



On the Legal and Market Analysis of “Direct Selling” in China

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Abstract

By exploring the origins and literal translations of “direct selling”, “multi-level marketing”, and “pyramid scheme” and analyzing the principles of laws, the principles of market economy, and the relationship between laws and regulations and market principles, this thesis concludes the positive meanings and the unscientific points of *Regulation on Administration of Direct Sales & Regulation on Prohibition of Chuanxiao*, expecting to founding a sound theoretical basis for the amendment and perfect of laws in the direct selling field.

Keywords: Direct selling, Illegal multi-level, Pyramid scheme

1. The positive meanings of the two *Regulations* and the social effect after the issue

1.1 Positive meanings

On Dec. 1st, 2005, the *Regulation on Administration of Direct Sales & Regulation on Prohibition of Chuanxiao* issued by the Ministry of Commerce of the People's Republic of China put in force in China. Afterwards, direct selling is formally taken as a legal activity in China. But multi-level marketing will be prohibited as an illegal activity. (The law of China takes multi-level marketing as an illegal activity, which means: organizers or operators take in new members, calculate and pay salaries one member according to the number of new members who join in the multi-level marketing, introduced by one member directly or indirectly, or the sales performances. Or, the organizer asks new members to hand in a sum of money as a precondition to join in. Or, by means of developing new members, the organizer or the operator ask members to invite more people join in, forming a multi-level relationship. The salaries of members at certain level are based on the sales of members at a lower level. By this way, the organizer and the member at top level obtain interests illegally, disturbing normal economic order, and affecting social stability. The great difference between direct selling and multi-level marketing according to the law of China relies in: all direct sellers are normally trained by the direct selling companies and any direct seller is not allowed to develop new followers or form multiple levels; the direct selling companies pay direct sellers salaries according to their sales; the total salary (includes wages, rewards, bonuses, or other economic benefits) of one direct seller should not exceed 30% of his sales.)

Firstly, the positive meaning of the two *Regulations* normally establish the legal position of direct selling and the illegal position of multi-level marketing by laws in China, what serve as definite rules for national commerce and business management agencies and juridical institutions in administration and execution (Gazette of the State Council of the People's Republic of China, 2005).

Secondly, due to the popularization and execution of the two *Regulations* and the fast reform of commercial circulation system, China's distribution industry is already open. Sorts of distribution models, ideas, and management methods appear in succession, what exerts certain positive effects on the perfect and development of modern market economic system.

Thirdly, after the direct selling, as an industry with easy entrances, gets protection from laws, it becomes a nice choice in employment. According to the *Analysis and Investment Consulting Report on China Direct Selling Industry* issued by China Investment Consulting in Jan. 2008, “till 2006, there are about 3 million direct sellers or so. In next few years, about 70 million people will be engaged in direct selling.” It will help to relieve social employment pressure and make best use of human resource.

Fourthly, according to China's commitments to WTO, China will cancel restrictions on foreign capitals founding businesses in no-fixed location wholesale and service field and constitutes *Regulations* that are in accordance with WTO principles and China's commitments after the entry into WTO. To issue the *Regulation on Administration of Direct Sales* is to fulfill the commitment. It is meaningful. (Details are from the *World Codes of Conduct* constituted by the World Federation of Direct Selling Associations. The “no-fixed location wholesale or retail” is also named as “no-shop sale”. It refers to the commercial activity that sells final consumers commodities or services without retailers’

fixed shops. The “no-shop sale” includes three types: direct marketing, direct selling, and auto sale.)

1.2 Analyze the social effect after the execution of the two Regulations in recent three years

A prominent phenomenon appears after the execution of the two *Regulations*. The distribution companies that accept normal direct selling education lose their bases of values all at once. Quite a lot of direct sellers are lost. Performances of companies with certificates decline wholly. The policy risks caused by the execution of the two *Regulations* hurt traditional large companies mostly. Companies with certificates of direct selling face challenges of “no market”. The following cases rightly illustrate the fact.

Many large-sized companies, such as the Harbin Pharmaceutical Group, declare to enter the direct selling industry in succession. At last, they fail, such as the well-known Onlly Company. It has founded the direct selling team and invited specialized firms to make market researches and designs. It has even established specific series of products for direct selling before its failure. Similarly, Procter & Gamble (Guangzhou) suffers from a terrible fate. Even for USANA, the world first-class direct selling company, the result is same. One fundamental reason for them stopping entering China’s direct selling market is the greater risks in policies and laws. Similarly, it is also the reason for why other companies, such as Qizheng Tibetan Medicine Company, grow slowly in the direct selling field. It is hard for companies to master and execute the state policies and laws. Therefore, companies have no choice but adopt relatively conservative tactics in case of suffering from failures.

