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REGULATION OF DIRECT SELLING AS AN AID TO COUNTERING PONZI/PYRAMID SCHEMES

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SUMMARY EXTRACTS OF IICA WHITEPAPER ON REGULATION OF DIRECT
SELLING INDUSTRY IN INDIA (SEPTEMBER 2015)

WHAT IS 'DIRECT SELLING'

The term 'direct selling' refers to a model of doing business. It is mode of sale of goods and services that does not occur out of a fixed location. Such sales are usually conducted in a personal or face-to-face manner. Direct selling is centuries old, but has not undergone regulation until very recently. Some prominent companies using the direct selling business model are LIC of India, Tupperware, Amway, Avon, Herbalife etc.



HOW ARE PONZI/PYRAMID SCHEMES CLOAKING THEMSELVES AS DIRECT SELLING



Although direct selling can be a source of significant benefits to any human-resource-rich economy (such as India's), the industry has been beset with problems due to the proliferation of illegal Ponzi / pyramid schemes that pass themselves off as 'direct selling businesses.' Under this guise, they manage to cheat huge sections of the public.

Recent examples of such illegitimate Ponzi / pyramid Schemes that try to pass off as Direct Sellers are QNet (fraud in India > Rs. 250 Crores) and SpeakAsia (fraud in India > Rs. 2,276 Crores), and these are only the prominent ones which have been caught.

For this reason, it is necessary to establish a means of differentiating between the Ponzi / pyramid Schemes and Direct Selling companies.

THE DIFFERENCE BETWEEN PONZI/ PYRAMID SCHEMES AND DIRECT SELLING

Numerous courts (both in India and abroad) have considered the legality of direct selling; they have generally laid down a simple test: whether or not the business depends solely on the recruitment of new members in order to generate income.

This is due to the fact that any illegitimate Ponzi / pyramid scheme are economically unsustainable in the long run. They make fraudulent representations to prospective recruits about future earnings in order to entrap them into joining. Such schemes may purport to sell genuine products, but whatever income they generate is derived from the entry fees that they charge new members. When new members cease to be recruited, the pyramid scheme collapses and existing members have no way of recovering the funds they have invested. Further differences are illustrated in the table below:



PARAMETER	DIRECT SELLING	PYRAMID SCHEMES
Definition	Marketing of the product/ services to the consumers generally from home through a direct seller.	Money is primarily made from recruiting other people to market the programme.
Driving objective	Sale of products and services to the ultimate consumer.	Little or no effort is made to market the product. All the focus is on enrolment on new people and collecting money from them.
Cost of entry	No or only a reasonable entry fee.	Charge steep start-up costs for joining, including mandatory training, a starter kit and a non-refundable membership fee.
Plan/Schemes	Plans are primarily based on the value of sale of products.	Plans are primarily based on money paid by new recruits, and not on product sales
Mandatory enrolment	Enrolment of recruits is not compulsory for doing business.	Enrolment of recruits is compulsory for doing business.
Underlying product	Involves marketing of products under established brand names	Either no products are involved, or else the products are a cover and are not really sold to consumers

PARAMETER	DIRECT SELLING	PYRAMID SCHEMES
Buy-back/guarantee of product(s)	Highly competitive.	No right to return, buy-back or cooling off scheme required.
Exit	Sellers can exit at any time by returning the inventory.	No refund or exit policy exists.
Returns	Depends upon the value of products sold and not the number of people recruited.	Money from new participants is used to pay recruiting commissions to earlier participants.
Sales incentives	Primarily derived from sale of goods and are paid directly through banking channels.	Based on recruiting new people rather than on sales. The payments are made usually through members

APPLICATION OF PRIZE CHITS AND MONEY CIRCULATION SCHEMES (PCMCS) ACT, 1978 TO THE DIRECT SELLING INDUSTRY



Most foreign jurisdictions have already established direct selling regulations and best practices that protect the interests of legitimate direct sellers as well as the public. However, India does not have dedicated legislation or a specific regulatory body for direct selling.

The PCMCS Act enacts a complete ban on Ponzi schemes and fly-by-night operators. The Act specifically focuses on schemes for the making of “quick and easy money”, and defines these as ‘money circulation schemes’. However, the terms “quick and easy money” are not defined anywhere in the Act. The broadness of the Act’s language means that it may be misapplied to a variety of business models, including those that are legitimate direct sellers. This adds to the confusion, clogs the law enforcement and judicial redress system, while the Ponzi / pyramid scheme continue to operate.

Further, an attempt is made in the study to provide for a grievance redressal mechanism and regulation of direct selling industry (for example laying down certain obligations on direct selling entities, prohibition of doing certain practices by direct selling entity, etc.)

REGISTRATION OF DIRECT SELLERS + CIS (SEBI) = GREATER PROTECTION FOR CONSUMERS

At the heart of the fight against Ponzi / pyramid schemes, is consumer awareness and consequent protection. Requirement of a registration, as under SEBI, is an immediately and easily identifiable benchmark on whether a scheme soliciting investment (without sale of any goods or services) is legitimate or not. This also aids in citizens blowing the whistle for any solicitations by unregistered schemes, triggering greater enforcement and deterrence.

Having a similar registration for Direct Sellers would ensure that citizens have an identifiable benchmark for Direct Sellers as well and can identify as well as complain against any Ponzi/ Pyramid Schemes attempting to garb themselves as Direct Sellers.



SUGGESTIONS ON WAY FORWARD

In order to redress the regulatory uncertainty present in the environment, two steps are indicated. Firstly, there must be a mandatory registration process for any businesses involved in direct selling activities. The registration process may be facilitated through the establishment of a Central regulatory body (which would also be responsible for detecting and penalizing unlawful activity). This regulator will ensure that citizens are protected from illegal money circulation schemes, while still enabling legitimate activity to continue.

Secondly, a clear definition of direct selling must be established. Ideally, this definition would provide identifiers of legitimate Direct Selling business models. Most importantly, the definition would enumerate the various features of illegitimate Ponzi / pyramid schemes so that law enforcement authorities would be able to investigate and put a stop to these schemes more efficiently.

In conclusion, legislative reform in the direct selling arena is necessary in order to identify advanced Ponzi / pyramid schemes, clear up regulatory uncertainty, and also ensure protection of both direct sellers and consumers.

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