

LEGISLATIVE COUNCIL BRIEF

Pyramid Schemes Prohibition Bill

INTRODUCTION

A At the meeting of the Executive Council on 17 May 2011, the Council ADVISED and the Chief Executive ORDERED that the Pyramid Schemes Prohibition Bill (“the Bill”) (copy at Annex A) should be introduced into the Legislative Council.

JUSTIFICATIONS

The Vice of Pyramid Schemes

2. Pyramid schemes refer to those schemes where participants’ income is primarily derived from recruiting further participants. Participants are required to pay a “participation fee” to join such schemes (which would be shared among the participants who introduce them, other participants at the higher tiers of the hierarchy or the establishers of the schemes), in return for the right to earn their income entirely or mainly from the introduction of further new participants (i.e. a right to receive a share of the “participation fee” paid by new participants). Economic activities like selling of goods and services are lacking or are limited. In such schemes where the sale of goods or services is involved, the selling and buying are only used as a smoke-screen. The participation fee may be packaged as a payment for goods or services acquired by participants for their own consumption or onward sale, and the goods or services are often of dubious value or at an inflated price. The premium above the real value is indeed the payment for the right to receive benefits for the introduction of further new participants.

3. Pyramid schemes serve no economic purpose. By encouraging the introduction of new participants from which participation

fees are extracted, these schemes would eventually become unsustainable when recruitment runs out¹, resulting in a loss down the line. Since new participants may be recruited from amongst participants' family members and friends, participants may come under social or family pressure when the schemes fall through. Furthermore, promoters of some schemes adopt high pressure tactics or make misrepresentation about earning opportunities when recruiting participants. There were some cases where participants were tempted to borrow substantive sums (with the help of forged documents in certain cases) to join the schemes, only to find out later that they were unable to recruit enough new participants to generate sufficient recruitment payments to repay their debts.

Current Legislative Provisions

4. At present, the Pyramid Selling Prohibition Ordinance (Cap. 355) ("the Ordinance") prohibits pyramid selling. As defined in the Ordinance, a scheme is a pyramid selling scheme whereby -

- (a) a participant in the scheme is granted a licence or right to introduce another participant into the scheme who is also granted such licence or right, and who may further extend the chain of persons; and
- (b) a participant receives a reward on, or at any time after, the introduction into the scheme by him of another participant which reward is based, whether wholly or in part, otherwise than on the fair market value of goods or services actually sold by him or by or through that other participant.

5. The Ordinance provides that any person who knowingly promotes (meaning "establishes, advertises, manages or assists in the management") a pyramid selling scheme commits an offence and is liable on conviction upon indictment to a fine of \$100,000 and to imprisonment for three years.

¹ Under a scheme design where a participant may introduce five new participants, there could be 2,441,406 participants if the scheme expands to ten full tiers.

Limitations

6. The current provisions of the Ordinance, particularly the definition of “pyramid selling scheme”, are no longer effective in combating objectionable schemes which adopt a pyramid structure in various guises. In 2003 and 2004, when ruling on two cases involving alleged pyramid selling schemes (CACC 96/2003 and CACC 55/2004), the Court of Appeal acquitted the defendants in both cases of charges of breaches of the Ordinance. The Court held that the Ordinance implied that the operation of a pyramid selling scheme **must** involve the selling of goods or services, which meant that schemes not involving the sale of goods or services would fall outside the scope of the Ordinance. The Court further held that the Ordinance implied that that a pyramid selling scheme must involve the sale of goods and services **by or through participants**. This means that schemes under which goods or services are sold in other ways (for example, sold by the company directly to new participants) would fall outside the scope of the Ordinance too.

Review

7. We have reviewed the current regulatory approach, and the effectiveness and operation of the Ordinance, having regard to regulatory regimes in other jurisdictions and the judgments of the Court referred to in paragraph 6 above.

(a) Regulatory approach

8. Under the existing regulatory regime implemented through the Ordinance, express provisions are in place to prohibit undesirable pyramid selling schemes. Many other jurisdictions, including the United Kingdom, Ireland and Australia, adopt a similar approach. On the other hand, in the Mainland of China and Singapore, a total ban on marketing schemes adopting a multi-level structure is imposed. Only schemes meeting specified requirements and registered with competent authorities are allowed.

