

For discussion on
25 October 2010

Paper for Panel on Economic Development

Review of Pyramid Selling Prohibition Ordinance (Cap. 355)

Purpose

This paper informs Members of the outcome of our review of the Pyramid Selling Prohibition Ordinance (Cap. 355) (“the Ordinance”) and sets out proposals on how to strengthen the control over pyramid schemes. We would like to invite Members’ views which we will carefully examine before proceeding with public consultation.

Background

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.

3. Pyramid schemes serve little or 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 inevitable 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, some promoters adopt high pressure tactics or make misrepresentation about earning opportunities when recruiting members into the schemes. In some reported cases, new recruits 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

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

debts.

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).

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”.

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.

Review

7. In two judgments in 2003 and 2004 (CACC 96/2003 and CACC 55/2004), 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 goods or

services, which means that schemes not involving the sale of products 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.

8. Flowing from the assumption that a pyramid scheme must involve the sale of products, according to section 2(b) of the Ordinance, whether the reward a participant receives for introducing a new member is based, wholly or in part, on the fair market value of the products involved is one of the criteria for determining whether a scheme is a pyramid selling scheme. This requirement may not be applicable to cases where no selling or buying of products is involved.

9. Notwithstanding the limitations of the current Ordinance, the Police has endeavoured 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”. In addition, the charge of using a false instrument may be pursued if participants abet or induce new participants to borrow money with false instruments.

10. In considering how to improve the effectiveness and operation of the Ordinance, we have examined the regulatory regimes in other jurisdictions, including the United Kingdom, Ireland and Australia. We have also carefully considered the views expressed previously by Members of this Council on the subject. Furthermore, we have exchanged views with the Direct Selling Association of Hong Kong to gain a better understanding of the operation of their member companies.

11. One key consideration adopted in the review is to make it clear that the defining characteristic of a “pyramid scheme” is that the incentives for participants to join such a scheme come from the benefits which are primarily derived from the recruitment of new members. In order to address the loopholes mentioned in paragraph 7 above, we should also make it clear in the law that a scheme can 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 the level of penalties for offences of a similar nature. In considering these matters, we are mindful not to hinder the operation and development of legitimate multi-level marketing schemes².

Initial Proposals

12. In the light of the above considerations and taking reference of legislative provisions in Australia³ and Ireland⁴, we propose that the Ordinance be amended in the following manner:

- (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 (financial or otherwise) in relation 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:
 - the emphasis given in the promotion of the

² Multi-level marketing schemes can provide earning opportunities for those who prefer to work outside conventional business hours or settings. They may also help meet the shopping needs of consumers who prefer more personalized services.

³ Sections 44 to 46 of the Australian Consumer Law (contained in Schedule 1 to the Trade Practices Amendment (Australian Consumer Law) Bill (No. 2) 2010).

⁴ Sections 64 to 66 of the Consumer Protection Act 2007.

scheme to the entitlement of participants to the benefit receivable from 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, as assessed if appropriate by reference to the price of the same or comparable products available elsewhere.
- (b) to provide that any person who establishes, manages or promotes a pyramid scheme commits an offence under the Ordinance;
- (c) to make available defences for publishers who innocently published advertisements promoting pyramid schemes, and to persons who committed an offence due to a mistake or information supplied by a third party and he took reasonable precautions and exercised due diligence; and
- (d) to increase the **maximum** penalty to imprisonment for 7 years and a fine of \$1 million on conviction upon indictment⁵.

Further Issues For Consideration

(a) Participation in Pyramid Schemes

13. We would also like to invite Members' views on the question of whether persons who participate in pyramid schemes should shoulder criminal liability. While persons establishing, promoting or managing a pyramid scheme are clearly culpable, it is arguable that participants who knowingly participate in a pyramid scheme in order to obtain benefits from recruitment fees should also be held responsible. Since a pyramid

⁵ 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.

scheme cannot be sustained if not for the introduction of new participants by existing participants, participants should be treated on par with persons establishing, promoting or managing a pyramid scheme. As participants help to propel pyramid schemes and drawing reference from regulatory regimes in Australia and Ireland where participation in pyramid schemes is prohibited and subject to criminal sanctions, consideration should be given to deterring people from participating in and inducing others to join pyramid schemes. In order not to cast the net so wide as to catch innocent participants who may be lured into joining the scheme, our inclination is to target those who **induce or attempt to induce** other persons to participate in the scheme, **with the knowledge that the benefits he may get from joining the scheme are entirely or substantially derived from the introduction of further new participants.**

(b) Penalty Level

14. If the proposal set out in paragraph 13 is supported, further consideration needs to be given on the level of penalty to be set. In both Australia and Ireland, a single maximum penalty level is set for promoters, establishers and participants of pyramid scheme. 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 (see paragraph 12(d)).

Way Forward

15. Members are invited to offer views on our initial proposals set out in paragraphs 12 to 14 above. We will consider and take Members' views into account in finalizing our public consultation document. We will also further engage the Direct Selling Association of Hong Kong.

Commerce, Industry and Tourism Branch
Commerce and Economic Development Bureau
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