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**PROGRAM MATERIALS**  
**Program #32214**  
**September 26, 2022**

## **New Legal Risks Facing International Companies Operating in China and Hong Kong**

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# New Legal Risks Facing International Companies Operating in China and Hong Kong

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# Recent Political Developments in China Region

- Rise in Tension over the Taiwan Strait
- The re-capture of Hong Kong under the National Security Law
- United Nations Human Rights Committee heavy criticism of Xinjiang
- 20th Party Congress in 20th Century
- 'Covid Zero' Policy and Economic downturn

**The rise of Chinese Nationalism  
and obsession with ‘national  
security’**

**What is driving nationalism under  
Xi Jinping’s CCP?**

**What is the obsession with  
‘national security’ in both  
Mainland and Hong Kong?**



# Chinese Nationalism

- “East on the Rise, West in Decline”
- Rejuvenation of the Chinese Civilisation
- Reigning in Hong Kong
- Taiwan and South China Sea
- Wolf warrior diplomacy
- Xi’s “Common Prosperity”

# New Legal Developments in the PRC

- Abolition of Term Limits by Xi / Centralisation of Powers
- PRC National Security Law and Hong Kong National Security Law
- PRC Data Security Law and Cybersecurity Law
- US Strategic Competition Act and Hong Kong Democracy and Human Rights Act
- US Sanctions and Uyghur Forced Labour Prevention Act
- PRC Anti-Sanctions Law

# Financial / Tech Security

- Crackdown on Big Tech in China
- Halt to Ant Financial IPO / Jack Ma
- People's Daily criticism of online securities brokerage firms backed by Tencent and Xiaomi
- Massive fines for Tencent on violations of money laundering rules and other anti-trust regulations
- ByteDance and Pinduoduo CEOs stepping down



# Data Security

- Cyberspace Administration of China new enforcement measures against Didi Chuxing and the handling of personal data
- PRC Data Security Law / Cybersecurity Law - prohibition of data transfer out of the country
- Data controllers must undergo security assessment and any export of data out of China is strictly controlled and monitored
- Didi Chuxing's IPO problems in NY



# Cultural Security

- Sony China's fine for launching product on a sensitive historical date
- Xi's crackdown on private tutoring and national curriculum standardisation
- Ban on foreign textbooks and discouragement of English learning
- War movies glorifying Korean War
- Heavy censorship laws in Hong Kong
- Communist Party cells in Western Financial Firms mandated by law

# National Security Law in Hong Kong SAR

- Direct promulgation by National People's Congress Standing Committee on 30 June 2020
- Creates a broad concept of 'national security'
- 4 broadly worded offences including: foreign collusion, secession, subversion and terrorism
- Global jurisdiction
- Art 47 of NSL - what amounts to state secret or national security mandated by Chinese Govt.

# Personal Information Protection Law (PIPL) / PRC Data Security Law

- PIPL applies to all businesses both within China and outside
- A company that processes personal data of PRC residents must observe the law
- A local representative of the company based in the PRC to bear legal responsibility and compliance
- PRC Data Security Law - new 'core data' regulation. 'Core data' covers everything that is vital to national security, economy and major public interest

# Geopolitical Tensions between China and 'West'

- Taiwan Strait tension - predicted rise further after November 2022
- South China Sea / East China Sea
- Further National Security Laws in Hong Kong - foreign espionage
- Sanctions and anti-sanction laws in US and China respectively
- US / Russia / China dynamics
- ESG and human rights violations in Xinjiang supply chains

# Practical Points

- Does your commercial deal or contract touch on an area of ‘national security’ inadvertently? If so, take advice on the HK National Security Law and PRC National Security Law. ‘National security’ is a very wide subject matter. Commercial firms might venture into this without knowing
- Does your contract address the potential of new and different types of geopolitical conflicts? Standard *Force Majeure* clause not enough to address: supply chain disruptions, financial or trade sanctions, cyber security attacks
- Dispute resolution clauses - does it address political change going forward? e.g. Hong Kong’s continued development

# THE | DIPLOMAT

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PACIFIC MONEY | ECONOMY | EAST ASIA

## Nickel Short Saga Raises Questions About China's Interference in International Markets

Beijing's bailout of a "big shot" metals billionaire is a warning about the growing influence of authoritarian regimes in the financial services industry.

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By **Dennis Kwok** and **Sam Goodman**

March 23, 2022

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Credit: [Depositphotos](#)

Beijing's decision last week to bail out a metals billionaire from a disastrous "short position," and in doing so tarnish the credentials of the once respected London Metals Exchange, will not soon be forgotten. Even before the latest incident, Western investors were looking at the painful reality of losses they face when it comes to blindly betting big on investments in authoritarian regimes who consider themselves above established rules.

The Chinese billionaire in question is Xiang Guangda, the founder of China's leading stainless steel and nickel producer Tsingshan Holding Group [worth \\$4.1 billion](#). Earlier in March, Tsingshan Holding Group was set to face [\\$8 billion in losses](#) after the price of nickel doubled to over \$100,000 a ton. Xiang, fondly referred to as "big shot," had staked a sizable amount of his personal fortune shorting nickel, only to see the price of the metal surge to as much as [111 percent](#) as a result of the ongoing economic fall-out of Russia's war in Ukraine.

In normal times a mistake of this magnitude would put Xiang's personal fortune and the fortunes of Tsingshan Holding Group in deep trouble. Luckily for him, he has powerful friends in Beijing and the London Metal Exchange was bought out in 2012 by the Hong Kong Stock Exchanges and Clearing.

These two facts no doubt influenced the London Metal Exchange's unprecedented decision on March 8 to suspend nickel trading in a move not seen since 1985, [canceling 5,000 nickel trades](#) that had been executed that day, and wiping out [\\$1.3 billion of profit and loss on](#)



[deals](#). The next day Shanghai's Futures Exchange followed [suit](#) and also froze nickel trading.

Bloomberg reported that one of Tiangshan's brokers, [a unit at China Construction Bank](#), "narrowly missed defaulting after the LME gave it more time to pay hundreds of millions of dollars of calls."

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It has been reported that the Chinese government is backing Xiang and Tsingshan Holding Group to the hilt, [ordering domestic banks](#) to provide further loans. Some reports say China may even [consider](#) swapping Tsinghan's nickel for high-quality reserves held by the Chinese state. Xiang has said that with his government's backing he intends to hold onto his short position, with the potential even now to turn his folly into further fortune.

The possibility of Xiang extricating himself from this position will be a further red flag for those investors who believe that the London Metal Exchange crossed a line by suspending trading and giving up its neutrality in favor of a particular market participant. AQR, one of the largest funds in the world, is already [exploring legal options](#) after its trading profits were wiped out.

Sadly, the metals exchange may have lost its neutrality some time ago. Since being bought by Hong Kong Stock Exchanges and Clearing, whose largest shareholder is the Hong Kong government, which appoints six of its board members, in 2012 the London Metal Exchange has increasingly relied on business from Chinese state-owned banks and state supported companies.

During Xi Jinping's state visit to the United Kingdom in October 2015, the metals exchange signed a memorandum of understanding with [seven Chinese financial institutions](#), including state-run banks – the Bank of China and the Industrial and Commercial Bank of China – to increase market access and provide renminbi internationalization service as part of the Belt and Road Initiative. In April 2016, China Construction Bank acquired [a 75 percent stake in MetDist](#); this made it the first majority-owned Chinese bank to trade on the exchange floor.

For those of us who follow Hong Kong politics closely this is characteristic of Beijing's co-option of capital and

businesses that are dependent on Communist Party patronage. In 2021, [a report by Hong Kong Watch](#) detailed that despite widespread reservations about the quality of mainland audit firms, the Hong Kong Stock Exchange was forced to allow mainland auditors to audit the mainland incorporated companies listed on the Stock Exchange in 2010. In many ways this move over the years has increasingly compromised the city's regulatory regime.

