

PAMPHLET SERIES
NO. 4

**DANGER
POSED BY
PYRAMID SCHEMES
&
NETWORK MARKETING PROGRAMS**



In the recent past, the Central Bank became aware of the operation of a Pyramid Scheme which was disguised as a network marketing scheme and had attracted a large number of participants from Sri Lanka. The Central Bank, recognising the danger such schemes would pose to the economy and to its participants, took immediate steps to prevent the spread of the scheme. These included initiating changes in the law to make such schemes illegal in Sri Lanka, and mounting of an awareness campaign to educate the public on Pyramid Schemes. This pamphlet which explains the nature of different types of Pyramid Schemes, outlines the danger they pose and provides tips on identifying Pyramid Schemes. It is issued by the Bank as a part of its awareness campaign on Pyramid Schemes.



Central Bank of Sri Lanka

May 2006

DANGER POSED BY PYRAMID SCHEMES & NETWORK MARKETING PROGRAMS

Have you ever been approached by someone who has asked you to join a scheme which would make you rich quickly without much effort?

Be careful, this may be a Pyramid Scheme which is illegal in Sri Lanka.

You will not only lose your money but could even face prosecution and the punishment imposed could include even imprisonment.

Pyramid Schemes have been described as Personal and Financial Tsunamis by Pyramid Alert of the USA because:

“The harm spreads rapidly, sweeping across cities and nations gaining momentum, leaving long term suffering in its wake and causing social and personal damage in addition to financial destruction. They can trigger further disruption and are little understood, seldom studied and known by many different names”

WHAT IS A PYRAMID SCHEME ?

A **“Pyramid Scheme”** is defined as a scheme under which a person makes a payment to get the right to recruit others into the scheme for which he receives an income. The new recruits also make payments to get the right to further recruit others and in turn receive incomes for such recruitment. Such a scheme is called a Pyramid Scheme, because over time, a hierarchy of participants resembling a Pyramid is formed with the introduction of new and larger levels of participants to the scheme. The salient feature of a Pyramid Scheme is that the number of participants expands rapidly in an exponential manner at each stage, as new participants are drawn to the scheme. We shall see below that a large majority of participants at the bottom levels of Pyramid Schemes inevitably lose the money they pay in to the scheme. This is why Pyramid Schemes are considered **calculated consumer frauds**.

ANTI PYRAMID LAWS

Pyramid Schemes have been made illegal in Sri Lanka in view of the potential danger they pose to the economy.

The Banking Act No 30 of 1988 was amended by incorporating the following provision to prevent the operation of Pyramid Schemes.

“No person shall directly or indirectly initiate, offer, promote, advertise, conduct, finance, manage or direct a scheme where benefits earned by the participants to such a scheme are largely dependent on

- (a) increase in the number of participants*
- (b) increase in the contributions made by the participants in the Scheme”*

Any person who contravenes the above provision of the Banking Act is guilty of an offence and on conviction is liable to a fine not exceeding Rs. 1,000,000 and/or a term of imprisonment not exceeding 3 years. Further, if the offence is committed willfully or knowingly, or with the knowledge that the act will cause damage or harm to any other person, the offender will be liable to rigorous imprisonment for a term not less than 3 years and not more than 5 years and to a fine of Rs. 2,000,000 or twice the aggregate amount in Sri Lanka currency revealed or divulged to have been received from the participants in the scheme, whichever is higher.

