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Paper for the House Committee meeting on 25 November 2011

**Report of the Bills Committee on
Pyramid Schemes Prohibition Bill**

Purpose

This paper reports on the deliberations of the Bills Committee on Pyramid Schemes Prohibition Bill (the Bill).

Background

Pyramid Schemes

2. According to the Legislative Council Brief on the Bill, pyramid schemes refer to those schemes under which profits are mainly derived from recruiting participants who pay to join the schemes. Participants are required to pay a "participation fee" to join such 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). In such schemes where the sale of goods or services is involved, the selling and buying are only used as a smoke-screen. Pyramid schemes serve no economic purpose and are unsustainable as they rely solely on the recruitment of new members. Participants may suffer from financial loss when such recruitment runs out.

Existing regulatory regime

3. At present, the Pyramid Selling Prohibition Ordinance (Cap. 355) ("the Ordinance") prohibits pyramid selling. One of the characteristics of pyramid selling schemes as defined under the Ordinance is that the reward a participant may receive through the introduction of another participant to join the scheme is

based otherwise than on the fair market value of goods or services actually sold by him or by or through that other participant.

4. In 2003 and 2004, the Court of Appeal acquitted the defendants in two cases involving alleged pyramid selling schemes (CACC 96/2003 and CACC 55/2004) on the basis that the schemes in question did not involve the sale of goods and/or services, or the sale of goods and/or services by or through participants (i.e. the goods and/or services were sold by the company directly to new participants), and as such fell outside the scope of the Ordinance. In view of these two decisions, the current Ordinance is considered no longer effective in combating objectionable schemes which adopt a pyramid structure in various guises.

5. Having regard to legislation which prohibits or regulates pyramid schemes in other jurisdictions, the Administration proposed to put in place a new regulatory regime for combating such schemes. Following public consultation on the legislative proposals which took place from December 2010 to January 2011, the Administration introduced the Bill into the Legislative Council on 1 June 2011.

The Bill

6. The object of the Bill is to repeal the Ordinance and introduce a new regime for the prohibition of pyramid schemes irrespective of whether they involve the sale of goods or services.

7. The major provisions of the Bill include the following –

- (a) clause 3 defines what constitutes a "pyramid scheme", with clause 4 setting out the matters to which the court must have regard when determining whether a scheme involving the marketing of goods or services (or both) is a pyramid scheme;
- (b) clause 5 provides for:
 - (i) the offence of knowingly promoting a pyramid scheme; and
 - (ii) the offence of participating in and inducing others to join a pyramid scheme with the knowledge (actual or constructive) that the benefit receivable is entirely or substantially derived from the introduction of new participants to the scheme,

either of which attracts a maximum penalty of a fine of \$1,000,000 and imprisonment for seven years upon conviction on indictment;

- (c) 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; and
- (d) 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 that offence.

The Bills Committee

8. At the House Committee meeting held on 3 June 2011, Members agreed to form a Bills Committee to study the Bill. Under the chairmanship of Hon Fred LI Wah-ming, the Bills Committee has held 4 meetings. The membership list of the Bills Committee is at **Appendix I**. The Bills Committee has invited views from the public including relevant trades and professional organizations such as the Law Society of Hong Kong (LawSoc) and Direct Selling Association of Hong Kong (DSA). The Bills Committee received oral representations from 7 deputations at the meeting held on 22 July 2011, and 3 submissions from other organizations/individuals. A list of the organizations and individuals who have submitted views to the Bills Committee is at **Appendix II**.

Deliberations of the Bills Committee

9. The Bills Committee has noted from the submissions that the public generally support the Bill. The Consumer Council and DSA have expressed their support for the Bill which they believe will be effective in plugging loopholes in the existing Ordinance. In deliberating the Bill, members of the Bills Committee have indicated their support for the Administration's initiative in combating pyramid schemes and have given views on various aspects of the Bill, which is drafted for achieving this purpose. The ensuing paragraphs summarize the Bills Committee's deliberations.

Definition of pyramid schemes

10. In defining recruitment payment as a characteristic of a pyramid scheme, clause 3(1)(c) states that recruitment payment was "entirely or substantially derived from the introduction to the scheme of a further new participant". Hon Alan LEONG has enquired about whether the word "substantially" was necessary. The Bills Committee has noted the suggestion of LawSoc that the words "or substantially" should be deleted on the ground that there may be difficulty to construe the exact meaning of "substantially" thereby resulting in innocent participants being prosecuted.

