

Fractured Foundations: Assessing Risks to Hong Kong's Business Environment

By Logan Wright

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Fractured Foundations

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Executive Summary

Hong Kong's legal and institutional structure has changed fundamentally since the implementation of the National Security Law in 2020. When changes of this magnitude occur, it is difficult for anyone to know what shifts are transitory, and what adjustments will end up becoming permanent features of Hong Kong's political and commercial environment.

Over the past three years in Hong Kong, a system based upon legal and institutional restrictions on government action founded on the Basic Law and British common law has shifted toward a system governed by political norms reinforced by the National Security Law. In that process, those dominant political norms have changed significantly from those that had governed the "one country, two systems" policy since the handover of sovereignty in 1997, and are increasingly driven by priorities in Beijing, rather than the previously dominant local leadership of Hong Kong.

The National Security Law created a parallel system of authority operating both behind and above Hong Kong's system of government established by the Basic Law and the Sino-British Joint Declaration of 1984. This new structure permits a broad interpretation of the definition of "national security," leaving individuals and businesses with few options to challenge the law's reach. The National Security Law has been used to target multiple institutions seen as politically challenging to Beijing, including independent newspapers, media outlets, and pro-democracy politicians. It also has limited activities of the press, the publication and distribution of books and films, and the flow of information in other formats, including those essential to the operation of a modern commercial and financial system.

The bet for businesses operating in Hong Kong, and the financial industry in particular, is that they will continue to be viewed as essential for Hong Kong's globally competitive position. Despite the widespread

changes in the political and social landscape in Hong Kong, some argue that changes in the rest of Hong Kong's operating environment will not influence their own businesses, because they will continue to enjoy some degree of special treatment.

This report attempts to provide an objective framework to assess the wager that business conditions for most firms operating in Hong Kong will remain unchanged, despite the dramatic changes that Hong Kong has seen within its legal and institutional infrastructure. The report analyzes in detail the risks to the commercial operating environment in Hong Kong that have emerged since the 2020 introduction of the National Security Law, including currency risks, compliance challenges, threats to judicial independence, access to accurate information, and data security.

While Western governments have already attempted to change their policies toward Hong Kong in the wake of the National Security Law, the business community needs a different set of strategies to maintain and protect its interests given these rising risks. While no strategy can completely eliminate these risks, lobbying collectively and maximizing the political relevance of Hong Kong's self-declared status as an important international commercial and financial hub can be useful, and may have already generated some modest successes. Other recommendations include approaching outreach to Hong Kong authorities as a political campaign; communicating to Beijing the consequences of uncertainty over Hong Kong's status; investing in compliance infrastructure and developing risk mitigation strategies; monitoring pro-Beijing media in Hong Kong and broader US-China political trends, as well as data concerning national security cases and outcomes, foreign participation, and outcomes within the legal system; and communicating the importance of independent media for Hong Kong's future.

Rebranding Hong Kong

Under “one country, two systems” Hong Kong will continue to practice the capitalist system, and practice the common law system, an independent judiciary, a free flow of capital, no exchange control. Our dollar [the Hong Kong dollar] will continue to be pegged to the US dollar. So from investors’ perspective, indeed, Hong Kong will continue to function as a free international financial center with the best international regulatory regime and a trusted judicial system.

—Paul Chan, October 2022 remarks at Future Investment Initiative Forum

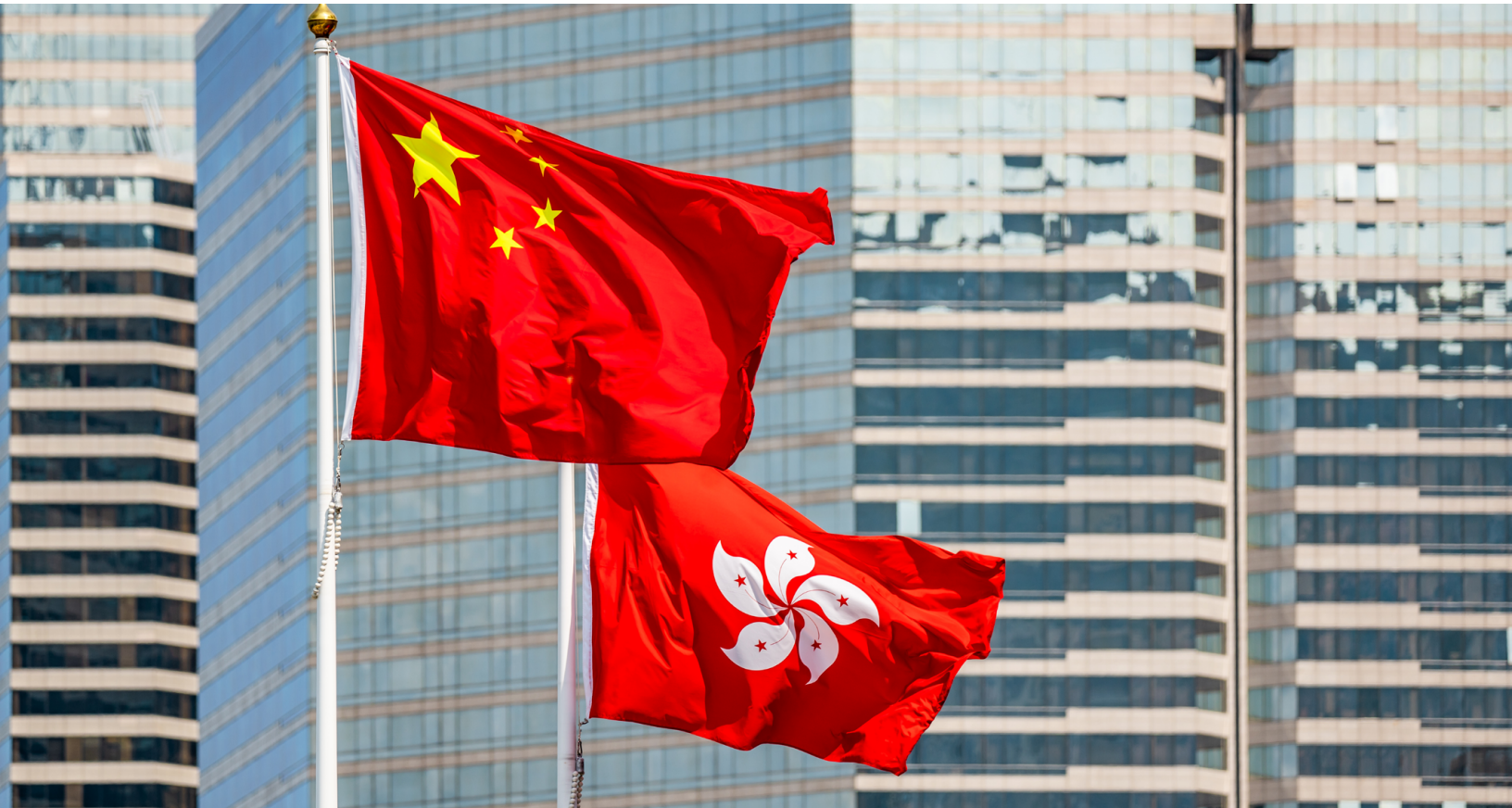
When conditions change rapidly, there is a natural tendency to seek certainty and stability. In that context, Hong Kong’s Financial Secretary Paul Chan knew his audience. Speaking at a financial forum in Saudi Arabia last October, he specified some of the exact fears that the global financial industry had developed concerning Hong Kong over the previous three years. Since the 2019 protests, the imposition of a sweeping National Security Law in July 2020, and the enforcement of strict COVID-19 restrictions and quarantine requirements in 2021 and early 2022, Hong Kong’s politics, media environment, legislative institutions, and business environment had changed fundamentally. But Chan’s audience in the financial industry was less concerned with what had already happened and more interested in what might come next. In very few words, he isolated some of the key components of Hong Kong’s attractiveness to international business, and argued forcefully that they would remain in place. The “capitalist system,” “common law,” an “independent judiciary,” the “free flow of capital,” and a credible peg of the Hong Kong dollar to the US dollar were exactly the pillars of Hong Kong’s operating environment that businesses valued.¹ The fact that Chan had to make

this reassurance highlighted the rising perceptions that all were at risk. The financial industry in Hong Kong continues to operate on the assumption that the fundamental changes in Hong Kong’s political and legal institutional structures will not impact their business prospects specifically.

Chan’s mission was difficult. He was in the Middle East a week ahead of a summit of financial executives in Hong Kong meant to showcase that Hong Kong was reopening to the rest of the world and remained a viable place to do business. Even after the 2019 protests, Hong Kong had been largely closed off throughout the three years of the COVID-19 pandemic. With lengthy required quarantine periods for all travelers including Hong Kong residents, international travel was extremely unattractive and the volume of international flights declined sharply—on some days in 2022, fewer than one hundred people arrived at the Hong Kong international airport. The border between Hong Kong and the mainland remained similarly closed, with quarantines usually required to enter mainland China, even for those with permission. An exodus of both expatriates and Hong Kong residents also was underway, with the total population of Hong Kong declining by 216,300 people between June 2019 and June 2022, a drop of 2.9%.² Numerous media stories circulated about Singapore gaining new residents and investment at Hong Kong’s expense.³ Businesses in Hong Kong were facing problems retaining staff and recruiting new people to replace them.⁴

The aftermath of the 2019 protests created a far different and more expansive challenge for Hong Kong. The National Security Law enacted in July 2020 was Beijing’s response to the protests of the previous year. The measure was enacted through Annex III of Hong Kong’s Basic Law, which concerned security

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- 1 Remarks by Paul Chan at Future Investment Initiative, Sixth Edition, Riyadh, Saudi Arabia, October 25, 2022; see video of Chan’s remarks (starting at 3:20:00), https://www.youtube.com/live/x1n_kT-hAfw?feature=share&t=12003. For coverage of the event, see Mia Castagnone, “2023 Is ‘Year of Hope’ for Hong Kong, Says Financial Secretary Paul Chan, as City Vies to Reclaim Former Status,” *South China Morning Post*, October 25, 2022, <https://www.scmp.com/business/banking-finance/article/3197221/2023-year-hope-hong-kong-says-financial-secretary-paul-chan-city-vies-reclaim-former-status>.
 - 2 Hong Kong Census and Statistics Department, “Mid-Year Population for 2022,” August 11, 2022, https://www.censtatd.gov.hk/en/press_release_detail.html?id=5078.
 - 3 Michelle Toe, “Hong Kong Expats Are Up In Arms About Quarantine. Singapore Stands to Gain,” CNN.com, September 27, 2021, <https://www.cnn.com/2021/09/22/business/hong-kong-singapore-business-covid-intl-hnk/index.html>.
 - 4 Reuters, “AmCham Survey Flags Potential Expatriate Exodus from Hong Kong,” May 11, 2021, <https://www.reuters.com/world/china/amcham-survey-flags-potential-expatriate-exodus-hong-kong-2021-05-12/>.



China & Hong Kong flag with commercial building at background, September 27, 2021. iStock/Chunyip Wong.

arrangements for Hong Kong and circumvented the usual legislative process of approval through Hong Kong's Legislative Council. The new law established parallel systems of authority to Hong Kong's traditional institutions, while permitting interventions into those jurisdictions on issues related to national security, and potentially conflicting with the provisions of the Basic Law. Early cases indicated that the National Security Law was being used against behavior in 2019 that Beijing sought to prohibit in the future, including the routine political activities of the opposition or pro-democratic politicians in Hong Kong. The concern for the business community and for financial institutions was whether the National Security Law meaningfully imposed restraints on government action under the law, the extent of those restraints, and the lines that were being redrawn between national security and commercial activity.

This report aims to clarify what has changed within the business environment in Hong Kong over the past

three years, and the significance of those changes for businesses and financial institutions operating in Hong Kong now and in the future. The report aims to step back from politicized rhetoric to evaluate actual changes in institutions and outcomes.

Welcome Back

Hong Kong's "Global Financial Leaders Investment Summit," a financial forum held in early November 2022, was designed by Hong Kong's government to demonstrate that the global financial industry remained committed to Hong Kong—despite all of the changes in the territory—and implicitly, to China's markets. Hong Kong has always played a role linking China with the international marketplace, and historically has highlighted the effectiveness of Western legal and judicial institutions operating under Chinese sovereignty. Chief Executive John Lee summarized the case as, "Hong Kong remains the only place in the world where the global advantage

and the China advantage come together in a single city.”⁵

The events surrounding the financial conference presented several confounding facts to the attendees and the international media, raising numerous questions about Hong Kong’s continued convergence with international norms and practices. The event started with a tour of M+, Hong Kong’s newly completed international art museum. Between the project’s groundbreaking ceremony and its eventual opening in 2021, the legal environment surrounding the display of some pieces of contemporary art by Chinese artists had shifted within Hong Kong, and the museum shelved certain exhibitions in 2021 and then removed some paintings that were seen as politically charged from the walls in 2022 (although they were still visible on the museum’s website).⁶

On the same day of the financial forum, a trial was being conducted of an independent media organization, Stand News, with Hong Kong authorities accusing its publications of being seditious. The organization and the editors and journalists involved were not being charged under the National Security Law but an old colonial law created in 1938 targeting sedition.⁷ However, no journalist or publication had been charged under the law since the 1960s, until the National Security Law was in place.⁸

One of the most notable differences between Hong Kong and other global financial centers over the past three years was the territory’s restrictive measures to contain COVID-19, which mirrored the mainland’s approach. Hong Kong’s coronavirus response became a visible manifestation of the broader changes in governance underway and Beijing’s growing influence, with political mandates taking precedence over technocratic or scientific guidance.