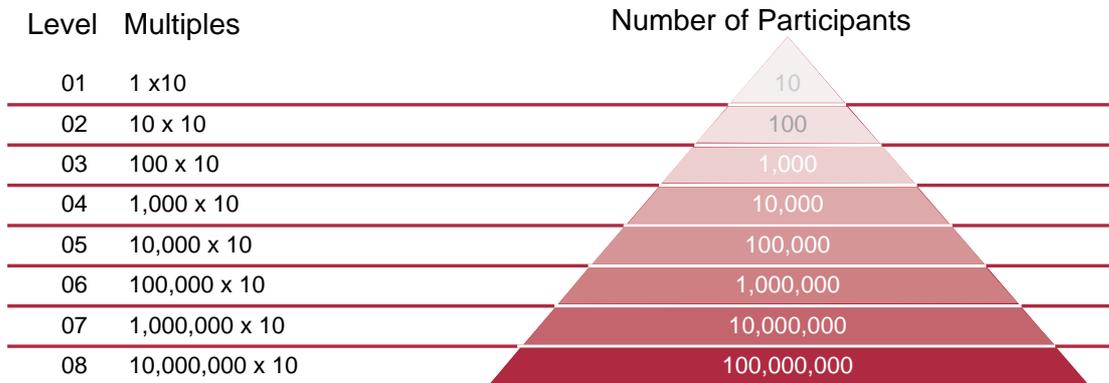
Also, violation of the above provision of the Banking Act is specified as an “unlawful activity” under the Prevention of Money Laundering Act No. 5 of 2006 and the Financial Transactions Reporting Act No. 6 of 2006. Therefore, any funds earned by promoting Pyramid Schemes are liable to seizure and forfeiture, in the event such funds are used for the offence of Money Laundering or for financing terrorism.

TYPES OF PYRAMID SCHEMES

There are basically two types of Pyramid Schemes – the **Naked Pyramid Scheme** and the **Product-based Pyramid Scheme**. The Naked Pyramid scheme is one in which no product is offered. The Product-based Pyramid Scheme is operated in most instances as a **Multi-level or Network Marketing Scheme** in which a participant is required to purchase a product at an inflated price in return for which he receives:

- (1) the right to sell a product and
- (2) the right to receive a return for recruiting other participants into the program.

Diagram I - Naked Pyramid Scheme



The product is therefore a false front to hide the true nature of the scheme and those purchasing the product are not true customers but are actually sales persons in that they recruit others who also join the schemes to get the right to recruit further participants. The most common Pyramid Schemes now operating are those that are disguised as Multi-level or Network Marketing Schemes.

HOW PYRAMID SCHEMES ARE PROMOTED

Pyramid Schemes gain popularity by exploiting the greed, gullibility and desperation of individuals who are uninformed and under financial pressure. Therefore, they could be deceived into believing that they could get rich quickly with minimum effort.

Prospective participants are solicited by messages telling them that they could earn huge amounts of money for doing nothing, other than recruiting a small number of members to the scheme.

Promoters sometimes even offer to contribute on behalf of participants, until they find the money.

Promoters often use the names of world famous persons or organizations to mislead the public into believing that the scheme is reputable.

Motivational seminars are organized by promoters/participants where the audience is subject to intense propaganda with regard to gains that could be derived from the scheme. In these seminars sometimes pictures of those who have gained from the scheme are exhibited together with their luxury vehicles and/or

mansions, in order to demonstrate their affluence and thereby attract the greedy and gullible to the scheme.

