (Founder's Circle, Chairman's Club and President's Team) with close ties to the Company, including:

John Tartol	Harry Lee & Candyce Johnson
Leslie Stanford	Brett Bartholomew & Katie Carr
Shawn Dahl	Garry & Jennifer De Brabander
Doran Andry	Russell Gain
Maurice & Sandra Smith	Anthony Powell
Steven & Debbie Combs	Kurt & Cindy O'Connell
John & Susan Peterson	David Bevan & Jane Clark
Paul Michaels	Michael Burton
Tish Rochin & Larry Thompson	Rick & Carla Berg
Brad Harris	Dan Waldron

Those profiles are available online at http://www.herbalifepyramidscheme.com/, and they are replete with examples of clear violations of rules purportedly on the books at Herbalife, including by current and former members of the Company's board of directors including Leslie Stanford and John Tartol. Despite the widespread violations of Herbalife's rules apparent from the profiles, those rules are seldom, if ever, enforced. The profiles also evidence pervasive violations of consumer protection laws, labor laws and other Federal, State and local laws and regulations. We encourage you to spend time examining these profiles; they paint a damning picture of Herbalife's most important distributors.

The profiles make clear that many of those most in need of oversight by a robust compliance department are at the top of the pyramid. Some of these senior distributors play a key role in the Company's management. For example: John Tartol, a longtime member of the Chairman's

Club and a current member of Herbalife's board of directors, has a long history of deceptive recruiting practices from which he has earned many millions of dollars, including discretionary bonuses awarded by Herbalife itself.[4] We have also profiled Leslie Stanford, a current member of the Chairman's Club and a former member of the board of directors,[5] and our July 22, 2014 presentation implicated Pedro Cardoso, another member of the Chairman's Club and a current member of the board of directors.[6]

Further, we understand from multiple sources that top distributors have an unusual level of access to senior executives, including Messrs. Johnson, Walsh, Goudis and De Simone, in particular with regard to compliance matters. These instances should be probed carefully and appropriate disciplinary action should be taken.

To credibly institute an effective compliance program, you will need the independence to examine the relationships between senior executives and senior distributors. You must have the authority to follow the trail of wrongdoing wherever it leads, including to the top of the pyramid and to the top levels of the executive suite. We can only hope the Company will afford you and your staff the authority and independence you need to do your job.

We have published a white paper on the practice of lead generation, a once-prevalent method of recruiting – which Herbalife supposedly shut down last year – that involves coaxing potential recruits (with misleading promises of easy riches) to provide their contact information and then selling that contact information to another recruit who was initially brought into the scheme in the same manner. That white paper, which is available online at http://www.herbalifepyramidscheme.com/deceptive-practices-supporting-herbalife-pyramid-scheme-lead-generation/, outlines Herbalife's long history of fostering and supporting lead generation, as well as Herbalife's self-serving (and ineffective) efforts to distance itself from the practice once the Company's business practices were subjected to public scrutiny. These corrective efforts were too long in coming and do not absolve Herbalife of responsibility for the massive harm inflicted on consumers by lead generation over more than a decade. As far as we are aware, no effective sanctions have been imposed upon the perpetrators of lead-generation systems. To the contrary, the Company has defended key distributors in litigation arising from their lead-generation practices and continues to lionize and financially reward those distributors.

Also posted on our website http://www.factsaboutherbalife.com/ is a documentary in which former Herbalife distributors tell their stories and speak out against the Company. These are the sorts of victims whose protection, we hope, would be a priority for any chief of compliance. We urge you to see their faces and hear their stories.

4 http://www.herbalifepyramidscheme.com/perpetrators/john-tartol.

5 http://www.herbalifepyramidscheme.com/perpetrators/leslie-stanford.

6 http://www.herbalifepyramidscheme.com/media/2014/07/Nutrition_Club_Presentation_The_Big_Lie_7.22.14.pdf.

Our websites are also full of primary source materials on the recruiting practices of Herbalife and its top distributors. As the new chief of compliance, you will find these materials useful in understanding the many issues that confront you.

