

For discussion on
28 March 2011

Legislative Council Panel on Economic Development

Report on the Outcome of Public Consultation on Proposed Legislative Amendments to eradicate Pyramid Schemes

Purpose

This paper reports on the outcome of the public consultation exercise on proposed legislative amendments to eradicate pyramid schemes and seeks Members' support on our proposed way forward.

Background

----- 2. On 7 December 2010, we issued a paper (copy at the Annex) to seek public views on a package of proposed legislative amendments aimed at eradicating pyramid schemes. The consultation period ended on 31 January 2011. We have received 20 submissions (including two late submissions). Copies of the submissions are available at <http://www.cedb.gov.hk/citb>¹.

Public Views and Our Response

3. The package of proposed legislative amendments receives wide support from respondents. There is no disagreement that efforts should be stepped up to eradicate pyramid schemes. Some respondents make specific comments on our individual proposals. The following paragraphs set out these views and our response.

¹ We have crossed out the identity of some of the respondents at their express request and also the contact details in the submissions from individuals. Some of the submissions refer to names of individuals or companies. We have crossed out such references while keeping as far as we could the rest of the submissions intact.

(a) Regulatory approach

4. The current regulatory approach in Hong Kong is that express legislative provisions are in place to prohibit pyramid schemes. Only three respondents have different views. One (submission No. 008) suggests that instead of prohibiting only pyramid schemes, all multi-level direct marketing schemes should be banned. Two (submissions No. 010 and 018) propose that a specific licensing regime be established for multi-level marketing companies so that there can be better control. The Direct Selling Association of Hong Kong (submission No. 013), on the other hand, considers that legitimate multi-level marketing operations should not be over-regulated and objects to any change in our regulatory approach.

Our response

5. Multi-level marketing is but one form of business operations and is itself not objectionable. We do not consider that there are sufficient grounds to devise a specific regime to regulate the operation of companies undertaking such activities. We consider that our current approach of only prohibiting objectionable schemes is appropriate. We will, as suggested by some of the submissions (e.g. submissions No. 014 and 020), enhance publicity efforts and alert the public to possible scams.

(b) Revised definition of “pyramid scheme”

6. In paragraph 3.2(a) of the consultation paper, we proposed that the definition of “pyramid scheme” in the Pyramid Selling Prohibition Ordinance (Cap. 355) be revised. In gist, we proposed that a pyramid scheme should be defined as a scheme in which new participants must make a payment (or other consideration) and such a payment is entirely or substantially induced by the prospect held out to them that they will be entitled to receive a benefit (financial or otherwise) substantially relating to the introduction of further new participants. We further proposed to clarify that a scheme can be a pyramid scheme (as long as it meets the above definition) irrespective of whether it involves the sale of any goods or services.

7. Five respondents comment on the proposed revised definition. The Hong Kong Christian Service (submission No. 011), the Direct Selling Association of Hong Kong (submission No. 013), the Chinese Manufacturers' Association of Hong Kong (submission No. 014), Economic Synergy (submission No. 016) and the Consumer Council (submission No. 020) indicate express support for the proposed definition. While indicating support for the aims and direction of the proposed revised definition, the Direct Selling Association of Hong Kong (submission No. 013) offers suggestions on how the definition should be crafted to make it, in its views, more precise.

Our response

8. We welcome the support and maintain our proposal. As regards the drafting suggestions made by the Direct Selling Association, we will duly consider them when drafting the Bill.

(c) Uplifted penalty

9. In paragraph 3.2(d) of the consultation paper, we proposed that the maximum penalty for breaches of the Ordinance be increased from a fine of \$100,000 and imprisonment for 3 years to a fine of \$1,000,000 and imprisonment for 7 years.

10. Only four respondents make specific comments on the proposal. The Hong Kong Christian Service (submission No. 011), the Chinese Manufacturers' Association of Hong Kong (submission No. 014) and the Consumer Council (submission No. 020) indicate express support. A respondent (submission No. 006) considers that the uplifted penalty is still insufficient in deterring pyramid schemes, suggesting that the maximum penalty be pitched at a fine of \$5,000,000 and imprisonment for 15 years.

Our response

11. We welcome the general support. Having regard to the levels of penalties for comparable offences², we maintain our proposed maximum penalty of a fine of \$1,000,000 and 7 years in prison.

(d) Criminal liability for knowing participants

12. In paragraphs 3.3 and 3.4 of the consultation paper, we invited public views on whether persons who participate in pyramid schemes should shoulder criminal liability. We proposed that any persons 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. In paragraph 3.5 of the consultation paper, we proposed that such persons should be subject to the same maximum penalty as is applicable to persons who establish, advertise or manage pyramid schemes.