Fulong’s reform of system. Here the “reform” is to turn multi-level structure into single-level structure and regulate the rate less than 30%. Fulong Company, also named as “little Amway”, offers us a typical case. Originally, customers can buy its oral liquid (its retail price is 200 RMB per box) at a preferential price 167 RMB per box. If buy more, customers can enjoy a discount from 6% to 21%. After the reform, customers buy the oral liquid at the retail price. Preferential prices are only for customers who spend more than 750 RMB in its oral liquid in one month. The preferential discount cannot be accumulated. If customers want lowest preferential price, they have to spend another 750 RMB in the oral liquid in one month. This reform is regarded as a “self-destructive”. It brings about nothing but poor business performances and loose cooperation. However, in order to obey the rules of two *Regulations*, many direct selling companies have to adjust themselves even at the price of future development to get legal certificates.

As a matter of fact, no matter how formal companies that have already got or are applying for certificates are, rules in the two *Regulations* are definite. If companies escape from investigations of execution institutions, everything will be ok. If not, almost all companies will suffer from questions. Companies have to survive from a dilemma. To follow the *Regulations* means poor profitability. To implement the multi-level direct selling will be canceled by execution institutions. (Gang Zhen, 2007, p. 12-13)

Mr. Weihua Zeng, the office director of Direct Selling Professional Commission of China Marketing Association, in his thesis concludes the development of direct selling in China in recent years after the execution of the two *Regulations*, “since the issue of the two *Regulations* in China, it has experienced two years’ execution. As for the development of direct selling at present, “dilemma” is right for depicting the fact. Companies with certificates have to reform themselves unwillingly. Illegal companies realize further development by any possible means. China’s direct selling is far from a legal and normal development. It is still in a confusing condition today.” (Weihua Zeng, 2008, p. 48)

Viewing from the general effects, the transformation of direct selling companies based on present laws make them get in a dilemma.

2. Legal analysis on direct selling

Why the effects exerted by the direct selling during years of operations since its birth in western countries or regions are far different from that in China. Reasons are multiple. To identify the root of the problem is the key for resolutions.

2.1 Errors in the application of legal concepts of “direct selling” and “multi-level marketing”

(1) International organizations’ definition of direct selling

As for the definition of direct selling, the World Federation of Direct Selling Association (WFDSA for short) defines it as: in a place except fixed retail shops (such as personal home, office or other places), independent direct sellers introduce products or services to consumers by face-to-face presentation and demonstration and realize sales.

Face to face presentation, demonstration, and sale of products or services, usually at the home or office of a prospect by the independent direct sales representatives. Employed by firms such as Avon, Mary Kay, and Tupperware, direct selling differs from network marketing in that it offers little or no incentives for recruiting ever increasing number of sales representatives. The direct seller is: a person who is a member of a distribution system of a direct selling company. A direct seller may be an independent commercial agent, independent contractor, independent dealer or distributor, employed or self-employed representative, franchisee or the like. (Details are from the *World Codes of Conduct* constituted by WFDSA: Direct Seller: A Direct Seller is a person who is a member of a distribution system of a Direct Selling company. A Direct Seller may be an independent commercial agent, independent contractor, independent dealer

or distributor, employed or self-employed representative, franchisee or the like.) According to these definitions, direct selling, as a matter of fact, means the direct seller sells and popularizes products or services directly to consumers by face-to-face presentation and demonstration. The direct seller gets salaries according to the sales. The door-to-door sale promotion is the earliest traditional way of direct selling.

(2) China's legal definition of direct selling

The direct selling regulated in the *Regulation on Administration of Direct Sales* in China is not the same with the definition of WFDSA.

According to China's *Regulation on Administration of Direct Sales*, the direct selling is a selling method, in which direct selling company recruits direct sellers who directly sell products to final consumers at no-fixed places. By referencing from the contents of *Measures for Managing Trainings for Direct Sellers* and *Regulation on Prohibition of Chuanxiao* issued at the same time, the greatest difference between China's legal explanation to direct selling and the WFDSA explanation lies in not only the different definitions and requirements for the subjects of direct selling, but also the former imposes narrow and strict limits on the selling methods. The differences are mainly:

First of all, although the former positions direct seller as a member of direct selling company's marketing system, it focuses on the independence of direct seller as an independent individual seller. The later emphasizes that the direct seller must be recruited by direct selling company and has to pass strict training examinations, and in marketing the direct seller must wear the certificate as a seller. (Details are from the *Measures for Managing Trainings for Direct Sellers*) These rules make China's direct seller is not an independent individual seller but more like a state servant. Although almost no direct seller wears the certificate, these rules make direct seller's commercial activities tend to be embarrassing.

