



Hong Kong's proposed Mandatory Reference Checking Scheme – the end of 'Rolling Bad Apples'?

May 2021

Introduction

The Hong Kong Monetary Authority (**HKMA**) released its consultation conclusions¹ on the proposed Mandatory Reference Checking (**MRC**) Scheme (**MRC Scheme**) on 3 May 2021. It will apply to all authorised institutions (**AIs**) in respect of their Hong Kong business. It is intended that the MRC Scheme will address the “rolling bad apples” phenomenon and will be an industry-led initiative endorsed by the HKMA (as opposed to a supervisory requirement).

The MRC Scheme will be implemented in two separate phases. Phase 1 will require AIs to obtain references from current and former employers of applicants who are directors and bank employees in senior management positions² and Phase 2 will extend the scope to applicants permitted to carry out regulated activities.³

Timing for implementation has not been confirmed. To assist with the development and implementation of the MRC Scheme, the HKMA has requested that the Hong Kong Association of Banks (**HKAB**) set up an industry working group (**IWG**) to formulate operational details within six months from the date of the Consultation Conclusions. The IWG will also confirm the transition period for implementing Phase 1 – a period that will run from when the HKMA has endorsed the IWG operational plans.

This bulletin summarises the MRC Scheme requirements and identifies key practical challenges and considerations for AIs.

01_The HKMA's Consultation Conclusions Paper on Implementation of Mandatory Reference Checking Scheme to Address the “Rolling Bad Apples” Phenomenon (3 May 2021) (the **Consultation Conclusions**).

02_See ‘The obligation to obtain a reference’ below for details.

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Summary

The HKMA's stated purpose of the MRC Scheme is to address the "rolling bad apples" phenomenon in relation to the employment of specified positions by the AIs.

Under the MRC Scheme, a recruiting AI will be required to request a reference for prospective employees from all prior AI employers (**AI Referees**) over the last seven-year period, irrespective of the length of employment with each AI Referee, to facilitate its assessment and recruitment decision. In turn, AI Referees will be under an obligation to provide references containing: (a) information that is material or serious in nature, including as to incidents that cast serious doubts on honesty or integrity; and (b) "any other information" that they reasonably consider relevant to the recruiting AI's assessment of whether the individual is fit and proper.

AIs will be required to put in place adequate internal systems and controls, policies and procedures to safeguard the information collected, used and processed in relation to the MRC Scheme.

Generally, the MRC Scheme proposals are not controversial, particularly given the use of similar schemes in other jurisdictions, such as the Senior Managers and Certification Regime (**SMCR**) in the United Kingdom. However, AI Referees may face difficult decisions when establishing a framework and protocols to comply with the MRC Scheme.

For example, questions may arise as to how AI Referees should deal with a reference request when there are ongoing (and continuing) investigations as to potential misconduct involving the employee subject to the request, or draw a line between employee conduct and conduct within a private life – a line that is becoming increasingly hard to identify. We consider these and other issues that may arise when complying with the regime below.



The obligation to obtain a reference

When is an employee in scope?

- (a) The MRC Scheme initially identifies only a small group of employees in respect of whom an AI will be required to issue a reference request, defined by their intended role at the recruiting AI.
 - (i) Specifically, for Phase 1, any individual who is to perform a role that requires him or her to be a director,⁴ a chief executive,⁵ an alternate chief executive,⁶ a manager,⁷ an executive officer⁸ or a responsible officer (**RO**)⁹ will be subject to the scheme.
 - (ii) This will expand for Phase 2 as currently envisaged. In Phase 2, subject personnel will be extended to cover all staff permitted to carry out regulated activities under the Securities and Futures Ordinance (Cap 571) (**SFO**), the Insurance Ordinance (Cap 41) or the Mandatory Provident Fund Schemes Ordinance (Cap 485). The IWG will further consider including other roles under Phase 2 having regard to the experience in Phase 1.
- (b) Geographic limitation: The MRC Scheme will apply to AI employees in Hong Kong but not those employed at a head office, subsidiary or branch outside Hong Kong. Accordingly, there will be no requirement to seek a reference in respect of staff employed outside Hong Kong.
- (c) Intra-group transfers: The MRC Scheme will apply to individuals who are moving between two AIs within the same group (provided the requesting AI is in Hong Kong). However, the HKMA has indicated that in these circumstances recruiting AIs can use alternative ways to conduct reference checks instead of the (**the MRC Information Template**), such as by making use of the AI's group internal records, common human resources functions or other means of sharing relevant information.