With rising metal prices, the strategic value of the London Metal Exchange cannot be understated. China dominates global markets as the [largest consumer](#) of copper, aluminum, and iron ore. Both domestic growth and the growth of its influence overseas through building infrastructure projects in the developing world as part of the Belt and Road are heavily dependent on its ability to secure metals.

At the intersection of these interests lies Xiang's Tsingshan Holding Group, which supplies large volumes of nickel to electric vehicle battery manufacturers at home, and is one of China's flagship companies delivering Belt and Road projects across abroad. With recorded [company revenue of \\$19 billion last year](#) and a sprawling business empire that makes Xiang's family one of the wealthiest and most powerful in Zhejiang, is it any wonder that Beijing believes Xiang is simply big to fail?

The Financial Conduct Authority and the Bank of England helped the London Metal Exchange to [restart](#) nickel trading last week, as well as looking at reforms, which may include banning short positions. However, the specter of Beijing looms large and the legal battles over the protection afforded to Xiang will rage on. This will pull the credibility of the metals exchange further into disrepute.

With Beijing's unwavering support, this "big shot" could still make out like a bandit, reinforcing the depressing reality of who really controls this exchange and has the power to control the metals industry.

It is a further lesson for those alarmed by the growing influence of authoritarian regimes in the financial services industry.

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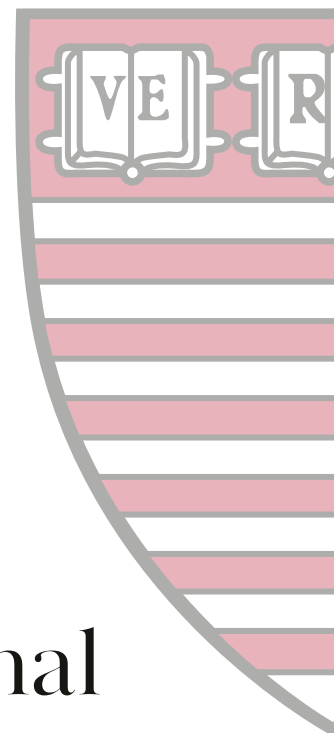
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# The Risks for International Business under the Hong Kong National Security Law

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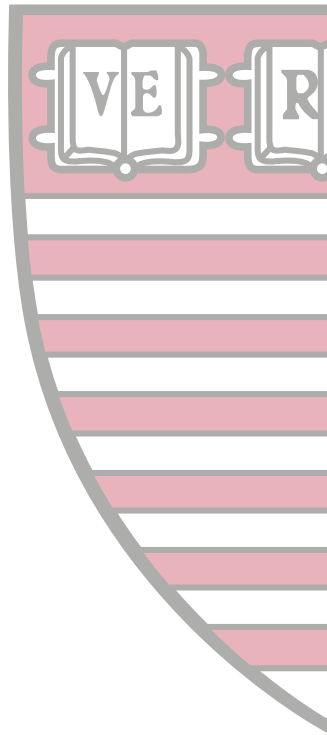
July 2021



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July 2021

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Dennis Kwok was elected as the member of the Legislative Council (LegCo) representing the Hong Kong legal profession in 2012. The legislature in Hong Kong is divided into geographical seats and functional seats. Each member of the legal profession has one vote and is entitled to elect their representative in LegCo. Kwok succeeded veteran lawmaker Dr. Margaret Ng who held the LegCo legal seat for 16 years. Previous occupant of the legal seat includes Mr. Martin Lee, S.C., father of the democratic movement in Hong Kong. In 2016, Kwok was re-elected for a second four-year term with a 69% majority of votes from the legal profession.

In LegCo, the main policy areas that Kwok focused on included access to justice, human rights protection and the independence of the judiciary in Hong Kong. Kwok oversaw the development of legal policy issues including the independence of prosecution decisions, the development of the legal profession and legal education.

Kwok accepted numerous speaking engagements outside Hong Kong to discuss geopolitical issues related to the region. These engagements include the Asia Society, New York City Bar and the Council on Foreign Relations (New York), the United Nations Business and Human Rights Forum (Geneva), an European Parliament Subcommittee (Brussels), German Marshall Fund, Georgetown University and the Heritage Foundation (Washington DC), Venstre (Norway), the Stockholm Free World Forum (Sweden) and the Lowy Institute (Australia). In his private legal practice, Kwok specializes in cross-border commercial disputes and international arbitration. He obtained his LLB from King's College London. He qualified as a solicitor in England & Wales (2003) and as a barrister in Hong Kong (2006).

Elizabeth Donkervoort is currently the Program Director for the American Bar Association's Rule of Law Initiative in East Asia, where she oversees programming to strengthen access to justice and rule of law. Donkervoort has a decade of experience working in the democracy and governance sphere, working with grassroots organizations in some of the world's most restrictive environments to strengthen their organizational capacity, strategic planning, and security. For five years she was based in Hong Kong where she oversaw the International Republican Institute's civil society capacity building programs in the People's Republic of China and Laos People's Democratic Republic (2015-2016) helping develop the Institute's largest collection of training curriculum and resources for activists, organizations, and citizen movements. Prior to IRI, Donkervoort helped administered Freedom House's Emergency Assistance Program, providing support to threatened human rights defenders and civil society organizations around the globe.

Donkervoort is admitted to the bar in both Alberta, Canada and New York, USA. She worked with Brownlee LLP as a member of their Municipal Law Practice, providing legal advice and assistance to local governments in Alberta and representing clients before all levels of court up to the Court of Appeal, as well as administrative tribunals. Donkervoort received her JD and Master of Asia Pacific Policy Studies from the University of British Columbia and an Honours Bachelor degree from the University of Toronto.



## **Abstract**

Hong Kong, a former British colony, has been a special administrative region of the People's Republic of China (PRC) since 1997. The National People's Congress promulgation of the Law of the People's Republic of China on Safeguarding National Security in the Hong Kong Special Administrative Region (Hong Kong National Security Law, HK NSL) on June 30, 2020, has a substantial impact on Hong Kong's constitutional structure known as "One Country, Two Systems." Enshrined under the Basic Law (Hong Kong's constitution under the Sino British Joint Declaration), One Country, Two Systems guaranteed that Hong Kong would exercise a high degree of autonomy—with its own political, economic, and legal systems—based on the rule of law. The HK NSL has been in operation for one year. This article analyzes the impact of the HK NSL on Hong Kong's legal system and, in particular, its civil law jurisprudence. The article also explores the new legal risks and challenges international businesses face when dealing with PRC businesses or matters impinging on national security in mergers and acquisitions, commercial transactions, and civil disputes. These issues will be examined against the current geopolitical landscape and rising tensions between the PRC and other nations.

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## Introduction

Businesses looking for guidance on how the Hong Kong National Security Law (HK NSL) will affect their operations may be inclined to review how Hong Kong courts have interpreted the People's Republic of China's (PRC) own 2015 National Security Law (PRC NSL) in commercial contexts. In doing so, companies should proceed with caution.

Hong Kong courts have had few occasions to consider issues related to national security and state secrets in the commercial/regulatory context and even fewer opportunities to review the PRC's definition of those terms. In the limited case law available, Hong Kong courts have in the past rejected a party's attempts to avoid disclosure of information based upon claims that the disclosure would harm the PRC's national security.

In one such case decided in 2015,<sup>1</sup> the High Court of Hong Kong rejected an argument made by Ernst & Young to resist compliance with a disclosure order made by the Hong Kong Securities and Futures Commission on the basis that the requested documents were, *inter alia*, state secrets and therefore PRC law prohibited disclosure. The disclosure order required Ernst & Young to disclose audit papers and correspondence in connection with a PRC-based company. The High Court rejected Ernst & Young's argument and found there was no evidence to support the contention that the requested documents constituted "state secrets" under the relevant PRC law.<sup>2</sup>

Courts in the United States have taken a much harder line against the application of PRC law with respect to state secrets. In *BDO China Dahua CPA Co., Ltd., et al. (BDO China)*, the PRC affiliates of four major banks raised a similar defense as Ernst & Young. They were censured for failing to produce documents pursuant to Section 106 of the Sarbanes-Oxley Act of 2002.<sup>3</sup> While acknowledging the overly broad scope of "state secrets" under PRC law, the US administrative law judge in *BDO China* rejected the defendants' arguments, stating compliance with PRC's State Secrecy Law was no defense to noncompliance of US law. The judge had "no sympathy" for the defendants, who were "between a rock and a hard place" of their own choosing.<sup>4</sup>

Ordinarily, case law such as *Ernst & Young* may provide instructive authority for businesses looking for legal certainty. But the HK NSL has fundamentally changed the legal landscape in Hong Kong, upending previously settled judicial precedents.