The financial conference was designed to highlight Hong Kong’s return to normalcy after COVID-19 restrictions were eased, but mainland Chinese officials did not travel to the forum, and instead appeared virtually. One Chinese official, Fang Xinghai of the China Securities Regulatory Commission, argued, “I would advise international investors to find out what’s really going on in China and what’s the real intention of our government by themselves. Don’t read too much of the international media.”⁹ Chan, the financial secretary, had his own problems after suddenly testing positive for COVID-19 in Saudi Arabia the week before. Under Hong Kong’s rules at the time, testing positive upon arrival in Hong Kong would have forced Chan to isolate for seven days. Instead, despite testing positive to a PCR test at the airport, Chan was declared to have recovered in time to attend the forum, where he appeared in person without a mask, while outdoor mask mandates were still enforced outside the conference. At the event venue, the Four Seasons hotel, delegates at the summit were given different rules to allow them to socialize with one another without the benefit of masks or the required isolation, unlike normal travelers to Hong Kong at the time. Chan later responded to the criticism in a press conference, claiming that, “The treatment that I have been given was the same as anyone. There’s no particular privilege at all.”¹⁰

The changes in Hong Kong’s political system following the 2019 protests impacted the territory’s response to the COVID-19 pandemic as well, which revealed the growing influence of Beijing’s political priorities. Following the mainland’s “zero COVID” approach led to Hong Kong pursuing a draconian policy of isolating individual cases and close contacts of cases—even if they had no symptoms. After the Hong Kong leadership declared in late 2021 that the objective was to open the border with

5 Selena Li, Kane Wu, and Xie Yu, “Hong Kong, Struggling to Revive Hub Status, Sells ‘China Advantage’ to Global Banks,” Reuters, November 2, 2022, <https://www.reuters.com/business/finance/hong-kongs-lee-pitches-china-advantage-rebuild-citys-image-financial-hub-2022-11-02/>.

6 Vivienne Chow, “The M+ Museum Has Removed Three Political Paintings by Chinese Artists as Beijing Continues Its Clampdown on Hong Kong,” *Artnet*, April 21, 2022, <https://news.artnet.com/art-world/political-chinese-paintings-removed-m-plus-hong-kong-2102659>.

7 The 1938 Crimes Ordinance, with text here under Cap. 200, Crimes Ordinance, https://www.elegislation.gov.hk/hk/cap200?xid=ID_1438402821397_002.

8 For an explanation of past uses of the 1938 sedition law, see Candice Chau, “Explainer: Hong Kong’s Sedition Law – A Colonial Relic Revived After Half a Century,” *Hong Kong Free Press*, July 30, 2022, <https://hongkongfp.com/2022/07/30/explainer-hong-kongs-sedition-law-a-colonial-relic-revived-after-half-a-century/>.

9 Hudson Lockett et al., “Global Bankers ‘Very Pro-China,’ Says UBS Chair,” *Financial Times*, November 2, 2022, <https://www.ft.com/content/037cc9d0-b214-43a6-8bcb-43f76507f9c5>.

10 Sammy Heung and Natalie Wong quoted Chan in their article, “Hong Kong Finance Chief Paul Chan Denies ‘Special Treatment’ After Attending Banking Summit despite Testing Positive for Covid-19,” *South China Morning Post*, November 2, 2022, <https://www.scmp.com/news/hong-kong/hong-kong-economy/article/3198111/hong-kong-finance-chief-paul-chans-pcr-test-covid-positive-upon-return-city-middle-east-viral-load>.



Paul Chan, Financial Secretary of Hong Kong, speaks during the Global Financial Leaders' Investment Summit in Hong Kong, China November 3, 2022. REUTERS/Tyrone Siu.

the mainland before international travel,¹¹ restrictions on businesses and individuals became far more common, with the apparent rationale of bringing Hong Kong's practices in COVID-19 containment more in line with those of the mainland, to smooth the opening of the border. Whether or not Beijing officials ever communicated specific requirements to Hong Kong's health authorities that were necessary for opening the mainland border, however, remained unclear throughout the three years of the pandemic.

Ultimately, even these highly restrictive measures were ineffective at containing the virus. The Omicron variant of COVID-19 eventually spread into the population in early 2022, with some cases ironically emerging from quarantine hotels themselves. The spread quickly overwhelmed the hospital system.

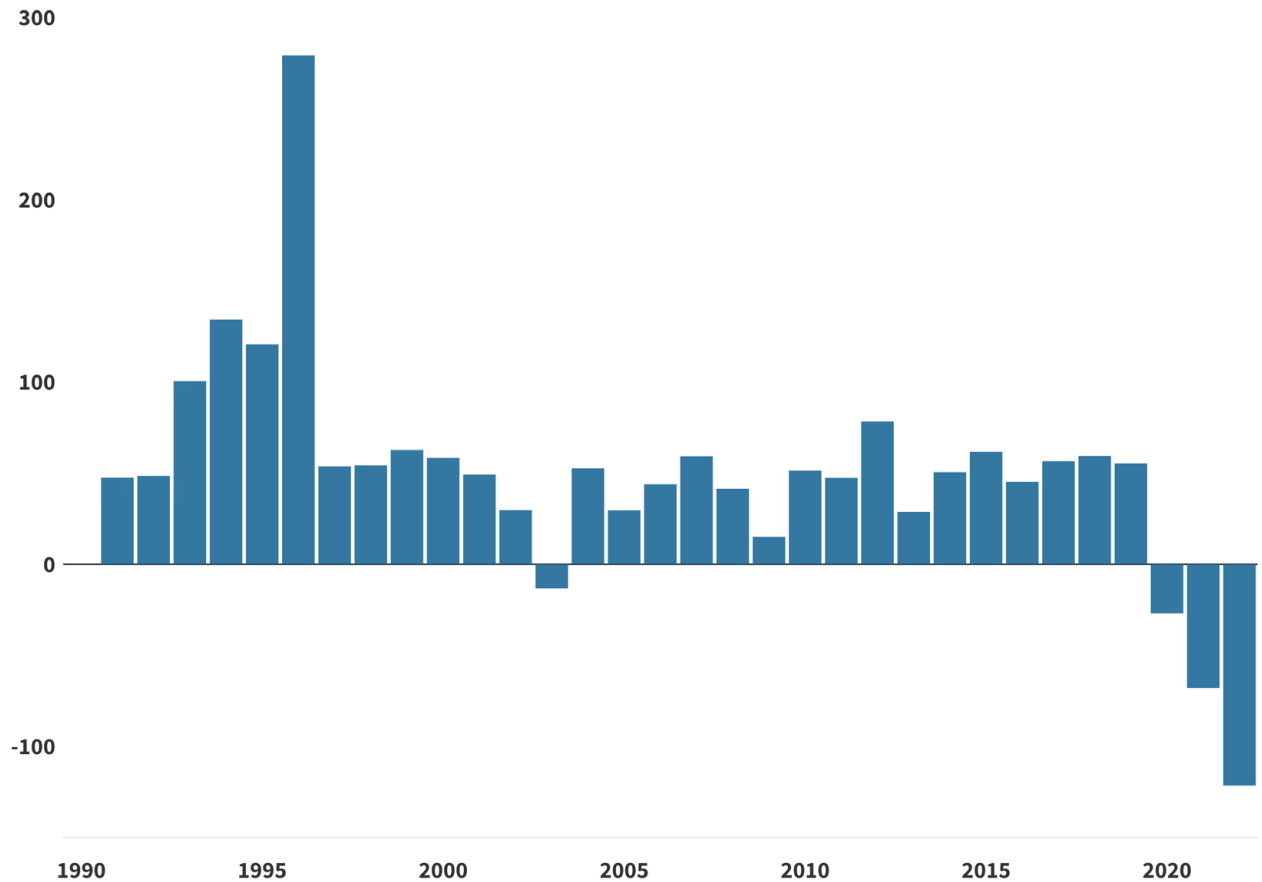
Photos of elderly patients sitting on hospital beds outside, exposed to the elements, dominated the local media.¹² Hong Kong experienced the highest death rate in the world per capita during its Omicron wave from February to April 2022, with over 10,770 COVID-19 deaths, or around 0.15 percent of the population.¹³ Even though Hong Kong had already faced a devastating wave of cases that had impacted most of the territory, it was only after Beijing abandoned its own restrictions that Hong Kong's COVID-19 controls were scrapped, with the border finally reopened to quarantine-free travel in January 2023.

The financial forum organized in early November 2022 was meant to show that Hong Kong had finally moved beyond its strict quarantine requirements

11 Jessie Yeung, "Hong Kong Prioritized Opening to China Over the Rest of the World. Now it's Stuck in Covid Limbo," October 8, 2021, CNN, <https://amp.cnn.com/cnn/2021/10/08/china/hong-kong-china-covid-border-mic-intl-hnk/index.html>.
12 Pheobe Sedgman, "Overflowing Hong Kong Hospitals Forced to Put COVID Beds Outside," Bloomberg, February 17, 2022, <https://www.bloomberg.com/news/articles/2022-02-17/overflowing-hong-kong-hospitals-forced-to-put-covid-beds-outside>.
13 Data from Hong Kong University, School of Public Health, accessed December 2, 2022, <https://covid19.sph.hku.hk/>.

Annual Change in Hong Kong’s Population, All Age Groups, 1991–2022

Thousand people



Source: Hong Kong Census and Statistics Department

and restrictions, and was ready to rejoin the rest of the world. But the industry participants were still receiving treatment that differed from what prevailed for the rest of the population.¹⁴ The executives who had agreed to participate in the Hong Kong summit also reciprocated the hospitality of their hosts, and said favorable things about Hong Kong’s position in the international financial system. Mary Callaghan Erdoes, head of JP Morgan’s asset and wealth management division, commented, “There hasn’t been a city in the East that has emerged in the same way that Hong Kong has . . . Hong Kong never left.

I mean, it shouldn’t be so hard on itself. It never disappeared.”¹⁵

The event was a microcosm of the implied assumptions about the financial industry’s position and importance in Hong Kong: that the sector would always be exempt in some way from the broader changes taking place in the rest of Hong Kong’s legal and political system. This was despite the growing risk that compliance obligations and international sanctions from both China and the United States could force financial institutions to operate between legal jurisdictions, or to choose between compliance

14 Radio Television Hong Kong (public broadcaster), “HKMA Outlines COVID Rules for Summit Guests,” October 24, 2022, <https://news.rthk.hk/rthk/en/component/k2/1672495-20221024.htm?spTabChangeable=0>.

15 Peggy Sito quoted Mary Callahan Erdoes in her article, “Hong Kong ‘Never Left,’ the City’s Status as Global Finance Hub Never Faltered during Pandemic, JPMorgan’s Wealth Chief Says,” *South China Morning Post*, November 1, 2022, <https://www.scmp.com/business/banking-finance/article/3197896/hong-kong-never-left-citys-status-global-finance-hub-never-faltered-during-pandemic-says-jpmorgans>.

with one system or the other. These assumptions about the financial industry's position within Hong Kong will be tested more directly in the years ahead.

As Hong Kong's political and legal structure changed and COVID-19 restrictions intensified over the past three years, many people chose to leave the territory. Ultimately, changes in population, particularly within a territory of Hong Kong's size, can be viewed as an indicator of societal health and political support. Hong Kong's demographic challenges are significant. Birth rates have declined sharply, from 95,500 births in 2011 to 53,700 in 2018, and only 37,000 in 2021; meanwhile, death rates have climbed in recent years. This is consistent with broader regional trends in East Asian countries including Korea and Japan, but the declines have been particularly sharp in Hong Kong itself. The median age as of 2021 is 46.3 years old—one of the world's highest.¹⁶ The natural trajectory of Hong Kong's population will be to decline in the absence of new immigration, which historically has flowed from the mainland via “one-way permits” allowing long-term migration.

The exodus that has taken place since the implementation of the National Security Law and coronavirus restrictions is unprecedented in Hong Kong's history. The proximate cause of the wave of migration—politics or disease control—remains debatable, but the fact of the wave of emigration is indisputable, and distinct from other countries in the region facing declining populations. Since the summer of 2019, Hong Kong's population has declined by 2.9%. The British government's 2021 offer of a five-year path to citizenship for Hong Kong holders of British nationals overseas (BNO) passports, meaning those born in the territory before the 1997 handover, had been taken up by thousands.¹⁷ While there was a wave of outbound travel immediately after the National Security Law's implementation in 2020, the fastest period of emigration occurred in 2022, presumably in response to COVID-19 restrictions.

These statistics may be understating the true level of outbound migration, in part because many people may have simply traveled abroad quickly without formally changing residence. After significant legal and institutional changes, the decision to “vote with one's feet” was the last form of meaningful popular franchise still available in Hong Kong.

Objectives and Methodology

The most fundamental change in Hong Kong over the past three years has been a shift from legal and institutional constraints on government actions to political and normative constraints. Specifically, a legal system founded on the Basic Law and British common law has shifted toward a system governed by political norms reinforced by the National Security Law. In that process, those political norms have changed significantly, and are driven more by priorities in Beijing than the previous local leadership of Hong Kong.