OPERATION OF PYRAMID SCHEMES

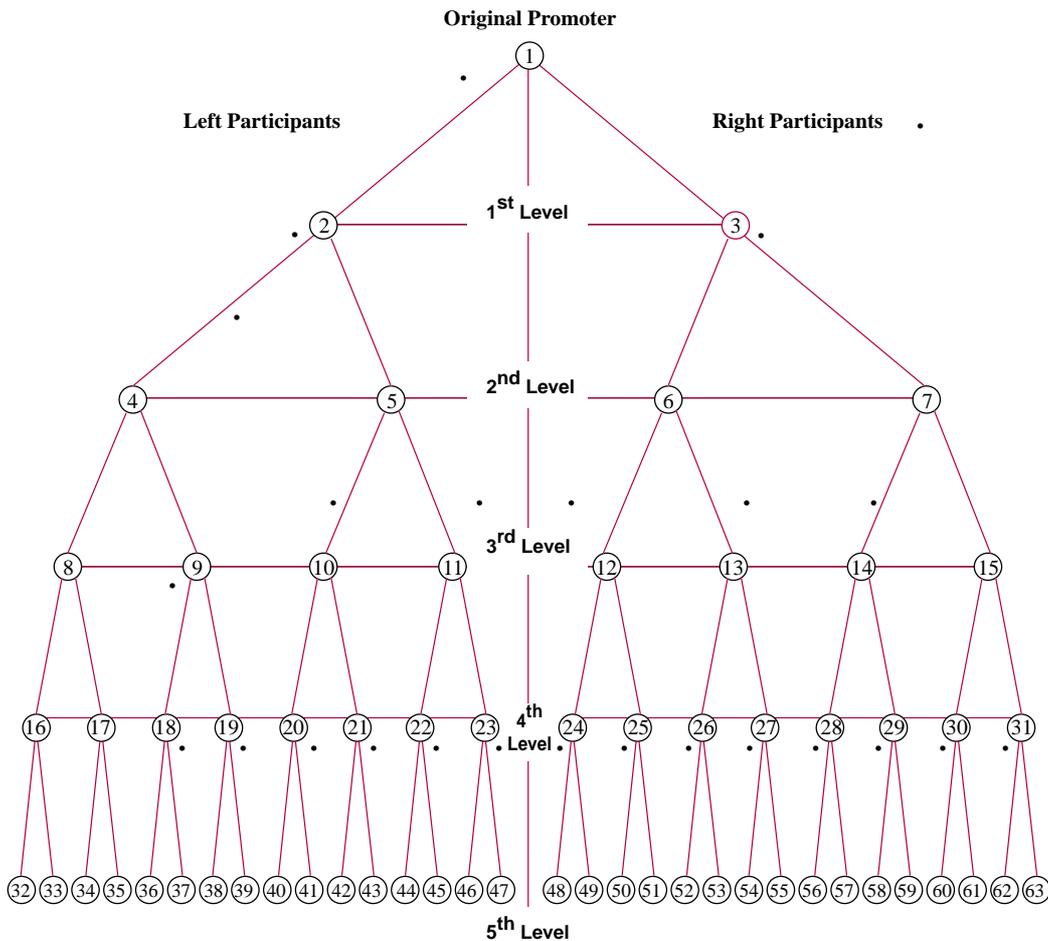
Example 1-Naked Pyramid Schemes

A person (promoter) commences a scheme by recruiting 10 other persons at Level 1 who are required to send him Rs. 100 each and recruit a further 100 persons (10 persons each). The process continues in this manner with each new participant needing to recruit 10 more participants and send Rs. 100 to the promoter. At some stage, the promoter exits from the scheme and ceases to collect any further payments. Now the 10 participants at Level 1 (see **Diagram 1**) move to the top of the Pyramid and all subsequent levels of participants recruited after this stage make their payments of Rs. 100 to the 10 participants at Level 1 until the stage is reached for these 10 participants to exit from the scheme. Thereafter, the 100 participants at Level 2 are supposed to move to the top of the Pyramid and the process is supposed to continue in this manner.

Suppose the original promoter exits from the Pyramid Scheme when the 6th Level is reached, the payoff to the original promoter will be Rs. 111,111,000 as indicated below.

From the first level participants he collects	Rs. 1,000
From the second level participants he collects	Rs. 10,000
From the third level participants he collects	Rs. 100,000
From the fourth level participants he collects	Rs. 1,000,000
From the fifth level participants he collects	Rs. 10,000,000
From the sixth level participants he collects	Rs. 100,000,000
Total payoff	Rs. 111,111,000

Diagram II - Multi-level Marketing / Network Marketing Pyramid Schemes



○ The number in the circle indicates the number of persons who have joined the scheme at a given point