The method of its adoption and the framework of oversight established by the HK NSL and other recent electoral reforms in Hong Kong<sup>5</sup> brings the once semiautonomous region almost fully into the PRC's unified party-governance structure. To date, an analysis on how the HK NSL could impact the civil jurisdiction of the Hong Kong courts, and commercial transactions involving PRC entities, is lacking. This article will explore whether Hong Kong courts have jurisdiction to decide what constitutes a state secret or national security concern in civil disputes, as well as the potential impact of national security issues on international businesses operating in the region or having dealings with PRC entities.

There is a tendency within the commercial sector to view laws such as the HK NSL as primarily aimed at curbing political dissent. This is a dangerous assumption in light of the current environment in the PRC, where the Chinese Communist Party (CCP) is at the heart of the political, legal,<sup>6</sup> and private sectors.<sup>7</sup> In the PRC anything, including civil disputes, can become "political" or of a "national security" nature. In the PRC, national security concerns can touch on any aspect of the economy, from finance to energy to technology to infrastructure (further analyzed below).<sup>8</sup> As cases such as *BDO China* and *Ernst & Young* demonstrate, the PRC's expansive definition of national security and state secrets poses considerable challenges to statutory disclosure obligations in multiple jurisdictions. The international community can expect further change from the status quo as the CCP expands its absolute authority in the private business sector, in the PRC, in Hong Kong, and beyond. The abrupt halt to

the Ant Financial IPO in Hong Kong is one such example.<sup>9</sup> Already, the uncertainty caused by the HK NSL is leading some international companies to choose Singapore over Hong Kong as the Asian dispute resolution center for arbitration.<sup>10</sup>

So far, substantial attention has been paid to the impact the HK NSL has on judicial independence, the One Country, Two Systems framework, and the harsh conditions defendants charged under the HK NSL face. This article argues that the central question is not whether Hong Kong courts are still independent in the traditional sense under established rule of law principles. Rather, with the overarching authority to supervise and decide on matters of national security fully vested in the Central People's Government (CPG) under the new HK NSL legal framework, the jurisdiction for Hong Kong courts to independently decide on issues of national security is highly limited. Under the new framework, national security issues will be treated much in the same way that national defense and foreign affairs do; that is, matters of national security are outside the authority and jurisdiction of Hong Kong SAR (save for most criminal offenses committed in Hong Kong) and are exclusively within the power and authority of the CPG.<sup>11</sup>

## The National Security Law for Hong Kong

To put matters into context, we must first understand the extremely unusual nature of the HK NSL. Hong Kong is a Special Administrative Region of the PRC via the 1984 China-United Kingdom Joint Declaration on the Question of Hong Kong (Joint Declaration), an international treaty pursuant to which the United Kingdom transferred sovereignty over Hong Kong back to the PRC on July 1, 1997, and the PRC promised Hong Kong would retain a high degree of autonomy.

The basis of what is known as the One Country, Two Systems doctrine governing Hong Kong is set out in its Basic Law—Hong Kong's de facto constitution passed by the National People's Congress Standing Committee (the NPCSC) pursuant to the Joint Declaration. Under this system, Hong Kong's legislative body, the Legislative Council, has the authority to establish laws, including for national security. Article 23 of the Basic Law obligates the Hong Kong government to enact laws under its own authority, prohibiting, *inter alia*, “any act of treason, secession, sedition, subversion against the CPG or theft of state secrets.”<sup>12</sup>

Notwithstanding Article 23 of the Basic Law, the NPCSC directly promulgated the HK NSL on June 30, 2020. The HK NSL empowers the CPG to establish an Office for Safeguarding National Security within Hong Kong, which oversees the implementation of national security activities within Hong Kong and can recommend cases to be remanded to courts in the PRC,<sup>13</sup> eroding Hong Kong's high degree of autonomy in breach of the fundamental principle underlying the One Country, Two Systems framework promised under the Joint Declaration. The means by which the HK NSL was adopted and the oversight by the CPG thus create a constitutional rupture not anticipated by the Basic Law. As such, norms and practices previously accepted in Hong Kong's legal system must be revisited.

## Who Has Jurisdiction to Consider National Security Issues in Civil Disputes?

Prior to the adoption of the HK NSL, it would be assumed that Hong Kong courts had the jurisdiction to decide all cases pursuant to its judicial powers under the Basic Law (Articles 80 and 84). The promulgation of the HK NSL has fundamentally changed Hong Kong's original constitutional setup. Articles 40, 41, and 45 of the HK NSL clearly confer jurisdiction on Hong Kong courts to try criminal offenses arising under the HK NSL, with the notable exception of cases of great severity, imminent threat, or

involving “external elements.”<sup>14</sup> The relevant language is clear: Hong Kong courts have the authority to deal with matters of national security that are *criminal* in nature. But the HK NSL is silent on whether the Hong Kong courts have jurisdiction to hear *civil* proceedings that involve matters of national security and/or state secrets. Given the law’s vagueness, if a PRC conglomerate or state-owned enterprise (SOE) makes a similar claim as Ernst & Young, would courts in Hong Kong have jurisdiction to hear it and make a judicial determination?

To answer the question, guidance from the State Council, the top administrative authority of the PRC, is instructive. The State Council provides guiding principles on how PRC laws, including the Basic Law and HK NSL, are to be interpreted and implemented.

In the same year as Hong Kong’s 2014 Occupy Central movement, the State Council issued a white paper titled “The Practice of the ‘One Country, Two Systems’ Policy in the Hong Kong Special Administrative Region,” wherein it asserted that the PRC retains “comprehensive jurisdiction” over Hong Kong and the Hong Kong SAR has no “residual powers” of its own.<sup>15</sup> Accordingly, any Hong Kong official organs of power, including the judiciary, does not have any authority unless explicitly provided for by the CPG. Much like national defense and foreign affairs under the Basic Law framework, matters of national security are strictly under the CPG’s authority and jurisdiction.<sup>16</sup> This perspective has been echoed by PRC state media.<sup>17</sup> Put another way, based on the white paper, all of Hong Kong SAR’s powers emanate from and are under the CPG’s supervisory control. Thus, if the CPG does not specifically grant a power to the Hong Kong SAR, then that power is retained by the CPG. Because the HK NSL explicitly provides jurisdiction to Hong Kong courts to hear (most) criminal cases under the law but is silent as to civil cases involving national security, it follows that Hong Kong courts have no jurisdiction to preside over civil proceedings involving national security issues, and/or the Hong Kong courts shall have to defer such matters to the CPG for determination through the mechanism under the HK NSL (analyzed below).

This interpretation is supported by recent case law. The Court of Final Appeal (CFA), Hong Kong’s highest court, recently held in *HKSAR v. Lai Chee Yin* (Jimmy Lai case) that the Hong Kong courts do not have the jurisdiction to consider legal challenges to the HK NSL based on grounds that it contravened the Basic Law or the International Covenant on Civil and Political Rights as applied to Hong Kong.<sup>18</sup> The CFA also laid down extremely high hurdles for someone who is charged under the HK NSL to obtain bail. The CFA decision in the Jimmy Lai case effectively establishes that HK NSL supersedes Hong Kong’s de facto constitution and its protection of human rights. Even though the Basic Law and the HK NSL are both enacted by the National People’s Congress, the latter effectively trumps the former. It is therefore unclear how one could assert the supposed guarantees of human rights under Article 4 of the HK NSL. There are also provisions within the HK NSL itself that further limit the powers of Hong Kong courts. Article 62 provides that where local laws are inconsistent with the HK NSL, the HK NSL governs. Local laws include the Hong Kong Bill of Rights Ordinance. Also, Article 14 prohibits judicial review of decisions of the National Security Committee created under the HK NSL (in direct contravention to the right to judicial review under Article 35(2) of the Basic Law). As analyzed below, Article 47 gives wide powers to the chief executive (hence the CPG) to decide what amounts to national security and/or state secrets, and this determination is binding on the Hong Kong courts. These HK NSL provisions, when combined with the effect of the CFA decision in Jimmy Lai, mean there is no legal avenue to challenge the HK NSL or its implementation by the National Security Committee.