Secondly, in the definition of direct selling the former definitely distinguishes the legal multi-level direct selling from some commercial activities that obtain profits by cheating or fake multi-level direct selling, namely the "multi-level marketing" in China. The former strongly opposes and forbids these cheating pyramid selling organizations and names them as "pyramid schemes". (Details are from the website of WFDSA: http://www.wfdsa.org/legal_reg/index.cfm?fa=pyramid. Publications) (Charles Mackay & Joseph De La Vega, 2000) The later regards the multi-level direct selling as illegal multi-level marketing and strictly forbids the multi-level direct selling teams as cheating pyramid selling system. It only regards single-level direct selling as legal. (Details are from the Article 7 in the *Regulation on Prohibition of Chuanxiao*.)

These analyses prove that the connotations of direct selling definitions are far different though China uses the same term with WFDSA. Professionals name it as "Chinese-style direct sales".

(3) Confusions caused by the application of the "multi-level marketing (Chuanxiao)" concept in laws

As a matter of fact, the connotation of world universal concept of direct selling includes single-level direct selling and multi-level direct selling. Both the direct selling concept and the multi-level marketing concept are from western market economy. They origins from An American term "direct selling". Because of people's different understandings to the term, it turns into "direct selling" and "multi-level marketing" after being translated into Chinese. If we translate the two terms back to English, it is only the term "direct selling" but not the "pyramid schemes" since the later has not a connotation of multi-level direct selling. Therefore, strictly speaking, in a cultural and original sense, direct selling is equal to multi-level marketing. They are just two names for one term. However, the law of China defines the multi-level marketing as an illegal concept. Its connotation includes the "pyramid schemes" forbidden by the world and also the "multi-level direct selling" confirmed by the world. Therefore, in this paper, the author takes the term "illegal multi-level" as the key word. Since the pyramid scheme is a kind of multi-level cheating "selling" activity, it is one of connotations of "illegal multi-level". Although there are sharp differences between multi-level direct selling and pyramid schemes, the multi-level direct selling is also one of connotations of "illegal multi-level" since it has been confirmed as an illegal activity by the law of China.

For certain law or regulation, firstly its words and terms should be more precise than that in other fields. In the perspective of culture and origins of terms, the two *Regulations* fail to define the two legal terms "direct selling" and "multi-level marketing" scientifically, precisely, and internationally.

As a result, in the official English version of *Regulation on Prohibition of Chuanxiao*, a Chinese-style legal term "Chuanxiao" appears. For the two *Regulations*, the English versions are respectively *Regulation on Administration of Direct Sales* and *Regulation on Prohibition of Chuanxiao*. (Details are from the Chinese-English versions of two *Regulations*, published by China Legal Publishing House, 2006)

Apparently, in a sense, it is not easy to explain the Chinese-style legal term "Chuanxiao" to Chinese. So, it will be hard to introduce its pronunciation and meaning to foreigners. Today, no matter what it is the direct selling market or the theoretical field, the economic field or the legal field, the Chinese field or the English field, nobody translates the

“multi-level marketing” as “Chuanxiao” or accepts this translation, except for the Chinese-English version of *Regulation on Prohibition of Chuanxia* issued by China. As a result, the issue becomes more confusing due to the unclear term.

According to these analyses, the legal term “multi-level marketing (Chuanxiao)” may cause confusions in three aspects at least. (1) Neglect the common recognition to the use of legal term. Both “Chuanxiao” and “direct sales” origin from “direct selling”. They originally have legal connotations but with different names. However, since the issue of the two *Regulations*, “Chuanxiao” tends to be illegal, and “direct sales” legal. The absence of the rationality and continuousness of literal and conceptual connotation leads to confusions for people’s understanding. (2) Conflict with the law of English-Chinese translation. Generally speaking, the transliteration is only for appellation (names, places, countries, or articles, etc.). If break this law and adopt the transliteration for legal term, not only foreigners can not understand its meanings, but more people will adopt this method for other terms. Finally, the Chinese-English translation will be in a mess. (3) Fail to follow the international concept in the direct selling market and arouse numerous conflicts. These conflicts make linguists at a loss in translation. They have to betray the law of translation and transliterate the “multi-level marketing” as “Chuanxiao”. Secondly, it obstructs and restrains the development of domestic companies and the internationalized normalization of direct selling mode. (Yin Wu, 2008). Besides, it makes the operation of the well-known foreign-funded direct selling company embarrassing in world market.