The report will evaluate changes and risks in Hong Kong's business environment in five critical areas. First, the changes in Hong Kong's institutional structure create new risks for the future of Hong Kong's independent currency, the Hong Kong dollar, and its peg to the US dollar via the linked exchange rate system (LERS). The credibility of the Hong Kong dollar's currency peg is intrinsically linked to the credibility of the “one country, two systems” policy as it is practiced in Hong Kong. Questions about the currency peg were always going to be raised after “one country, two systems” was scheduled to sunset in 2047—now, those questions are surfacing much earlier. Central to the nature of Hong Kong's currency arrangement is the prospect for maintaining open capital flows between Hong Kong and the rest of the world.

Second, Hong Kong-based financial institutions are confronting new compliance-related risks tied to sanctions activity, from both Washington and Beijing. There are reasonable concerns that both sides may intensify the use of sanctions-related controls in the future, and may seek to prevent the enforcement of conflicting directives in Hong Kong. Global financial institutions will plausibly be asked to devote increasing efforts to balancing business and compliance risks, with rising political risk associated with their decisions.

Third, the report will discuss the nature of the legal environment in Hong Kong and risks to the continued independence of the judiciary, which is essential for Hong Kong to maintain its reputation and attractiveness as a center of international commerce,

16 Data from Hong Kong Census and Statistics Department, “Demographics: Table 3: Vital Events,” https://www.censtatd.gov.hk/en/web_table.html?id=3#; among major countries, only Italy, Germany, and Japan have higher median ages.

17 “Media Factsheet: Hong Kong BN(O) Visa Route,” United Kingdom Home Office, February 24, 2022, <https://homeofficemedia.blog.gov.uk/2022/02/24/media-factsheet-hong-kong-bnos/>.

and for adjudication of disputes in financial and commercial transactions.

Fourth, there are rising risks related to press freedom and the free exchange of ideas and information in Hong Kong. Business and finance depend upon reliable and credible information. Hong Kong's media environment was very liberal by global standards before the National Security Law was imposed in July 2020. The environment has tightened considerably since that time, and there are considerable risks to the business environment should that trend continue.

Fifth, data security in Hong Kong is a new uncertainty after the passage of the National Security Law. The use of new legal sources of authority to seize data and control of company information creates new risks for businesses managing both internal and customer data. China's own data security and protection laws may also create new risks if they are applied to Hong Kong in the future.

The direction of the accumulated changes is important as a signal of future actions. There are few effective measures determining when legal and institutional constraints no longer bind powerful actors. If norms and practices are changing in conflicting directions, with some pointing to a liberalization of the media environment and others to rising censorship, the implications may be unclear. But if the vast majority of institutional changes point to centralization of authority and reduced autonomy in the public sphere, it is more reasonable to draw conclusions about the steps that will follow.

Most critical for global business and the financial industry at present is to separate the changes that are resulting from a security-driven political campaign from the lasting shifts in the operating environment for businesses in Hong Kong. But measures that appear transitory and tied to security-related priorities can become permanent features of the business environment as well.

Assessing Risks to Hong Kong's Business Conditions

Institutional Changes in Hong Kong Since 2019

The fact that the legal and institutional environment has changed in Hong Kong is not in dispute: the leadership in Beijing and Hong Kong have been trumpeting those changes as essential in restoring “law and order” in Hong Kong after the protest movements of 2019.¹⁸ Other governments—notably the United States and the United Kingdom—have used those legal and institutional changes in Hong Kong to make the case that changes in their own policies toward the territory are warranted. The US Commerce Department's Bureau of Industry and Security (BIS) stopped treating Hong Kong as a separate destination under its own export controls following a December 2020 executive order.¹⁹ The United Kingdom has declared that Hong Kong's changes to the Legislative Council election system represent a “state of ongoing noncompliance with the Sino-British Joint Declaration.”²⁰

This section very briefly summarizes the most significant and fundamental changes in Hong Kong's legal and institutional environment since the 2019 protests.

National Security Law and the National Security Committee

The Law of the People's Republic of China on Safeguarding National Security in the Hong Kong Special Administrative Region (aka, the National Security Law) was the most significant change in Hong Kong's system of institutions following the 2019 protests. It was formally passed by Beijing's

National People's Congress on June 30, 2020, and was applied to Hong Kong under Annex III of Hong Kong's Basic Law, which consists of national laws in China that also apply in Hong Kong. The law did not enter the normal legislative process in Hong Kong, and most officials in the Hong Kong government were unaware of the contents of the law before it was implemented.²¹ The law formally designates four specific offenses related to national security, including secession, subversion, terrorism, and collusion with foreign organizations. The National Security Law also can be applied to alleged offenses that occur outside of Hong Kong.²²

The National Security Law is enforced in Hong Kong using a parallel system of policing and enforcement to Hong Kong's conventional system, including a newly established Office for Safeguarding National Security. For cases deemed to involve national security or the crimes designated under the law, this office may involve mainland courts or other aspects of the mainland legal system. The structure of the National Security Law and its parallel system raise questions about where Hong Kong's Basic Law still applies and where the National Security Law circumvents and overrides the authority under the Basic Law. For cases in which this is in dispute, the National People's Congress Standing Committee in Beijing has the authority to interpret the law.

Judges presiding over cases under the National Security Law are to be selected by Hong Kong's chief executive, rather than through the conventional process of selecting judges for criminal cases in Hong Kong, through the Judicial Officers Recommendation Commission. It remains unclear at this point whether

18 Abigail Ng, “Hong Kong's Leader Says National Security Law Has City ‘Back on the Right Track,’ ” CNBC.com, October 6, 2021, <https://www.cnbc.com/2021/10/06/hong-kongs-carrie-lam-says-national-security-law-has-curbed-chaos.html>.

19 “Risks and Considerations for Businesses Operating in Hong Kong,” Hong Kong Business Advisory issued by US Departments of State, Treasury, Commerce, and Homeland Security, July 16, 2021, <https://www.state.gov/wp-content/uploads/2021/07/HKBA-FOR-FINAL-RELEASE-16-JUL-21.pdf>.

20 United Kingdom Foreign Commonwealth and Development Office and Dominic Raab, “Radical Changes to Hong Kong's Electoral System: Foreign Secretary's Statement,” March 13, 2021, <https://www.gov.uk/government/news/foreign-secretary-statement-on-radical-changes-to-hong-kongs-electoral-system>.

21 Iain Marlow and Natalie Lung, “Hong Kong Leader Says She Still Hasn't Seen Draft Text of Security Law,” *Time*, June 23, 2020, <https://time.com/5857735/hong-kong-draft-security-law-text/>.

22 For more information, see this review of the law's provisions from the *Hong Kong Free Press*, “Explainer: 10 Things to Know About Hong Kong's National Security Law—New Crimes, Procedures and Agencies,” July 1, 2020, <https://hongkongfp.com/2020/07/01/explainer-10-things-to-know-about-hong-kongs-national-security-law-new-crimes-procedures-and-agencies/>.



Anti-government protesters march against Beijing's plans to impose national security legislation in Hong Kong, China May 24, 2020. REUTERS/Tyrone Siu.

or not lawyers involved in national security cases must also be approved or selected by the chief executive, as a recent interpretation of the law from Beijing suggests the chief executive may be able to overrule the courts concerning such questions.²³ Hong Kong's secretary of justice can similarly specify that cases related to the National Security Law be conducted without a jury. So far, no criminal cases tried under the National Security Law have involved a jury. Very few cases have been tried so far since the passage of the National Security Law, and not all of those arrested have been formally charged with offenses, but the conviction rate for all such cases under the National Security Law remains at 100 percent.

Legislative Council Structure and Elections

Hong Kong's Legislative Council, the de facto legislature for the city established under the Basic Law, had previously consisted of seventy seats, with thirty-five elected via popular vote through a system of proportional representation involving multimember districts, and thirty-five elected through "functional constituencies," or representatives of different occupational groups, guilds, and unions. The next election to be held under this system was scheduled for September 2020, but was delayed by then-Chief Executive Carrie Lam, citing the COVID-19 pandemic.

In January 2021, fifty-three members of the pan-democratic alliance of political parties in Hong Kong were arrested under the National Security Law based on their participation in a primary election

23 Selena Cheng, "China Lets Hong Kong Leader Override Courts Over Jimmy Lai Lawyer," *Wall Street Journal*, December 30, 2022, https://www.wsj.com/articles/china-lets-hong-kong-leader-override-courts-over-jimmy-lai-lawyer-11672417546?st=si5xpi2ol8rcwrq&reflink=share_mobilewebshare.

for the upcoming Legislative Council race.²⁴ Hong Kong's Legislative Council electoral system was then changed in March 2021 by legislation passed through China's National People's Congress.

The new system expanded the overall number of seats to ninety, and reduced the number of seats that could be directly elected via popular vote to twenty. The change reduced the functional constituencies to thirty seats, and then authorized forty seats for an Election Committee consisting of the people that also elect the chief executive in Hong Kong.²⁵ The 2020 Legislative Council elections were eventually held in December 2021, and voter participation for the seats elected via geographic constituencies declined from 58 percent in 2016 to 30.2 percent.²⁶ The majority of pro-democratic politicians (the "pan-democrats") who had not been arrested did not choose to stand in the December 2021 elections.

The election process for the chief executive of Hong Kong was changed as well. The previous system under Annex I of the Basic Law provided for 1,200 members of the Election Committee, with 117 seats selected by the District Councils. The last District Council elections, which were held in November 2019, were won overwhelmingly by pro-democratic candidates. The National People's Congress decision changing Hong Kong's electoral system removed the potential influence of these pan-democratic votes by expanding the Election Committee to 1,500 members and increasing the number of seats named by the Chinese People's Political Consultative Conference (CPPCC) and other organizations controlled by Beijing. While Lam received 777 of the 1,194 votes in the 2017 chief executive election, Lee was the only candidate in the 2022 chief executive election, receiving 99.4 percent of the vote in the new system.

Along with changes in the structure of legal and political institutions in Hong Kong, the COVID-19 pandemic prompted new legal restrictions on the business environment in Hong Kong over the past three years. Hong Kong's public health restrictions have been applied under a law passed in 2008 as the Prevention and Control of Disease Ordinance, and applied through administrative changes and amendments, rather than the normal legislative

process. These restrictions imposed have similarly interfered with provisions of the Basic Law, such as Article 31, which permits free movement into and out of Hong Kong by Hong Kong residents. While most of these controls have since been dismantled, as the mainland moved quickly to remove COVID-19 restrictions, it remains unclear whether or not these authorities will remain a permanent feature of Hong Kong's legal and regulatory structure, to be reimposed in the future.

One Country, Two Currencies?

One of the most significant risks to the business environment in Hong Kong is the possibility that the Hong Kong dollar's peg to the US dollar might change, and with it, free capital flows in and out of Hong Kong. The currency peg, through LERS, has been in place since 1983 and has significantly reduced the risks of operating in Hong Kong, particularly for companies engaged in international trade. The challenge to the currency peg is that fixed exchange rate regimes inherently depend upon the credibility of the institutions and leadership that maintain them. Hong Kong's currency was always going to confront a "2047 problem," in that the status of the currency would be uncertain after the fifty years of "one country, two systems" ended on June 30, 2047. Given the dramatic changes in Hong Kong over the past three years, however, and uncertainties about the degree of change between now and 2047, many of the future concerns about Hong Kong's currency have advanced into the present day. It is highly unusual in global finance for any one sovereign country to issue two separate currencies, and to run two separate monetary policies.

The fundamental question is how long such a "one country, two currencies" system can persist. Credibility and confidence in Hong Kong's fixed exchange rate regime depends upon confidence in the "one country, two systems" policy framework itself. There is no reason that the current arrangement, with the Hong Kong dollar trading in a range of 7.75 to 7.85 per US dollar, necessarily needs to change. As long as Hong Kong is willing to accept the consequences of US monetary policy within its domestic economy (primarily felt through its property

24 "53 Hong Kong Democrats, Activists Arrested under Security Law Over 2020 Legislative Primaries," *Hong Kong Free Press*, January 6, 2021, <https://hongkongfp.com/2021/01/06/breaking-over-50-hong-kong-democrats-arrested-under-security-law-over-2020-legislative-primaries/>.

25 The Election Committee also had received six seats in the Legislative Council before these were abolished in 2004.

26 "Hong Kong Elections: 30.2 Per Cent Turnout in First Legislative Council Poll Since Beijing Overhaul," *South China Morning Post*, December 20, 2021.



Front entrance of Two IFC skyscraper, Hong Kong. Home of the Hong Kong Monetary Authority.

market), it is still very unlikely that capital outflows from Hong Kong will overwhelm the system and force an exchange rate adjustment. The Hong Kong Monetary Authority (HKMA), the central bank that operates the LERS maintaining the peg, is expected to continue emphasizing publicly that the system will remain unchanged. Paul Chan's October comments clearly indicate that Hong Kong authorities, including those outside the HKMA, agree that the peg is highly significant for Hong Kong.