Consent of the prospective employee

- (a) Before initiating a reference request, written consent should be obtained from the prospective employee to:
 - (i) authorise the recruiting AI to conduct reference checking with his/her current or former employer AIs; (ii) authorise the AI Referees to disclose relevant employment records to the recruiting AI; and (iii) exempt AI Referees from any contractual obligations that may limit their ability to disclose information regarding the prospective employee. In this regard, AI Referees should ensure they comply with Data Protection Principle (**DPP**) 3 – Use of Personal Data under the Personal Data (Privacy) Ordinance (Cap 486) (**PDPO**). See further discussion below.
- (b) If a prospective employee refuses to provide consent, the MRC Scheme provides that a recruiting AI should consider the reasons behind the refusal and whether it casts doubt on the individual's fitness and propriety (**F&P**). If the recruiting AI decides to proceed with employment without going through the MRC Scheme process, the recruiting AI should document its justifications for such exemption.
- (c) The MRC Information Template will indicate whether consent of the prospective employee has been obtained.

Confidentiality agreements

AI Referees are not permitted by the terms of the MRC Scheme to fail to disclose matters that would otherwise be required to be disclosed merely because the AI Referee is subject to a contractual or other obligation of confidentiality.

Accordingly, AI Referees should be careful when entering into any contractual obligations that may limit their ability to disclose information as required under the MRC Scheme. This may be of particular relevance should employees depart from an AI following a grievance that has been settled under terms containing strict confidentiality. Both recruiting AIs and AI Referees should seek written consent of the individual to exclude their disclosure obligations under the MRC Scheme from any contractual obligations that may otherwise limit their ability to disclose the necessary information, although this may not be straightforward in respect of departed employees. Without this, AIs may find themselves in non-compliance with the MRC Scheme.

04_ Approved under section 71 of the Banking Ordinance (Cap 155) (**BO**).

05_ Approved under section 71 of the BO.

06_ Approved under section 71 of the BO.

07_ Notified to the HKMA under section 72B of the BO.

08_ Approved under section 71C of the BO.

09_ Approved by the Insurance Authority under section 64ZE of the Insurance Ordinance (Cap 41), or approved by the Mandatory Provident Fund Schemes Authority (**MPFA**) under section 34W of the Mandatory Provident Fund Schemes Ordinance (Cap 485).



Matters to be included in the reference

For consistency across the industry, the HKMA has created an MRC Information Template (which the IWG will finalise during the course of the next few months) to be completed by AI Referees.

The MRC Information Template sets out questions expected to be asked in each case and to which the AI Referee is required to respond.

The MRC Information Template requires an AI Referee to provide basic employee information, including confirmation of an individual's name, ID/passport number, details of the relevant position(s) held, name of business/function, department, period of employment, and reason for cessation of appointment.

It also contains requests to which AI Referees may find it more difficult to respond due to breadth and lack of clarity. For example:

- *“Incidents which cast serious doubts on honesty, integrity or matters of similar nature”.*

It will be for the AI Referees to decide whether they consider any misconduct that occurred is “serious” enough to warrant inclusion in this regard, leaving a significant amount of discretion. AIs may like to consider guidance under the SMCR in this regard, which provides a number of factors that referees should take into account when determining if misconduct is “serious”. These include: (a) whether the individual has committed a serious breach of a code of conduct, whether the breach was dishonest, deliberate or reckless, the frequency of breach, and the extent of loss; and (b) whether the individual's conduct caused the firm to breach a regulatory requirement. It will be interesting to see whether the IWG also has regard to these factors when it considers the MRC Information Template over the coming months.

- *“Internal or external disciplinary actions arising from conduct matters”.*

According to the HKMA, “internal disciplinary actions” include actions that are taken by the AI against the employee as a result of misconduct on the part of the employee. It may include internal warnings, financial penalty involving remuneration, and suspension and dismissal due to misconduct. It does not include managerial coaching and counselling, suspension pending investigation, leave taken while investigations are being carried out, or investigations that do not result in adverse findings.

