

Update

Pyramid Schemes in Hong Kong

“Fool’s gold”

A new law has recently been enacted in Hong Kong regarding pyramid schemes. The Pyramid Schemes Prohibition Ordinance (Cap. 617 - the Ordinance) is in force and replaces the Pyramid Selling Prohibition Ordinance (Cap. 355 - the old Ordinance). The aim of the Ordinance is to eradicate pyramid schemes in Hong Kong by introducing a new criminal offence aimed at people who participate in such schemes, in addition to the offence of promoting a pyramid scheme. In this article we take a look at the Ordinance’s key provisions.

Key points

- It remains an offence to knowingly promote a pyramid scheme.
- If a corporate (eg, a company) or unincorporated (eg, a partnership) body promotes a pyramid scheme through the deliberate action or neglect of certain designated persons, then those individuals also commit an offence. Such persons could include the director, secretary, principal officer or manager of a corporate body or a partner, office holder, member or manager of an unincorporated body or any person purporting to act as such.
- A new offence has been created. A person who knows (or ought reasonably to have known) that they are participating in a pyramid scheme and who induces or attempts to induce another person to participate commits an offence.
- The punishment for these offences is potentially tough; namely, a fine of HK\$1 million and imprisonment for up to seven years.
- The Ordinance widens considerably the definition of a pyramid scheme. Under the old Ordinance, the prohibition was directed at a “pyramid selling scheme”, which linked the scheme to the selling of goods and/or services. That created a loophole for pyramid schemes that did not involve the sale of goods and/or services.
- The gist of the new definition is aimed at schemes in which new participants must provide a payment (or non-financial benefit) that is entirely or substantially induced by the prospect that they will be entitled to receive a financial or non-financial benefit that is entirely or substantially derived from the introduction of new participants. This covers schemes irrespective of whether they involve a sale of goods and/or services.
- Introducing criminal liability on participants of pyramid schemes puts a responsibility on individuals to determine whether a scheme is illegal.

- Pyramid schemes should be contrasted with genuine multi-level marketing activities, where the income or benefits which members receive are derived from the sale of genuine goods and/or services.
- Operators of multi-level marketing schemes should be familiar with the Ordinance to ensure that their operations fall outside its scope. Similarly, individuals should also satisfy themselves that their participation and reward in a multi-level marketing scheme is tied to the sale of a genuine good and/or service (and is not substantially derived from the recruitment of new members).

Background

Pyramid schemes

Generally understood, a pyramid scheme is a scheme in which new participants pay to join in return for the right to payment (or payment in kind) when they recruit other people to join the scheme. A defining characteristic of a pyramid scheme is that the reward is substantially linked to the introduction of new participants; the pyramid scheme itself serves little (if any) economic purpose and there is no genuine underlying business. Eventually, such schemes become unsustainable and collapse because (short of the whole population of Hong Kong joining) there is not enough profit to pay participants.

In this regard, pyramid schemes are much like “ponzi” schemes, which promote dubious “investment” opportunities. Pyramid schemes and “ponzi” schemes have been topical subjects, particularly after the financial credit crisis in 2008 when such schemes came under closer scrutiny.

In Hong Kong pyramid schemes have often targeted participants and their family members and friends. The participation fee can take various forms and may be disguised (in part or whole) as a “training” or “marketing” fee that entitles the participant to introduce new members and share a percentage of the “profit” for every person he or she recruits to the scheme. It is not unknown for pyramid schemes to be accompanied by high pressure sales tactics and/or dubious loan arrangements¹.

Legitimate multi-level marketing schemes involve genuine selling activities relating to goods and/or services. The income or financial benefits that members can receive

are derived from their selling activities and those of new members that they introduce.

Alarming loopholes in the old Ordinance

Despite a relatively high level of complaints about pyramid schemes in Hong Kong in the past, there were few successful convictions under the old Ordinance. This was in large measure due to the difficulties in prosecuting an offence under the old Ordinance and its definition of a “pyramid selling scheme”².

First, under the old Ordinance the definition of a “pyramid selling scheme” envisaged that there must be some “goods or services actually sold by (the participant)”³. Therefore, the old Ordinance did not apply if there was no element of selling goods and/or services and a scheme’s sole purpose was to make money from the recruitment of new participants⁴. This was the tendency of some schemes (sometimes promoted in Hong Kong from overseas) and, paradoxically, was the very mischief that one would expect any such legislation to be aimed.

Second, if the goods and/or services were not sold by the participant, but by the company that managed the scheme and directly to new participants, then the old Ordinance did not apply.

Indeed, at the time of the passage of the old Ordinance in 1980, the government in Hong Kong acknowledged that this area of legislation was “tricky” and might have to be reviewed⁵.

This left the prosecution authorities in Hong Kong having to consider prosecutions arising out of pyramid schemes based on (for example) fraud⁶, common law conspiracy to defraud⁷ or fraudulently inducing a person to invest money⁸.

Pressure to review the old Ordinance also came from the fact that in other jurisdictions relevant consumer legislation and legislation relating to multi-level marketing activities and pyramid schemes has been revamped, making it an offence to operate, promote or participate in a pyramid promotional scheme⁹.

The Ordinance seeks to address the above loopholes and put Hong Kong on a similar statutory footing with many other jurisdictions that have banned pyramid schemes.