Under Article 3 of the HK NSL, the CPG has overarching responsibility for Hong Kong’s national security affairs. Hong Kong’s chief executive is accountable to the CPG on all matters of national security and is required to submit annual reports.<sup>19</sup> Given the broad and expansive nature of national security (as analyzed below), this represents a fundamental change to the legal landscape in Hong

Kong. Two foreign nonpermanent judges from the United Kingdom and Australia have either resigned or declined to be reappointed to sit on the CFA.<sup>20</sup> The use of prominent foreign judges was an important constitutional tradition for the Hong Kong legal system. While it is likely that foreign judges from other jurisdictions would not be allowed to hear HK NSL,<sup>21</sup> the gradual loss of this tradition signals a worrisome trend over the implementation of the HK NSL.

The HK NSL creates a framework where political appointees have the ultimate authority on national security issues with no checks and balance. Article 44 of the law gives the chief executive, who is accountable to the CPG, the power to create a list of designated judges for all Hong Kong courts, from magistrates to judges on the CFA. Only those on the list can preside over HK NSL cases. This list of judges is most certainly vetted by the National Security Committee, which the chief executive chairs. The term of office of the designated judges is limited to one year. This is a highly unusual arrangement to say the least. Designated judges may also be removed at any time on the grounds of his/her statements or behavior.<sup>22</sup> This arrangement arguably constitutes the most serious systemic intrusion into judicial independence. In addition, the PRC state media is increasingly vocal and assertive over Hong Kong judicial decisions. This creates enormous political and social pressure on the Hong Kong judiciary.

In a recent meeting between the Hong Kong chief justice and the president of the Supreme People's Court in Beijing, President Zhou Qiang expressed that he expects the Hong Kong judiciary to thoroughly and accurately implement the PRC Constitution, Basic Law, and HK NSL and to comprehensively implement the “patriots administering Hong Kong” principle (patriotism is defined by the CPG).<sup>23</sup>

## What Is “National Security”?

The HK NSL does not define “national security,” nor do the implementing regulations made under Article 43 of the HK NSL. The definition currently being applied by Hong Kong police and prosecutors is sufficiently broad as to encompass participation in journalistic activities and democratic primary elections. Following from the above analysis, understanding what constitutes “national security” within the PRC legal framework will be instructive for individuals and companies continuing to operate in Hong Kong and the PRC in light of the HK NSL. In other words, the HK NSL must be understood and interpreted within the context of the broader PRC legal framework.

PRC law provides an expansive definition of national security and does not confine the concept to traditional topics such as acts of terrorism, separatism, or extremism. The PRC definition also encompasses “non-traditional security fields such as economic security, cultural security, societal security, science and technology security, cybersecurity, environmental security, resource security, nuclear security, and the security of overseas interests.”<sup>24</sup> The PRC NSL requires all actors to safeguard key economic interests including industries vital to the national economy, key industrial sectors, key infrastructure projects, and key construction projects:<sup>25</sup>

- finance
- resources and energy
- food safety
- culture<sup>26</sup>
- technology
- cybersecurity<sup>27</sup>
- ecological and environmental protection
- nuclear technology
- exploration and use of outer space, international seabed areas, and polar regions

This expansive definition of national security and application across industries has been echoed by top government officials in Hong Kong, including the chief secretary (who is a member of the National Security Committee).<sup>28</sup> Importantly, both the PRC NSL and HK NSL apply to state-owned as well as private entities. With that in mind, what are the risks to international companies in the context of commercial transactions, civil litigation, or international arbitration proceedings?

## HK NSL Impact on International Business

International businesses with operations and interests in the PRC and Hong Kong face new risks and challenges because of the HK NSL. First, the extraterritorial reach of the law under Articles 37 and 38 means that individuals and companies can be criminally liable for documents, work, or activities conducted outside of Hong Kong that nevertheless “endanger” PRC national security. This could include receiving information about meetings if they fall within a key industry,<sup>29</sup> purchasing documents that later become classified as state secrets,<sup>30</sup> or hosting a website or server outside Hong Kong that contains content that violates the HK NSL.<sup>31</sup> Similarly, given the breadth of industries subject to national security concerns by the PRC, disputed intellectual property claims over a piece of technology could amount to national security or state secrets.

The recent raid on local news outlet Apple Daily, which included freezing HK\$ 18 million in assets spread over three affiliated companies, [suspending trade in shares of Next Digital](#) (Apple Daily’s parent company), and arresting five senior management staff, highlights the breadth of authorities’ powers under the law as well as the potential punishments provided for by the NSL HK. As of this writing, none of the specific news articles alleged by Hong Kong authorities to have violated the HK NSL have been identified. The future of Apple Daily is in serious doubt. According to the National Security Department of the Hong Kong Police, these news articles [date back to 2019](#), before the HK NSL was promulgated, and that even the [sharing of those articles could be a violation of the law](#).<sup>32</sup> This case highlights that even journalistic activities could be regarded as endangering national security in the eyes of the Hong Kong authorities. International media outlets operating outside of the PRC and Hong Kong are also caught under the HK NSL.

In the PRC, trade secrets often overlap with state secrets, especially in the context of SOEs or in the context of the PRC’s regional economic development strategy or the country’s competitive edge in the international market.<sup>33</sup> The consequences for “unlawfully”<sup>34</sup> providing state secrets to a foreign institution, organization, or individual outside Hong Kong or the PRC can be harsh, carrying a maximum sentence of life in prison.<sup>35</sup> In a civil dispute or arbitration, a party might refuse to disclose evidence on the basis that to do so could violate the HK NSL or resist deployment of such evidence on the same basis. In addition, a SOE or PRC conglomerate could threaten an opposing party that it is disclosing evidence and information to a foreign court or tribunal that constitutes “state secrets or intelligence” in contravention of the HK NSL.

In international commercial arbitration, there is a procedural mechanism for tribunals to exclude evidence on grounds of special political or institutional sensitivity (including evidence that has been classified as secret by a government or a public international institution) that the arbitral tribunal determines to be compelling.<sup>36</sup> In investment treaty arbitrations between states, the arbitral tribunal would usually determine whether a claim to nonproduction of the documents is well taken. Some treaties permit a state to withhold documents on national security grounds, and some of those treaties make that a self-judging exercise, that is, the state withholding the evidence judges for itself whether it must withhold the documents.<sup>37</sup> In light of the HK NSL, it would be interesting to see how these issues related to national security play out when it comes to the enforcement of arbitral awards where an application needs to be made to Hong Kong courts.



Considering the reality in Hong Kong and the PRC today, it is highly likely that Hong Kong courts will have to defer to the Hong Kong government, which is accountable to the CPG, on national security issues arising in civil disputes. This structure is reinforced by Article 47 of the HK NSL that states “the courts of the Hong Kong Special Administrative Region shall obtain a certificate from the Chief Executive to certify whether an act involves national security or whether the relevant evidence involves state secrets when such questions arise in the adjudication of a case. The certificate shall be binding on the courts.”<sup>38</sup> This provision is, in our opinion, deliberately worded wide enough to cover any proceedings in Hong Kong. It could provide an important procedural advantage to an SOE or PRC conglomerate that raises the issue of national security in a case. The PRC entity in question could foreseeably lean on the Hong Kong government to issue a certificate, which would in turn have to take instructions from the National Security Committee. With the ultimate power of interpretation of the HK NSL vested in the NPCSC, together with the overarching authority of the CPG, whether or not an issue is indeed a national security issue is not a legal determination but a political one. Going forward, there is a very real possibility that cases involving national security issues in civil and commercial disputes, similar issues as those in Ernst & Young, will be dealt with quite differently under the HK NSL.