- *“Any other information” that an AI Referee reasonably considers “relevant to the [recruiting AI's] assessment of the conduct of the individual, i.e. their fitness and propriety”.*

The HKMA has clarified that such information be related to *“misconduct that is of a material or serious nature”*. A similar “catch all” appears in SMCR, where the requirement is to provide *“any other information that the [firm] reasonably considers to be relevant to the requesting firm's assessment as to whether the individual is fit and proper”*.

Firms inevitably have a significant degree of discretion as to what they include within the scope of this category. One way to think about whether or not to include information about an individual is for the AI Referee to consider whether it would expect to be notified of that information if it were hiring the individual in question and having to approve him or her as fit and proper to perform his or her future role.

Further guidance on these categories of information may be provided via the IWG in due course.

Easier said than done?

Regardless of the form of the questions, the MRC Scheme is likely to give rise to challenges when assessing what information is within (or might be within) scope. Some areas of possible challenge are addressed below.

(a) Ongoing investigations

The HKMA expects that the information provided under the MRC Scheme will be *“true, fair, complete, accurate and capable of substantiation”*. Reference-providing AI Referees should therefore not withhold information that may otherwise render the reference incomplete, inaccurate or misleading.

However, it may be particularly difficult to satisfy this obligation should an employee that is subject to a request be mid-way through a misconduct investigation or disciplinary process.

The HKMA considers that the reference providing AI should nevertheless provide information regarding ongoing investigations with serious allegations as well as those that are about to conclude with disciplinary action. To do otherwise could create a loophole within the regime. The HKMA's objective is to strike a balance between managing an AI's litigation risk and the risk of hiring bad apples. Disclosure might include basics of the investigation and its status, following which the recruiting AI may pick up the conversation with the employee.

This could be seen as a more strict approach than that taken in other jurisdictions. For example, the UK's Banking Standards Board's (**BSB**) statement of good practice advises that when an employee leaves before a full disciplinary process can be completed, information about alleged poor conduct should generally be considered unverified, hence not required to be disclosed unless the evidence of wrongdoing in relation to an employee is such that it would have been pursued through further investigation or disciplinary proceedings; the latter information should be included.

The HKMA acknowledges that the IWG should consider this area of disclosure and consider producing guidance on the types of ongoing investigations that should be included and exemptions that should be applied. It is expected that the IWG will do so based on HKMA's views and from industry feedback.



(b) The relevance of private conduct and behaviour

F&P is defined in the SFO¹¹ and the SFC's Fit and Proper Guidelines include references to an individual's: (a) financial status or solvency; (b) educational or other qualifications or experience; (c) ability to carry on the regulated activity competently, honestly and fairly; and (d) reputation, character, reliability and financial integrity.

Certain private conduct and behaviour is, therefore, clearly relevant to an assessment of an individual's F&P, such as conduct of a criminal nature even if it occurs in the individual's private life.

Similarly, FCA guidance asks firms to consider whether an individual has been convicted of a criminal offence, in particular, offences of dishonesty, fraud, financial crime, market manipulation and insider dealing, or offences under certain company and business legislation, as a factor that may be relevant to his or her F&P.¹²

However, there may be less obvious matters of private conduct such as discrimination, bullying and harassment. The FCA has made it clear that these are relevant matters under the SMCR.¹³ The HKMA appears to take a similar position, stating in its Consultation Conclusions that "*sexual harassment or bullying should be considered misconduct activities and should be included as reportable matters under the scope of MRC*".¹⁴

More difficult assessments may arise should, for example, an employee make what is ostensibly a political comment in public or on social media but one that is later subject to criminal investigation by relevant authorities.

In addition, quite how an AI must assess the relevance of private conduct to an F&P assessment is unclear. In the recent case *Beckwith v Solicitors Regulation Authority* [2020] EWHC 3231 (Admin), the English High Court considered how an institution should assess the impact that events that take place in an individual's private life may have on his or her professional standing in the following terms:

"[The applicable rules] may reach into private life only when conduct that is part of a person's private life realistically touches on [their] practise of the profession... or the standing of the profession... Any such conduct must be qualitatively relevant... Regulators will do well to recognise that it is all too easy to be dogmatic without knowing it; popular outcry is not proof that a particular set of events gives rise to any matter falling within a regulator's remit" (paragraph 54).