2.2 The legal basis for the existence of China’s direct selling system

The development of China’s direct selling industry has experienced four stages: the first stage is the entry of direct selling industry into China (1990-1993), represented by the register of American Avon, Sunrider, and Amway in China. At that moment, no more domestic companies enter this industry and the legalization and relevant policies are still an absence. The concept means “multi-level marketing” instead of “direct selling”.

The second stage is an exploring period with disordered industrial development and unclear government supervision policies (1994-1998). During this period, foreign investments, especially Taiwan companies, rush into this industry. And many domestic companies follow their steps. The market becomes more confusing. The government begins to interfere with the direct selling market gradually and constitutes some policies and laws, mainly including the *Notice for Forbidding the Illegal Activity of Multi-Level Chuanxiao* issued by the State Administration of Industry & Commerce on Aug. 11th, 1994, the *Notice for Checking the Illegal Activity of Multi-Level Chuanxiao* issued on Sep. 22^{ed}, 1994, and the *Notice for Stopping to Develop Multi-Level Chuanxiao Companies* issued by the Office of State Council on Sep. 22^{ed}, 1995. Soon, the State Administration of Industry & Commerce constitutes the *Rules for Checking and Clearing up Multi-Level Chuanxiao Companies* and approves 41 companies starting multi-level marketing businesses for the first time. The *Rules for Administration of Chuanxiao* issued on Jan. 10th, 1997 offers detailed regulations on direct selling, with a hope of regulating market orders and forbidding the illegal activities in direct selling. The guiding lines are: permit its existence, restrict its development, manage it strictly, and set pilot places carefully.

The third stage is the transformation period (1998-2005). Some multi-level marketing companies’ illegal systems and illegal pyramid schemes’ “mouse meetings” trigger serious social problems. The government takes multi-level marketing as an illegal activity and forbids it completely. During this period, the government constitutes a series of policies, mainly including the *On Forbidding the Multi-Level Chuanxiao Business Activity* issued by the State Administration for Industry & Commerce on Apr. 18th, 1998, the *Notice of Forbidding the Multi-Level Chuanxiao Business Activity* issued by the State Council on Apr. 21st, regulating that “stopping all multi-level marketing business activities right once”, and the *Notice on Issues of Foreign-Funded Multi-Level Chuanxiao Companies Transforming the Selling Ways* issued by three Ministries (Ministry of Foreign Trade and Economic Cooperation, PRC, State Administration for Industry & Commerce, Ministry of Domestic Trade, PRC) on June 18th, 1998. Since the year of 1998, the direct selling and the multi-level marketing are completely forbidden in China.

The fourth stage is a re-opening period (after 2005). Due to China’s commitment to WTO, the two *Regulations* issued in late 2005 partially fulfill the commitment in WTO agreement, what makes China enter a limited Chinese-style direct selling stage. During this period, besides the *Regulation on Administration of Direct Sales & Regulation on Prohibition of Chuanxiao* issued by the Ministry of Commerce, PRC, there are a series of equipped measures and regulations, including *Suggestions for Strengthening the Supervision and Management of Direct Sales*, the *Regulations for Industrial and Commercial Administrative Institutions and Police Striking Chuanxiao*, the *Functional Positions for Supervising Direct Sales in State Administration for Industry & Commerce*, the *Regulations on Internal Structure and Personnel Composition*, the *Management Rules for Direct Sellers’ Training*, the *Regulations on the Pay and Use of Direct Sales Companies’ Deposits*, the *Management Rules for Direct Sales Company Releasing and Reporting Information*. Till then, China has basically founded the legal basis for the direct selling system.

According to the law of China, multi-level marketing is illegal but direct selling is legal. The Chinese-style legal concepts fail to match the world definitions. In the legal and institutional aspect, the government keeps in strengthening the Chinese-style administration and supervision mode and constructs a supervision system for the direct selling market

and the institutions of direct selling, including the issue of market entrance, for which the State Administration for Industry & Commerce and the Ministry of Commerce, PRC, set up an approval communication mechanism. Compared with other countries, China's legal system and mechanism for direct selling is too strict and consume too much national resources. Here, the author has already analyzed the unfavorable market effects under this system.

3. Domestic market conditions, legal environment, and the reform

3.1 An awkward circle

Companies are the most active and important roles in market economy, whose development reflects market trends. From companies, we can understand the general market conditions and the legal environment.