The Critical Importance of a Robust Herbalife Compliance Department

Herbalife has a massive network of almost four million distributors operating in 91 countries. Those distributors host countless Success Training Seminars (STS) and Herbalife Opportunity Meetings (HOM), and they run tens of thousands of Nutrition Clubs, training programs, and Wellness Coaching programs throughout the world. These distributors hand out flyers, set up websites, make cold calls, send unsolicited emails and text messages, stop people on the street and otherwise do everything they can to bring new recruits into the Herbalife scheme. In the face of dismal statistics demonstrating the low likelihood of success in pursuing the Herbalife business opportunity, these distributors naturally resort to false promises and deceptive income claims. In an effort to sell the overpriced commodity products they were required to buy in order to climb the pyramid, they make misleading claims about the supposed health benefits of Herbalife's products. This is just the tip of the iceberg. We believe Herbalife distributors routinely violate a wide range of laws, including labor, tax, and anti-money laundering laws.

For many years, Herbalife has depended upon paltry—indeed illusory—compliance programs to create a veneer of legitimacy as the engine churns. As we showed in our December 20, 2012 presentation, enforcement of rules purportedly designed to encourage retail sales and discourage inventory-loading is essentially non-existent.[7] Herbalife also has repeatedly refused to collect its distributors' retail receipts, which distributors are contractually required to create, maintain and provide to the Company upon request,[8] even after Pershing Square offered to pay the cost of doing so.[9] Herbalife has made only the weakest of excuses for its failure to track and report retail sales.[10]

These excuses are meritless, and evidence about the extent to which Herbalife products are actually sold to genuine retail customers outside the distribution network would be not only highly material to investors and regulators, but also essential for any minimally effective compliance program. If there are few genuine, documented retail sales or if retail sales are actually at deep discounts from the Suggested Retail Prices, that would be important information to provide to all distributors and new recruits—to warn them that the retail-selling opportunity is

[7] http://www.factsaboutherbalife.com/media/2013/04/HLF-Presentation-Exec-Summary-final_4_9_13.pdf (Slides 127-28).

[8] Rule 17-A, available at http://factsaboutherbalife.com/wp-content/uploads/2012/12/Marketing-Plan-and-Business-Rules-2012.pdf. See also North America Advisory: Providing Retail Receipts to Customers (May 16, 2013), reminding Distributors to create Retail Receipts and to provide them to customers and, under Rule 18-E: Maintenance of Records, to keep copies of the Retail Receipts and deliver them to Herbalife "immediately upon request."

[9] http://www.factsaboutherbalife.com/robin-hood-in-reverse/ (Slide 43).

[10] June 1, 2009 Hr'g Tr., *Herbalife* v. *Ford*, No. 2:07-cv-2529-GAF-FMO (C.D. Cal.), Dkt. #300, at 13 (price-fixing concerns); http://video.cnbc.com/gallery/?video=3000140234 (privacy concerns).

illusory. The company and its top distributors constantly state that, in addition to commissions and royalties, supervisors have the opportunity to earn retail profits.

Herbalife has claimed (inconsistently) that the Company has either 250 or 350 staff members worldwide in its compliance department.[11] We have heard from an insider whom we consider to be reliable that the real number is far lower. But even taking Herbalife's numbers at face value, it is difficult to see how the Company could police almost 4 million distributors in 91 countries with a staff of 250 or 350 people. (That is well over 11,000 distributors per compliance staff member, let alone accommodating the challenges of geography, time zones and other impediments.) In addition, the Company has never, to our knowledge, disclosed the amount of money or other resources it spends annually on compliance. And, as far as we aware, the Company has never had a chief of compliance—until now.

We sincerely hope your arrival signals that Herbalife is finally going to begin addressing the widespread infractions of applicable law and of its own rules that we believe have been ongoing for many years. Viewed against the backdrop of Company's long history of lax or nonexistent compliance programs, the arrival of someone with an enforcement and consumer protection background is long overdue.

Compliance Priorities for Herbalife

In practice, the Herbalife compensation system incentivizes distributors to focus their efforts on recruiting new distributors into the scheme rather than selling Herbalife products to genuine retail customers outside the distribution network. Only a radical redesign of Herbalife's compensation system could remedy serious and ongoing violations of consumer protection laws and securities laws.