However we may observe from Diagram 1 that the number of participants at Level 6 has reached 1 million. For the scheme to continue, it is necessary for the participants at Level 6 to recruit 10 million further participants. This is an unlikely outcome given that the population of Sri Lanka is below 20 million. In any event, these 10 million participants at Level 7 will not be able to recruit the required 100 million participants to progress up to Level 8 within Sri Lanka. In fact, the total population of the world would be insufficient to recruit the number of participants required to continue with the scheme beyond Level 10. **So the collapse of the scheme and the loss of “investment” by a large number of participants at the bottom levels of the Pyramid is inevitable.**

Example 2 – Product Based Pyramid Scheme

A company promotes a Pyramid Scheme in which a product is sold at a highly inflated price of say Rs. 50,000 and the buyers becomes eligible to earn commissions by recruiting further customers. These customers will in turn be eligible to earn commissions on recruiting further customers. However the 1st commission of Rs. 10,000 becomes payable to a participant heading a particular hierarchy (promoter) only if the number of participants below him reaches at least 10 and when these participants are placed on his right and left forming his right and left participant groups as depicted in Diagram II, the number of participants in his right participant group is at least 5 and the number of participants in his left participant group is at least 5. Each subsequent

Box 1
Ponzi Schemes

Another type financial scam which bears similarities to a pyramid scheme is the Ponzi Scheme named after Charles Ponzi who ran such a scheme in 1919-1920. This type of scheme is run by a central company or an individual who receives funds from clients falsely claiming that such funds will be invested in very productive ventures and promising very

attractive returns. In reality funds received from later investors are used mainly to pay earlier investors the promised returns, and very little if any is invested. When funds run out as is inevitable, the scheme collapses. Unlike in the case of pyramid schemes, participants in Ponzi schemes will be unaware of the nature of the scheme in which they participate.

participant also earns a commissions of Rs.10,000 whenever the number of new participants reach 10, (with 5 on his left participant group and 5 on his right participant group) and all those higher in the hierarchy will continue to receive further commissions each time 10 new participants are recruited at lower levels with at least 5 in his left and five in his right participant groups.

Now assume that the hierarchy continues to expand in a “balanced binary” manner as depicted in Diagram II. When the scheme progresses to Level 5 there would be 63 persons involved in the Pyramid. On the basis of Rs.50,000 per product at Level 5, the total sales proceeds earned by the company would be Rs.3,150,000 (Rs.50,000 x 63). In the process, the company would have paid commissions on 17 occasions to 7 persons (7 commissions to the original promoter, 3 commissions each to the participants at Level 1 and 1 commission each to participants at Level 2). The total commissions paid out would amount to Rs.170,000 (only 5.4 per cent of total sale proceeds). Also, only 11 per cent of total participants have earned commissions at this point.

It is clear that the number of participants earning commissions is only a small fraction of the total number of participants, while the value of commissions paid out is a small fraction of the sale proceeds of the company. Therefore the actual gainer is the company which operates the scheme. On the inevitable collapse of the

scheme, a large proportion of participants at the bottom of the “Pyramid” would lose out and be left only with the items purchased at an inflated value.

ARE PYRAMID SCHEMES DIFFERENT TO GAMES OF CHANCE SUCH AS LOTTERIES?

Yes, because all participants do not have equal chance of winning. In a Pyramid Scheme a person organizing it, is always in the winning position. The vast majority who join later are always losers.

WHY PYRAMID SCHEMES COLLAPSE?

▲ The number of potential participants are finite and limited

As explained above Pyramid Schemes depend on bringing in an exponentially growing number of participants. That is, if you get one person who gets “n” persons to join and each of those persons gets “n” more persons to join and so on, the total number of persons grow by powers of “n” (exponential growth). Even if “n” is a small number the total number of persons joining grows very large in a relatively few steps.

As seen in Diagram I, if 10 persons need to be recruited, the level of 10 million is reached within 7 steps and it is no longer possible to continue with the Pyramid in a country like Sri Lanka, given its population size. At this point, the Pyramid collapses and a majority of persons who have participated lose their money.