9. We consider that the regulatory approach currently adopted in Hong Kong, i.e. enacting express provisions prohibiting pyramid

schemes, is in line with international practices and appropriate to our legal and economic environment. Such an approach will avoid over-regulation of legitimate multi-level marketing schemes which are themselves not objectionable. We therefore propose to maintain our current approach.

(b) Definition of “Pyramid Scheme”

10. In the light of the Court of Appeal’s judgments referred to in paragraph 6 above, we need to define more clearly what constitutes a “pyramid scheme”. We consider that the new definition should, based on the fundamental characteristics of a pyramid scheme, stipulate clearly that the incentives for participants to join such a scheme come from benefits which are primarily derived from the recruitment of new members. Specifically, we propose that a pyramid scheme should be defined as a scheme in which new participants must make a payment (or other consideration) to other participants and/or establishers and such a payment or consideration is entirely or substantially induced by the prospect held out to the new participants that they will be entitled to receive a benefit (financial or other otherwise) which is derived entirely or substantially from the introduction of further new participants. In other words, whether sale of goods or services is involved is not material.

(c) Regulatory Reach

11. A pyramid scheme can only be sustained by the introduction of new participants by existing participants. To combat and curb the expansion of pyramid schemes, we propose that provisions be enacted with a view to deterring people from participating in and inducing others to join pyramid schemes. Specifically, we propose that any participants who induce or attempt to induce other persons to participate in a pyramid scheme, with the knowledge that the benefits they may get from joining the scheme are entirely or substantially derived from the introduction of further new participants, should be held criminally liable. Innocent participants, i.e. participants who do not satisfy both the above limbs, will not be caught by the law. In view of the role that participants play in sustaining pyramid schemes, we propose that knowing participants as defined should be liable to the same maximum penalty as persons

establishing, promoting or managing a pyramid scheme.

(d) Enhanced Deterrent

12. At present, the Ordinance prescribes as the maximum penalty a fine of \$100,000 and imprisonment for three years. We consider that they are insufficient to deter people from establishing or participating in pyramid schemes, having regard to the potentially enormous financial returns². Having regard to the level of penalties of other offences of a similar nature³, we propose to increase the maximum penalty to imprisonment for seven years and a fine of \$1 million on conviction upon indictment.

OTHER OPTIONS

13. The current Ordinance fails to tackle objectionable pyramid schemes effectively. There are no options other than improving the law.

THE BILL

14. To give effect to the proposals at paragraphs 8 to 12 above, almost the entire Ordinance would have to be amended. For clarity, we propose that a new piece of legislation be enacted instead.

15. The main provisions of the Bill are -

- (a) clause 1 provides for the short title and commencement. The Bill if enacted will be known as “Pyramid Schemes Prohibition Ordinance”, i.e. the reference to “selling” will be removed;

² In the hypothetical case referred to in footnote 1, if each participant pays \$5,000 as the participation fee, the aggregate fees will amount to \$12.2 billion.

³ The offence of fraud under section 16A of the Theft Ordinance (Cap. 210) and the common law offence of conspiracy to defraud both carry a maximum penalty of 14 years’ imprisonment without a fine. The offence of “fraudulently inducing persons to invest money”, contrary to section 107 of the Securities and Futures Ordinance (Cap. 571), carries a maximum sentence of seven years in prison and a fine of \$1 million.

- (b) clause 3 defines the meaning of “pyramid scheme”, with clause 4 setting out the matters which the court must consider when determining if a scheme involving the sale of goods or services (or both) is a pyramid scheme;
- (c) clause 5 provides for the offence of knowingly promoting a pyramid scheme and the offence of participating in and inducing others to join a pyramid scheme with the knowledge that the benefit receivable is entirely or substantially derived from the introduction of new participants into the scheme. Either offence attracts a maximum penalty of a fine of \$1,000,000 and imprisonment for seven years upon conviction on indictment;
- (d) clause 6 provides that if a body corporate or a member of an unincorporated body commits an offence under the Bill, a relevant person of the body is also liable for the offence if it is proved that the offence was committed with the consent or connivance or is attributable to the neglect of that person;
- (e) clause 7 empowers the court to order a person who is convicted of an offence under the Bill to pay compensation to any person who has suffered financial loss arising from the offence; and
- (f) clause 9 repeals the Ordinance.