Modifying the incentive structure embedded in Herbalife's Sales and Marketing Plan, which promotes recruitment above all else, would be the most effective mechanism to reduce Distributors' recruitment focus. In addition, there are a number of ways in which a new compliance chief could curtail some of the most harmful practices that are prevalent throughout Herbalife. Below we outline seven potential priorities that you might consider focusing on as you get started.

1. ***Nutrition Club "Training" Programs***

On July 22, 2014, Pershing Square made a detailed public presentation entitled "The Big Lie," in which we showed that Herbalife Nutrition Clubs, which purport to be daily consumption centers for Herbalife products, operate in practice as recruitment centers for the poorest members of the disadvantaged communities targeted by Herbalife, including the urban Latino community in the United States. In our presentation, we showed that, in order to (i) lure potential recruits into the Herbalife scheme, (ii) convince them that they can be successful, and (iii) extract as much money

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[11] http://www.theglobeandmail.com/report-on-business/herbalife-kept-links-to-canadian-pyramid-scheme-for-a-decade/article13789659/ (claiming 350 staff members in compliance as of August 2013); http://www.cnbc.com/id/101103661 (claiming 250 staff members in compliance as of October 2013).

and unpaid labor from them as possible, the vast majority of Herbalife Nutrition Clubs offer so-called "training" programs.

Using Club 100 as a case study, we revealed that these purported "training" programs require aspiring Nutrition Club operators to (i) provide unpaid labor to established Nutrition Club operators in the form of making shakes and cleaning the premises; (ii) purchase and consume Herbalife products every day; (ii) go to other Nutrition Clubs and pose as customers to help club operators convince prospective recruits that they will have no trouble finding such customers; and (iv) enlist their family and friends to purchase and consume products and also pose as customers. Thus, "trainees" provide substantial benefits both to their upline club operators, who benefit from unpaid labor, mandatory consumption of Herbalife products and the misimpression that the "trainees" are genuine retail customers, as well as to Herbalife, which generates very substantial revenues from the mandatory consumption that is inherent in these so-called "training" programs.

Notwithstanding Herbalife's statements to the contrary, there is no real "training" involved: trainees spend most of their time mixing shakes and cleaning toilets. Trainees are also required to attend classes, where they purchase and consume Herbalife products, listen to testimonials of others who claim to be successful in the business, and are presented with deceptive projections of the income they can expect to earn once they are permitted to open their own Nutrition Clubs. These "training" programs often take months or even years to complete, with advancement dependent on subjective judgments made by the Nutrition Club operator as to whether a "trainee" has adequately mastered each skill.

These "training" programs are fundamentally deceptive and likely violate a number of consumer protection laws. In addition, we believe these "training" programs operate in violation of the Fair Labor Standards Act ("FLSA") and state law analogues.

The Department of Labor has developed a six-factor test to distinguish genuine "trainees" who are learning a vocation from "employees" who must be compensated in accordance with wage and hour regulations.[12] Herbalife Nutrition Club "training" programs fail on every factor.[13] There is no real training, the programs are not for the benefit of the trainees, there are no regular employees in the Clubs, the Club operators benefit substantially from the free labor, and trainees are told that they are essentially guaranteed a highly lucrative job if they complete the training. Indeed, in July 2013, Herbalife issued an advisory to its distributors warning that participants in Nutrition Club "training" programs could be seen as unpaid workers, in violation of federal law. We urge you either to revamp these "training" programs from the ground up or to ensure that the "trainees" who work tirelessly in Nutrition Clubs are paid at least the minimum wage. Without

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[12] *Opinion Letter Fair Labor Standards Act (FLSA)*, FLSA2004-5NA, 2004 WL 5303033 (Cir. Ct. May 17, 2004); *see also* U.S. Dep't. of Labor, Fact Sheet #71: Internship Programs Under The Fair Labor Standards Act (Apr. 2010), *available at* http://www.dol.gov/whd/regs/compliance/whdfs71.pdf.

[13] http://www.herbalifepyramidscheme.com/media/2014/07/Nutrition_Club_Presentation_The_Big_Lie_7.22.14.pdf (Slides 156-57).

vigilant enforcement, Herbalife's July 2013 Advisory will be unmasked as hypocritical window-dressing.[14]

2. ***Herbalife's Compensation Statement***

It is unclear whether your new role as head of "global member compliance" will give you any authority to demand changes from Herbalife itself. We hope that it will. In light of the ubiquitous nature of deceptive income claims about the Herbalife business opportunity, one of the most important changes a new compliance chief might push for would be substantial revision to Herbalife's misleading income disclosure, sometimes called its Compensation Statement.