The risk to the Hong Kong dollar's stability comes not from Hong Kong but from Beijing, or more specifically from market uncertainty about Beijing's intentions. Should Beijing at some point offer a public opinion about the future of the Hong Kong dollar, those words are likely to carry greater weight in global markets relative to statements from the HKMA. After all, throughout the legal and institutional changes from 2019 to 2022, Beijing's will typically prevailed over

the preferences of Hong Kong's local authorities, such as the changes in the Legislative Council which reduced the roles of even the local pro-Beijing parties, and requirements for loyalty oaths to the government from career civil servants.²⁷

The reason Beijing may start to see risks attached to the Hong Kong dollar itself stems from the leaks in China's capital controls. One of the primary benefits of Hong Kong's position to Beijing is the fact that the territory permits capital flows to and from mainland China, in a legal and institutional system more appealing and understandable to foreign investors and financial institutions. The free flow of capital carries benefits as well as risks for Beijing: capital outflows from China via Hong Kong to the rest of the world have tightened financial conditions in China in the past, and could endanger financial stability in China itself if these outflows accelerated. China's domestic savings of households and corporations

27 Reuters, "Hong Kong Civil Servants Given Four Weeks to Pledge Loyalty to the Government," January 15, 2021, <https://www.reuters.com/article/us-hongkong-security/hong-kong-civil-servants-given-four-weeks-to-pledge-loyalty-to-the-government-idUSKBN29K1HY>.

are extremely high by global standards, and China has the largest money supply of any country in the world, measured in US dollars, at \$37 trillion. Most of China's household and corporate savings is still invested in renminbi-denominated assets, at around 98 percent. That pool of savings could generate trillions of dollars in capital outflows should China's capital controls ease or if there were sudden changes in China's economy that would drive capital flight.

If China were facing considerable capital flight, Hong Kong's environment of free capital flows could appear as a greater vulnerability than benefit to Beijing, and to China's central bank, the People's Bank of China (PBOC). In early 2016 and January 2017, China's central bank had already tried to shut down capital flight from China by intervening in Hong Kong's market for the offshore renminbi (RMB) [labeled the CNH in currency trades to distinguish it from the onshore Chinese yuan or CNY], by tightening funding conditions for the offshore currency, making it more expensive to borrow and speculate on its depreciation. The actions supported the value of the offshore currency, but also introduced considerable new policy uncertainty, as the currency became far less attractive to hold as a result. Prior to this intervention, Hong Kong's leadership was marketing the territory as a center for "RMB internationalization" and a market for offshore RMB-denominated financial instruments such as so-called "dim sum" bonds. The sudden squeeze in financing rates created significant obstacles to these financial markets developing within Hong Kong. But the priorities of Beijing in maintaining onshore financial stability clearly took precedence. If capital flight intensifies in the future, Beijing's priorities could once again outweigh maintaining the conditions necessary to preserve Hong Kong's currency peg and free capital flows.

The most likely alternative to the Hong Kong dollar's peg to the US dollar is not a free float of the currency, allowing the market to set its price, but repegging the Hong Kong dollar to the renminbi. This would mean, in effect, that Hong Kong would be "importing" China's own monetary policy rather than US monetary policy. The Hong Kong dollar would essentially transform into an offshore RMB. If there were any meaningful divergence between interest rates in Beijing and Hong Kong, capital would quickly flow toward the higher-yielding jurisdiction. As a result, such a change would place Beijing in a difficult position of needing to impose stricter capital controls between Beijing and

Hong Kong or between Hong Kong and the rest of the world to prevent broader capital flight that would endanger the stability of China's currency. China's own "managed float" against the US dollar would similarly face peril through broad-based capital flight and diversification of Chinese savings into foreign assets. China's foreign exchange reserves are now only 8 percent of the money supply, down from 16 percent during the last period of aggressive capital flight, in 2015 and 2016.

Hong Kong needs free and open capital flows for its own survival as a global financial center, and for its benefits to Beijing. But any change to Hong Kong's currency peg to the US dollar would create new questions about how long those capital flows would continue without new controls being imposed. Those fears alone could start to diminish Hong Kong's attractiveness as a financial center.

China's capital controls are porous, and Beijing is aware of that fact. If fundamental conditions point to China's currency depreciating, the PBOC can only slow capital outflows to a limited extent. Often, these outflows show up under so-called "errors and omissions" in China's balance of payments data. From 2015 to 2019, these cumulative outflows under errors and omissions were larger than China's current account surplus, at \$933 billion.²⁸ As long as China's current account for trade-related transactions remains open, capital flows are likely to take place, disguised as trade flows. This often occurs in China through overinvoicing or underinvoicing in trade transactions, to facilitate flows that would otherwise be permitted in developed financial systems. It also can occur through transactions designated as outbound tourism, in which individuals claim they need foreign exchange for travel, but may use it for any number of financial transactions instead. As a result of these porous controls, Beijing often experiments with tightening some of these channels when they see outflows intensify. The risk for Hong Kong is that those same incentives would start to apply in the territory itself.

One can easily argue that Beijing has no interest in changing the Hong Kong dollar's peg to the US dollar, and that may be true. But most importantly, financial markets will start looking to Beijing to assess those preferences, rather than the words of the HKMA or other Hong Kong authorities. Regardless of how one assesses the probability of Beijing's preferences

28 Balance of payments data tables from China's State Administration of Foreign Exchange, <https://www.safe.gov.cn/safe/2019/0627/13519.html>.

changing, this is still a significant new risk that any company or financial institution operating in Hong Kong must consider and manage carefully.

Compliance: Sanctions and National Security Directives

One of the most significant new risks confronting businesses operating in Hong Kong, particularly for financial firms, is linked to compliance with international sanctions and the possibility of being caught between two different legal systems. Hong Kong represents China's financial gateway to the rest of the world, which also means that the territory's financial institutions must maintain access to US dollar financing channels, which involve transactions between banks that can be governed by the US legal system. Most of these transactions between banks involving US dollars use clearing accounts within the United States.

The risks arising from these compliance obligations are not theoretical. In July 2020, the US Congress passed the Hong Kong Autonomy Act,²⁹ and the Trump administration issued Exec. Order No. 13936, which included blocking sanctions for any individual involved in implementing the National Security Law in Hong Kong, as well as the use of the law for a number of other purposes, including censorship and "policies that undermine democratic processes or institutions in Hong Kong."³⁰ The list of individuals sanctioned included several members of the Hong Kong government, including former Chief Executive Lam and the current Chief Executive Lee, who was then secretary for security³¹

The Hong Kong Monetary Authority also issued a circular in August 2020 clarifying its own stance on foreign sanctions implemented in Hong Kong, arguing that "a distinction is made between targeted financial sanctions applicable under Hong Kong

law and unilateral sanctions imposed by foreign governments."³² The circular argued that these "unilateral sanctions" had "no legal status in Hong Kong."³³

China has similarly retaliated against US sanctions by enacting its own Anti-Foreign Sanctions Law in June 2021, which permits Chinese institutions to freeze and seize assets of individuals and entities engaged in the creation or implementation of "discriminatory restrictive measures" against China's interests.³⁴ As of now, the law has not been applied in Hong Kong, after an extensive lobbying campaign by the financial industry and Hong Kong authorities. However, China has administered its own sanctions against a list of US elected officials, private citizens, and organizations involved in government-related programs.³⁵

Local security agencies in Hong Kong also are requesting that financial institutions make decisions which potentially conflict with their obligations to their clients and legal requirements in other countries. The request of the Hong Kong Police to freeze the accounts of Hong Kong activists, independent media, and civic groups put HSBC in the challenging position of suspending transactions in accounts of political figures in Hong Kong.³⁶

In addition, the National Security Law itself creates potential legal risks for financial institutions. Article 29 of the National Security Law specifies that if a person "engages in activities such as requesting, conspiring with, receiving instructions etc., from a foreign country" that they commit an offense under the law.³⁷ Simply by abiding by US sanctions policies, foreign financial institutions potentially invite legal risk within Hong Kong courts. No such cases have arisen so far, but the history of case law under the National Security Law remains a very short one. For the seventy-eight banks operating in Hong Kong,

29 Hong Kong Autonomy Act, US Pub. L. No. 116-149, <https://www.congress.gov/116/plaws/publ149/PLAW-116publ149.pdf>.

30 US Exec. Order No. 13936, 85 Fed. Reg. 43413 (July 14, 2020), <https://www.govinfo.gov/content/pkg/FR-2020-07-17/pdf/2020-15646.pdf>.

31 US Department of the Treasury, "Treasury Sanctions Individuals for Undermining Hong Kong's Autonomy," August 7, 2020, <https://home.treasury.gov/news/press-releases/sm1088>.

32 Hong Kong Monetary Authority (HKMA), Circulars, "Financial Sanctions," August 8, 2020, <https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2020/20200808e1.pdf>.

33 HKMA, Circulars, "Financial Sanctions."

34 Akin Gump, "The New PRC Anti-Foreign Sanctions Law," law firm's Asia Alert, July 2, 2021, <https://www.akingump.com/en/news-insights/the-new-prc-anti-foreign-sanctions-law.html>.

35 "China Imposes Sanctions on US Officials," BBC, July 23, 2021, <https://www.bbc.com/news/world-asia-china-57950720>.

36 Sumeet Chatterjee and Clare Jim, "Hong Kong Bank Account Freezes Rekindle Asset Safety Fears," Reuters, December 8, 2020, <https://www.reuters.com/article/hongkong-security-banks/hong-kong-bank-account-freezes-rekindle-asset-safety-fears-idUSKBN2811ZK>.

37 Hong Kong Department of Justice, Statement by Secretary for Justice Teresa Cheng, "Article 29 of National Security Law," February 2, 2021, https://www.doj.gov.hk/en/community_engagement/speeches/20210202_sj1.html.

which are among the world's top one hundred,³⁸ it will become increasingly difficult to thread the needle between obligations under US law and sanctions policies and Hong Kong's changing governance.

Rising Risks and Compliance Obligations

There is a growing risk that financial institutions operating in Hong Kong will be forced to make decisions related to sanctions compliance that invite regulatory scrutiny from either Beijing or Washington, and expose the institution to legal risks as well. Both Washington and Beijing are clearly attentive to the risks of sanctions compliance or noncompliance in Hong Kong, and as a result, financial institutions are at greater risk of potential secondary sanctions or additional compliance obligations in Hong Kong relative to other jurisdictions. On July 16, 2021, the US State, Treasury, Commerce, and Homeland Security Departments released a Hong Kong business advisory discussing several potential risks for businesses operating in Hong Kong under the National Security Law.³⁹ The release of this advisory alongside updated lists of specially designated nationals (SDNs), including Chinese government officials in Hong Kong, highlighted the US government's awareness and monitoring of Hong Kong-related sanctions efforts.

In November 2020, the United States government began to confront China's use of dual-use technologies and firms by sanctioning the financing of specific companies contributing to the development and modernization of China's military, intelligence, and security structures, and preventing US financial institutions from holding securities issued by those companies. Exec. Order No. 13959 provided a window between November 30, 2020, and January 11, 2021, for compliant firms to exit investments in the sanctioned entities.⁴⁰ The list of companies has continued to expand to include sixty-eight different entities. As these restrictions went into effect in January 2021, the shares of the affected firms sold off heavily in Hong Kong's market, but were quickly purchased by mainland investors seeking bargains.

The expanding list of restricted firms makes bundling assets and creating financial products less transparent, as selling the stock of restricted firms could also hypothetically be considered "receiving instructions from a foreign country" under the National Security Law. Navigating these limitations and exemptions increases compliance costs for financial institutions, particularly as these restrictions expand.

Hong Kong's own position on enforcing foreign sanctions remains ambiguous as well. Most foreign financial institutions remain broadly in compliance with US blocking sanctions and those targeting specific individuals, in attempting to reduce their own legal exposure. However, in October 2022, Alexi Mordashov, a sanctioned Russian oligarch, was allowed to dock his yacht in Hong Kong, an act requiring approval from the Hong Kong Marine Department.⁴¹ In response, the Hong Kong government stated that it would only enforce sanctions imposed by the United Nations Security Council.

In response to the Russian sanctions after the invasion of Ukraine, China's central bank and finance ministry convened a meeting of domestic and international banks to better understand the threat of the same types of sanctions being implemented against China.⁴² The consensus of that meeting, according to a *Financial Times* report citing people familiar with the discussion, was that China is highly exposed to the US dollar system and cannot effectively replace USD-denominated assets with other foreign exchange reserves.⁴³ The net result, if accurate, is that Hong Kong would remain in a critical position as a conduit of capital to China and the country's critical link to the US dollar-denominated global financial system. It remains more likely that Beijing would attempt to tighten links between its own legal and political institutions and Hong Kong's financial system, rather than allowing Hong Kong to strengthen legal and institutional ties to the rest of the world.

38 Data from the Hong Kong Financial Services and the Treasury Bureau, "Hong Kong: The Facts: Financial Services," July 2020, https://www.gov.hk/en/about/about/hk/factsheets/docs/financial_services.pdf.

39 "Risks and Considerations for Businesses Operating in Hong Kong," Hong Kong Business Advisory issued by US agencies. July 16, 2021.

40 US Exec. Order No. 13959, 85 Fed. Reg. 73185 (November 12, 2020), <https://www.federalregister.gov/documents/2020/11/17/2020-25459/addressing-the-threat-from-securities-investments-that-finance-communist-chinese-military-companies>.