Beyond the direct application of the HK NSL to companies with interests and activities involving Hong Kong, commercial disputes could arise out of the merger and acquisition of companies whose operations and business fall within the ambit of national security but may not be apparent at the time the deal was signed. As discussed above, the HK NSL is silent as to Hong Kong courts’ jurisdiction in civil disputes involving national security issues, and there is a very real possibility those disputes would be considered outside the authority and jurisdiction of the Hong Kong courts. Commercial parties should think much harder in deciding what choice of law and dispute resolution clauses they should adopt in future deals involving key economic sectors. Again, to fully understand the scope of national security under the HK NSL, it is important to read it in the context of related PRC laws.

Geopolitical tensions also play a role in defining whether a commercial matter is a national security issue. Mounting trade disputes between Australia and the PRC,<sup>39</sup> and global disputes and bans regarding 5G and Chinese technology companies such as Huawei and ZTE (and many others), have created a range of challenges for companies seeking to balance operations in the PRC and the United States. Both the PRC and the United States have increased state scrutiny of mergers and acquisitions on national security grounds, and the European Union has frozen the ratification process of its market access treaty with the PRC.

Recent legislation adopted by the CPG further suggests that commercial entities could be caught engaged in national security issues. First, the PRC Data Security Law, adopted on June 10, 2021, categorizes data and data flows as national security issues and provides officials with broad authorities to punish companies and their employees for illegal transferring data.<sup>40</sup> Second, the NPCSC recently revised its criminal law to target corporate espionage and penalize anyone for “stealing, spying into, buying or unlawfully supplying business secrets for overseas institutions, organizations, and individuals.”<sup>41</sup> Finally, the PRC also issued new measures expanding its national security review of foreign investments that became effective in January 2021.<sup>42</sup> As tension between China and other countries continues to rise, it is foreseeable that national security issues would surface in a far greater number of areas than before.<sup>43</sup> In a related development, the United States and other nations have expressed growing concerns regarding supply chain dependence on the PRC, leading some companies to consider offshoring manufacturing away from the PRC.<sup>44</sup> We have yet to see the full extent of this potential relocation of supply chains due to the ongoing pandemic. However, the Hong Kong American Chamber of Commerce has conducted a recent survey showing more than 40% of US expatriates are considering leaving Hong Kong.<sup>45</sup> In the process of relocation, individuals and international businesses should be careful of inadvertently

transferring state and/or trade secrets or intelligence to foreign entities in breach of Article 29 of the HK NSL.

The dynamics of this decoupling are complex and made more so by recent legislation enacted by the NPCSC in June 2021, in a likely response to the passage of the US Strategic Competition Act. As discussed above, under the PRC Data Security Law, companies face heavy penalties for transferring “sensitive” data outside PRC borders. When companies are requested by overseas judicial or law enforcement authorities to hand over data, such data may not be transferred without the permission of PRC authorities.<sup>46</sup> Companies, and their employees, could face legal challenges in the PRC for complying with regulations and policies imposed by foreign countries.<sup>47</sup> On the other hand, while some companies move their commercial operations away from the PRC, there is an increasing level of investments in PRC financial markets by Wall Street firms such as Goldman Sachs, Blackrock, and JP Morgan. The financial sector is of course a key economic sector that comes under the umbrella of national security in the PRC. However, in light of these legal and regulatory changes, international businesses will find it increasingly difficult to simultaneously comply with laws and regulations in both the PRC and elsewhere. The same dilemma faced by the parties in the BDO China case will be much more acute in today’s legal environment.<sup>48</sup> This tension would probably have the most significant impact on the finance and technology sectors due to the interdependency between the US and the PRC.

Foreign business executives have been detained or banned from leaving the PRC for economic disputes<sup>49</sup> and, in some cases, for crimes committed by their clients<sup>50</sup> or family members.<sup>51</sup> Under the recent amendments to Hong Kong’s [Immigration Ordinance](#), authorities can impose exit bans on anyone. The Hong Kong Bar Association has warned against the unfettered powers given to the director of immigration under the amended ordinance,<sup>52</sup> which will come into effect on August 1, 2021.

## Conclusion

The balance between genuine national security concerns and civil liberties is an ongoing challenge in most countries, including liberal democracies. However, the promulgation of the HK NSL is a significant change from where the region was a year ago and has far-reaching consequences. Supporters of the HK NSL often ignore the nature of the HK NSL, which is fundamentally different in both form and substance when compared to similarly named legislations in liberal democratic countries. Its method of enforcement by the authorities is also very different. And we are still in the early days.

In a recent article published by the PRC legal scholar Tian Feilong (who contributed to the drafting of the HK NSL), Tian described the HK NSL as bringing about the structural expansion of the Hong Kong constitutional order and legal environment.<sup>53</sup> Mainland legal scholars like Tian have borrowed from the ideas of German jurist Carl Schmitt in arguing that “laws are designed to institutionalize the primacy of politics and sovereignty over the rule of law” or individual rights as understood under the common law.<sup>54</sup> They have also argued that law is an extension of politics and is used to achieve PRC national and geopolitical objectives. The HK NSL should be seen in the same light.

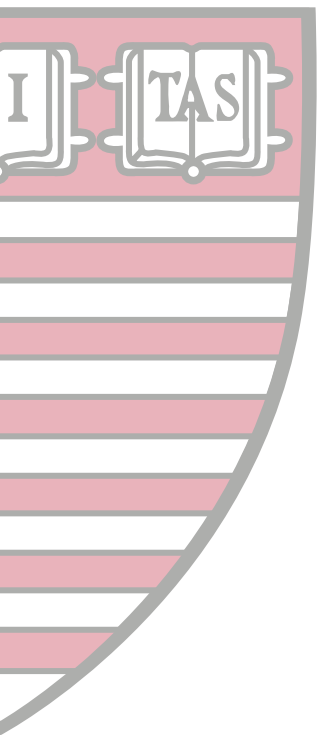
As the CCP’s centenary fast approaches and the PRC continues to aggressively “reclaim” its role as a global leader in social, political, and economic terms, the future trend is likely to move Hong Kong even further away from its past liberal traditions. It is imperative that the international community understands this paradigm shift and takes these new risks into account in their future operations and dealings in Hong Kong and the PRC.