B The Ordinance is at Annex B.

LEGISLATIVE TIMETABLE

16. The legislative timetable is as follows -

Publication in the Gazette	20 May 2011
First Reading and commencement of Second Reading debate	1 June 2011

Resumption of Second Reading debate, to be notified
committee stage and Third Reading

IMPLICATIONS OF THE PROPOSALS

17. The proposal has no economic, financial, productivity, environmental, sustainability or competition implications. Additional workload arising from the implementation of the proposals, if any, will be absorbed by the relevant departments. The proposal is in conformity with the Basic Law, including the provisions concerning human rights. The Bill does not contain any express provisions on its binding effect. Neither does the current Ordinance.

PUBLIC CONSULTATION

18. We consulted the public from December 2010 to January 2011 on the proposals at paragraphs 8 to 12 above. The great majority of respondents, including the Direct Selling Association of Hong Kong (which comprises major multi-level marketing companies in Hong Kong) support the proposals. We briefed the Economic Development Panel of this Council on the outcome of the public consultation on 28 March 2011. Members of the Panel support our proposals and urge for their early introduction into this Council.

PUBLICITY

19. A press release will be issued today and a spokesman will be available to handle media and public enquiries.

BACKGROUND

20. The Ordinance currently prohibits pyramid selling schemes. Its effectiveness has been eroded by new tactics that have emerged amidst changing socio-economic conditions. We have completed a review of the Ordinance and consulted the public on a package of legislative amendments aimed at combating pyramid schemes.

ENQUIRIES

21. Enquiries on this brief can be addressed to Mr K.C. Yau, Principal Assistant Secretary (Commerce and Industry), whose telephone and fax numbers are 2918 7449 and 2869 4420 respectively.

Commerce, Industry and Tourism Branch
Commerce and Economic Development Bureau
20 May 2011

A BILL

To

Prohibit certain acts in relation to a pyramid scheme and to provide for related matters.

Enacted by the Legislative Council.

1. Short title and commencement

- (1) This Ordinance may be cited as the Pyramid Schemes Prohibition Ordinance.
- (2) This Ordinance comes into operation on a day to be appointed by the Secretary for Commerce and Economic Development.

2. Interpretation

In this Ordinance—

goods (貨品) includes all chattels personal and things in action;

new participant (新參與者) includes a person who has applied, or been invited, to participate in a pyramid scheme;

participant (參與者) means a person who participates in a pyramid scheme;

participate (參與) means to take part in a pyramid scheme in any capacity other than as a promoter of the scheme;

participation payment (參與費)—see section 3(1)(a);

promote (推廣) means establish, advertise, manage or assist in the management of a pyramid scheme;

promoter (推廣者) means a person who promotes a pyramid scheme;

recruitment payment (招募得益)—see section 3(1)(b).

3. What is a pyramid scheme

- (1) A pyramid scheme is a scheme with all of the following characteristics—
 - (a) to participate in the scheme, any or all new participants must provide either of the following (*participation payment*)—
 - (i) a financial or non-financial benefit to, or for the benefit of, any participant or any promoter of the scheme;
 - (ii) a financial or non-financial benefit partly to, or for the benefit of, any participant or any promoter of the scheme and partly to, or for the benefit of, another person;
 - (b) the making of the participation payment is entirely or substantially induced by the prospect held out to the new participant that the new participant will be entitled to either of the following (*recruitment payment*)—
 - (i) a financial or non-financial benefit to, or for the benefit of, the new participant;
 - (ii) a financial or non-financial benefit partly to, or for the benefit of, the new participant and partly to, or for the benefit of, another person;
 - (c) the recruitment payment referred to in paragraph (b) is entirely or substantially derived from the introduction to the scheme of a further new participant.
- (2) A scheme may be a pyramid scheme regardless of—
 - (a) who holds out to a new participant the prospect of entitlement to a recruitment payment;
 - (b) who is to make a recruitment payment to a new participant; and
 - (c) who is to introduce a further new participant to the scheme.