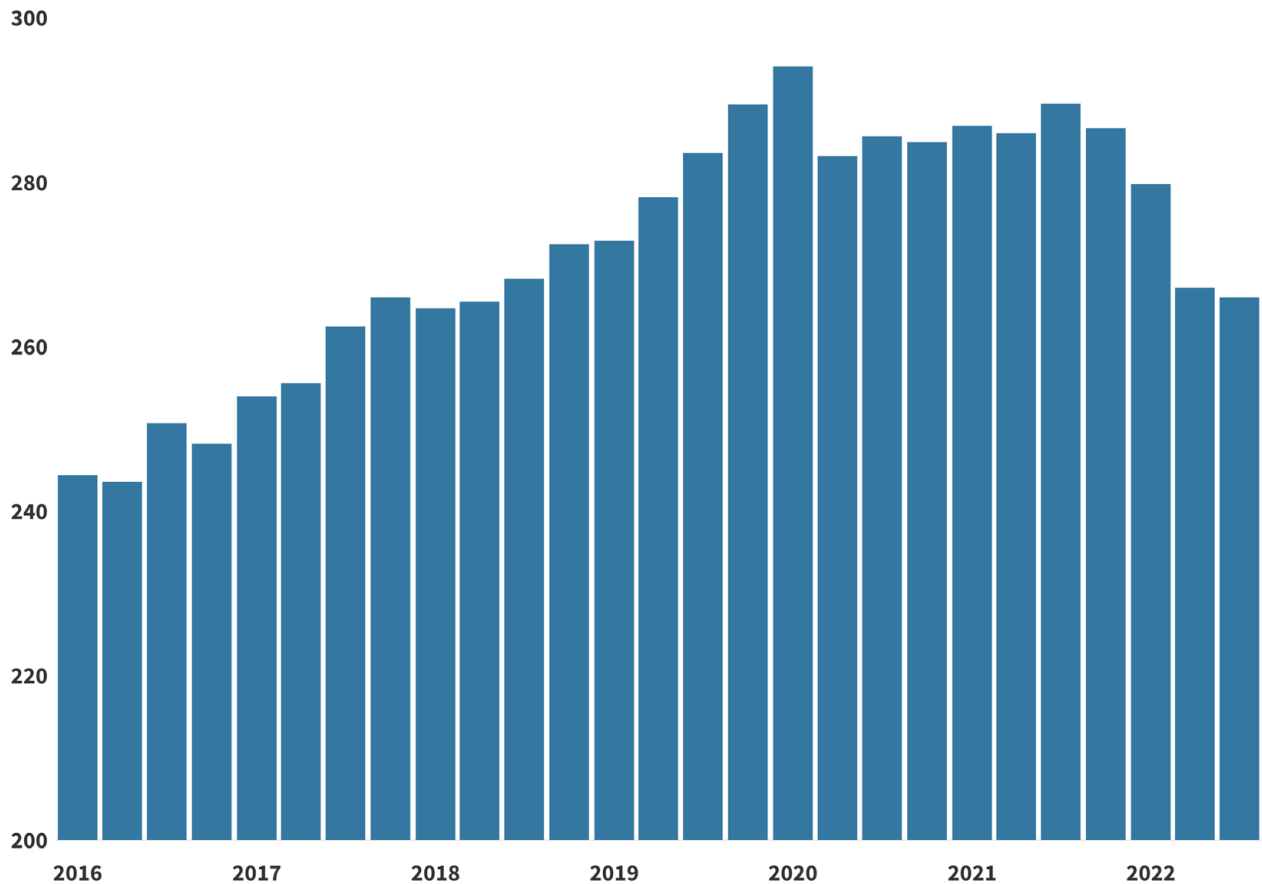
41 Hong Kong Marine Department, "Information Notes for Masters of Visiting Yachts/Pleasure Vessels," accessed November 30, 2022, https://www.mardep.gov.hk/en/pub_services/ocean/notes_ymaster.html.

42 Sun Yu, "China Meets Banks to Discuss Protecting Assets from US Sanctions," *Financial Times*, April 30, 2022.

43 Yu, "China Meets Banks to Discuss Protecting Assets."

Employment in Hong Kong's Financing and Insurance Sectors, 2016–2022

Thousand people



Source: Hong Kong Census and Statistics Department

As strategic competition between the United States and China has intensified, Hong Kong's location at the nexus of global finance and the Chinese political system has increased the risk of operating businesses within the territory. The continued escalation of financial restrictions from the United States and the enactment of the National Security Law in Hong Kong create additional compliance obligations and rising costs for firms. These restrictions and requests can potentially create circumstances where abiding by one government's laws places individual banks and financial institutions in violation of the other's requirements. Navigating these dynamics presents a new set of challenges for banks offering a wide variety of services, as noncompliance by one branch of the bank could open the entire institution to restrictions.

While China serves as an attractive market for expanding financial services, the lack of clarity and

broad reach of the National Security Law make future business operations in Hong Kong far more complex than in the recent past.

The Rule of Law and Judicial Independence

The National Security Law's changes to Hong Kong's legal and institutional framework have generated considerable uncertainty surrounding the continued operation of the rule of the law and the independence of Hong Kong's judiciary, which have historically been cornerstones of the territory's attractiveness to international business. The creation of a new system of authority under the National Security Committee leaves the jurisdiction of Hong Kong's courts unclear in several matters that are relevant for commercial and financial transactions. Any loss of the transparency and predictability of the British common law system

Perceptions of the Rule of Law, Fairness of the Judicial System, Impartiality of Courts, 1997–2022

Rating points



Source: Hong Kong Public Opinion Research Institute

of jurisprudence creates significant problems for businesses and lawyers working within Hong Kong’s legal system.

Most significantly, under the National Security Law, Hong Kong courts cannot necessarily decide what falls within the definition of national security, even though they are granted jurisdiction over criminal national security-related cases.⁴⁴ This necessarily leaves the interpretation of national security to mainland law, which has historically interpreted

the term expansively. Notably, Beijing’s conception of national security can include fields such as the economic interests of Chinese state-owned firms, food safety, and security of resources and energy, as well as “ideological security.”⁴⁵ In January 2023, Xia Baolong, the director of the mainland’s Hong Kong and Macau Affairs Office, commented that Hong Kong should amend its existing laws, given that the National People’s Congress had designated “overriding status to the national security law, which application should take priority [over other laws].”⁴⁶

44 Dennis W. H. Kwok and Elizabeth Donkervoort, “The Risks for International Business under the Hong Kong National Security Law,” Harvard Kennedy School, Ash Center for Democratic Governance and Innovation, July 2021, https://ash.harvard.edu/files/ash/files/the_risks_for_international_business_under_the_hong_kong_national_security_law_7.7.21.pdf.

45 Jude Blanchette, “Ideological Security as National Security,” Center for Strategic and International Studies, December 2, 2020, <https://www.csis.org/analysis/ideological-security-national-security>.

46 Jeffie Lam, Chris Lau, and Lilian Cheng, “Top Beijing Official Urges Hong Kong Government to Amend City Laws to Align Them with ‘Overriding’ National Security Legislation,” *South China Morning Post*, January 13, 2023, <https://www.scmp.com/news/hong-kong/politics/article/3206676/top-beijing-official-urges-hong-kong-government-actively-amend-local-laws-align-them-overriding>.

In addition, while the National Security Law is clear in its treatment of criminal cases, it remains unclear how it could be applied in future civil cases, which are most relevant for business and financial institutions. In such civil proceedings, the boundary of where the Hong Kong courts' jurisdiction ends and the authority of the National Security Committee begins is governed by political norms in Beijing, rather than legal restraints decided in Hong Kong. There are reasonable legal interpretations of the National Security Law that suggest Hong Kong courts lack any jurisdiction over civil cases involving national security-related matters, with the boundaries of "national security" decided by Beijing.⁴⁷

Since the 2019 protests and the passage of the National Security Law, public perceptions of the quality of Hong Kong's legal system and its independence and fairness have plummeted, as the results of polling from the Hong Kong Public Opinion Research Institute reveal.⁴⁸

Judges Under the National Security Law

Under Article 85 of Hong Kong's Basic Law, judicial independence is guaranteed.⁴⁹ Hong Kong has historically featured a high degree of judicial independence, with credibility reinforced through nominations of judges via an independent Judicial Officers Recommendation Commission and subsequent approval by the chief executive. Prior to the enactment of the National Security Law, the Hong Kong government did not influence the selection of judges involved in trying particular cases. The Hong Kong Bar Association and the Law Society of Hong Kong (for solicitors in the Hong Kong legal system) had operated independently from the government as well, as professional bodies regulating the professional conduct of their members.

Foreign lawyers and judges have played a significant role in Hong Kong's legal system, as it is based

upon British common law. When trials are being adjudicated by Hong Kong's Court of Final Appeal, one nonpermanent judge from another common law jurisdiction is chosen to sit with three permanent judges and the chief justice. Foreign lawyers' and judges' participation in Hong Kong's legal system is not essential for judicial independence, but their presence does help to provide legitimacy to the independence of the judiciary similar to principles in other common law jurisdictions.

The passage of the National Security Law has changed the process through which judges are appointed to individual national security cases, with Article 44 of the law stipulating that the chief executive chooses these judges specifically for a term of one year.⁵⁰ However, the list of appointed judges is not made publicly available by the Hong Kong government.⁵¹ The one-year appointment potentially introduces political influence into the selection of judges for national security cases, since the chief executive can arguably replace any judge seen as less favorable to the government's positions.

Similarly, the question of which lawyers can serve on national security cases in Hong Kong remains in question. The highly publicized trial of media tycoon Jimmy Lai has introduced new uncertainties, given that Lai has requested that he be represented by King's Counsel Timothy Owen, a British barrister. Hong Kong's Court of Final Appeal rejected the Hong Kong government's attempt to prevent Owen from acting as defense counsel for Lai in the national security case.⁵² However, rather than accepting that outcome, the Hong Kong government instead requested that China's National People's Congress Standing Committee (NPCSC) issue a ruling clarifying whether or not it was the intention of the National Security Law that foreign lawyers could serve in Hong Kong's national security cases. While waiting for the NPCSC to rule, Hong Kong's Immigration Department withheld Owen's visa, preventing him from acting

47 Kwok and Donkervoort, "The Risks for International Business," 3.

48 Hong Kong Public Opinion Research Institute, "The Rule of Law, Fairness of the Judicial System, Impartiality of the Courts—Combined Charts," data from June 1997 to November 2022, <https://www.pori.hk/pop-poll/rule-law-indicators-en/g-combined.html?lang=en>.

49 Basic Law, Article 85, "Members of the Judiciary Shall Be Immune from Legal Action in the Performance of Their Judicial Functions," <https://www.basiclaw.gov.hk/en/basiclaw/index.html>.

50 Lydia Wong, Thomas Kellogg, and Eric Yanho Lai, "Hong Kong's National Security Law and the Right to a Fair Trial," Center for Asian Law at Georgetown University Law Center, June 28, 2021, <https://www.law.georgetown.edu/law-asia/wp-content/uploads/sites/31/2021/06/HongKongNSLRightToFairTrial.pdf>.

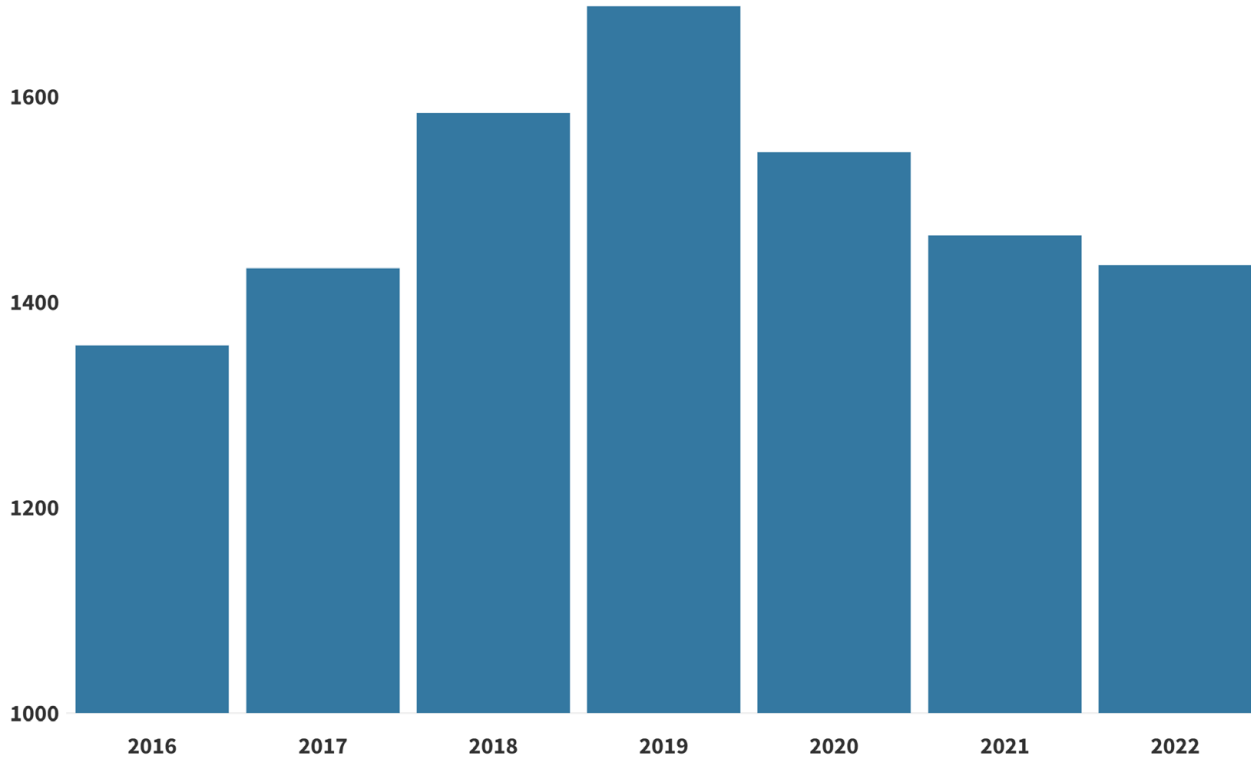
51 Wong, Kellogg, and Lai, "Hong Kong's National Security Law," 10.