More recently, the FCA has assessed the relevance of an offence arising out of the private conduct of a financial adviser by considering the fact that the regulated individual was "*in a position of trust as regards his customers, who rely on his advice when making significant financial decisions and need to be able to trust that he will act*

appropriately" and also explained that "*in order to maintain public confidence in the financial services industry, the [FCA] and the public are entitled to expect that approved persons and financial advisers are individuals with integrity and good reputation*". Even though the offence concerned was not committed at work and did not involve financial dishonesty, the FCA found that it involved the individual "*deviating from legal and ethical standards and seeking to exploit those more vulnerable than himself, which in the [FCA's] view is fundamentally incompatible with his role as a financial adviser*".

We expect the HKMA will apply the regime in a manner that upholds public policy and market integrity at the heart of its responsibilities, although whether the HKMA will take a similar stance to the assessment remains to be seen.

(c) Privilege and statutory secrecy

The Consultation Conclusions do not expressly acknowledge that privileged information need not and should not be disclosed in MRC Scheme references. Nonetheless, an entity, including a reference-providing AI, is entitled to resist disclosure of privileged information under the common law.

Similarly, although the HKMA has not expressed a view as to whether statutory secrecy is an excuse for not disclosing information in the reference, an AI Referee should nevertheless preserve secrecy relating to matters subject to an SFC or HKMA investigation when providing disclosure of information through the MRC Scheme.

An opportunity to be heard

In the event that negative information is received from AI Referees, the recruiting AI should provide the prospective employee with an opportunity to be heard, both as a matter of fairness, and also taking into consideration PDPO rights to request correction of personal data.¹⁵

It is of course possible that an AI Referee may choose to discuss the facts to be disclosed in its response with the subject employee, before sending its response to the requesting AI. It is worth noting that in those circumstances, in the UK an employee's "opportunity to comment" on information in a reference does not mean "*the firm should provide an opportunity [to the employee] to comment on the reference itself, as opposed to the allegations on which it is based*". The FCA has said that a firm "*should take those views into account so far as appropriate when deciding whether something should be disclosed and how the disclosure is drafted*".¹⁶

While this view has not been expressed by the HKMA, it would seem to be a reasonable and fair approach to adopt with respect to the MRC Scheme.

11_Section 129.

12_FIT 2.1.3G.

13_ <https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-non-financial-misconduct-wholesale-general-insurance-firms.pdf>;

<https://www.fca.org.uk/publication/correspondence/wec-letter.pdf>; and <https://www.fca.org.uk/news/speeches/opening-and-speaking-out-diversity-financial-services-and-challenge-to-be-met>.

14_ The Consultation Conclusions, page 27, item number 20

15_ PDPO section 22; DPP 6 – Data Access and Correction.

16_ <https://www.handbook.fca.org.uk/handbook/SYSC/22/5.html?date=2021-01-05>.





Timings

Reporting timeframe covered by the MRC Scheme

In Phase 1, the recruiting AI should approach all former and current employers (which are AIs) of the prospective employee for employment records in the past seven years from the date of request.¹⁷ This is in contrast to the HKMA's original proposed timeframe of ten years.

As a result, all AI Referees should maintain employment records of their employees who have ceased to be employed by the AI Referees for a period of at least seven years from the date of the employees' departure.

Recognising that not all AI Referees will have retained relevant records for a seven-year period before implementation of the MRC Scheme, the HKMA has stated that the IWG will work out suitable transitional arrangements or grace periods for AI Referees in relation to past or current employees about whom the AI may subsequently receive an MRC reference request.

Time to initiate the MRC Scheme process

The HKMA has advised that the recruiting AI may consult with the prospective employee as to when within the recruitment process the MRC request should be sent to the AI Referees. The HKMA suggests adopting a "staggered approach" so that the recruiting AI can proceed to conduct MRC with former employers first and the current employer later, after the prospective employee has tendered his/her resignation. The recruiting AI should then extend written MRC information requests to the AI Referees, indicating clearly that the prospective employee's consent has been obtained to perform reference checking under the MRC Scheme.

