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## PROHIBITION OF PYRAMID SCHEMES AND REGULATION OF DIRECT SALES IN INDIA

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### ABSTRACT

Pyramid schemes will progress and not cease to exist as long as new participants continue join at the bottom level to keep expanding the pyramid's foundation. The overall structure starts to collapse when the number of viable and willing participants recedes. Pyramid schemes cannot survive for a substantial duration, as the design/structure solely depends on the perpetual recruitment by the participants. Further, due to the delay in payments made by the new recruits, at times, even the top-level members tend to incur heavy financial loss. This nature of the pyramid scheme threatens to destabilize the financial assets of individuals and as a result, pose as a threat to the economy.

The paper analyses the *Consumer Protection (Direct Selling) Rules, 2021* (herein, referred to as the '2021 guidelines') to widen the difference between illegal pyramid schemes and legal direct selling entities. Additionally, the paper analyses the improvements brought by the 2021 guidelines compared to the Direct Selling Guidelines, 2016 (herein, referred to as the '2016 guidelines'). The paper has also objectively studied the 2021 guidelines and the Consumer Protection Act, 2019 side by side to derive express and implied liabilities of direct sellers and entities. Finally, a comparative analysis of the laws of Singapore and India pertaining to

the subject matter to figure out the scope for development of the provisions laid down by the Central government has been comprehensively discussed in the paper.

### I. INTRODUCTION

The issue in terms of pyramid schemes is the consequential instability caused in society due to the heightened probability of its failure. Since a pyramid scheme solely depends and focuses on the recruitment of new members, rather than focusing on the sale of actual products; once the recruitment of members has reached saturation, the scheme tends to fail. The intensity of this failure is of a higher degree for individuals at the bottom of the scheme, while it has minimal effect on the higher-level members of the pyramid. Pyramid selling is a scheme founded and built by its promoters, on deceptive and insignificant claims of higher returns in shorter periods. As the scheme does not cohere to focus on its actual business and solely concentrates on recruitment, the relevancy of the sale of their products or services does not even come into the picture. The word 'pyramid' emphasizes that the members on top earn money at the cost of those participants at the bottom of the scheme.

Pyramid schemes may be described as a business model where each paying participant recruits two additional participants, with the initial participants receiving returns from money contributed by subsequent participants. The foundation of these schemes is based on a few original key members, enlisting new members who are ready to pay fees/charges for participation in the scheme in the desire of receiving the enticing benefits promised by the promoters.

The functioning of these deceiving schemes contradicts the various rights guaranteed to consumers. The scheme obligates its members to purchase products at an unreasonable amount or quantity, resulting in members purchasing the products far from 'competitive'

or 'market prices.' Furthermore, pyramid schemes often resort to misrepresentation and deceit to attract new individuals. Most often, persons who join such organizations based on the false representation by the promoters suffer unmanageable financial loss. The dishonest and fraudulent functioning of falsely representing information often acts as a tool shielding the unfair trade practices from the consumers. Therefore, violating the consumer's right to information and awareness, and such a right has been guaranteed to the consumers to enforce it against these unfair trade practices. These entities clearly do not set out any redressal mechanisms to address the grievances that the consumer might face. The absence of such a redressal structure clearly violates the right of the consumer to be heard and seek redressal.

The researchers have undertaken this research by adopting doctrinal, historical, and comparative modes of research. This paper aims to paint a picture of the reality of pyramid schemes by analyzing the various legislations and guidelines imposed to prevent and differentiate direct sellers from pyramid schemes. Additionally, the paper shall contain an objective historical study on the rules and guidelines adopted prior to the 2021 guidelines. Lastly, this paper seeks to carry out a comparative study of the rules pertaining to pyramid schemes between Singapore and India.

## II. PYRAMID SCHEME AND DIRECT SELLING ENTITY – AN OVERVIEW

As per the Department of Consumer Affairs, a direct selling entity is "an entity, not being engaged in a pyramid scheme, which sells or offers to sell goods or services through a direct seller".<sup>888</sup> On the other hand, a pyramid selling entity is a network of individuals with the primary goal of receiving benefits directly or

indirectly as a result of enrolling participants in the scheme.<sup>889</sup> It is of extreme significance that the entities that are solely focused on the sale and distribution of their products and services, rather than concentrating on the benefits through recruitment, fall within the legal ambit of direct selling entities.<sup>890</sup> An inference is drawn to notice that all pyramid schemes can be considered as direct selling entities, but not all direct selling entities can be said to be pyramid schemes.