- (3) A scheme may be a pyramid scheme even if it has any or all of the following characteristics—
- (a) the scheme involves the marketing of goods or services (or both);
 - (b) a participation payment may or must be made after a new participant begins to participate in the scheme;
 - (c) making a participation payment is not the only requirement in order to be eligible to participate in the scheme;
 - (d) making a participation payment is not the only requirement in order to be eligible to receive a recruitment payment under the scheme;
 - (e) the holding out of the prospect of entitlement to a recruitment payment does not give any new participant a legally enforceable right;
 - (f) the arrangement for the scheme is not recorded in writing (whether entirely or partly).

4. Matters to be considered by court in schemes involving marketing of goods or services

- (1) To determine, for the purpose of this Ordinance, whether a scheme that involves the marketing of goods or services (or both) is a pyramid scheme, a court must have regard to the following matters in determining whether a participation payment under the scheme is entirely or substantially induced by the prospect held out to a new participant of entitlement to a recruitment payment—
- (a) whether the participation payment bears a reasonable relationship to the value of the goods or services that the new participant is entitled to be supplied with under the scheme, having regard to the price of comparable goods or services available elsewhere;

- (b) the emphasis given in the promotion of the scheme to the entitlement of the new participant to the supply of goods or services by comparison with the emphasis given to the new participant's entitlement to a recruitment payment.
- (2) Subsection (1) does not limit the matters to which the court may have regard in determining whether a participation payment is entirely or substantially induced by the prospect held out to a new participant of entitlement to a recruitment payment.

5. Offences in relation to pyramid scheme

- (1) A person who knowingly promotes a pyramid scheme commits an offence.
- (2) A person who—
 - (a) participates in a pyramid scheme;
 - (b) knows or ought reasonably to know that any benefit that the person may get from participating in the scheme would be entirely or substantially derived from the introduction to the scheme of new participants; and
 - (c) induces or attempts to induce another person to participate in the scheme,
 commits an offence.
- (3) A person who commits an offence under subsection (1) or (2) is liable on conviction on indictment to a fine of \$1,000,000 and to imprisonment for 7 years.

6. Liability of directors, partners, etc.

- (1) If an offence under this Ordinance is committed by a body corporate or by a person as a member of an unincorporated body, and it is proved that the offence has been committed with the consent or connivance or is attributable to the neglect of a person specified in subsection (2), that person also

commits the offence and is liable to be proceeded against and punished accordingly.

- (2) The person referred to in subsection (1) is a person who, at the time of the offence, was—
- (a) (in the case of a body corporate) a director, secretary, principal officer or manager of the body corporate;
 - (b) (in the case of a member of an unincorporated body) a partner or office holder in or a member or manager of the unincorporated body; or
 - (c) (in either case mentioned in paragraph (a) or (b)) purporting to act in the capacity of a person referred to in that paragraph.

7. **Power to award compensation**

- (1) If a person is convicted of an offence under this Ordinance, the court may, in addition to passing any sentence that may otherwise be passed by law, order the person to pay an amount of compensation that it thinks reasonable to any person who has suffered financial loss resulting from that offence.
- (2) An amount of compensation ordered to be paid to a person under subsection (1) is recoverable as a civil debt.

8. **Saving of rights and claims**

This Ordinance does not limit, restrict or otherwise affect any rights or claims a person would have had if this Ordinance had not been enacted.

9. **Pyramid Selling Prohibition Ordinance repealed**

The Pyramid Selling Prohibition Ordinance (Cap. 355) is repealed.

Explanatory Memorandum

The object of this Bill is to prohibit certain acts in relation to a pyramid scheme and to provide for related matters.

2. Clause 1 sets out the short title and provides for commencement.
3. Clause 2 defines certain expressions used in the Bill.
4. Clause 3 defines what a pyramid scheme is. A pyramid scheme is a scheme with all of the following characteristics—
 - (a) to participate in the scheme, a new participant must provide a financial or non-financial benefit (*participation payment*);
 - (b) the making of the participation payment is entirely or substantially induced by the prospect held out to the new participant that the new participant will be entitled to a financial or non-financial benefit (*recruitment payment*);
 - (c) the recruitment payment is entirely or substantially derived from the introduction to the scheme of a further new participant.
5. Clause 4 provides for the matters which must be considered by the court when determining whether a participation payment under a scheme involving the marketing of goods or services (or both) is entirely or substantially induced by the prospect held out to a new participant of entitlement to a recruitment payment.
6. Clause 5 provides for offences in relation to a pyramid scheme. A person commits an offence if—
 - (a) knowingly promoting a pyramid scheme; or
 - (b) participating in a pyramid scheme and inducing (or attempting to induce) another person to participate in the scheme and knowing that any benefit gained from that

participation is entirely or substantially derived from the introduction to the scheme of new participants.