From 2004 to 2012, Herbalife's Compensation Statement was highly misleading, for many reasons. *First*, the 2004-2012 versions of Herbalife's Compensation Statement showed average compensation only for "Active Sales Leaders" defined as those with at least 2,500 Volume Points in the year after becoming a Sales Leader. That obscure definition had the effect of excluding approximately 93% of all Herbalife distributors from the calculation. *Second*, the 2004-2012 versions of Herbalife's Compensation Statement purported to disclose "Average Earnings" but did not take any account of distributor expenses. Not until July 2012 did Herbalife even acknowledge that its "Average Earnings" were "gross, not net income." *Third*, the 2004-2012 versions of Herbalife's Compensation Statement stated that "[o]ver 25% of Distributors reach the rank of Supervisor and above." But our analysis demonstrates only approximately one in six new Distributors reaches the rank of Supervisor. The statistical likelihood of any new recruit becoming financially successful is nearly nil, especially when considering the year-on-year churn of entrants.

In February 2013, after we criticized the prior versions of the Compensation Statement, Herbalife revised it substantially, but only in the United States. The substantial revision of the Compensation Statement constitutes an admission that the 2004-2012 versions of the Compensation Statement were misleading. The new version is not much better.

The 2014 Compensation Statement discloses that 88% of distributors received no payments from Herbalife during 2013, and further discloses that 62.5% of distributors who qualified as Supervisors in 2013 failed to re-qualify at the end of the year. Despite these disclosures, Herbalife's 2014 Compensation Statement remains misleading in several respects. *First*, the 2014 Compensation Statement provides earnings figures only for "Sales Leaders with a Downline," which account for only 13.6% of Herbalife distributors. *Second*, the 2014 Compensation Statement no longer discloses median compensation figures, which has the effect of obscuring both the paltry earnings for those at low levels of the Herbalife pyramid and the extraordinary earnings of those at the top. *Third*, the 2014 Compensation Statement does not include any specific expense information, despite its acknowledgement that such expenses "might include advertising or promotional expenses, product samples, training, rent, travel, telephone and internet costs, and miscellaneous expenses."

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[14] In addition, we encourage you to examine whether Herbalife Nutrition Clubs are in compliance with tax, zoning, food safety, branding, public accommodations and employment law. We have serious doubts.

The misleading nature of the Compensation Statement is only compounded by statements by Herbalife executives that falsely represent the likelihood of success in pursuing the Herbalife business opportunity. For example, in a CNBC interview on January 10, 2013 in connection with Herbalife's Investor Day, Andrew Ross Sorkin asked President Des Walsh whether "a large majority of those [new] distributors at the end of year one don't become the millionaires or even making $100,000 or $50,000 or $10,000 that they see in the ads but ultimately that they lose money. Is that true?" Mr. Walsh responded:

> Absolutely not! . . . Of those distributors who come for business opportunity, absolutely they make money. Here is the reality, our core training is for a new distributor who wants to build a business. If they talk to 10 customers a day, 10 people a day about the products and business opportunity. I have never spoken to any distributor who is doing that, who's actively engaged, who is not making money.[15]

Given the rate at which new distributors fail, it is preposterous for Herbalife senior management to be making such unqualified statements about the prospects for success among low-level distributors. Moreover, if distributors followed Mr. Walsh's advice and each spoke to ten new people each day, they would quickly exhaust the adult population of the United States. The impossibility of following this advice, which Walsh claims is part of Herbalife's "core training," reveals that failure in the Herbalife business opportunity is a fait accompli.

3. ***Deceptive Income Claims***

As explained above, deceptive income claims are ubiquitous throughout the Herbalife distribution network. As a starting point, we encourage you to review the profiles we have released, which document countless misleading income claims made by senior distributors. For example, the profile on Doran Andry, which can be found here http://www.herbalifepyramidscheme.com/perpetrators/doran-andry, provides links to a Financial Success System video in which Andry states that, by following his system, in 10 years a distributor could have 27,475 Nutrition Clubs operating in his downline, annual revenue of nearly $1.4 billion, and net annual income of $55.8 million. Such claims are absurd on their face, but they lure many credulous and unsophisticated people into the Herbalife scheme. Some additional examples include the following:

- "We have a plan here that shows you how you can make $120,000 in a year or $240,000 a year," and "we have it up to [$]3.6 million for those of us who really like to dream big and think big."
  – Leslie Stanford (former board member)

- "How many of you would like to make at least a million dollars a year? Every extra million dollars, I find, comes in handy.