13. Ten respondents respond to the proposals. Five of them (the Direct Selling Association of Hong Kong (submission No. 013), the Consumer Council (submission No. 020) and three individuals (submissions No. 001, 004 and 010)) either express support or raise no objection to the proposal. The Economic Synergy (submission No. 016) goes further and suggests that participants should be held criminally liable irrespective of whether they participate knowingly, but those without knowledge should be treated leniently.

14. On the other hand, three respondents (submissions No. 003, 009 and the Chinese Manufacturers' Association (submission No. 014)) either do not agree to or have reservations over our proposals. They generally consider that participants may not know the nature of the schemes in which they participate. The Law Society of Hong Kong

² The offence of fraud contrary to 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 penalty of 7 years in prison and a fine of \$1 million.

(submission No. 019) considers that whether participants should be made criminally liable is a policy matter. It however expresses the concern that “innocent” participants might be inadvertently caught.

Our response

15. We note that most respondents agree that participants should be held criminally liable. By definition, pyramid schemes reward participants for recruiting further participants. The schemes cannot be sustained without participants recruiting others to join. Seen in this light, participants are as culpable as persons establishing pyramid schemes in sustaining such schemes. We however recognize that some participants may be ignorant of the true nature of these schemes, and have therefore proposed in the consultation paper that participants commit an offence under the Ordinance only if they induce or attempt to induce other persons to participate in a pyramid scheme, and have the knowledge that their income derives mainly from recruiting further participants. In other words, “innocent” participants (taken as those who do not have the knowledge) will not be prosecuted in the first place. We propose to maintain our original proposals.

Way Forward

16. We have started drafting the bill with a view to implementing these proposals as soon as possible. Our target is to introduce the bill into this Council for scrutiny within the current legislative session.

Commerce, Industry and Tourism Branch
Commerce and Economic Development Bureau
March 2011

Public Consultation Paper

**Proposed Legislative Amendments
to Eradicate Pyramid Schemes**

Commerce, Industry and Tourism Branch
Commerce and Economic Development Bureau

December 2010

Commerce, Industry and Tourism Branch
Commerce and Economic Development Bureau

Public Consultation Paper on

Proposed Legislative Amendments to
Eradicate Pyramid Schemes

This consultation paper can be found on the internet at

<http://www.cedb.gov.hk/citb>

December 2010

CHAPTER ONE

INTRODUCTION

1.1 The Pyramid Selling Prohibition Ordinance (Cap. 355) (“the Ordinance”) currently prohibits pyramid selling. However, its effectiveness has been eroded by new tactics that have emerged amidst changing socio-economic conditions. The Government has recently completed a review of the Ordinance, targeting at the operation of pyramid schemes and the promotional tactics deployed by participants. We now propose a package of legislative amendments to combat pyramid schemes for public consultation.

Background

1.2 The defining characteristic of pyramid schemes is that participants are required to pay a participation fee¹ to join such schemes in return for the right to receive benefits on the introduction of further new participants. The primary incentive for joining such schemes is to make money by recruiting new participants.

1.3 Pyramid schemes serve no economic purpose. By encouraging the ongoing introduction of members from which recruitment fees are extracted, these schemes would eventually become unsustainable when recruitment runs out, resulting in loss down the line. Since new participants may be recruited from amongst participants’ family members and friends, participants have to come under social or family pressure when the schemes fall through. Furthermore, promoters of some schemes adopt high

¹ The participation fee may take various forms. It may be disguised as a fee for receiving training in marketing (or any other) skills, the completion of which then qualifies the participants to introduce new members.

pressure tactics or make misrepresentation about earning opportunities when recruiting members. 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 gain sufficient recruitment payments to repay their debts.

1.4 Pyramid selling schemes are currently prohibited under the Ordinance. Section 2 of the Ordinance provides that:

“pyramid selling scheme” 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 (emphasis added).

1.5 Section 3 of the Ordinance provides that any person who knowingly promotes a pyramid selling scheme commits an offence and is liable on conviction upon indictment to a fine of \$100,000 and to imprisonment for 3 years. Section 2 defines “promote” to mean “establish, advertise, manage or assist in the management of a pyramid selling scheme”.

1.6 Under section 4 of the Ordinance, where an offence has been committed by a body corporate, a director, secretary, principal

officer or manager of that body corporate commits a like offence.

1.7 In recent years, there have been a number of complaints concerning pyramid schemes and related promotional tactics. During the period from 2007 to September 2010, the Police received 10 complaint cases related to suspected pyramid selling schemes and subsequently arrested 27 persons in connection with five of the cases. After investigation, no prosecution was made due to insufficient evidence. During the same period, the Police received 148 complaint cases related to objectionable marketing tactics adopted by marketing companies or their agents. After investigation, 8 cases were found to be related to offending acts of a criminal nature (including withholding other people's goods, supplying other persons with or abetting others to use false documents to secure loans). The Police arrested 11 persons, and one of them was convicted by the Court of "using a false instrument" and was sentenced to imprisonment.