## Notes

1. SFC v. Ernst & Young [2015] 5 HKLRD 293, at p. 327–328 per Ng J: [https://legalref.judiciary.hk/lrs/common/search/search\\_result\\_detail\\_frame.jsp?DIS=93214&QS=%2B&TP=JU](https://legalref.judiciary.hk/lrs/common/search/search_result_detail_frame.jsp?DIS=93214&QS=%2B&TP=JU).
2. SFC v. Ernst & Young [2015] 5 HKLRD 293, at p. 327–328 per Ng J: [https://legalref.judiciary.hk/lrs/common/search/search\\_result\\_detail\\_frame.jsp?DIS=93214&QS=%2B&TP=JU](https://legalref.judiciary.hk/lrs/common/search/search_result_detail_frame.jsp?DIS=93214&QS=%2B&TP=JU).
3. Admin. proc. file no. 3-14872 and 3-15116 (January 22, 2014): <https://www.sec.gov/alj/aljdec/2014/id553ce.pdf>.
4. For a more comprehensive comparative analysis of the Ernst & Young and Dahua decisions, see Raymond Siu, Yeung Chan, and John Kong Shan Ho (2015), “Could Complying with China’s Secrecy Laws Be an Excuse for Auditors Not to Provide Their Working Papers of Auditing Chinese Companies? Recent Cases in the United States and Hong Kong,” *King’s Law Journal*, 26:1, 99–128.
5. Such as reforms to Hong Kong electoral process including reducing the number of legislators directly elected while increasing the number appointed by CCP entities or proxies, “national security” screening of candidates (<https://www.bbc.com/news/world-asia-57236775>), and “patriotic” oath regulations being adopted for various sectors from civil servants to judges and possibly teachers (<https://www.reuters.com/world/asia-pacific/hong-kong-legislators-pass-patriotic-oath-law-2021-05-12/>).
6. Articles 3 and 4 of the Regulation on Political-Legal Work of the CCP (中共中央印发《中国共产党政法工作条例》) establish the CCP as the absolute leader of the PRC’s legal system, including law enforcement and the judiciary; see [http://www.gov.cn/zhengce/2019-01/18/content\\_5359135.htm](http://www.gov.cn/zhengce/2019-01/18/content_5359135.htm). See also Nis Grünberg and Katja Drinhausen (September 24, 2019), “The Party Leads on Everything,” Mercator Institute for China Studies, [https://merics.org/sites/default/files/2020-05/The%20Party%20leads%20on%20everything\\_0.pdf](https://merics.org/sites/default/files/2020-05/The%20Party%20leads%20on%20everything_0.pdf).
7. In September 2020, the General Office of the CCP Central Committee issued an opinion on “Strengthening the United Front Work in the Private Economy in the New Era” (中共中央办公厅印发《关于加强新时代民营经济统战工作的意见》); see [http://www.gov.cn/zhengce/2020-09/15/content\\_5543685.htm](http://www.gov.cn/zhengce/2020-09/15/content_5543685.htm). For a detailed analysis of this directive, see Scott Livingston (October 2020), “The Chinese Communist Party Targets the Private Sector,” Center for Strategic and International Studies, [https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/201008\\_Livingston\\_CCP%20Targets%20Private%20Sector\\_WEB%20FINAL.pdf](https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/201008_Livingston_CCP%20Targets%20Private%20Sector_WEB%20FINAL.pdf).
8. <https://www.csis.org/analysis/ideological-security-national-security>.
9. As this article was being drafted, the geopolitical and legal landscape of Hong Kong and the PRC continued to evolve. While the authors have endeavored to reference these ongoing changes throughout the article, there was insufficient time for a complete analysis and not all changes may be adequately accounted for.
10. [http://www.arbitration.qmul.ac.uk/media/arbitration/docs/LON0320037-QMUL-International-Arbitration-Survey-2021\\_19\\_WEB.pdf](http://www.arbitration.qmul.ac.uk/media/arbitration/docs/LON0320037-QMUL-International-Arbitration-Survey-2021_19_WEB.pdf).
11. Article 19(3) of the Basic Law and footnotes 16 and 17 below.
12. Full text: [https://www.rightofassembly.info/assets/downloads/Hong\\_Kong\\_Basic\\_Law.pdf](https://www.rightofassembly.info/assets/downloads/Hong_Kong_Basic_Law.pdf).
13. Article 55 of HK NSL.
14. Article 55 of HK NSL.
15. CPG State Council white paper (2014): [http://www.china.org.cn/government/whitepaper/2014-06/10/content\\_32623618.htm](http://www.china.org.cn/government/whitepaper/2014-06/10/content_32623618.htm).
16. The Court of Final Appeal endorsed this view in FACC no. 1 of 2021 [2021] HKCFA 3 at para. 32.
17. 依据香港国安法规定，香港国安委工作信息不予公开，其决定不接受司法复核。对此，法律专家分析指出，香港国安委负责处理与香港特区有关的国家安全事务，而国家安全事务性质上与国防、外交等一样，属中央事权。 [http://www.xinhuanet.com/gangao/2020-07/02/c\\_1126189870.htm](http://www.xinhuanet.com/gangao/2020-07/02/c_1126189870.htm).
18. FACC no. 1 of 2021 [2021] HKCFA 3 at para. 37.
19. Article 11 of HK NSL.
20. <https://www.thetimes.co.uk/article/lady-hale-quits-hong-kong-court-as-china-tightens-grip-09pjsvrnb>; <https://www.abc.net.au/news/2020-09-18/judge-quits-over-hong-kong-national-security-law/12679318>.
21. <https://beta.thestandnews.com/politics/> 國安法壓港-路透社引消息-外籍法官將被禁處理國家安全案件
22. See Article 44 of HK NSL: “A person shall not be designated as a judge to adjudicate a case concerning an offence endangering national security if he or she has made any statement or behaved in any manner endangering national security. A designated judge shall be removed from the designation list if he or she makes any statement or behaves in any manner endangering national security during the term of office.”

23. <https://www.chinadaily.com.cn/a/202105/21/WS60a78e15a31024ad0bac0ab6.html>.
24. An analysis by Jude Blanchette of CSIS on a report issued by the Central Party School of CCP titled “Ideological Security in the Framework of the Overall National Security Outlook” by Professor Tang Aijun: <https://www.csis.org/analysis/ideological-security-national-security>.
25. Article 19 of PRC NSL: [http://eng.mod.gov.cn/publications/2017-03/03/content\\_4774229.htm](http://eng.mod.gov.cn/publications/2017-03/03/content_4774229.htm).
26. The Hong Kong SAR now has power to censor films on national security grounds. See <https://hongkongfp.com/2021/06/11/new-guidelines-allow-hong-kong-to-censor-films-on-national-security-grounds/>.
27. Chapter VI of the Data Security Law, adopted on June 10, 2021, establishes extensive liability on companies and employees for “core data” that is improperly transferred outside of the PRC. [http://www.xinhuanet.com/2021-06/11/c\\_1127552204.htm](http://www.xinhuanet.com/2021-06/11/c_1127552204.htm).
28. <https://www.cso.gov.hk/eng/blog/blog20210411.htm>; “In fact, the challenges that we are facing in this new era have gone beyond political security, territorial security and military security as conventionally perceived. Extensive in breadth and depth, national security has a direct bearing on people’s interests and encompasses more than ten other key aspects, including economic security, cultural security, social security, technology security, cybersecurity, ecological security, resource security, nuclear security, overseas interests security and some emerging aspects like biosecurity, outer space security, deep sea security and polar security.” (emphasis added).
29. Such was the situation in the Rio Tinto case, in which four Australian iron ore exporters were jailed for inter alia receiving state secrets. While evidence regarding the state secrets was provided on camera, text of the verdict reveals the secrets obtained included discussions at meetings of the China Iron and Steel Association. See <https://www.reuters.com/article/china-secrets/china-defines-commercial-secrets-after-rio-tinto-trial-idUSTOE63Q02Y20100427> and <https://www.smh.com.au/business/just-what-is-a-chinese-commercial-secret-remains-a-secret-20100416-skmy.html>.
30. Michael Vines (July 5, 2010), “Geologist’s Sentence is Questioned,” *New York Times*, [https://www.nytimes.com/2010/07/06/world/asia/06china.html?\\_r=1&ref=jonmhuntsmanjr](https://www.nytimes.com/2010/07/06/world/asia/06china.html?_r=1&ref=jonmhuntsmanjr).
31. Hong Kong Police requested an Israeli website hosting company to remove contents from a website: <https://www.newsweek.com/wix-apologizes-removing-website-support-hong-kong-democracy-1597387>.
32. <https://www.reuters.com/world/asia-pacific/hong-kongs-apple-daily-newspaper-says-police-arrest-five-directors-2021-06-16/>.
33. Zheng Tang and Xu Huang (2021), “State Secrets in the Hong Kong National Security Law,” in *Hong Kong Natural Security Law*, edited by Hualing Fu, forthcoming.
34. Based on the recent prosecution of pro-democratic lawmakers and activists for subversion under the HK NSL, the question of what amounts to “unlawfulness” is vague and seems entirely at the discretion of the HK prosecutors. We will see how the HK courts would deal with such arguments advanced by the prosecution at trial.
35. Article 29 of HK NSL.
36. IBA Rules on Taking of Evidence in International Arbitration, Article 9(2)(f).
37. Special thanks to a contribution from an international arbitration expert
38. 第四十七条 “香港特别行政区法院在审理案件中遇有涉及有关行为是否涉及国家安全或者有关证据材料是否涉及国家秘密的认定问题，应取得行政长官就该等问题发出的证明书，上述证明书对法院有约束力。”
39. Gabriel Crossley and Kirsty Needham (May 5, 2021), “China Suspends Economic Dialogue with Australia as Relations Curdle,” Reuters, <https://www.reuters.com/world/china-suspend-economic-dialogue-mechanism-with-australia-2021-05-06/>.
40. 中华人民共和国数据安全法 [http://www.xinhuanet.com/2021-06/11/c\\_1127552204.htm](http://www.xinhuanet.com/2021-06/11/c_1127552204.htm); see also <https://www.scmp.com/tech/big-tech/article/3136996/chinas-new-data-security-law-promises-steep-punishments-unapproved>.
41. <https://www.scmp.com/economy/china-economy/article/3092939/china-sharpens-economic-espionage-penalties-tit-tat-provision>.
42. [https://www.ndrc.gov.cn/xwdt/xwfb/202012/t20201219\\_1255024.html](https://www.ndrc.gov.cn/xwdt/xwfb/202012/t20201219_1255024.html).
43. The recent Supreme Court of New Zealand decision in *Minister of Justice v. Kyung Yup Kim* [2021] NZSC 57 [June 4, 2021] is also cause for concern. In this case the defendant, a South Korean resident of New Zealand, was accused of killing a woman in Shanghai in 2009, and the PRC sought an extradition. In its judgement, the court determined that as long as the PRC provided sufficient assurances as to the accused’s treatment in the PRC, the extradition will go forward—subject to the minister’s final decision. It is significant that the accused is