Timeframe for providing a reference

An AI Referee should provide a response within one month from the date of the MRC request. This is an increase from the original proposal of ten working days, but is shorter than the UK where the period is six weeks following receipt. AI Referees will need to ensure that the internal record keeping and processes allow for this, especially where provision of a reference involves discussion with various internal stakeholders such as past line managers, HR or disciplinary committees.

If the AI Referee is going to find it difficult to provide a reference in the allotted time it should provide an interim response and indication of when the full MRC reference will be provided.

Using the information received

An MRC Scheme reference should be used in the recruiting AI's assessment of that individual's F&P to undertake the role for which they are to be hired. The HKMA is clear that in the event that a reference contains negative information, recruiting AI Referees will need to consider the likelihood of the prospective employee committing misconduct in the new working environment. The BSB provides similar but more expansive guidance for the SMCR regime, noting that firms should seek to make balanced decisions about hiring an individual whose regulatory reference discloses negative information, rather than using the regulatory reference as a binary screening tool. Such a decision should consider factors such as the seriousness of the information provided and the risk tolerance of HR and the business area.

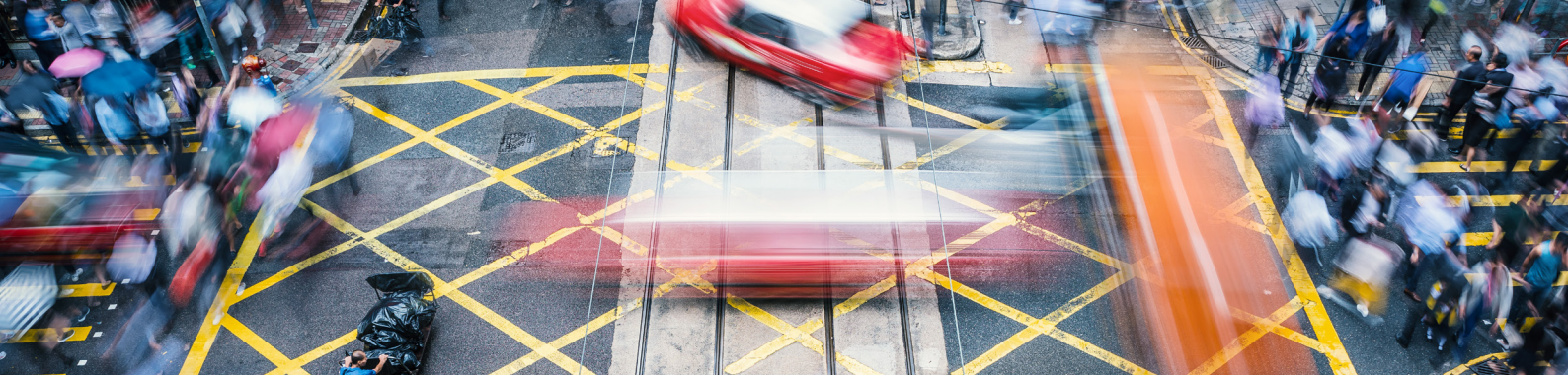
The recruiting AI is entitled to follow up where necessary with the AI Referees for clarification and further information if this would assist its recruitment considerations.

The HKMA has made clear that an AI Referee should respond to follow-up questions to facilitate the recruiting AI's reference checking processes as far as practicable, unless the information may reveal confidential and proprietary information about its business and employees other than the candidate, or commercially sensitive information.

The recruiting AI will have discharged its obligations if it has reasonably followed up but the AI Referee has refused to provide answers.

¹⁷ The SCMR's period is six years.





The obligation to update the reference

An AI Referee is required to provide an update to the recruiting AI on any investigation or proceeding that: (a) is commenced within seven years after the individual has left the AI Referee; and (b) concluded that the individual was guilty of misconduct or was involved in any misconduct incidents. It must provide that update within one month of conclusion of the matter.

In addition, an MRC update should be provided where the information in the update would lead to substantive changes to the reference information previously provided.

Moreover, the HKMA has suggested that when responding to the MRC Information Template, AI Referees may also indicate whether they expect to provide an update in the future, with an approximate indication on when this might be. The recruiting AI Referee will then be on notice to approach the AI Referee for an update if needed.