[15] http://www.cnbc.com/id/100369028.

2 million? 5 million?"
– John Tartol (current board member)

- "[T]his opportunity can provide persons with a career level / residual income of an average of $100,000 per year."
– Financial Success System publication (affiliated with Doran Andry)

- Cash flow of "$10,000+ by month 6th [sic] is common."
– Freedom Team Presentation (affiliated with Kurt & Cindy O'Connell)

- "Just after six months in the business, our income was over $6,000 a month. And by the eleventh month in the business, we were over $12,000 a month. . . . After sixteen months in the business, we were over $25,000 a month. And that number's staggering—the type of lifestyle you can have with that income. And since then, the income's doubled, tripled, quadrupled. It's just been absolutely exciting. And over the last nine years, we have made millions, we have been paid millions of dollars for doing this business. And what I know, you could have the same opportunity as we had."
– Michael Burton (later went into personal bankruptcy)

- "[I]t was crazy, it was unbelievable, I mean, we were able to pay cash for a £80,000 Ferrari. It was a lifelong dream of mine. And then we were able to buy, well as a Christmas present for Jane, her favorite car in the entire world, a 911 Porsche Carrera. It was absolutely fantastic. We had it built specially for us. And, you know, you should have seen her face. It was one the best presents I think I could ever have bought anybody. And we do play a lot, and we socialize a lot, we go out jet-skiing a lot. And it's absolutely fantastic. It really is a life, it's all you dream, really."
– David Bevan

These statements are materially false and misleading. The vast majority of Herbalife distributors make far less than the minimum wage.

You might also peruse the pages of *Herbalife Today*, a distributor magazine published by Herbalife. We analyzed every issue we could get our hands on and determined that from 1997 and 2004, *Herbalife Today* included approximately 393 income testimonials. Taken as a group, those income testimonials implied an average annual income of $178,000 per year. The probability of earning $178,000 per year as an Herbalife distributor is approximately 1 in 5,000. Thereafter, Herbalife preferred qualitative statements – 'More money than he could have imagined,' for example – but continued to emphasize dream-like financial success.

Or you could attend an Herbalife Extravaganza. At the Herbalife 2011 Extravaganza in Las Vegas, Founder's Circle member Susan Peterson told attendees that, if they were not getting rich in Herbalife, "it's wrong" and that they were taking things for granted:

> A lot of us, we built our organizations not when it was easy but when it was hard. When it was terrible. When it was tough. And to make a fortune in the tough times is really something. But to make it in the easy times you would think everyone would do it and to not do [it] is just to me wrong. I mean if you are not getting rich today in Herbalife, I'm going to be honest, it's wrong. It's really wrong. It means you're taking things for granted.[16]

Of course, "mak[ing] a fortune" is not a realistic prospect for anyone other than the very few distributors at the top of the Herbalife pyramid, many of whom were friends with the founder of the company or arrived in the early years. While a few people ascend to the upper ranks annually, there is very little turnover, year on year, among the most successful distributors.

The distributors who made these statements did so in violation of Herbalife's own rules. Indeed, the TAB Team Production Bonus Application and Agreement requires every distributor seeking commissions to agree not "to misrepresent Herbalife's . . . earnings opportunity," and Herbalife Rule 8-J gives you "absolute discretion" to "take whatever actions or measures" you "deem[] necessary and appropriate" in response to these violations. We urge you to use that power and make an example of the senior distributors whose deceptive conduct is a matter of public record. Herbalife's rules still permit you to address these violations and to impose appropriate sanctions that will send a salutary message to the entire network that standards will be upheld vigorously and evenhandedly.