CHAPTER TWO

REVIEW AND OUTCOME

2.1 We have reviewed the effectiveness and operation of the Ordinance, having regard to regulatory regimes in other jurisdictions and the views of Members of the Legislative Council. This Chapter sets out the outcome of the review.

Regulatory Approach

2.2 Under the existing regulatory regime implemented through the Ordinance, express provisions are in place to prohibit undesirable pyramid selling schemes. The great majority of countries and economies, including the United Kingdom, Ireland and Australia², adopt a similar approach. 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 allowed³. The regulatory regime in Taiwan amalgamates the above two approaches: on the one hand, “distorted multi-level selling activities” (meaning arrangements where participants receive economic benefits mainly from introducing others to participate, rather than from the marketing or sale of goods or

² United Kingdom: paragraph 14 of Schedule 1 to the Consumer Protection from Unfair Trading Regulations 2008; Ireland: sections 64 to 66 of the Consumer Protection Act 2007; Australia: sections 65AAA to 65AAE of the Trade Practices Act 1974 and sections 44 to 46 of the Australian Consumer Law (contained in Schedule 1 to the Trade Practices Amendment (Australian Consumer Law) Act (No. 2) 2010).

³ Mainland China: Regulations on Prohibition of Multi-level Marketing Activities and Regulations on Administration of Direct Selling Activities; Singapore: Multi-level Marketing and Pyramid Selling (Prohibition) Act and Multi-Level Marketing and Pyramid Selling (Excluded Schemes and Arrangements) Order 2000.

services or from work rendered at reasonable market prices) are prohibited. At the same time, a series of record-filing requirements concerning the operations of multi-level marketing schemes are laid down⁴.

2.3 We consider that the regulatory approach currently adopted in Hong Kong, i.e. enacting express provisions prohibiting pyramid selling schemes, is in line with international practices and appropriate to our legal and economic environment. Such an approach will avoid over-regulation on legitimate multi-level marketing schemes⁵. We therefore propose to maintain our current approach and consider appropriate legislative amendments on the basis of the Ordinance.

Legal Definitions

2.4 We consider that 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. In the judgments, the Court of Appeal raised the following problems in relation to the definition of “pyramid selling scheme” in the Ordinance:

- (a) section 2(b) of the Ordinance implies that the operation of a pyramid selling scheme **must** involve the selling of

⁴ Article 23 of the Fair Trade Act and the Supervisory Regulations Governing Multi-Level Marketing Activities.

⁵ Legitimate multi-level marketing schemes involve genuine selling activities. The income or benefits that members in such schemes can receive come mainly from the selling activities of their own and/or from the selling activities of any further new members that they may have introduced. On the contrary, participants are incentivized to join pyramid schemes by the benefits derived primarily from the recruitment of further new participants. Multi-level marketing schemes can provide earning opportunities for those who prefer to work outside conventional office hours or settings. They may also help meet the shopping needs of consumers who prefer more personalized services.

goods or services, which means that schemes not involving the sale of goods or services would fall outside the scope of the Ordinance; and

- (b) section 2(b) is also taken to imply that that a pyramid selling scheme must involve the sale of goods and services **by participants**. This means that schemes under which goods or services are not sold by participants (for example, sold by the company directly to new participants) would fall outside the scope of the Ordinance.

2.5 As indicated in the judgments, there are loopholes in the provisions of the Ordinance that have to be plugged. As mentioned in paragraph 1.7 above, of the complaint cases reported, only a few led to successful prosecutions, and conviction was based on criminal offences other than those prescribed under the Ordinance. Pending the completion of the amendment exercise, the Police will continue to tackle schemes adopting a pyramid structure on the basis of existing criminal offences, such as “fraud” contrary to section 16A of the Theft Ordinance (Cap. 210) and the common law offence of “conspiracy to defraud”. Besides, the charge of “using a false instrument” may be pursued if participants abet or induce new participants to borrow money with false instruments.

CHAPTER THREE

PROPOSED AMENDMENTS

3.1 On the basis of the outcome of the review, we propose to amend the Ordinance with the objective of defining more clearly what constitutes a “pyramid scheme”. We consider that the new definition should be based on its fundamental characteristic and 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. Besides, to plug the loopholes mentioned in paragraph 2.4 above, we should also make it clear in the law that a scheme can be deemed to be a pyramid scheme even if no sale of goods or services is involved. Furthermore, the level of penalty prescribed under the Ordinance should carry a sufficient deterrent, having regard to the harm done to society and individuals and the level of penalties for offences of a similar nature.