China's market economy origins from the planned economy. Although it experiences long-term economic system reform, the planned economy still marks its features on the market, which makes the market not a real commodity economic market. In China's market, there are many aspects that conflict with commodity economy. In specific, they are:

Firstly, the market dominated by state-owned enterprises gives economic priority to state-owned enterprises. With special privileges, state-owned enterprises can get amounts of resources at no prices. The group or people who control and manage national resources enjoy special rights regulated by laws, but do not shoulder relevant legal obligations and responsibilities. (China does not have the *Law of Anti-Corruption*, the *Law of Anti-Commercial Bribe*, and the *Civil Codes and Commercial Codes*. Although the *Anti-unfair Competition Law* has been issued, it merely lists the illegal activities but not regulate on how to punish these forbidden activities. Even with regulations, it is hard to put into effect under the condition that "the law readily forgives the oversights of the masses".) Under present system, the monopoly companies face no competitors due to their special rights. Their tremendous profits are usually at the price of serious waste of resources. The privileges of state-owned enterprises established by laws make the operation of market economy abnormal, unfair, and contradictory since the very beginning.

Secondly, private enterprises mostly develop themselves at the edge of policy and law under the special living environment. On one hand, private enterprises cannot get rid of their "original sins". On the other hand, they have to rely on these sins for existence. In a sense, it is an inevitable choice for them. To develop at the edge is only an ideal illusion. Once risks appear in the macro market, private enterprise will become the victims. Therefore, private enterprises pursue for more interests at any price. Short-term activities are common.

Thirdly, many foreign-funded enterprises, especially the one with powerful strengths, operate normally at their homelands. After entering China, impacted by China's commercial bribe environment and system, some foreign-funded enterprises may commit errors or crimes, such as commercial bribe, poor-quality commodity dumping, betraying commercial morals, unfair competition, and degrading consumers' rights and interests. People name this phenomenon as "When in Rome, do as the Romans do". (Li Ma, 2008, pp. 39; Yun Liang, 2007; Fei Li, 2007)

Apparently, from the legal positions and market operations of the three important economic subjects in China's market, we can clearly understand the market state and legal environment in which China's legal system of direct selling comes into being. Indeed it is not easy. On one hand, the "invisible hand" in market tries to turn the single-level direct selling into multi-level direct selling (Adam Smith, 2006); On the other hand, the law of China takes multi-level marketing as an illegal activity, which makes most direct selling companies survive at the edge (Yu Tian, 2008). However, the most unendurable fact is that the whole direct selling market runs into a vicious circle. Policies and laws are negatively always used as a relief for the vicious result of market operation. Their original function of protecting contract freedom, fairness and just, sincerity and credit, orderly competition and stable development of market seems to be ignored. Since policies and laws play such a role in market, it is understandable for some well-known companies giving up the direct selling mode in case of being stuck by risks of policies and laws (N. Gregory Mankiw, 2002).

3.2 The future reform of market conditions and legal environment

China's direct selling market has same economic operational laws with the whole macro market. They face the same fundamental problem. Therefore, the reform of direct selling market conditions and legal environment is not just for one industry or field. As we extremely emphasize on the market freedom and normalization, if without the social democratic mechanism as the base, or administrative monopoly and tight administrative regulation refusing to quit from the stage, the monopoly on natural resources, economic monopoly, and unfair competition will be lasting for a long period, and scientific and reasonable market freedom and normalization will be impossible (Zeng Weihua, 2008, pp. 48).

In 2008, more and more people realize the coming of "economy winter". By reviewing the law of China's economic development during the 30 years since the reform and opening policy in 1978, some economists conclude that China's economic reform is always trying "mistakes" and interests groups will give up their vested interests by no means. Evolvement of government policies in market comes along with the macro adjustment and control that costs more than ever. In this "economy winter", the greatest victim is not the direct selling companies but the private manufacturing

workshops that create the myth of “made in China”. Their losses cause a tremendous waste of commercial resources and also generate some by-product effects, including the rise of unemployment, the hollow regional industry economy, and the decline of monopoly companies’ profits. “Investments drive demands ----policies serve as an emergency brake ----crises loosen market policies”. It has already become the logical law of China’s macro- economic policies in recent 30 years (Wang Xiaobo, 2008).

The policy logics are to protect the vested interests. Each circulation sharpens social contradiction and makes it hard to settle this contradiction. It is the right time for designers of policies and laws to reconsider this issue. A positive and radical reform is a resolution for settling the sharpen market contradictions and improving the bad legal environment, and also an important subject for China’s sustainable development in future.

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