4. ***Sales of Recruiting Materials***

In addition to making deceptive income claims in their own right, many senior Herbalife distributors also run online recruiting businesses that teach paying customers how to lure new recruits into the Herbalife scheme, and provide them with the tools to do so. The profiles that we have published are filled with examples of online businesses that sell recruiting scripts, "decision packs," and access to training seminars where new distributors are taught how to use deceptive income claims and high-pressure sales tactics to recruit new distributors.

To pick just one example, a script published by President's Team members Maurice and Sandra Smith, which they tell distributors to use when talking to new recruits, directs those distributors to "maintain control of . . . the conversation by not jumping around following [recruits] with their questions." Rather, distributors are told to respond to questions by saying "let me ask you just a couple of things real quick so I can best answer everything for you – okay? (more of a statement than a question)." They are also told to obscure the cost of using the Smiths' proprietary "system," instructing distributors to explain, if a recruit asks about the cost, that

[16] https://vimeo.com/79692340.

"marketing websites and tools" are available "for a low monthly subscription" and then "don't ask [the recruit] if they understand or like this, just move on."[17]

We urge you to crack down on the sale of these sorts of deceptive recruiting materials. Fledgling distributors armed with such deceptive recruiting materials can do enormous damage to unsuspecting consumers. Past infractions still demand the imposition of sanctions if Herbalife's compliance program is to have any teeth and credibility.

5. ***Lead Generation***

As noted above, we have published a white paper outlining the deceptive practice of lead generation and documenting Herbalife's long history of supporting and fostering the practice.[18] As explained in that white paper, Herbalife fostered the development of lead generation beginning around 2001, and for more than ten years, Herbalife profited from, promoted and defended the practice. Beginning in late 2012, Herbalife expressly recognized its potential liability for lead generation and began taking steps to distance itself from the practice.[19] But Herbalife's purported rule changes were too little, too late. These measures do not permit Herbalife to escape responsibility for all of the damage inflicted on unwitting consumers by lead generation in the past or going forward to the extent lead generation continues, which we think it does. Moreover, despite its belated rule changes, Herbalife continues to promote and celebrate many of the senior distributors who were behind the practice of lead generation.

We urge you, first and foremost, to ensure that the practice of lead generation (now acknowledged by Herbalife to be inappropriate and legally risky) has been discontinued. In addition, we urge you to hold accountable those distributors who engaged in, and profited enormously from, lead generation. Those distributors must not be permitted to wreak tremendous harm on consumers, reap huge rewards, and then simply sweep their past wrongdoing under the rug. Appropriate sanctions on perpetrators would send a useful message.

6. ***Product Claims***

In order to maintain their positions or advance in the Herbalife pyramid, distributors are required to order large volumes of Herbalife products. Because there is little retail demand for these overpriced and under-advertised commodity products, distributors resort to outlandish claims

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[17] http://www.herbalifepyramidscheme.com/media/2014/09/Smith-Exhibit-F.pdf.

[18] http://www.herbalifepyramidscheme.com/deceptive-practices-supporting-herbalife-pyramid-scheme-lead-generation/.

[19] *See, e.g.*, Herbalife's December 7, 2012 Advisory, available at http://herbalifepyramidscheme.com/media/2014/02/Advisory-12.7.12-Unregistered-Business-Methods-Notice-Re-Bridge2Business-USEN.pdf (recognizing "the potential exposure to Herbalife" if the Company recognized qualifications attributable to the sale of unregistered business methods because such support "could be misconstrued as supporting and rewarding Distributors with recognition, when the methods used to achieve that qualification may involve misleading advertising or other abuses and therefore put the Distributor and Herbalife at risk").

about the supposed health benefits of Herbalife products in order to sell their inventory of those products for whatever price they can get.

The Internet is teeming with examples of outrageous claims about Herbalife products, including that Herbalife products can cure diabetes, arthritis, cysts, fibroids, ulcers, gout, seasonal and food allergies, hay fever, chronic sinusitis, sleep apnea, insomnia, ulcerative colitis, migraines, chronic fatigue syndrome, PMS, menopause, osteoporosis, back pain, joint pain, hemorrhoids, constipation, irritable bowel syndrome, depression, anxiety disorders, attention deficit disorder, obsessive compulsive disorder, heart palpitations, heart disease, anemia, Crohn's disease, Parkinson's disease, hepatitis, lupus, multiple sclerosis, hypoglycemia, pancreatitis, fibromyalgia, and the common cold. It is quite a list.