11. The Administration has explained that the definition of "pyramid scheme" in clause 3 of the Bill follows the approach adopted in legislation in Australia, Ireland and the United Kingdom and emphasizes the substance of pyramid schemes. It is tightly drafted to prevent circumvention. Deleting "substantially" from the definition would defeat the purpose of the Bill in tackling pyramid schemes. Should the Bill merely require that the benefit be derived "entirely" from the introduction of new recruits, it would be easy for operators of pyramid schemes to get around the law simply by offering a small giveaway as part of a participant's benefit.

Differentiation of pyramid schemes from legitimate marketing schemes

12. Some members have expressed concerns about whether the Bill would have the effect of over-regulating legitimate multi-level marketing schemes (MLMS), fettering the normal business operations of these schemes and deterring foreign entities from starting relevant business in Hong Kong. The Administration has responded that the industry has been consulted on the Bill and has generally expressed support for it. The Bills Committee has noted the indication of DSA that all its members support the Bill which provides a precise definition of pyramid scheme such that the public will be able to differentiate legitimate MLMS from illicit pyramid schemes. According to the Administration, DSA and a multi-national company which operates MLMS in a number of jurisdictions have indicated that the Bill would help combat objectionable pyramid schemes operated under the guise of legitimate MLMS, thereby creating a more favourable operating environment for legitimate MLMS.

13. Some members have suggested that the Bill should set out pointers or criteria (for instance, the provision for a cooling-off period or a right of return of goods) by reference to which the public and business entities could easily differentiate pyramid schemes from legitimate MLMS. The Administration considers that under clause 4(1) of the Bill, the court must, in determining

whether a scheme that involves the marketing of goods or services is a pyramid scheme, consider (among other factors that it considers relevant) (i) whether the participation payment bears a reasonable relationship to the value of the goods or services that participants are entitled to be supplied with, and (ii) whether the emphasis given in the promotion of the scheme centres on the participants' entitlement to a recruitment payment or the supply of goods or services. The Bill does not specify the lack of the right of return of goods or a cooling-off period as a defining characteristic of a pyramid scheme because such features could easily be circumvented by promoters of objectionable pyramid schemes with ingenious modifications. Under clause 4(2), the court may take into account other relevant matters including the details of cooling-off period and arrangements for the return of goods. The Police will look into the whole operation of the scheme during investigation.

The offence of participating in a pyramid scheme

14. Some members including Hon Starry LEE have enquired about the regulatory reach of anti-pyramid schemes legislation in other jurisdictions, in particular whether participants (as opposed to promoters) are held criminally liable. Members of the Bills Committee have noted from the information provided by the Administration on relevant offences in Australia, Ireland, the United Kingdom, Singapore and Macau that most of these jurisdictions impose criminal liability on participants in pyramid schemes but that the mental elements required vary.

15. The Bills Committee has noted the LawSoc's suggestion that the reference to "ought reasonably to know" should be deleted from clause 5(2)(b) as this is too harsh on innocent people who may be caught the future ordinance. The Administration has responded that clause 5(2)(b) of the Bill is targeted at the act of participants who might not know about the entire operation of the scheme. The requisite "mens rea" refers to the participant's knowledge that the benefit he or she may get is mainly derived from recruiting further new participants (not from the selling of goods/services). The Administration considers it appropriate to allow "constructive knowledge" under the subclause, so that the court can infer the mental state of a reasonable person in the particular circumstances of the case. The burden of proof still rests with the prosecution, and the standard of proof remains to be "proof beyond reasonable doubt".

16. Hon Starry LEE has enquired whether participants in pyramid schemes can rely on good faith as an exculpatory circumstance. Hon Vincent FANG and Hon Cyd HO have also expressed concern that those with little formal education and experience might inadvertently join a pyramid scheme and

become liable for prosecution as knowing participants under the Bill. In response, the Administration has explained that under the Bill, participants in a pyramid scheme will commit an offence only if they (i) induce or attempt to induce other persons to take part in that scheme, and (ii) know or ought reasonably to know that their benefit is entirely or substantially derived from recruiting further participants. The burden of proof rests with the prosecution and the standard of proof is high (i.e. beyond reasonable doubt). Unlike the situation in Australia where participation in a pyramid scheme is a strict liability offence, the Bill requires the establishment of a mental element, i.e. the aforesaid knowledge that participants' benefit is entirely or substantially derived from recruiting further participants.

Liability of directors, partners, etc. (clause 6)

17. Hon WONG Kwok-hing has enquired whether unlimited companies, or shadow promoters in these companies, would be subject to the regulation of the Bill. In response, the Administration has explained that clause 6 of the Bill provides that if a body corporate or a member of an unincorporated body committed an offence under the Bill, a relevant person of the body would also be liable to the offence if it could be proved that the offence was committed with the consent or connivance of the relevant person, or was attributable to his neglect.