¹ See HK Legislative Council Paper No. CB(1)1657/10-11(04)

² See in the matter of re Promail [2006] HKCU 1231, 1487

³ Section 2 Pyramid Selling Prohibition Ordinance (Cap. 355 - emphasis added)

⁴ HKSAR v Yau Mee Kwan & Ors [2004] 1 HKC 526 and HKSAR v Li Chi Yung & Ors [2004] HKCU 652

⁵ *Ibid.* 1, para. 4

⁶ Section 16A Theft Ordinance (Cap. 210)

⁷ HKSAR v Lee Hin Hoe [2009] HKCU 31

⁸ Section 107 Securities and Futures Ordinance (Cap. 571)

⁹ See HK Legislative Council Paper No. CB(1)1657/10-11(04), paras. 5 to 9

The Ordinance

New definition of pyramid scheme

The new definition of a pyramid scheme is much wider¹⁰. It covers schemes irrespective of whether they involve any sale of goods and/or services.

In short, a pyramid scheme is now defined as a scheme in which:

- new participants must provide a financial or non-financial benefit to reward (whether in whole or part) a participant or promoter of the scheme;
- the financial or non-financial benefit is entirely or substantially induced by the prospect that the new participant will be entitled (whether in whole or part) to a financial or non-financial benefit; and
- the entitlement is entirely or substantially derived from the introduction to the scheme of a new participant.

The definition also applies even if (among other things) a new participant pays to join the scheme after having started participating and the making of a payment is not the only requirement to be eligible to participate in the scheme or to be eligible to receive a payment.

The Ordinance also prescribes a number of matters that a court must take into account in determining whether a payment under the scheme is “entirely or substantially induced” by the prospect of a new participant being entitled to a payment¹¹.

Offences

There are two offences under the Ordinance.

First, it remains an offence to promote a pyramid scheme knowing that it is such¹².

Second, a new offence targets participation in a pyramid scheme. A person commits an offence if he or she:

- participates in a pyramid scheme;
- knowing (or having ought reasonably to have known) that any benefit he or she might get would be entirely or substantially derived from the introduction of new participants; and
- induces or attempts to induce another person to participate in the scheme¹³.

Similar to the old Ordinance, where an offence under the Ordinance has been committed by a corporate body or 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 director, secretary, principal officer or manager (in the case of a corporate body) or a partner, office holder, member or manager (in the case of an unincorporated body) or any person purporting to act as such, that person commits an offence¹⁴.

Sanctions

A person who is convicted of an offence under the Ordinance is liable to a fine of HK\$1 million and imprisonment for up to seven years. In addition, a court may order a person convicted to compensate any victims who have suffered financial loss resulting from the offence¹⁵. Offences under the Ordinance are triable either in the District Court (before a single judge without a jury) or in the High Court.

Comment

In a city like Hong Kong, with its densely populated areas and strong family and business ties, pyramid schemes can sometimes thrive. Certain “get rich quick” schemes can have a certain superficial appeal, particularly to those hoping to make “an extra buck”. Often such schemes are tied-in with dubious lending arrangements and/or dubious products or services; for example, certain “skin care” or “beauty care” products or “training” fees. In that context, the Ordinance is to be welcomed.

Consumers in Hong Kong are probably more discerning after the “mini-bonds” saga. However, the low yield environment for many conventional investments encourages some to seek alternative methods of making money. Pyramid schemes play on these dynamics and on ignorance.

Unlike some jurisdictions, Hong Kong has not banned outright multi-level marketing schemes.

As with most new legislation there are concerns. First, the new offence of “participation” in a pyramid scheme means that members of the public will have to satisfy themselves whether a scheme is legitimate or not. Given that some pyramid schemes are quite sophisticated there is still a prospect of unsophisticated people being duped. However, now participants risk being prosecuted (besides losing their “investment”).

¹⁰ Pyramid Schemes Prohibition Ordinance (Cap. 617), section 3

¹¹ Ibid. 10, section 4

¹² Ibid. 10, section 5(1)

¹³ Ibid. 10, section 5(2)

¹⁴ Ibid. 10, section 6

¹⁵ Ibid. 10, sections 5(3) and 7, respectively

Second, prosecutions will still not be easy. Pyramid schemes commonly involve many participants and promoters are often based overseas (or can leave Hong Kong quickly).

Prosecutorial discretion will, no doubt, concentrate on the public interest and the reasonable prospect of conviction, but difficult judgement calls will have to be made. It is not uncommon, when new legislation is passed criminalising conduct, for a prosecution to proceed as an early “test” case and against persons who were not initially thought to be in the prosecutor’s first sight. For example, the first conviction under the UK Bribery Act 2010 (that came into force last year and in respect of which much has been written) was of an administrative clerk at a London Magistrates’ court.

One might be forgiven for hoping that the first prosecution under the Ordinance will target those at the top of the pyramid, rather than the bottom. One should also not be surprised if the first prosecution under the Ordinance proceeds in the District Court.

While the motives behind the Ordinance are laudable, as is often the case, greater public awareness and education regarding pyramid schemes is also important. In the meantime, the old adage remains true – “If it sounds too good to be true, it probably is”.

Further information

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