- not a PRC citizen or resident yet he is still potentially subject to extradition from a third country. See <https://perma.cc/NZ3F-DB7D>. For more analysis, see Donald Clark (June 15, 2021), “New Zealand’s Troubling Precedent for China Extradition,” Lawfare <https://www.lawfareblog.com/new-zealands-troubling-precedent-china-extradition>.
44. Japan is leading the charge on offshoring manufacturing away from the PRC, earmarking several million dollars to encourage companies to transfer production back to Japan or Southeast Asia. See Simon Denyer (July 21, 2020), “Japan Helps 87 Companies to Break from China after Pandemic Exposed Overreliance,” *Washington Post*, [https://www.washingtonpost.com/world/asia\\_pacific/japan-helps-87-companies-to-exit-china-after-pandemic-exposed-overreliance/2020/07/21/4889abd2-cb2f-11ea-99b0-8426e26d203b\\_story.html](https://www.washingtonpost.com/world/asia_pacific/japan-helps-87-companies-to-exit-china-after-pandemic-exposed-overreliance/2020/07/21/4889abd2-cb2f-11ea-99b0-8426e26d203b_story.html).
  45. <https://www.bloomberg.com/news/articles/2021-05-12/more-than-40-of-hong-kong-expats-may-leave-amcham-survey-says>.
  46. <https://www.bloomberg.com/news/articles/2021-06-10/china-passes-law-to-strengthen-control-over-tech-firms-data?sref=6ZE6q2XR>.
  47. 授权发布) 中华人民共和国反外国制裁法 [http://www.xinhuanet.com/politics/2021-06/10/c\\_1127551959.htm](http://www.xinhuanet.com/politics/2021-06/10/c_1127551959.htm); Law of the PRC on Countering Foreign Sanctions unofficial English translation: <https://www.chinalawtranslate.com/en/counteringforeignsanctions/>.
  48. The extradition case involving Huawei executive Meng Wenzhou and HSBC is a good illustration of this tension. At issue in this case are financial services provided by HSBC to Huawei that were used to support business in Iran, in contravention of US sanctions. This case began in 2019 and has resulted in a series of complications as well as two Canadian NGO workers being detained in a form of political retribution against Canada, where the extradition hearing is occurring. See Kim Richard Nossal (January 19, 2021), “Wrong Place, Wrong Citizenship: The Tribulations of the ‘Two Michaels,’” <https://www.lowvinstitute.org/the-interpretor/wrong-place-wrong-citizenship-tribulations-two-michaels>.
  49. Harris Bricken (November 28, 2020), “China Hostage Situations: What You Need to Know,” China Law Blog, <https://harrisbricken.com/chinalawblog/china-hostage-situations-what-you-need-to-know/>; Erika Kinetz (May 5, 2020), “‘No Remedy, No Rights’: China Blocks Foreigners from Leaving,” *The Diplomat*, <https://thediplomat.com/2020/05/no-remedy-no-rights-china-blocks-foreigners-from-leaving/>.
  50. Bloomberg (October 19, 2018), “Wealth Managers Curb China Travel after UBS Banker Is Detained,” <https://www.bloomberg.com/news/articles/2018-10-19/ubs-is-said-to-curb-some-china-travel-after-banker-detained>.
  51. <https://thediplomat.com/2020/05/no-remedy-no-rights-china-blocks-foreigners-from-leaving/>.
  52. <https://www.theguardian.com/world/2021/apr/28/hong-kong-passes-law-that-can-stop-people-leaving>; <https://www.reuters.com/world/asia-pacific/hong-kong-passes-immigration-bill-raising-alarm-over-exit-bans-2021-04-28/>; Hong Kong Bar Association submissions on the Immigration (Amendment) Bill: <https://www.hkba.org/sites/default/files/Immigration%20%28Amendment%29%20Bill%202020%20-%20Clause%203%20-%20Further%20Submission%2011.2.2021.pdf>.
  53. *Sing Tao Daily*, May 31, 2021.
  54. For more analysis, see “The Restructuring of Hong Kong and the Rise of Neostatism” by Professor Sebastian Veg; [https://tocqueville21.com/le-club/the-restructuring-of-hong-kong-and-the-rise-of-neostatism/#\\_ftnrefl](https://tocqueville21.com/le-club/the-restructuring-of-hong-kong-and-the-rise-of-neostatism/#_ftnrefl).



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# Taiwan: A Risk Analysis through the Lens of Hong Kong

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### A PUBLICATION OF THE

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## **Acknowledgments**

The authors wish to thank Mason Wong for his valuable insights and assistance in editing this paper.

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## Abstract

Our paper aims to provide an overall risk analysis of the Taiwan Strait situation by using Hong Kong's experience over the past three decades as a point of comparison. We focus on three areas where those watching Taiwan can learn from Hong Kong. Since Deng Xiaopeng's rule, Hong Kong and Taiwan have been inextricably intertwined, with China intending to reunify both territories using the "one country, two systems" formula. There are, of course, fundamental differences between the situations in Taiwan and Hong Kong. But there are also many similarities from which one can draw useful lessons. In the past three decades, Hong Kong tried to preserve its liberal democratic values whilst co-existing under an authoritarian regime. Hong Kong's experience proved that a liberal democratic society cannot survive alongside an increasingly aggressive and authoritarian Chinese Communist Party (CCP) regime. Taiwan essentially faces the same dilemma.

Hong Kong offers four key insights: First, Hong Kong provides a window through which to understand the modus operandi of Xi Jinping's CCP. Political priorities trump all others—while CCP actions make sense within the system, they may confuse outsiders. Ultimately, Xi's words should be taken literally and seriously. Second, the failure of the "one country, two systems" formula and Hong Kong's collapse should not be lost on Taiwan. The so-called "United Front" tactics and the political polarization that occurred in Hong Kong are being emulated in Taiwan, with the Kuomintang's (KMT's) platform feeling increasingly untenable and anachronistic, especially in light of Hong Kong's experience. Third, the infiltration of Mainland capital into Hong Kong over the past two decades have changed the underlying structure of Hong Kong as a business and financial center. The effect of 'red' capital made local Hong Kong and international business voices irrelevant. We saw their ability to influence and thereby moderate government policies waned over the years—leading to disastrous consequences for Hong Kong. Finally, Hong Kong has changed the geopolitical landscape in ways that have profound ramifications for Taiwan and how the international community perceives the CCP. The CCP openly walked back on an international treaty registered with the United Nations. The response of the international community and businesses reveals important lessons about the West's vulnerabilities to this kind of geopolitical shock should the situation over the Taiwan Strait worsen.