52 James Pomfret and Greg Torode, "Hong Kong Leader Asks Beijing to Rule on 'Blanket Ban' on Foreign Lawyers in National Security Cases," Reuters, November 28, 2021, <https://www.reuters.com/world/china/hong-kongs-top-court-rejects-bid-block-british-lawyer-defending-democrat-jimmy-2022-11-28/>.

Foreign Lawyers Working in Hong Kong, 2016–2022

Number of lawyers

1800



Source: The Law Society of Hong Kong

in Lai’s defense, and the trial was delayed.⁵³ When Beijing formally interpreted the law in late December 2022, it appeared to give the chief executive—rather than Hong Kong courts—the authority to decide whether or not foreign lawyers could appear in a national security-related trial, or to make other decisions related to national security cases, even if those decisions conflicted with those of the courts.⁵⁴ It remains unclear if a ban on foreign lawyers might eventually be applied within national security cases or the Hong Kong judicial system as a whole, with

more authority over this question now seemingly vested in the hands of the chief executive.⁵⁵

In March 2022, both Lord Robert Reed and Lord Patrick Hodge, the president and deputy president of the UK Supreme Court, respectively, resigned from Hong Kong’s Court of Final Appeal. Lord Reed said upon resigning, “The judges of the Supreme Court cannot continue to sit in Hong Kong without appearing to endorse an administration which has departed from values of political freedom, and freedom of

53 Guardian staff and agencies, “Hong Kong Withholds British Lawyer’s Visa, Delaying Jimmy Lai Trial,” *Guardian*, December 1, 2022, <https://www.theguardian.com/world/2022/dec/01/hong-kong-jimmy-lai-british-lawyers-visa-withheld-trial-delay-timothy-owen>.

54 Selina Cheng, *Wall Street Journal*, December 30, 2022.

55 Chris Lau and Jeffie Lam, “Legal Experts Predict Foreign Lawyers Will Be Barred from National Security Cases Involving Seized Assets if Beijing Interprets Law,” *South China Morning Post*, November 30, 2022, https://www.scmp.com/news/hong-kong/politics/article/3201461/legal-experts-predict-foreign-lawyers-will-be-barred-national-security-cases-involving-seized-assets?module=lead_hero_story&pgtype=homepage.



Judges wearing wigs attend a ceremony to mark the beginning of the new legal year in Hong Kong, China January 16, 2023. REUTERS/Tyrone Siu.

expression.”⁵⁶ Their resignations marked the end of twenty-five years of British judges sitting on the Court of Final Appeal. There are still nonpermanent judges serving on the Court of Final Appeal in Hong Kong as well. Many released statements which stated their intention to remain in their roles.⁵⁷ Of the ten remaining foreign judges, six are from the United Kingdom, three are from Australia, and one is from Canada.

Over the past three years, there has been a notable decline in the number of foreign lawyers practicing law within Hong Kong’s legal system. Since 2019, the number of registered foreign lawyers in Hong

Kong declined by 15 percent, from 1,688 in 2019 to 1,442 as of December 2022.⁵⁸ The former chairman of the Hong Kong Bar Association, Philip Dykes, noted in 2020 that “a career at the Bar may not be so attractive to fresh law graduates because of the change in the legal atmosphere.”⁵⁹ Dykes went on to say that the plans of many barristers to leave Hong Kong would negatively impact the legal system’s ability to operate effectively.

The Hong Kong Bar Association (HKBA) has been subjected to political criticism as well. Paul Harris, the chairman of the HKBA, publicly suggested in early 2021 that the Hong Kong government propose

56 Haroon Siddique and Helen Davidson, “UK Judges Withdraw from Hong Kong’s Court of Final Appeal,” *Guardian*, March 30, 2022, <https://www.theguardian.com/world/2022/mar/30/uk-judges-withdraw-from-hong-kong-court-of-final-appeal>.

57 “We Are Seeing the . . . Criminalising of Dissent’: British Official Explains Hong Kong Judge Resignations,” Law.com International (platform), April 1, 2022, <https://www.law.com/international-edition/2022/04/01/we-are-seeing-the-criminalising-of-dissent-british-official-explains-hong-kong-judge-resignations/?sreturn=20221008135157>.

58 “Defender of the Rule of Law Annual Report 2019,” Law Society of Hong Kong, 2019. 2022 data from the Law Society of Hong Kong, “Profile of the Profession,” <https://www.hklawsoc.org.hk/en/About-the-Society/Profile-of-the-Profession>, December 2022 monthly statistics, accessed February 5, 2023.

59 Philip Dykes, “Chairman’s Report 2020,” Hong Kong Bar Association, December 31, 2020.

some modifications to the National Security Law given apparent conflicts with the Basic Law. China's State Council Hong Kong and Taiwan Affairs Office accused Harris of using "his British nationality to collude with foreign forces in interfering with Hong Kong affairs."⁶⁰ Harris left Hong Kong in March 2022 only hours after being interviewed by the national security police.⁶¹ Reuters has reported upon a broader pattern of seemingly state-directed intimidation against prominent lawyers in Hong Kong, particularly those within the Hong Kong Bar Association or those making statements concerning the National Security Law.⁶² Recent statements by the HKBA later in 2022 have tended to be more supportive of the Hong Kong government's official positions, including in the case of Lai's request for representation by Owen.⁶³

Disposition of Cases

The National Security Law is relatively new, and there have been only a small number of cases tried under the law so far. However, no defendant has yet been acquitted under the law, and no case tried under the National Security Law has involved a jury trial. It remains unclear whether or not this trend will change. An estimated 213 people have been arrested under the National Security Law and other national security-related statutes between July 2020 and October 2022, with an estimated 125 facing formal charges.⁶⁴

In terms of national security cases involving businesses, the most prominent examples have included the prosecution of Next Digital, which is the parent company of *Apple Daily*, and the use of a colonial sedition law to target the independent media organization Stand News. Both have since

ceased publication and broadcasting after the arrests of key executives. Next Digital and *Apple Daily* were charged with collusion with foreign governments under the National Security Law. With its assets frozen (along with those of its subsidiaries), *Apple Daily* was unable to publish after its issue of June 24, 2021. Stand News and its parent company and executives were charged with sedition, under a 1938 crimes ordinance from British colonial times. The Court of Final Appeal ruled in December 2021 that some of the investigative powers of the National Security Law could be used in other cases involving national security, including sedition.⁶⁵ Stand News ceased distributing news on December 28, 2021, and police seized HK\$61 million of the company's assets.⁶⁶

The broader risk to businesses operating in Hong Kong is the expansive power of the National Security Committee to interpret the scope of "national security" within the Hong Kong legal system. In the cases of *Apple Daily* and Stand News, different laws were applied by authorities to achieve the same objective—the closure of these enterprises and the silencing of their editorial voices. While these cases are identified closely with the pro-democracy movement within Hong Kong politics and the 2019 demonstrations, there were few legal avenues through which these companies were able to challenge the charges in order to stay in business. The broader risk is that Beijing's conception of national security will continue to expand and encompass activities related to individual businesses or financial transactions. In this regard, the recent experiences of Western companies subject to mainland propaganda campaigns (H&M, Nike, and others) reveal potential concerns about business activities becoming

60 Jeffie Lam, "National Security Law: 'We Are Not a Political Organisation,' Hong Kong Bar Association Says After New Chief Comes Under Fire from Beijing," *South China Morning Post*, February 3, 2021, <https://www.scmp.com/news/hong-kong/politics/article/3120423/national-security-law-we-are-not-political-organisation>.

61 Hillary Leung, "Hong Kong Bar Assoc. Ex-Chief Paul Harris Reportedly Leaves City Hours After Meeting with National Security Police," *Hong Kong Free Press*, March 2, 2022, <https://hongkongfp.com/2022/03/02/hong-kong-bar-assoc-ex-chief-paul-harris-reportedly-leaves-city-hours-after-meeting-with-national-security-police/>.

62 James Pomfret et al., "Lawyers Exit Hong Kong as They Face Campaign of Intimidation," Reuters, December 29, 2022, <https://www.reuters.com/investigates/special-report/china-lawyers-crackdown-exodus/>.

63 See press releases for the Hong Kong Bar Association, <https://www.hkba.org/events-publication/press-releases-coverage/2022/>; and specifically, "Statement of the Hong Kong Bar Association ("HKBA")—the Law of the People's Republic of China on Safeguarding National Security in the HKSAR ("NSL") in Respect of Participation of Overseas Lawyers," November 28, 2022, <https://www.hkba.org/uploads/97f289d7-d89e-46ec-bf48-d86267ec1d9b.pdf>.

64 Chinafile, "Tracking the Impact of Hong Kong's National Security Law," October 25, 2022, <https://www.chinafile.com/tracking-impact-of-hong-kongs-national-security-law/>; and Kelly Ho, "Hong Kong National Security Arrests Exceed 200," *Hong Kong Free Press*, July 25, 2022, <https://hongkongfp.com/2022/07/25/hong-kong-national-security-arrests-exceed-200-deception-cases-soar-in-first-half-of-2022/>.

65 Thomas Kellogg, "How a Ruling by Hong Kong's Top Court Opens the Door to a More Intrusive Security Law," *Hong Kong Free Press*, December 17, 2021, <https://hongkongfp.com/2021/12/17/how-a-ruling-by-hong-kongs-top-court-opens-the-door-to-a-more-intrusive-security-law/>.

66 Edmond Ng and James Pomfret, "Hong Kong Pro-Democracy Stand News Closes After Police Raids Condemned by U.N., Germany," Reuters, <https://www.reuters.com/business/media-telecom/hong-kong-police-arrest-6-current-or-former-staff-online-media-outlet-2021-12-28/>.

suddenly politically salient.⁶⁷ In addition, continued reinterpretations of the National Security Law by the National People's Congress Standing Committee are unlikely to provide for more autonomy or judicial independence in Hong Kong in the future.

Freedom of the Press, Transparency of Information Flows

Prior to 2020, Hong Kong's media environment was one of the most open and free from censorship in Asia, and comparable to those in Western democratic and pluralist political systems. The situation has changed significantly over the past decade, but the fastest change in practices has occurred since the introduction of the National Security Law. Free flows of information and access to reliable data are essential for the operation of an economy and financial markets. A media that is free to report on both macroeconomic developments, governance, and corporate performance and decision-making is a similarly essential ingredient within those markets. Establishing trust in media institutions and the credibility of information they provide requires time and a competitive landscape in which reliable information is rewarded and less trustworthy outlets are gradually ignored. Decisions based on the fundamentals or relative value of certain assets or securities depend upon the information underlying the valuations and the reporting of corporate and macroeconomic data.

Financial analysts in Hong Kong are now reportedly engaging in clandestine forms of communications, including private WeChat groups or "burner" telephones, in order to share views on the economy or individual securities with their clients.⁶⁸ Bloomberg reported recently on a significant level of self-censorship among financial analysts, even for reports within firms, out of concern about the vague lines of

the National Security Law.⁶⁹ Individual analysts in China have seen their own social media accounts removed for reporting negatively on China's economic prospects, and analysts in Hong Kong now fear similar treatment, which has reduced the flow of financial information.⁷⁰

Some of the earliest prosecutions under the National Security Law have been focused on journalists and media organizations, notably *Apple Daily* and its parent company Next Digital, as well as Stand News, as discussed previously. Citizen News, a small online publication, also closed its doors early in 2022. Radio Television Hong Kong (RTHK) has also removed some of its content concerning local politics, including the show "Headliner," following the introduction of new management at the station.⁷¹

Immediately after the implementation of the National Security Law, some books authored by individuals identified with the pro-democracy movement were removed from Hong Kong libraries, based on the need to review them for compliance with the law.⁷² Hong Kong's Leisure and Cultural Services Department assembled a list of titles removed from libraries in breach of the law, but then authorities refused to make that list public in April 2022.⁷³ The university library at the University of Hong Kong is now requiring users to register in order to access some books alleged to be politically sensitive.⁷⁴

Even Beijing agrees that the media environment in Hong Kong has changed fundamentally. After the arrests of the officers of Stand News, a People's Daily editorial argued that Western critics were ignoring the criminal acts of the journalists, claiming, "Ignoring right and wrong, these people have willfully misrepresented the lawful actions taken by the Hong Kong Police Force, vainly attempting to use press freedom as a shield for criminal acts and hamper

67 British Broadcasting Corporation, "Nike, H&M Face China Fury Over Xinjiang Cotton 'Concerns,'" March 25, 2021, <https://www.bbc.com/news/world-asia-china-56519411>.