### A. THE DIFFERENCE

Comprehending the difference between the legal and illegal establishments, there only exists a thin line that separates the legal direct selling and prohibited pyramid selling companies. The Indian jurisprudence has established various elements that differentiate an entity undertaking direct selling from a pyramid selling entity.

- i. The first element is that the area of focus for a direct selling entity is the sale of goods and services. In contrast, in a pyramid scheme, the area of concentration is on recruiting more participants.<sup>891</sup>
- ii. A direct selling entity will not establish an obligation for the newly recruited individuals to purchase goods at a higher cost or quantity than the cost or quantity at which a rational consumer is expected to consume the product.<sup>892</sup>
- iii. In addition to this, a legitimate direct selling entity does not obligate an individual to pay any form of fees on registration and draws a contract to establish the level of participation of the individual.<sup>893</sup>

<sup>888</sup> [Consumeraffairs.nic.in. 2022. \[online\] Available at: https://consumeraffairs.nic.in/sites/default/files/file-uploads/direct-selling/Direct%20Selling%20Guidelines%20Final%200.pdf.](https://consumeraffairs.nic.in/sites/default/files/file-uploads/direct-selling/Direct%20Selling%20Guidelines%20Final%200.pdf)

<sup>889</sup> Payyakkal Devadas versus State of Kerala & others, LNIND 2013 KER 38580, (India).

<sup>890</sup> *supra* note 1.

<sup>891</sup> Jasdeep Singh Bains And Ors. vs U.T. Chandigarh, II (2004) BC 344, (India).

<sup>892</sup> *supra* note 1.

<sup>893</sup> Smt. Sharda Mahajan vs. Maple Leaf Trading International P. Ltd., : (2007) 139 Comp Cas 718, (India).

iv. A direct selling entity usually provides a buy-back policy for all the marketable unsold goods along with a grievance redressal mechanism for all the individuals who are part of the organisation.<sup>894</sup>

### B. GUIDELINES ISSUED BY RBI

The Reserve Bank of India has clarified its stand on the issue of Pyramid scheme by notifying the citizens about its complications.<sup>895</sup> The statutory body has requested the citizens to refrain from these schemes requiring excessive registration charges to be a part of such organisations. The RBI has stated that the sole source of income for such schemes is these entry charges paid by individuals. Hence, the probability of the pyramid to collapse is high, and this will result in individuals at the bottom to face a substantial monetary loss as it is not feasible once the target market is diluted.<sup>896</sup> The notification was released as a consequence of the increase in these frauds and more and more individuals falling prey to it. It has been advised to all citizens to report such frauds and scams to the concerned authority at the earliest to prevent its escalation.<sup>897</sup>

### III. GUIDELINES AND REQUIREMENTS FOR DIRECT SELLING ENTITIES ESTABLISHED BY LAW

The 2021 guidelines enlist specific requirements that direct selling entities must follow.<sup>898</sup> By way of these requirements, it also expressly prohibits the existence of pyramid schemes. These rules widen the segregation between Direct Selling entities and Pyramid schemes. Prior to the 2021 guidelines, the Central government had put

forth the Direct Selling Guidelines of 2016. The 2021 guidelines expand the scope of a direct seller's accountability and responsibility compared to the 2016 rules. The Ministry has specified a limitation period of 90 days for the entities to comply with the requirements put forth by the 2021 guidelines.

The 2021 rules have been structured in accordance with Section 101(2) (zg), read with Section 94 of the Consumer Protection Act, 2019<sup>899</sup>. According to the Ministry of Consumer Affairs press release<sup>900</sup> the applicability of the new rules extends to; *"...all goods and services bought or sold through direct selling, all models of direct selling, all direct selling entities offering goods and services to consumers in India, all forms of unfair trade practices across all models of direct selling and also to also to a direct selling entity which is not established in India, but offers goods or services to consumers in India."*<sup>901</sup>

### A. RULES UPDATED IN THE 2021 GUIDELINES

The 2021 guidelines have extended its scope to include e-commerce platforms that undertake direct selling.<sup>902</sup> The new rules mandate a direct selling entity to establish a framework or mechanism to handle consumer grievances.<sup>903</sup> In addition, direct sellers have been made directly accountable for ensuring the accuracy of the advertisements they publish.<sup>904</sup> Further, the entity shall also be held liable in case it fails to fulfill any claims vouched by them.<sup>905</sup>

Government intervention in regulating the direct selling entities was a requirement to ensure these companies do not operate in violation of the rights of the consumers. According to the 2021 guidelines, all the direct selling entities are required to partner with the convergence

<sup>894</sup>Suresh Thimiri vs. State of Maharashtra, (2016) 2 AIR Bom R (Cri) 465, (India).