▲ **No new wealth is created, the only wealth gained by any participant is the wealth lost by other participants**

In a Pyramid Scheme no new wealth is created. It is like participants putting their money into a black box. If the money put up is distributed in a way that some people gain more than they put in, then inevitably some people have to lose what they put in. Therefore, for a few to gain many have to lose.

WHY DO PYRAMID SCHEMES CONTINUE TO EXIST?

- ▲ **Victims Silence and Shame** – Persons who have lost money do not divulge the fact, as they tend to be ashamed of being deceived. Victims often blame themselves as losers.
- ▲ **Revolving Door Group** – The bottom layers of a Pyramid become a “revolving door group” with the losers leaving and being replaced by new members.
- ▲ **Heavy Lobbying & Strong Pressure** – Promoters lobby government officials and often ingratiate themselves by making contributions to political parties.
- ▲ **Deception Practised by Promoters** – Promoters do not divulge the average level of payouts to participants but focus on earnings of the handful of customers (usually the promoters themselves) who have gained from the Pyramid Scheme.
- ▲ **Complexity of the Scheme** – Promoters deliberately introduce complexity to the scheme and the rules of participation so that the ordinary person finds it difficult to understand its true nature.

DAMAGE CAUSED BY PYRAMID SCHEMES

- ▲ By its design a large number (usually 90%-99%) of those participating in Pyramid Schemes would sustain losses with the inevitable collapse of such schemes. In extreme cases, collapse of such schemes have even led to social unrest and violence. The experience of Albania given in Box 2 is an example of the ill effects that could accrue to a

country through large scale operations of a Pyramid Scheme within its territory.

- ▲ As persons tend to recruit friends and relations to the scheme, the collapse of the scheme would sour human relations and destroy trust. Pyramid Schemes have been known to have caused divorces and even suicides.
- ▲ As some of those engaging in Pyramid Schemes are likely to be those who are already financially vulnerable, they are likely to sink into poverty when the scheme collapses. There could also be a significant alteration in the distribution of income and an increase in inequality in a country due to large scale operations of these schemes as they transfer funds from the large number at the bottom of the Pyramid to the few at the top.
- ▲ Persons participating in Pyramid Schemes may use funds borrowed from financial institutions to engage in this type of activity, hoping to repay out of earnings from the scheme. A collapse of the scheme would cause large scale defaults and threaten the financial stability of the economy.
- ▲ If payment for participation in a Pyramid Scheme has to be made abroad in foreign currency, there could be a significant drain of foreign exchange from a country owing to the operation of such a Pyramid Scheme. This could cause volatility in the exchange rate, balance of payments problems and reduce the country’s foreign exchange reserves.
- ▲ Participants in Pyramid Schemes may increase their demand for goods and services on the expectation of future income which would accrue to them from the scheme. This may cause inflation and a deterioration of the current account of a country (due to an increase in the demand for imports). With the inevitable collapse of the scheme, many persons would sustain severe losses and as a result there would be a contraction in demand which could lead to deflation and a reduction in output.

Box 2

Albania's Experience with Pyramid Type Schemes

Due to the weaknesses in the formal financial sector in Albania in the immediate post transition period, an informal financial market flourished and was at the time tolerated by the authorities. These informal companies were considered to be making a valuable contribution to growth. Among them were some who accepted deposits and offered loans and others who borrowed money at very high interest rates for investment on their own account. The precise nature of business of these latter companies were unknown. It was these that either were or later transformed into operators of Pyramid type financial schemes. Their claim was that there were very profitable opportunities for investment in small businesses and on that basis they promised unrealistically high interest and return on the principal invested. In reality investments if any made by these companies were purely for "window dressing." In early 1996 more companies became involved in these types of schemes and in order to attract funds, interest rates were hiked competitively drawing in more depositors. People even