68 "Secret World of China Market Research Emerges from Xi Crackdowns," Bloomberg News, November 23, 2022.

69 "Secret World of China Market Research," Bloomberg.

70 Ji Siqi, "Chinese Economists Censored, Removed from Social Media After Critical Takes on Zero-Covid Policy," *South China Morning Post*, May 3, 2022, <https://www.scmp.com/economy/china-economy/article/3176388/chinese-economists-censored-removed-social-media-after>.

71 "Dismantling a Free Society: Hong Kong One Year After the National Security Law," Human Rights Watch, June 25, 2021, <https://www.hrw.org/feature/2021/06/25/dismantling-free-society/hong-kong-one-year-after-national-security-law>.

72 "Hong Kong Security Law: Pro-Democracy Books Pulled from Libraries," BBC, July 5, 2020, <https://www.bbc.com/news/world-asia-china-53296810>.

73 "'Banned Book List' Won't Be Made Public: Home Affairs," *Standard (Hong Kong)*, April 6, 2022, <https://www.thestandard.com.hk/breaking-news/section/4/188901/Banned-book-list-won-t-be-made-public-home-affairs>.

74 Candice Chau and Marie Brockling, "Exclusive: University of Hong Kong Makes Library Users Register to Access Some Politically Sensitive Books," *Hong Kong Free Press*, October 31, 2022, <https://hongkongfp.com/2022/10/31/exclusive-university-of-hong-kong-makes-library-users-register-to-access-some-politically-sensitive-books/>.

the rule of law in Hong Kong through the straw-man trick.”⁷⁵ Similarly, Lee argued that press freedom required support for the police's actions, claiming in a letter to the *Wall Street Journal* that, “If you are genuinely interested in press freedom, you should support actions against people who have unlawfully exploited the media as a tool to pursue their political or personal gains.”⁷⁶

However, measuring the extent of the changes involved and their magnitude remains a difficult exercise. One of the most objective tools available are surveys conducted about the environment for journalists, with opinions from both journalists themselves and consumers of media. In addition, external organizations conducting cross-country surveys of press freedom conditions can help to place the overall change in Hong Kong's media environment in context.

The Hong Kong Journalists Association (HKJA) has conducted its own annual poll of press conditions since 2013. The results in 2022 showed the steepest decline in perceptions of the media environment ever recorded within this survey, both from the perceptions of journalists themselves and from public consumers of media. In 2022, a full 97 percent of survey respondents indicated that conditions for press freedom had become “much worse” over the year, and 53.5 percent of the public respondents agreed.⁷⁷ In addition, the HKJA reported a significant nonresponse problem in the survey, as several respondents refused to provide data, believing that the HKJA was under political scrutiny. Only 169 journalists or media industry employees provided answers to the survey of 737 journalists, a response rate of 23 percent, down from 83 percent in the previous year.⁷⁸ The chairman of the HKJA, Ronson Chan, was arrested in September 2022 and charged

with obstructing a police officer. He was granted bail, and was not restricted in his travel to the United Kingdom for a fellowship later that month.⁷⁹

Other surveys of media conditions in Hong Kong help to place the environment within a global context, including those conducted by Reporters Without Borders. Hong Kong's ranking within that organization's Press Freedom Index fell from 73 in 2019 to 148 in 2022, between the Philippines and Turkey in the rankings.⁸⁰ In 2002, Hong Kong was ranked 18th globally, the highest score awarded within Asia.

Similarly, actions of journalists themselves point to a significant change in their perceptions of the space for free and open reporting. The Hong Kong Foreign Correspondents Club did not offer its annual Human Rights Press Awards in 2022, with the club president, Keith Richburg, citing “significant areas of uncertainty and we do not wish unintentionally to violate the law.”⁸¹

Changes in corporate registry practices in Hong Kong have also been underway since investigative reports have emerged concerning the wealth of mainland officials and their families, with some of the first changes proposed in 2013.⁸² The net result of these changes implemented since 2021 have made it more difficult for independent researchers and investors to identify shareholders of companies registered in Hong Kong. Some exceptions have now been granted for law firms and accounting firms in conducting due diligence and complying with know-your-customer policies for compliance purposes.⁸³

The next immediate threat to free information flows in Hong Kong is the consideration of a “fake news” law, discussed publicly by then-Chief Executive Lam

75 People's Daily article from January 2, 2022, quoted by Austin Ramzy in “How Beijing Has Muted Hong Kong's Independent Media,” *New York Times*, January 3, 2022, <https://www.nytimes.com/article/hong-kong-media-muzzled.html>.

76 People's Daily as quoted by Ramzy, “How Beijing Has Muted Hong Kong's Independent Media.”

77 Hillary Leung, “‘Shrinking News Industry’: Hong Kong Press Freedom Index Sinks to New Low as Media Outlets Disappear,” *Hong Kong Free Press*, September 24, 2022, <https://hongkongfp.com/2022/09/24/shrinking-news-industry-hong-kong-press-freedom-index-sinks-to-new-low-as-media-outlets-disappear/>.

78 Leung, “‘Shrinking News Industry.’ ”

79 Helen Davidson, “Hong Kong Journalist Allowed to Travel to UK After Court Grants Bail,” *Guardian*, September 22, 2022, <https://www.theguardian.com/world/2022/sep/22/ronson-chan-hong-kong-journalist-allowed-to-travel-to-uk-after-court-grants-bail>.

80 Reporters Without Borders, World Press Freedom Index, <https://rsf.org/en/index>.

81 James Pomfret, “Hong Kong's Foreign Correspondents' Club Suspends Top Asian Human Rights Awards,” Reuters, April 25, 2022, <https://www.reuters.com/world/china/hong-kongs-foreign-correspondents-club-suspends-top-asian-human-rights-awards-2022-04-25/>.

82 Jennifer Ngo, “David Webb Takes Database with Directors' ID Numbers Offline,” *South China Morning Post*, February 16, 2013, <https://www.scmp.com/news/hong-kong/article/1151195/david-webb-takes-database-directors-id-numbers-offline>.

83 Candice Chau, “Hong Kong to Block Public Access to Private Company Information,” *Hong Kong Free Press*, March 30, 2021, <https://hongkongfp.com/2021/03/30/hong-kong-blocks-public-access-to-private-company-information/>.



Copies of the final edition of Apple Daily, published by Next Digital, are seen at a newsstand in Hong Kong, China June 24, 2021. REUTERS/Lam Yik.

in 2021, which would give the government broad powers to limit the publication of information it finds objectionable, or “misinformation, hatred, and lies.”⁸⁴ Hong Kong authorities had reportedly hired a consultancy in order to examine potential options for the law.⁸⁵

The risks to the business environment and to the financial industry can be defined both narrowly and expansively. Narrowly, censorship in media and a limited publication of competing views can easily expand from political topics to economic and business media. More broadly, without a media environment in which journalists are able to work

effectively within institutions protecting their right to report freely, all forms of reporting and information flows will be threatened, including those necessary for the operation of financial markets. In mainland China, investigators engaged in due diligence concerning firms’ potentially fraudulent disclosures have occasionally faced arrest and prosecution under state secrets, corruption, or defamation laws.⁸⁶ In Hong Kong, the media environment is already tightening and the scope for quality journalism is narrowing. There are growing risks that the reporting necessary for transparency in business or financial markets will be undertaken by fewer outlets and fewer journalists in the future. And beyond journalism,

84 Reuters, “Hong Kong Leader Flags ‘Fake News’ Laws as Worries Over Media Freedom Grow,” May 3, 2021, <https://www.reuters.com/world/china/hong-kong-leader-flags-fake-news-laws-worries-over-media-freedom-grow-2021-05-04/>.

85 Chris Lau, “Eight in 10 Journalists in Hong Kong against Fake News Law, Survey Finds, with Improved Media Literacy Education Seen as Best Way to Tackle Misinformation,” *South China Morning Post*, October 26, 2022, <https://www.scmp.com/news/hong-kong/politics/article/3197361/eight-10-journalists-hong-kong-against-fake-news-law-survey-finds-improved-media-literacy-education>.

86 Ana Swanson, “China’s Chilling Crackdown on Due-Diligence Companies,” *Atlantic*, October 23, 2013, <https://www.theatlantic.com/china/archive/2013/10/chinas-chilling-crackdown-on-due-diligence-companies/280787/>; and Gwynn Guilford, “A Canadian Analyst’s Dire Fate Shows How Researching Chinese Companies Is a Dangerous Game,” *Quartz*, October 11, 2013, <https://qz.com/134458/a-canadian-analysts-dire-fate-shows-how-researching-chinese-companies-is-a-dangerous-game>.

there are growing risks to the transparency and accessibility of broader flows of information required for operating a modern economy and financial system, including basic reporting of economic data and corporate financial results.

Data Security

The National Security Law introduces new concerns for international businesses operating in Hong Kong concerning corporate data and intellectual property, in addition to potential duties to clients and customers to maintain privacy. The law permits Hong Kong authorities to conduct surveillance and intercept communications in cases related to national security, in addition to searching electronic devices or data servers.⁸⁷ Hong Kong authorities also can compel service providers to divulge information concerning their customers and clients in cases related to national security. The Implementation Rules of the National Security Law issued on July 6, 2020, outlined the police's ability to search National Security Law suspects' phones and online speech as well as freeze their assets without a warrant.⁸⁸ National security authorities can potentially compel the deletion of data or customer information.

The decision-making authority driving the selection of these cases remains the Committee for Safeguarding National Security—without any oversight or judicial review of its decisions.⁸⁹ The trend in data security is similar to the changes throughout Hong Kong, as political norms have replaced legal and institutional constraints on government authority.

There are obvious practical implications for businesses operating in Hong Kong, including financial service providers. Intellectual property and trade secrets are potentially at risk of disclosure. It is arguable whether these types of corporate information were “safe” before the promulgation of the National Security Law in Hong Kong. But the law itself now provides the legal framework in which such information can be accessed by Hong

Kong authorities, even without the knowledge of the companies involved. Firms have few legal remedies to shield data from authorities under national security investigations when it is requested or compelled, and this marks a notable change from the previous legal framework in Hong Kong.

For international firms prioritizing their clients' privacy and protection of personal information, the change in Hong Kong's operating environment likely requires different measures to segment data storage in order to maintain commitments to customers and users. The extraterritorial nature of the law creates additional risks in that a company's employees in Hong Kong could face criminal liability if they refused to provide data concerning a client or customer of the company in another country, if the powers of the National Security Law were invoked. There are clear risks for any information service provider. Shortly after the National Security Law was imposed, the *New York Times*, for example, relocated significant proportions of its digital news operations in Asia to Seoul from Hong Kong.⁹⁰

Furthermore, if a state-owned firm in China competing with international firms saw an advantage in accessing data held by a multinational firm in Hong Kong, the National Security Law would provide the legal authority with which to obtain that data, with potential criminal penalties for the firms attempting to protect it. Merely segmenting data services between Hong Kong and the rest of the world does not entirely reduce these risks for firms. Before the National Security Law was in effect, firms often stored data concerning their mainland operations in Hong Kong, before using it in regional or global offices.⁹¹ This effectively meant that any controls on data sharing between Hong Kong and the rest of the world were the most important consideration for foreign firms, and historically, these were limited. The National Security Law creates new reasons for firms to limit that cross-border data transmission to reduce legal and reputational risks.

87 Article 43, The Law of the People's Republic of China on Safeguarding National Security in the Hong Kong Special Administrative Region G.N. (E.) 72 of 2020, <https://www.gld.gov.hk/egazette/pdf/20202448e/egn2020244872.pdf>.

88 Wong, Kellogg, and Lai, “Hong Kong's National Security Law,” 4-5.

89 Gabriela Kennedy, “The Chamber of No Secrets: What Tech and Data/Content-Driven Companies Need to Know About the Hong Kong National Security Law,” Mayer Brown (law firm), July 28, 2020, <https://www.mayerbrown.com/en/perspectives-events/publications/2020/07/the-chamber-of-no-secrets-what-tech-and-data-content-driven-companies-need-to-know-about-the-hong-kong-national-security-law>.

90 Michael Grynbaum, “New York Times Will Move Part of Hong Kong Office to Seoul,” *New York Times*, July 14, 2020, <https://www.nytimes.com/2020/07/14/business/media/new-york-times-hong-kong.html>.

91 Xinmei Shen, “Hong Kong Saw Itself as Asia's Data Hub, but Beijing's Strict Cybersecurity Rules Threaten That Status,” *South China Morning Post*, November 16, 2021, <https://www.scmp.com/tech/policy/article/3156151/hong-kong-saw-itself-asias-data-hub-beijings-strict-cybersecurity-rules>.

The data security risks become even more complex when considering cross-border data flows between Hong Kong and mainland China, and the overlap of legal restrictions on data transfers. Simply put, multiple legal frameworks appear to be in place in Hong Kong regarding data security, and firms cannot easily know if they are in compliance with the law or not. China also passed a new Data Security Law in 2021, detailing several different standards for protection of data and preventing cross-border export of data according to these classifications, related to how they affect China's own national security. Initial public offerings in Hong Kong of Chinese firms are presumably still subject to those same controls and reviews by the Cyberspace Administration of China (CAC), before data concerning Chinese firms can be made public in the event of an initial public offering of equity.⁹² In addition, Beijing has passed a Personal Information Protection Law (PIPL) in 2021, which is more expansive than Hong Kong's own Personal Data Privacy Ordinance, which was implemented only in 1996. The controls on cross-border data flows in China's Data Security Law have not been imposed in Hong Kong at this point, or between Hong Kong and the rest of the world, but similar restrictions on data exports are possible in the future.