<sup>895</sup> Reserve Bank of India, 2015. *RBI cautions Public against Multi Level Marketing Activities*. [online] Available at: <https://www.rbi.org.in/commonperson/English/Scripts/PressReleases.aspx?id=1514>.

<sup>896</sup> *supra* note 8.

<sup>897</sup> The Times of India. 2022. *RBI warns against pyramid schemes - Times of India*. [online] Available at: <https://timesofindia.indiatimes.com/business/india-business/rbi-warns-against-pyramid-schemes/articleshow/45724589.cms>.

<sup>898</sup> India: Consumer Protection (Direct Selling) Rules 2021, No: 730, Indian Curr. Cen. Leg., 2021, (India).

<sup>899</sup> Consumer Protection Act, No. 35 of 2019, INDIA CODE (2019).

<sup>900</sup> *supra* note 11.

<sup>901</sup> *supra* note 11.

<sup>902</sup> Cloutail India Private Limited vs. Oriflame India Private Limited and Others, (2020) 267 DLT 228 (DB), (India)

<sup>903</sup> *supra* note 11.

<sup>904</sup> *supra* note 11.

<sup>905</sup> *supra* note 11.

process of the National Consumer Helpline.<sup>906</sup> This shall allow the Central Government to handle any issues raised by the consumers pertaining to the direct selling entities. The collaboration enables the government to easily hold such companies accountable for their shortcomings and decide the redressal associated in a quick and fast manner.

#### B. GUIDELINES FOR DIRECT SELLERS

As per the 2021 guidelines, the direct sellers carry a higher degree of responsibility for the goods that have been sold by the direct sellers.<sup>907</sup> Such accountability obligates the sellers to distribute quality products and refrains them from adopting unfair trade practices.<sup>908</sup> A mandate has been imposed on the companies to establish a grievance handling mechanism, where relevant details of such mechanism need to be specified on the company's official website.<sup>909</sup> Officials handling such grievances are required to accept the complaint within 48 hours and resolve the same within one month of receiving the complaint.<sup>910</sup> The provision has also mandated the presence of a nodal officer to ensure all the actions of the entity are in lieu of regulatory provisions.<sup>911</sup>

Every organisation is required to supervise the recruited direct sellers and is compelled to maintain a record of all its sellers. On account of any of the sellers being delisted, such removal must be made public.<sup>912</sup> The 2021 guidelines obligate the management to refrain from impersonating a consumer and posting false reviews about its goods or services. No direct selling business shall, directly or indirectly, misrepresent any information pertaining to the

quality or characteristics of any of the goods or services it offers.<sup>913</sup>

#### IV. LIABILITIES OF THE DIRECT SELLING ENTITIES UNDER 2021 DIRECT SELLING RULES

Direct sellers are bound to perform certain obligations under the Consumer Protection (Direct Selling) Rules of 2021<sup>914</sup>. These obligations under the guidelines recognize specific responsibilities and liabilities of the direct sellers due to the high probability of these entities exploiting the consumers and fair markets by way of pyramid schemes. These liabilities have already been established by the Consumer Protection Act of 2019<sup>915</sup> which these guidelines have further re-enforced.

##### A. PRODUCT LIABILITY

The first and foremost liability that forms an integral part of the Consumer Protection Act 2019<sup>916</sup> is the product liability. Though embodied in the 1986 act, the concept did not have a specific provision for itself; thus, it was introduced by the 2019 amendment in Chapter IV. From an international point of view, it can be inferred that this theory was given a structure by the judgment delivered by the House of Lords in the case of *Donoghue v. Stevenson*<sup>917</sup>. The product liability principle holds the manufacturer/seller of the product or the product service provider liable for the defect in the product sold to the consumer. The liabilities of these intermediaries are enumerated under sections 84, 85 and 86 of the Consumer Protection Act of 2019<sup>918</sup>. The direct selling rules further implement this concept by incorporating the responsibility of the direct selling entities to not make any false representations with regard to their goods and services. It has been made mandatory for these entities to ensure that the

<sup>906</sup> *supra* note 11.

<sup>907</sup> *supra* note 11.

<sup>908</sup> *Syngenta India Ltd. (earlier Novartis India Ltd.) vs. Velaga Narasimha Rao & Ors.*, IV (2010) CPJ 119, (India).

<sup>909</sup> *Amway India Enterprises Pvt. Ltd. vs Rajendra Medicos & Ors.* 2018 Latest Caselaw 6183 Del. (India).

<sup>910</sup> *supra* note 11.

<sup>911</sup> *supra* note 11.

<sup>912</sup> *Id.* at 22.

<sup>913</sup> *supra* note 11.

