PONZI AND PYRAMID SCHEMES: TOO GOOD TO BE TRUE?

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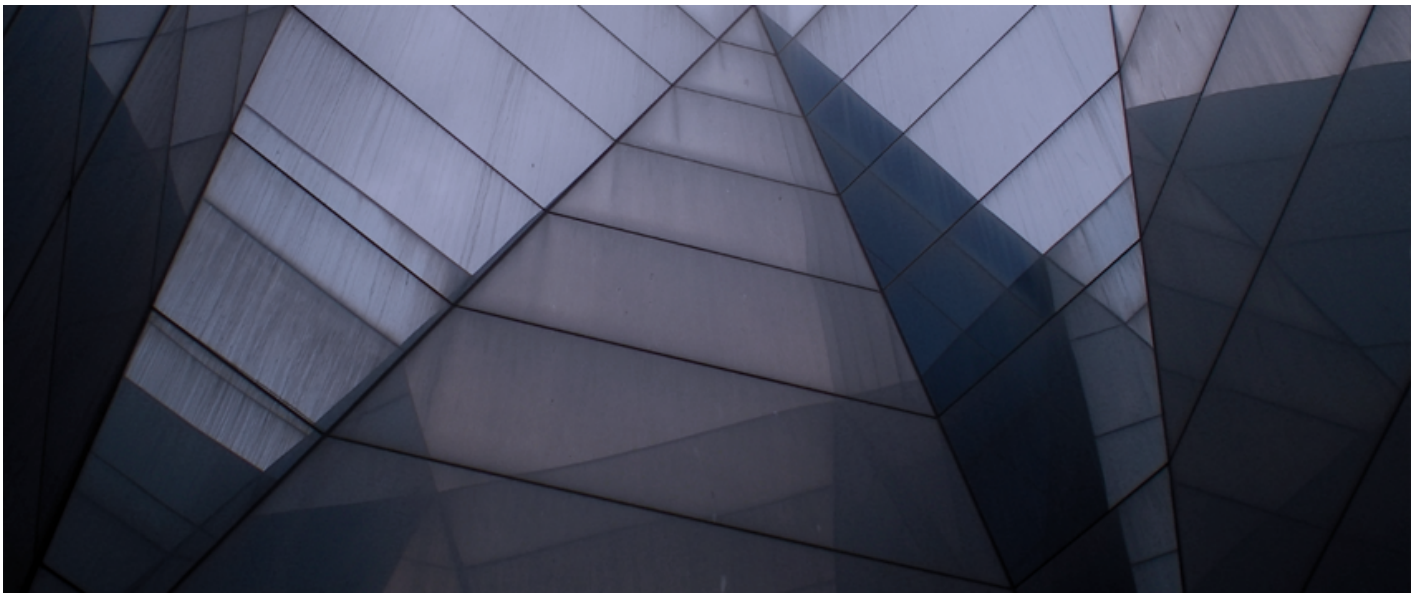

In the recent decision of Securities and Futures Commission v DFRF Enterprises LLC & Ors, the court addressed and redressed a Ponzi and Pyramid Scheme by ordering the scheme fraudsters to compensate victims following legal proceedings brought by the Securities and Futures Commission under section 213 of the Securities and Futures Ordinance (Cap. 571) ("SFO"). The background, the decision and some key takeaways will be addressed below.

DFRF, and its founder Daniel Filho, operated a Ponzi and Pyramid scheme between 2014 and 2015. Under the scheme, both DFRF and Daniel Filho (both of whom were never licensed under the SFO) claimed that DFRF would be listed in the US. They induced a number of Hong Kong investors to acquire "membership units" priced at US$1,000 per unit which would allegedly generate monthly returns of up to 15% on the initial subscription fee.

Around May 2015, DFRF released three promotional videos featuring interviews with Daniel Filho on YouTube in Cantonese, Mandarin and English and sent emails to investors claiming that DFRF had been listed in the US and emphasised the rising value of the stock and the need for members to take immediate action to convert their membership units into preferred shares at US$15.06 per share before the deadline. As a result, a number of Hong Kong investors transferred monies to bank accounts held by Heriberto C. Perez Valdes and Sealand Trading (Hong Kong) Limited for the purpose of acquiring membership units and converting the units into preferred shares.