Adequacy of the Bill in tackling pyramid schemes

18. Some members have expressed concern about whether the Bill is adequate in tackling pyramid schemes. Hon Starry LEE and the Chairman have enquired about the number of past cases that could have been successfully prosecuted and the number of participants/promoters who would likely have been convicted if the Bill had been in place. The Administration has explained that investigation of past cases and gathering of evidence have been carried out in accordance with the requirements stipulated in the Ordinance. Reviewing past cases for evidence relevant to the new constituent elements provided in the Bill will not be practicable.

19. Hon Vincent FANG has expressed concern that the court may have difficulty in determining whether a scheme that involves the marketing of goods or services is a pyramid scheme because it is not always easy to determine the market or reasonable value of goods and services. The Administration has responded that the court will not just consider the market prices or value of the goods and services involved in a scheme but will also have regard to the relative emphasis given to the new participant's entitlement to the supply of goods or services and to a recruitment payment in the promotion of the scheme as well as

other relevant factors.

Drafting matters

20. Members have raised concerns about the drafting of clause 4(1)(b) which provides that the court must have regard to "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" when determining whether a scheme involving the marketing of goods or services is a pyramid scheme. Hon Alan LEONG and Ms Cyd HO have requested the Administration to consider rewriting clause 4(1)(b) in a more reader-friendly way and using another Chinese rendition (originally "著墨") for "emphasis". The Administration has agreed to the suggestion and will move amendments at the Committee stage to make clause 4(1)(b) easier to read without changing its original meaning.

Education and publicity

21. Hon Vincent FANG has emphasized the need to target the publicity of the Bill when enacted as an ordinance to those engaged in direct marketing activities who are homemakers with little formal education. Hon Cyd HO has requested the Administration to give assurances to the public that in considering prosecution under the new ordinance, due consideration will be given to the social background of the participants especially the elderly and those with little formal education. To allay concerns about undiscerning members of the public being caught inadvertently, the Administration agrees to publicize in layman terms the relevant legal requirements after the enactment of the Bill in order to facilitate understanding by the general public. The Administration has also undertaken to step up publicity to help the public differentiate between legitimate MLMS and illicit pyramid schemes.

Commencement

22. The Bills Committee considers that the new law should come into force as soon as possible. The Administration has indicated that it will bring the new ordinance, if enacted, into operation on 1 January 2012.

Committee Stage amendments

23. As mentioned in paragraph 20 above, the Administration has proposed Committee Stage amendments (CSAs) with a view to improving the drafting of the relevant provisions. The Bills Committee agrees to the Administration's proposed CSAs which are set out in **Appendix III**. The Bills Committee has not proposed any amendment in its name.

Recommendation

24. The Bills Committee supports the resumption of the Second Reading debate on the Bill on 7 December 2011.

Advice sought

25. Members are invited to note the Bills Committee's deliberations and recommendation set out above.

Council Business Division 1
Legislative Council Secretariat
24 November 2011

Bills Committee on Pyramid Schemes Prohibition Bill

Membership List

Chairman	Hon Fred LI Wah-ming, SBS, JP
Members	Hon Vincent FANG Kang, SBS, JP Hon WONG Kwok-hing, MH Hon WONG Ting-kwong, BBS, JP Hon Cyd HO Sau-lan Hon Starry LEE Wai-king, JP Hon CHEUNG Kwok-che Hon Alan LEONG Kah-kit, SC Hon Tanya CHAN (Total : 9 members)
Clerk	Mr Derek LO
Legal Adviser	Mr Bonny LOO

Bills Committee on Pyramid Schemes Prohibition Bill

**List of organizations and individuals who have given views to
the Bills Committee**

1. Consumer Council
2. Economic Synergy
3. Mr CHAN Chung-yau
4. Mr LAM Chung-hoi, Tuen Mun District Councillor
5. Mr YEUNG Wai-sing, Eastern District Councillor
6. The Chinese Manufacturers' Association of Hong Kong
7. The Democratic Party
8. The Direct Selling Association of Hong Kong Ltd.
9. The Hong Kong Chinese Importers' & Exporters' Association
10. The Law Society of Hong Kong

Pyramid Schemes Prohibition Bill

Committee Stage

Amendments to be moved by the Secretary for
Commerce and Economic Development

<u>Clause</u>	<u>Amendment Proposed</u>
1(2)	In the English text, by adding “by notice published in the Gazette” after “Development”.
4(1)	By deleting paragraph (b) and substituting – “(b) the relative emphasis given in the promotion of the scheme to the new participant’s entitlement – (i) to the supply of goods or services; and (ii) to a recruitment payment.”.