<sup>914</sup> *supra* note 11

<sup>915</sup> *supra* note 12

<sup>916</sup> *supra* note 12.

<sup>917</sup> *Donoghue v. Stevenson* [1932] AC 562 (HL) 564 (appeal taken from Scot.).

<sup>918</sup> *supra* note 12.

advertisements published to market their goods or services are in accordance with the actual attributes and the original condition of the product or service sold/provided by them. In case the entities implicitly or explicitly endorse the authenticity of any of their products or services, they shall be held liable in a suit for the grievances arising out of such sale or service.

#### B. RESPONSIBILITY TO PROTECT THE PERSONAL DATA OF CONSUMERS

Personal data collection of consumers through virtual platforms and face-to-face transactions have helped the traders to develop much more precise customer profiles, which further aids in understanding and fulfilling the demands and expectations of the consumer base. Due to the increase in crimes concerning data privacy, such as identity theft, financial fraud, data sales, hacks, and breaches, etc., it is imperative to handle such sensitive information with care and caution.<sup>919</sup> Peter P. Swire, a well-known expert in the field of privacy law, argued that consumer privacy protection must be perceived as a quality of service towards the consumer, therefore forming an integral part of consumer welfare. Misuse of such data would unequivocally result in a compromise of consumer welfare.<sup>920</sup> The guidelines mandate that direct selling agencies take adequate and appropriate measures to protect and safeguard the sensitive personal information of the consumers collected by the direct sellers. Such measures shall be taken to prevent access or misuse of such information by unauthorized persons.

#### C. VICARIOUS LIABILITY

The concept of Vicarious Liability arises from the law of torts. The principle holds the master liable for the wrongful act or omission of the servant who has been committed the wrongful act or omission during the course of his

employment.<sup>921</sup> This liability is based on the maxim "*Qui Facit Per Alium Facit Per Se*" which translates to "*he who acts through another is deemed in law as doing it himself.*" The 2021 guidelines issued by the government enhance the liability of the direct selling entities for the functions and operations performed by their sellers. Therefore, the rules mandate these corporations to hold an official record of seller information and provide valid identity cards and documents to the direct sellers to define the liability of the entities; unlike the unregulated sellers under a pyramid scheme where the liability of the direct selling companies can be clouded due to inadequate training and improper records of employee information. Applying the principle explained in the landmark judgment of *Bartonshill Coal Co. v. McGuire*<sup>922</sup>, the direct selling corporations shall be held liable for any fraudulent behavior, misleading statements, unfair trade practices and other wrongful actions or omissions adopted by the direct seller during the course of the business within the scope of their employment.

Pyramid schemes exploit consumers, fair markets as well as the recruited personnel; and such entities abscond from any liability that arises from such schemes. Therefore, the guidelines were an absolute requirement to prohibit such schemes and paint a clear picture of the liabilities of the other direct selling companies and regulate their functioning and operations.

#### V. A COMPARISON BETWEEN INDIA AND SINGAPORE

Regulation of pyramid schemes is a much-needed ingredient for the protection of consumer rights, not just in India, but in every country. While India prohibits these schemes by way of the Consumer Protection (Direct Selling) Rules of 2021<sup>923</sup>, Singapore in the year 1973 had

<sup>919</sup> Russell G. Smith, *Identity theft and fraud*, HANDBOOK OF INTERNET CRIME, 2013, at 291.

<sup>920</sup> *The Inclusion of Data Privacy in Antitrust Analysis*, 6(2) NLUJ LR, 2020, at 1.

<sup>921</sup> Harold J. Laski, *The basis of vicarious liability*, 26 THE YALE LAW JOURNAL 105 (1916).

<sup>922</sup> *Bartonshill Coal Co. v. McGuire* [1858] 3 Macq 300.

<sup>923</sup> *supra* note 11.

passed a separate statute owing to the prohibition of these schemes called the Multi-level Marketing and Pyramid Selling (Prohibition) Act 1973<sup>924</sup> (*herein, referred as Singapore's 1973 act*). This Act primarily shines light on the prohibition of registration, incorporation and promotion of multi-level marketing entities and all pyramid-selling practices. However, certain companies fall outside the purview of this provision. These exclusions cover master franchises, direct selling entities and insurance companies by way of the Multi-Level Marketing and Pyramid Selling (Excluded Schemes and Arrangements) Order, also known as the exclusion order.