In the UK, the FCA has also introduced an obligation to update regulatory references already provided if the firm becomes aware of matters or circumstances that would have required it to draft the original regulatory reference differently had the information been known at the time. This obligation extends up to six years after the relevant individual was employed by the firm providing the reference.

The HKMA is silent on how long the obligation to provide an update will remain, but consistent with the MRC Scheme time frame, seven years would be appropriate.

The HKMA does not provide any guidance on whether the AI Referee should provide the individual with an opportunity to comment on the updated reference. However, consistent with UK practice, an AI Referee may wish to discuss the facts to be disclosed with the subject employee. If the subject employee denies or comments on the facts to be provided, the AI Referee can mitigate litigation risk by expressly stating the employee's position in the MRC Reference.

Limiting liability

Given the purpose of the MRC Scheme, AI Referees should be mindful of litigation risk when providing a response to the MRC Scheme. The HKMA has, however, sought to mitigate this risk through various measures within the Scheme.

First, the HKMA requires that any reference should be true, accurate, fair and not misleading to the best of the AI Referee's knowledge. Matters that an AI has not been able to identify notwithstanding adequate systems and controls and enquiry should fall outside that obligation.

Second, the MRC Information Template includes a disclaimer. This provides that the recruiting AI takes full responsibility in relying on the information provided in the template in making its recruitment decision, and that the AI Referee is excluded from liability in the absence of negligence and bad faith.

It appears there is no prohibition on AI Referees drafting their own disclaimers to make them more comprehensive should they wish.

The MRC Scheme also expects the recruiting AI to assess the individual's F&P and make a recruitment decision in its own discretion. In those circumstances, it would be difficult for the recruiting AI to hold the AI Referee liable in the absence of negligence and bad faith.

Regardless of these measures, AI Referees should of course assess employees' conduct in a consistent and fair manner, and maintain adequate records to allow them to do so, in order to further mitigate litigation risk.

The MRC Scheme is silent as to whether an AI Referee should discuss the facts to be disclosed with the subject employee before the reference is returned, allowing the AI Referee to record the employee's comments in the reference. That is the practice in the UK. The HKMA's view is rather that the recruiting AI should provide the prospective employee with an opportunity to be heard in the event that it receives negative information from AI Referees. AI Referees may wish to adopt the approach in the UK to further mitigate litigation risk.



Systems and controls

Policy

AI Referees should put in place adequate internal systems and controls, policies and procedures to safeguard the integrity and confidentiality of information obtained and processed during the MRC process.

Moreover, AI Referees should reconsider their employee Personal Information Collection Statement (**PICS**) (whether in the employment contract or elsewhere) to ensure they are fit for personal data collection under the MRC Scheme. Specifically, AI Referees are expressly required to ensure that prospective employees are informed of the matters in relation to the collection of their personal data under the MRC Scheme, such as the purpose for which the data is to be used, the details of data that will be collected, how the data collected will be used, and how the data will be transferred to recruiting AI Referees for reference checking under the MRC Scheme.

AI Referees should note that, under DPP6 and section 22 of the PDPO, prospective employees are given the right to request a copy of their personal data, which will include data obtained as part of the MRC Scheme.

In addition, all AI Referees should implement measures and have policies and procedures in place to ensure that they can comply with a data correction access as well as requests made by a job applicant, current or former employee.

Record keeping

- (a) The MRC Scheme reinforces the need for AI Referees to maintain sufficient records to support their compliance with the MRC Scheme – whether as a recruiting AI or an AI Referee.
- (b) As discussed above, all AI Referees should maintain employment records of their former employees for a period of at least seven years counting from the date of cessation of employment.