sold property and farmers sold livestock to invest in these schemes while employers found it difficult to attract workers as they preferred to live off their earnings of interest. At the peak of operations the nominal value of the liabilities of the Pyramid type schemes amounted to almost half of the country's 1996 GDP. Inevitably, due to the unsustainability of the schemes, the companies were forced to default somewhere in 1996. When payments which were regularly received by depositors stopped, there was a violent outburst of public protest. Within a short period of about 4 months all companies operating Pyramid type schemes collapsed. This caused the overthrow of the government in power and plunged Albania into anarchy, bringing with it tremendous social and economic costs. The widespread civil disorder that ensued caused an estimated contraction of output of about 7 per cent in 1997. Over 2000 lives were lost and thousands fell into poverty due to either their unwise investments in the companies that defaulted or the destruction of their property due to the violence.

Source: Chris Jarvis: The rise and fall of Pyramid Schemes in Albania. IMF Working Paper, July 1999.

- ▲ Pyramid Schemes would distort savings and investment in an economy with participants using their savings to invest in such schemes rather than engaging in productive investments. It also could cause a misallocation of resources such as human resources and time, with persons withdrawing from productive employment to engage full time in these schemes which would result in a loss of output.

HOW TO IDENTIFY PYRAMID SCHEMES?

Most Pyramid Schemes presently operate as multi-level or network marketing schemes and therefore persons should be wary of participating in such schemes, especially as the promotion of such schemes is now a violation of the law.

The following tips are presented to help you to identify Pyramid Schemes.

- ▲ **Beware of anyone who tells you that you can make huge amounts of money with very little effort.** They are almost certainly not telling you the truth and are trying to deceive and cheat you. You will most likely not only lose money but even find yourself subject to legal prosecution for fraud.
- ▲ **Avoid any sales plan that sells a product at an inflated price (higher than the intrinsic value of the product) and offers commissions for recruiting other purchasers.** Even if a money back guarantee is included, be cautious as there are likely to be a number of conditions attached to receiving money back which would in fact make it impossible to do so.
- ▲ **Be cautious of plans that claim you will make money at an exponential rate through the continued growth of your “downline”** i.e. the commissions on sales made by those recruited by you instead of sales made by you.
- ▲ **Avoid plans where advancement is based on recruitment rather than retailing** and where the training/motivational seminars provided by promoters focus on recruiting/enrolling members rather than retailing goods to the public.
- ▲ **Stay clear of plans where there is no evidence that a sizeable number of sales persons earn a majority of their income from retailing.** Legitimate multi-level marketing schemes offer products and services sold through a network of distributors and any commissions paid to distributors are related to the sale of goods and services to end users (those who buy the goods for its own sake and not to obtain the right to recruit others to the scheme). The lack of retailing to end users is the chief characteristic by which Pyramid Schemes can be distinguished from genuine multi-level marketing schemes. However, most multi-level marketing schemes currently in operation are Pyramid Schemes.
- ▲ **Avoid plans which emphasize on unlimited authorization of new sales representatives defeating local retailing opportunities.**
- ▲ **Beware of decoy references** - that is persons claiming to have made windfall profits through participating in a marketing plan. These persons may have been paid by the promoters to do so.
- ▲ **Do not make payment or sign contracts to participate in a marketing scheme in any seminar or other high pressure situation.** Think carefully whether the scheme could be a Pyramid Scheme and discuss the matter with a knowledgeable person such as an accountant, lawyer or banker before making any commitment.
- ▲ **Be careful not to be fooled by “business opportunities” and “get rich quick” schemes offered through the internet or through unsolicited e-mails.** With the growth of e-commerce, Pyramid Scheme operators are increasingly using the electronic media to attract potential participants around the globe, at a relatively low cost.
- ▲ **Be wary of schemes that claim to have secret plans, overseas connections and special relationships.** Charles Ponzi the inventor of the Ponzi Scam made such claims to attract the gullible to his scheme.