The term 'pyramid selling' under section 2<sup>925</sup> of Singapore's 1973 act lacks a definite scope, which leaves room for loose interpretation. The Singaporean case of *Tan Un Tian v. PP*<sup>926</sup> is one of the very few cases, in fact, one of the first cases dealing with this act. The judgment delivered by the court suggests the need for regulating the broad ambit of the act. The failure of the parliament to limit the meaning of this term has affected several incorrupt business entities that have not operated beyond the rights vested upon them.<sup>927</sup> The amendment to the act in 2000<sup>928</sup> further widened the scope of the definition to cover all companies that follow a multi-level marketing strategy (which was further limited by the exclusion order). Compared to the framework given to the definition of pyramid schemes under the 2021 Guidelines, 'pyramid selling scheme or arrangement' under section 2<sup>929</sup> of Singapore's 1973 act requires a sharp structure to limit the ambit of the term for effective regulation. A well-formulated definition for the term will address the lacunas in the law, if any, and also will suppress the probability of

incorrupt companies from being held liable under the act.

The 2021 guidelines mainly focuses on the regulation of direct selling corporations and sellers, and only a part of it prohibits the existence of pyramid schemes and practices related to it. Unlike these guidelines, Singapore's 1973 Act is solely based on the prohibition of pyramid schemes and multi-level marketing while intentionally excluding direct selling entities from its purview. The statute is solely committed towards the prohibition of these schemes; it sets out the ingredients that constitute each and every offence under the act and imposes appropriate penal measures that shall be taken for the said offences. However, India lacks appropriate provisions for the penalization of these schemes. The guidelines cannot be considered as an independent set of rules as it works in consonance with the consumer protection act of 2019<sup>930</sup> to determine the liability and the appropriate penal provisions applicable to the offenders. From the viewpoint of the rules, it prima facie attends to the regulation of direct selling entities; however, a distinct legislation addressing the prohibition, penalization and remedial mechanisms in relation to pyramid schemes would serve much more efficiently in curbing the frauds of the corrupt entities.

From comparing developments in relation to the regulation of pyramid schemes, it is inferred that Singapore definitely holds quite an undefeatable position in protecting the rights of the consumers. Despite the vague laws, the parliament has built an exhaustive statute that has been effectively functioning for almost 50 years.

## VI. SUGGESTIONS AND CONCLUSION

The prohibition of pyramid schemes and regulation of direct selling entities by way of the Consumer Protection (Direct Selling) Rules of

<sup>924</sup> Multi-level Marketing and Pyramid Selling (Prohibition) Act, (Act No 50/1973) (Sing.)

<sup>925</sup> Multi-level Marketing and Pyramid Selling (Prohibition) Act, (Act No 50/1973), §2, (Sing.).

<sup>926</sup> *Tan Un Tian v. PP*, [1994] 3 SLR 33.

<sup>927</sup> Edwin Peng Khoo Lee, *Pyramid Selling - The Need for Regulations*, 7 SAclJ 412 (1995).

<sup>928</sup> Multi-level Marketing and Pyramid Selling (Excluded Schemes and Arrangements) Order, 2000.

<sup>929</sup> *supra* note 39.

<sup>930</sup> *supra* note 12.



2021 can undoubtedly be opined as a progressive step towards the development in the protection of consumer rights. The escalation in the growth of pyramid schemes scams has called for such regulation. While the guidelines issued by the Central government is substantially observed as a success, the Indian Legal System is still in need of a distinct legislation to establish additional procedural and substantial laws with regard to the prohibition of pyramid schemes. The guidelines issued by the Ministry of Consumer Affairs in exercise of the powers conferred by the 2019 act, wholly focuses on the regulation of direct selling entities and by way of such regulation, it prohibits the pyramid schemes. The rules refer to the 2019 act in order to infer the appropriate penalties in case of contravention of the guidelines. However, this can be construed as an inadequacy of legal provisions. Non-adherence to direct selling guidelines has been covered under the 2019 act; nonetheless, penalties and liabilities attracted by pyramid selling entities are not enlisted by the provisions in a definite manner. As a consequence, the need for a separate legislation becomes imperative as the present laws do not cover integral aspects of laws concerning pyramid schemes.

On a suggestive note, the independent legislation shall legally establish each and every act or omission that constitutes an offence relating to pyramid schemes; liabilities of individuals and body corporates; the penalties attracted by the company, sellers/participants and any person who promotes or practices pyramid schemes; additional penalties, if any; the jurisdiction of courts in handling the matters relating to the schemes; the redressal mechanisms that can be adopted and the forums that can be approached by the consumers and any other material provisions in relation to regulation of these direct selling schemes. This suggestion finds its base on attaining the maximum protection of the consumers and creating a fair and a safe

market environment for them. Codifying a statute for the purpose of the aforementioned area and such a statute alongside the guidelines issued by the government would stand as a powerful tool in pushing India to have one of the best regulatory provisions for pyramid schemes.

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