One website, recently taken down, went so far as to claim:

> In September 2010 my father was diagnosed with terminal cancer and given a short time to live. I started him on the products and within 3 days he was out of bed and able to walk around the yard. He is still with me today.

Any serious compliance program at Herbalife must exercise an effective degree of control over what distributors say in their efforts to unload the large volumes of Herbalife products with which they find themselves saddled. To be effective, compliance cannot simply react one-off to egregious cases, but must affirmatively regulate distributors' conduct and enforce the rules across the network and consistently over time.

7. Rules Purportedly Designed to Incentivize Retail Sales

In response to accusations that the Company is a pyramid scheme, Herbalife often points to three rules purportedly designed to ensure retail sales and discourage inventory-loading: (i) the 70% Rule, (ii) the Ten Customer Rule; and (iii) Herbalife's return policy. Pershing Square believes, based on our investigation, that in the past Herbalife's compliance department made essentially no effort to enforce or audit compliance with the 70% Rule or the Ten Customer Rule and has taken steps to make Herbalife's return policy unattractive to distributors.

For example, a deposition taken in 2009 of Jacqueline Miller, an Herbalife employee responsible for enforcing the 70% Rule, established that, between 2006 and 2009, Herbalife had disciplined approximately 10, but certainly fewer than 25, distributors for violating the 70% Rule.[20] This amounts to approximately 1 out of every 100,000 Herbalife distributors. Moreover, in a July 5, 2012 letter to the Securities & Exchange Commission, Herbalife stated that "we do not rely on the '70% rule' in any meaningful way." In the same 2009 deposition, Miller testified that the individual at Herbalife with responsibility for auditing compliance with the Ten Customer Rule worked "in the refunds and repurchase area,"[21] suggesting that Herbalife may only audit distributors for compliance with the Ten Customer Rule when those distributors attempt to return

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[20] *See Herbalife* v. *Ford*, No. 2:07-cv-2529-GAF-FMO (C.D. Cal.), Dkt. #143-2 ("Miller Dep."), at 21

[21] Miller Dep. at 91-92.

products to the Company. This, of course, weakens both the Ten Customer Rule and the return policy.

We urge you to routinely and systematically audit distributors for compliance with the 70% Rule and the Ten Customer Rule, including by collecting the retail receipts Herbalife is contractually entitled to obtain. And we urge you not to use such audits as a sword to prevent distributors from trying to return products to the Company. After all, rules and policies like these only affect the determination whether an organization is a pyramid scheme if they are "enforced and actually serve[s] to deter inventory loading and encourage retail sales." *Webster* v. *Omnitrition*, 79 F.3d 776, 783 (9th Cir. 1996).[22]

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Herbalife has a long record of poor compliance practices. The lack of adequate monitoring of distributors' sales and recruiting and the lack of enforcement of legal and internal standards has furthered the harm caused to consumers. To create a serious compliance effort at Herbalife, if you were permitted to do so and supported in that effort, will require enormous resources and resolve.

We look forward to hearing from you to arrange a meeting to explain these issues in greater detail.

Very truly yours,

David Klafter

David Klafter, Senior Counsel

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[22] Even as written, these rules and policies are plainly ineffective. The 70% Rule and the Ten Customer Rule apply only to distributors who are at the level of Supervisor or above (about 20% of all distributors) and only require those distributors to *state* (rather than *demonstrate*) that they are in compliance. In addition, a distributor can satisfy the 70% Rule by selling products to downline distributors at wholesale (without regard for whether those products are ultimately sold to retail customers, stored in a garage, consumed, or thrown away), and can satisfy the Ten Customer Rule by selling trivial quantities of products at prices at which the distributor loses money. In order to take advantage of the return policy, a distributor is required to resign forever. Further, distributors are only permitted to return products in "resalable" condition, which is determined by Herbalife in its sole discretion and is particularly problematic because distributors are encouraged to open, sample and give away small amounts of Herbalife products immediately upon receiving them. In addition, when a distributor returns products, Herbalife claws back all rewards and qualifications earned on account of those products—meaning that upline Supervisors are often better off buying the products back themselves rather than allowing downline distributors to return those products to Herbalife.