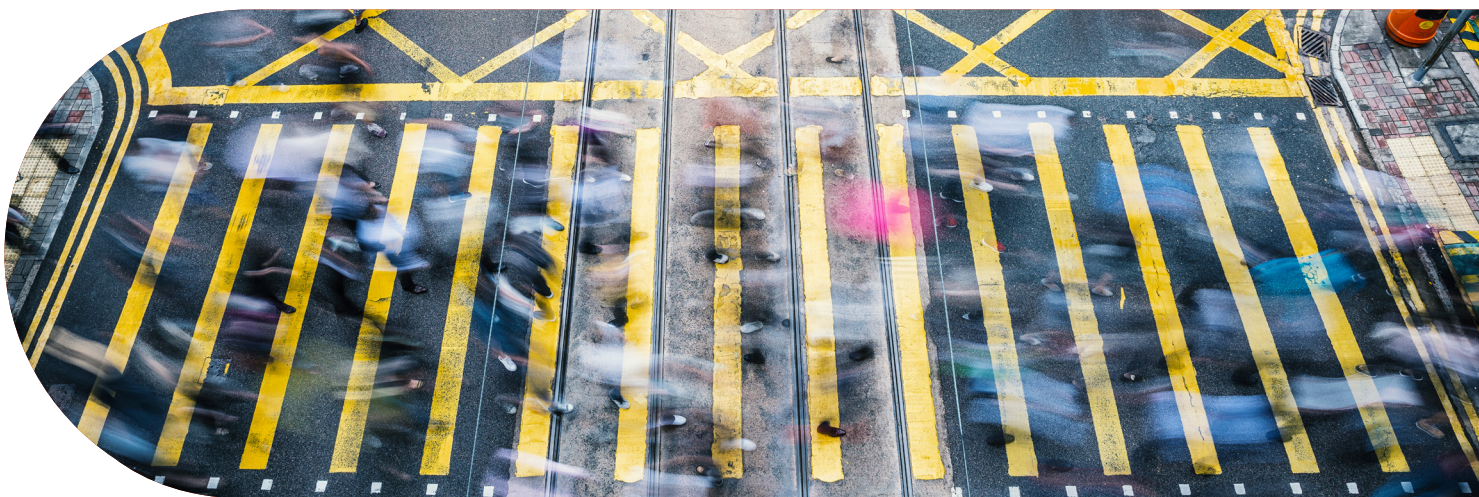
Fairness and alignment with the PDPO

Under DPP2(2), all practicable steps must be taken to ensure that personal data shall not be retained longer than is necessary for the fulfilment of the stated purposes.

Generally, an employer should implement a written data retention policy that specifies a retention period of no longer than seven years in respect of employment-related data from the date the employee leaves employment, unless there is a subsisting reason that obliges the employer to retain the data for a longer period or the former employee has given prescribed consent for the data to be retained beyond seven years.

Given that the stated purpose of the MRC Scheme is to enhance the integrity of the banking industry, the PCPD generally considers it as a subsisting reason and in the public interest for the employer to retain the data for a longer period. Having said that, the PCPD considers that it would be fair if the employees are given a right to request deletion of their data in specified circumstances, for example retirement and permanent departure from Hong Kong. Under these circumstances, it would no longer be necessary for the employers to retain the personal data of those employees.¹⁸

Recruiting AIs should not retain the personal data of an unsuccessful job applicant for a period longer than two years from the date of rejecting the applicant, unless there are special circumstances that are clearly documented.



¹⁸ The Consultation Conclusions, Annex 3, pages 56 to 57, paragraphs 10 to 11.



The role of the IWG

As well as facilitating the operation of the MRC Scheme, the IWG will provide a platform for gathering industry feedback on MRC Scheme implementation issues on an ongoing basis. It will also be tasked with reviewing Phase 1 two years

after its implementation, after which Phase 2 will be subject to consultation. This may result in general and specific changes to Phase 2 as currently envisaged including as regards scope, information content and timeframes.

Immediate action points

Although the timing for implementation of the MRC Scheme has not been confirmed, AIs should start designating a team to handle matters arising out of the MRC Scheme.

These include:

- Gathering historical records of misconduct of current and past employees in the previous seven years;
- Maintaining sufficient ongoing employment records of employees;
- Ensuring their internal record keeping and processes allow for compliance with the timeframe to provide a reference;
- Putting in place adequate internal systems and controls, policies and procedures to safeguard the information collected, used and processed in relation to the MRC Scheme;
- Ensuring their employee PICS are fit for personal data collection under the MRC Scheme; and
- Ensuring compliance with a data correction or access request made by a job applicant, current or former employee.

Key Contacts



Matt Bower
Partner
Tel +852 2974 7131
matt.bower@allenovery.com



Charlotte Robins
Partner
Tel +852 2974 6986
charlotte.robins@allenovery.com



Fai Hung Cheung
Partner
Tel +852 2974 7207
fai.hung.cheung@allenovery.com