The maximum penalty for both offences is a fine of \$1,000,000 and imprisonment for 7 years.

7. Clause 6 provides for the liability of a relevant person of a body corporate or unincorporated body if the body corporate or a person as a member of the unincorporated body commits an offence under the Bill.
8. Clause 7 empowers the court to order a person who is convicted of an offence under the Bill to pay compensation to any person who has suffered financial loss resulting from the offence.
9. Clause 8 clarifies that the enactment of the Bill is not to be interpreted as affecting any rights or claims.
10. Clause 9 repeals the Pyramid Selling Prohibition Ordinance (Cap. 355).

Chapter:	355	PYRAMID SELLING PROHIBITION ORDINANCE	Gazette Number	Version Date
		Long title		30/06/1997

To prohibit the promotion of pyramid selling schemes and to provide for connected matters.

[1 September 1980] L.N. 196 of 1980

(Originally 25 of 1980)

Section:	1	Short title		30/06/1997
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This Ordinance may be cited as the Pyramid Selling Prohibition Ordinance.

Section:	2	Interpretation		30/06/1997
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In this Ordinance, unless the context otherwise requires-

"goods" (貨品) includes all chattels personal and things in action;

"promote" (推廣) means establish, advertise, manage or assist in the management of a pyramid selling scheme;

"pyramid selling scheme" (層壓式推銷計劃) means a scheme whereby-

- (a) a participant in the scheme is granted a licence or right to introduce another participant into the scheme who is also granted such licence or right and who may further extend the chain of persons who are granted such licence or right, notwithstanding that there may be a limitation to the number of participants or that there may be any further conditions affecting eligibility for such licence or right; and
- (b) a participant receives a reward on, or at any time after, the introduction into the scheme by him of another participant which reward is based, whether wholly or in part, otherwise than on the fair market value of goods or services actually sold by him or by or through that other participant;

"reward" (報酬) includes refund, commission, discount or allowance but does not include payment for sales demonstration equipment and materials supplied at not more than their fair market value and not resold.

Section:	3	Offence of promoting a pyramid selling scheme		30/06/1997
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Any person who knowingly promotes a pyramid selling scheme commits an offence and is liable on conviction upon indictment to a fine of \$100000 and to imprisonment for 3 years.

Section:	4	Liability of directors, partners etc.		30/06/1997
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(1) Where an offence under this Ordinance has been committed by a body corporate or member of a body unincorporate, any person who at the time of the offence-

- (a) in the case of a body corporate, was a director, secretary, principal officer or manager of that body corporate; or
- (b) in the case of a member of a body unincorporate, was a partner or office holder in or a member or manager of that body unincorporate,

or who, in either case, was acting or purporting to act in any such capacity commits a like offence.

(2) Where any person referred to in subsection (1) is charged with an offence under this Ordinance it shall be a defence for him to prove that the offence was committed without his consent or connivance and that he exercised such diligence to prevent the commission of the offence as he ought to have exercised having regard to the nature of his functions and to all other circumstances.

Section:	5	Power to award compensation		30/06/1997
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(1) Notwithstanding any provision in any other Ordinance, where a person is convicted of an offence under this

Ordinance the court may, in addition to passing such sentence as may otherwise be passed by law, order the person so convicted to pay to any person who has suffered financial loss resulting from that offence, such amount as compensation as it thinks reasonable.

(2) An amount ordered as compensation under subsection (1) shall be recoverable as a civil debt by the person in whose favour the order is made.

Section:	6	Saving of rights and claims	30/06/1997
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Nothing in this Ordinance shall prejudice the enforcement by any person of any right or claim against any person ceasing to promote a pyramid selling scheme by reason of this Ordinance.