Proposals

3.2 We propose that the Ordinance be amended in the following manner⁶:

- (a) to revise the definition of “pyramid scheme” along the following lines:
 - (i) to define “pyramid scheme” as a scheme in which new participants must make a payment (or other consideration) 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

⁶ Subject to the outcome of public consultation, the proposed formulations would be subject to further refinement at the legal drafting stage.

(financial or otherwise) substantially relating to the introduction of further new participants;

(ii) on the basis of (i), a scheme may be a “pyramid scheme” no matter whether it involves the marketing or supply of goods or services (or both) by participants or by other persons or entities;

(iii) if a scheme involves the marketing or supply of goods or services (or both), in determining if the scheme is a pyramid scheme, the court may have regard to the following factors and any other factors as it may consider appropriate:

- whether, in the promotion of the scheme, any emphasis has been given to the entitlement of participants to the benefit receivable for the introduction of new participants; and

- to what extent the payment made by new participants bears a reasonable relationship to the value of the goods or services. The court may if appropriate, draw reference from the price of the same or comparable products available elsewhere.

(b) to provide that any person who knowingly establishes, manages or promotes a pyramid scheme commits an offence under the Ordinance;

(c) to provide appropriate defences for publishers who innocently published advertisements promoting pyramid schemes; and

(d) to increase the **maximum** penalty to imprisonment for 7 years and a fine of \$1 million on conviction upon

indictment⁷.

Other Relevant Issues

(a) Criminal Liability for Participation in Pyramid Schemes

3.3 We would also like to invite public views on the question of whether persons who participate in pyramid schemes should shoulder criminal liability. While there is consensus in the community that persons establishing, promoting or managing a pyramid scheme should be sanctioned, views are varied as to whether persons who participate in a pyramid scheme in order to obtain benefits from recruitment fees should also be held responsible.

3.4 Since a pyramid scheme cannot be sustained if not for the introduction of new participants by existing participants, there are views suggesting that participants should be treated on par with persons establishing, promoting or managing a pyramid scheme and be subject to sanctions. We consider that there are valid grounds for such views. In Australia and Ireland for example, participants are held liable for criminal offences. To combat and curb the expansion of pyramid schemes, we propose that additional provisions be added in the Ordinance with a view to deterring people from participating in and inducing others to join pyramid schemes through the introduction of criminal sanctions. In order not to cast the net so wide as to catch innocent participants who may be lured into joining the scheme, we propose that the legislative amendments should be targeted at those **who induce or attempt to induce other persons to participate in the scheme, with the knowledge that the benefits they may get from joining**

⁷ In making this proposal, we have paid regard to the penalties for existing offences of a like nature. 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 7 years in prison and a fine of \$1 million.

the scheme are entirely or substantially derived from the introduction of further new participants.

(b) Penalty Level

3.5. Apart from proposing to impose criminal liability on participants, we need to consider how to set the level of penalty. In both Australia and Ireland, a single maximum penalty level is set for promoters, establishers and participants of pyramid schemes. The court will have regard to all relevant factors (such as the extent of involvement and the role of the convicted in the offending conduct) when handing down sentences. It is for consideration whether the maximum level of penalty should be set at the same level for participants as that proposed for the offence of establishing or promoting a pyramid scheme (i.e. imprisonment for 7 years and a fine of \$1 million, see paragraph 3.2(d) above). In view of the fact that pyramid schemes live on participation, the effectiveness of the Ordinance in combating pyramid schemes would be compromised if participants were exempt from criminal liability. We are prepared to consider any different views that the public may have.

CHAPTER FOUR

COMMENTS SOUGHT

4.1 We welcome views from the public on the proposals set out in Chapter three. Comments can be submitted by mail, facsimile or email on or before 31 January 2011:

Address : Special Duties Division
Commerce, Industry and Tourism Branch
Commerce and Economic Development Bureau
Level 29, One Pacific Place
88 Queensway
Admiralty
Hong Kong
Fax number : 2869 4420
E-mail address : pyramid@cedb.gov.hk

4.2 It is voluntary for any member of the public to supply his/her personal data when providing views on this consultation document. Any personal data provided with a submission will only be used for the purpose of this public consultation exercise. The submissions and personal data collected may be passed to relevant Government bureaux and departments for purposes directly related to this consultation exercise.

4.3 This Bureau may publish the submissions made in response to this consultation document for public viewing after the conclusion of the public consultation exercise. If you do not wish your name or your affiliation (or both) to be disclosed, please state so when making your submission.

4.4 Any sender providing personal data to this Bureau in the submission will have the rights of access and correction with respect to such personal data. Any requests for data access or

correction of personal data should be made in writing to:

Address: Special Duties Division
Commerce, Industry and Tourism Branch
Commerce and Economic Development Bureau
Level 29, One Pacific Place
88 Queensway
Admiralty
Hong Kong
Fax number: 2869 4420
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