However, the reality was that DFRF have never been listed in the USA. Most of the investors failed to receive any returns on their investments and the monies received from the investors were, in fact, distributed to Daniel Filho personally, and his associates. Consequently, on the 24th August 2016, the Securities and Futures Commission commenced legal proceedings under s213 of the SFO against DFRF, Daniel Filho, Perez Valdes and Sealand, obtaining interim injunction orders to freeze monies in the accounts.

After trial, DHCJ Paul Lam SC was satisfied that there were multiple contraventions of the SFO. They included : –

- s114(1)(a) of the SFO by carrying on a business of advising on securities, which is a regulated activity under the SFO, which they were not licensed, registered or authorised for
- s114(1)(b) of the SFO by holding themselves out as carrying on a business of advising on securities, which is a regulated activity under the SFO, which they were not licensed, registered or authorised for
- s109(1) of the SFO by knowingly issuing an advertisement in which they held themselves out as being prepared to carry on the regulated activity of advising on securities which they were not licensed for
- s103(1) of the SFO by issuing an advertisement, invitation or document which to their knowledge is or contains an invitation to the public to enter into or offer to enter into an agreement to acquire, dispose of, subscribe for or underwrite securities, when such issue was not authorised by the SFC under s 105(1) of the SFO
- s107(1) of the SFO by making fraudulent or reckless misrepresentations for the purpose of inducing another person or enter into or offer to enter into an agreement to acquire, dispose of, subscribe for or underwrite securities.

Furthermore, DHCJ Paul Lam SC found that, by receiving the funds in the accounts from the investors, Perez Valdes and Sealand aided, abetted, assisted, counselled, or procured and/or directly or indirectly been knowingly involved in, and/or a party to, and/or attempted or conspired with others to commit DFRF and Daniel Filho's contraventions of the SFO. As such, the learned Deputy Judge granted declarations, injunctions and restitutionary orders sought by the Securities and Futures Commission against the defendants pursuant to s213 of the SFO. An order was also made appointing Mr James Wardell and Mr Jackson Ip as administrators to effect the distribution of the funds in the accounts to the investors, and that the fees and disbursements of the administrators shall be paid out of the balances in the accounts.

There are a number of interesting points to take away from this decision. First, the court clarified the fundamental difference between s114(1)(a) and s114(1)(b) of the SFO. While s114(1)(a) covers cases where the person involved actually carried on business in a regulated activity, s114(1)(b) covers cases where the person involved represented or pretended that they were carrying on business in a regulated activity. Hence, a person may be held to have breached s114(1)(b) but not s114(1)(a). However, in reality, it is most probable, if not virtually certain, that a person found guilty of breaching s114(1)(a) would have also contravened s114(1)(b).

Also, and in spite of the fact that the remaining balances in the accounts would not be sufficient to compensate the investors in full, the court agreed that restitution orders should still be granted pursuant to s213(2)(b) of the SFO to distribute the amounts frozen in the accounts to the victims on a pro rata basis.

And finally, whilst the court initially had concerns that the administrators would recover their fees and disbursements from the balances in the accounts with the result that the pool left in the pro rata distribution would reduce, it was eventually persuaded that such an order should be made. In particular, the court noted that the victims' interest could be safeguarded by imposing a ceiling on the total sum that the administrators may receive and that the maximum total sum to be received by the administrators in this case.

In conclusion, this case demonstrates the court's continued willingness to serve justice to the victims of Ponzi and Pyramid schemes, making various orders so that the investors provided with compensation to the extent that is reasonably practicable. Similar decision scan can be seen in two previous cases – the Cardell Ltd and Broadspan Securities cases). Furthermore, the court's approach in allowing the administrators to recover their fees and disbursements from the remaining balances in the accounts is practical and commercially sensible. Put simply, if the administrators are asked to administer the distribution process without any security as to their fees and disbursements, that would disencourage administrators to come forward to handle such a complicated process in the future. The court's approach in providing security for the administrators whilst also imposing a cap on the fees, thus protecting the investors, provides a reasonable balance between divergent interests and aims.

Norman Nip SC, leading Kelly Shum, acted for the SFC in SFC v DFRF Enterprises LLC & Ors [2022] HKCFI 1288.