The risks to firms' data security in Hong Kong remain difficult to define, but should be viewed in the context of the broader changes in the legal and institutional structures in Hong Kong, with greater authority vested in national security-related institutions. Managing data in Hong Kong after

the passage of the National Security Law requires monitoring overlapping legal risks from multiple jurisdictions, as well as reputational risks associated with management of client or customer information.

Most of the risks now facing businesses operating in Hong Kong have risen significantly since the National Security Law was implemented in June 2020. Most are related to the vague definition of "national security" and the newfound inability to challenge Hong Kong or mainland authorities' interpretations of whether or not a particular action involves security risks to the Chinese state. Institutions that could limit government authority through independent oversight, independent press coverage, or via legal channels are facing new obstacles in operating in Hong Kong. And as the harsh implementation and rapid reversal of COVID-19 restrictions in Hong Kong demonstrates, changes in the political climate in Beijing have become the primary motivating force behind critical governance decisions in Hong Kong.

All of these changes leave businesses with a different set of political variables to assess and risks to manage in operating in Hong Kong now and in the future. As political norms in Beijing are increasingly important in shaping outcomes in Hong Kong, particularly in the expanding universe of security-related matters, businesses must consider avenues beyond Hong Kong's traditional legal and institutional channels to defend their interests.

92 Dashveenjit Kaur, "How Will China's New Data Security Law Affect Hong Kong IPOs?" *Techwire Asia*, December 8, 2021, <https://techwireasia.com/2021/12/how-will-chinas-new-data-security-law-affect-hong-kong-ipos/>.

Recommendations

While governments have already taken some actions to respond to the legal and institutional changes in Hong Kong, the business community also has some agency in mitigating their own risks. The recommendations outlined here are not designed to pursue a particular policy agenda, but are offered as suggestions for how firms can manage some of the risks associated with changes in Hong Kong's legal and institutional structures.

The business community should speak collectively, and approach outreach to Hong Kong authorities as a political campaign, rather than a more traditional government relations effort. One of the most significant elements of leverage foreign businesses hold over Hong Kong authorities and Beijing is the fact that Hong Kong must protect its own public image as a major global financial center. This means that the perception that foreign businesses are comfortable and successful operating in Hong Kong is a key part of the government's public messaging: it was exactly the reason for the financial forum organized in Hong Kong in early November. In turn, this requires Hong Kong authorities to acknowledge the importance of the norms underpinning Hong Kong's competitiveness: faith in the rule of law, judicial independence, and free capital flows. It also increases the importance of the number of foreign employees working in Hong Kong, as a declining trend shows how some professionals are voting with their feet. The shift in regional headquarters out of Hong Kong, for example, provides an illustration of the changes in the business environment that ultimately will require a response from the Hong Kong government.

Engaging the Hong Kong government using collective lobbying on the basis of the norms that Hong Kong's authorities value can help to slow the pace of change in the legal and institutional environment. Pushback from the business community was already effective at preventing the application of China's anti-sanctions law in Hong Kong, and was similarly effective at delaying the implementation of separate

national security legislation under Article 23 of the Basic Law.⁹³

With political norms now dictating the restraints on government action in Hong Kong, there are few institutional obstacles in Hong Kong's current legal environment to the continued erosion of the rule of law and judicial independence. The obstacles to further changes in Hong Kong's environment will be political, and collective lobbying and public relations by the business and financial community can shape the political calculus in Hong Kong and Beijing.

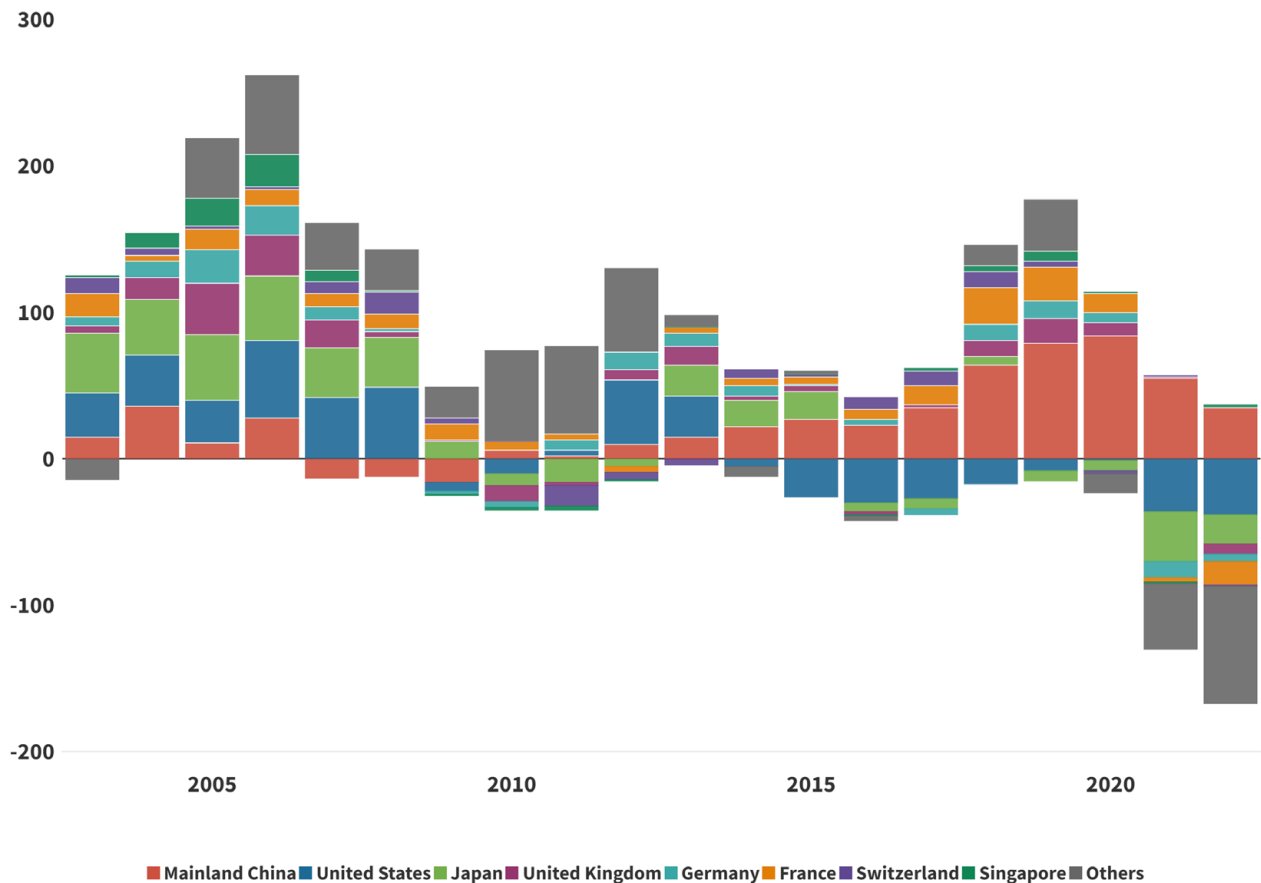
Collectively communicate to Beijing the consequences of uncertainty over Hong Kong's status. Consistent with the logic of speaking collectively and approaching lobbying as a political campaign, the business community should use opportunities to communicate the consequences of uncertainty in Hong Kong's status directly to Beijing officials, when possible. Businesses can link specific decisions about new investment or employment within the territory to the risks that have emerged since the imposition of the National Security Law. The financial community can collectively describe the potential consequences, for example, of changes in Hong Kong's peg to the US dollar or new capital controls. Reinforcing rhetorical support for Hong Kong's existing institutions can help to introduce some degree of caution or risk aversion in Beijing about continued changes in Hong Kong's legal and institutional framework. Using alternative channels such as track-two or informal dialogues may be useful to communicate these messages, in combination with a more direct public campaign.

Invest in compliance infrastructure and develop risk mitigation strategies. Companies and financial institutions operating in Hong Kong are exposed to a growing number of compliance challenges. Lists of restricted individuals and corporations make constructing funds, managing portfolios, buying securities, and selling securities more cumbersome. Each of these activities requires operational oversight and concern with regulatory compliance.

93 Tony Cheung, "Hong Kong's Own National Security Legislation Put on Hold for Further Research, Government Says," *South China Morning Post*, October 10, 2022, <https://www.scmp.com/news/hong-kong/politics/article/3195467/hong-kongs-own-national-security-legislation-put-hold>.

Three-Year Change in Number of Regional Headquarters in Hong Kong, by Nationality of Parent Company 2003–2022

Change in number of headquarters over previous three years



Source: Hong Kong Census and Statistics Department

While constructing funds, portfolio managers must continuously monitor the growing list of restricted stocks to avoid holding assets of firms sanctioned by the US government. Wealth managers must develop a deeper understanding of their clients’ relationships to avoid facilitating transactions with sanctioned individuals. Intermediaries facilitating trading of individual securities must also avoid trading restricted stocks or acting on behalf of restricted individuals.

Companies continuing to operate in Hong Kong should develop internal assessments of the costs and trade-offs between rising compliance-related risks and continued business opportunities, particularly concerning potential cross-border transfers of data, from Hong Kong to the rest of the world or between

Hong Kong and mainland China. Financial institutions should develop contingency plans associated with high-risk clients becoming subject to sanctions by the United States or China, or certain firms potentially being targeted for disinvestment.⁹⁴

Monitor pro-Beijing media in Hong Kong and broader US-China political trends. Monitoring the political dynamics and expectations from both China and the United States regarding Hong Kong is of critical importance. Within Hong Kong, many of the political “targets” of national security investigations first appeared in Beijing-aligned media within Hong Kong, or were criticized as part of the paper’s editorial voice. The People’s Daily, the Communist Party’s newspaper, seldom discusses Hong Kong

94 See, for example, Sumeet Chaterjee et al., “Exclusive: Global Banks Scrutinize Their Hong Kong Clients for Pro-Democracy Ties,” Reuters, July 19, 2020.

political issues directly, so when the territory is mentioned, it should assume outsized importance in terms of monitoring potential risks to any companies or individuals directly named. In the United States, policy changes targeting particular companies or intermediaries active in Hong Kong may be more transparent in some areas, but lists of targeted companies have still caught financial institutions by surprise, such as those designated for disinvestment due to links to the Chinese military.

More generally, monitoring the broader ebb and flow of the high-level diplomacy within the US-China relationship can be fruitful to understand when compliance and business-related risks may intensify. The timeframes before a high-level summit or multilateral conference may create less risk for companies operating in Hong Kong, because both sides will want to mitigate disruptions to the meetings themselves. Periods of higher tension in the relationship would also suggest higher risks to firms operating in Hong Kong and greater regulatory attention to their actions. These risks are obviously more acute when compliance requirements place businesses and financial institutions in awkward positions between sanctions or regulations in multiple jurisdictions. A more comprehensive politically minded risk-monitoring strategy can help business to scale resources accordingly.

Monitor key data concerning national security cases and outcomes, Hong Kong's foreign population and participation, and outcomes within the legal system.

Foreign participation is certainly not essential for Hong Kong's legal and institutional environment to function effectively. But trends in foreign participation—those who can choose to enter or exit the system—are a meaningful indicator of changes in the operations of Hong Kong institutions. Similarly, the functions of Hong Kong's legal system can be monitored objectively, in terms of the outcomes of cases where the government's positions do not prevail, as well as the participation of foreign lawyers and judges within the legal system. These are data series that are easy to monitor and will continue to be reported, either by Hong Kong's own statistical agencies or other external data providers (such as moving firms

or professional associations). Any attempts to censor or remove certain data series from regular reporting by Hong Kong's statistical agencies should similarly indicate a growing risk of expanding government authority in the areas covered by the data.

Similarly, trends in the frequency and targets of national security investigations are important indicators concerning the overall focus of Hong Kong's law enforcement institutions and political authorities. Monitoring those trends is therefore essential to interpret potential changes in political norms in Beijing and Hong Kong. Declining investigations in certain areas or for certain types of offenses will likely indicate a change in authorities' foci, and may provide more confidence that the political environment is easing. Similarly, a continued trend of prosecutions of cases spotlighted in pro-Beijing media in Hong Kong may be an indicator of a new political campaign that would generate new risks for businesses.

Emphasize the importance of independent media for Hong Kong's future.

In the course of lobbying and pushing back against further changes within Hong Kong's legal and institutional structures under the National Security Law, the fates of independent media outlets assume outsized significance. Companies should emphasize that "fake news" laws or further crackdowns on media outlets would endanger the flow of information necessary to conduct commercial and financial transactions, and would create new difficulties for companies to respond appropriately to libel, slander, and disinformation. More generally, continued growth of the business community in Hong Kong invites and requires a growing pool of journalists and press outlets to monitor commercial, financial, and political activity in the city. Conversely, a shrinking pool of local and international journalists covering the city's affairs will reflect the declining international significance of Hong Kong as a commercial and financial center. A shrinking scope for independent reporting will likely produce a shrinking financial industry in short order. And a recovering Hong Kong is inconsistent with a contracting public sphere for discussion, publication, and information flows.

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