## 1. Introduction

Those of us who have long advocated for Hong Kong often stress the importance of our city's freedom to the rest of the world. Hong Kong, in our view, has never been a “boutique” issue, a local concern with few implications for the wider world. Rather, we have urged the world to see Hong Kong as a bellwether for freedom in the Asia-Pacific region. If Hong Kong fell—and clearly, it has fallen—China would soon turn its eyes to Taiwan.

A little more than a year after the introduction of Hong Kong's National Security Law, Taiwan does indeed seem to be the next target of an increasingly assertive Chinese foreign policy. The People's Liberation Army (PLA) [now regularly sends more than 150 warplanes in a row](#) to breach Taiwan's air defense identification zone; at the same time, [Taiwan has invited U.S. marines to help shore up the island's military forces](#). Throughout all of this, the rhetoric surrounding these issues is becoming increasingly aggressive.

When examined in the context of what has happened to Hong Kong, there is no way to interpret these events except to realize that the status quo in Taiwan, built on a foundation of the “[1992 Consensus](#)” and American “[strategic ambiguity](#),” is soon coming to an end, if it has not already ended. This will likely have major ramifications both geopolitically and for international businesses.

Our intention in this paper is not to imply that the Hong Kong and Taiwan situations are identical or that the dynamics in each situation will play out in the same way. Taiwan has been a frozen conflict for decades, and there are many elements unique to the island's politics that do not have direct parallels in Hong Kong. However, we perceive there to be several key lessons that those watching Taiwan must draw from events in Hong Kong.

First, Hong Kong provides a window through which to understand the modus operandi of Xi Jinping's Communist Party. In Xi's China, political priorities trump all others—the Party's actions make sense within the system, but they may confuse outsiders. Xi's words should be taken literally and seriously. His intentions are more avowedly nationalistic, and he has brushed off the “[hide your strength, bide your time](#)” mantra, which guided the foreign policy of his predecessors and their approach in both Hong Kong and Taiwan. These changes have profound ramifications.

Second, the dynamics of Taiwan's domestic politics are beginning to mirror the dynamics of the democratic movement in Hong Kong, with Taiwan facing similar dangers of polarization and internal divisions. Hong Kong's democratic camp traditionally sought a democratic future within China, but it takes two to tango, and the Communist Party was never willing to accommodate Hong Kong's moderates. Polarization followed and the middle ground evaporated. A similar process is playing out in Taiwan, with the KMT's platform appearing increasingly untenable and anachronistic, especially in light of the collapse of the “one country, two systems” model in Hong Kong.

Third, Hong Kong has changed the geopolitical landscape of the Asia-Pacific region in ways that have profound ramifications for Taiwan. Just as those analyzing the situation in Taiwan must look at Xi's actions in Hong Kong, they should also look at the behavior of the United States and its allies. The fall of Hong Kong consolidated the [bipartisan consensus](#) about China in Washington and (less so) in [Brussels](#) and [London](#), giving senior administration officials and members of parliament the chance to assemble the full range of economic and financial policy options in their arsenal if the situation goes south in Taiwan. And given China's open breach of an international treaty over its commitments in the Sino-British Joint Declaration, questions are now being raised about how the international community should see China's commitments to international law across a range of issues, from Taiwan to [trade](#) and [climate change](#).

Finally, the changing political situation in Hong Kong has been a direct result of the rising power of red capital—i.e., mainland businesses—and the corresponding [weakening](#) of the hand of international and local business elites when negotiating with Beijing. This has two implications: First, Taiwan must be careful not to give red capital a foothold nor allow it to assist [United Front](#) interference in Taiwanese politics and media, something which was especially rampant during the [previous KMT administrations](#). Second, international businesses conducting risk audits should seriously consider how trends in Hong Kong revealed their dependencies on China and acute vulnerabilities to the kind of geopolitical shock that may be around the corner as a result of ratcheting tensions in Taiwan.

## 2. The Context

For nearly 75 years, the status quo has essentially allowed Taiwan, China, and the United States to fudge their answers to some of the most important questions in cross-Straits relations. Frank discussions of the meanings of [“one China”](#) (if so, which China?) or the U.S. position on Taiwan were shelved in favor of a calculated vagueness; the 1992 Consensus allowed Taiwan and China to work from a place of [“one China, different interpretations,”](#) while strategic ambiguity allowed American leaders to [hold back](#) from fully committing to a defense of Taiwan.

The drums of nationalism and menacing rhetoric are nothing new in Communist Party propaganda relating to Taiwan, but in recent years, the statements and policies coming out of Xi Jinping’s administration have made it abundantly clear that China’s tolerance for the blurry status quo lessens by the day. Xi has, much more so than his predecessors, sent the message that there is no longer room for differing interpretations. In a recent speech, he identified the reclamation of Taiwan as a key part of the [“rejuvenation of the Chinese civilization,”](#) and in a similar statement, he stressed the importance of [not leaving the “Taiwan question” to the next generation](#). Elsewhere, Xi has [conflated the 1992 Consensus with “one country, two systems,”](#) a clear signal that for Taiwan, the offer is reunification under “one country, two systems” and nothing else. In Xi’s view, there is no longer a question of “which China,” as “one China” now unambiguously means the People’s Republic of China (PRC). This is a subtle yet significant shift from the position adopted by the PRC in the 1992 Consensus.

Also important is what journalist Jude Blanchette has referred to as China’s [“narrow window,”](#) a 10-15-year period in which Xi believes he can take advantage of broad shifts in global politics, technological development, and Chinese internal politics to prepare China for inevitable economic slowdowns, looming corporate debts, and demographic challenges. [In Xi’s words](#), “profound changes” in the world, “unseen in [more than] a century,” demand strong leadership and drastic action to properly “rejuvenate the Chinese civilization” and position it for an uncertain future. Thanks to Xi’s other statements on “national rejuvenation,” we do not need to speculate on what this means for his attitude toward Taiwan.

From our perspective, Xi Jinping’s statements on this matter should not be taken lightly. In addition to the foreign policy dimension of the Taiwan issue, domestic political incentives in China have made reunification with Taiwan a top priority for Xi. Both his [actions](#) to hold onto power past the end of his appointed term as general secretary of the CCP and the tenor of the propaganda surrounding his developing [cult of personality](#) tell a clear story. In the near term, Xi’s top priority is to secure what essentially amounts to a lifetime tenure in the presidency—a task that requires him to build a substantive political legacy.

Xi clearly seeks a role in the annals of CCP history comparable to that of Mao or Deng; already, the political doctrine of Xi Jinping Thought has been enshrined into the [Chinese constitution](#), Chinese [university curricula](#), and [key Communist Party documents](#). At the [Chinese Communist Party’s sixth plenum](#), Xi became only the third paramount leader of the CCP to oversee the issuance of a historic

resolution centering on himself. As Professor Tony Saich pointed out, the Party uses such [historical resolutions](#) to define both leaders' legacies and the country's future direction.

But if Mao created the People's Republic and Deng made it rich, Xi must seek an achievement of similar stature to justify his inclusion among their ranks. He seeks to be the [leader who redeems China from its century of humiliation](#) and carries his country back to its place of global preeminence. This much was made clear in the aforementioned Party historical resolution, which casts Xi as the "[hero in the epic of China's national journey](#)," in the words of analyst Adam Ni. How does Xi achieve his position of preeminence in the long run? In Xi's words, a "strong" nation [cannot co-exist](#) with a "divided" one. Xi's statements make it clear that he strives to make the full reabsorption of Hong Kong—and, more importantly, Taiwan—into the PRC a central part of his political legacy. It is not a matter of if but when.

## 2.1 Limits to Parallels with Hong Kong

In light of increasingly aggressive rhetoric by the Chinese Communist Party, it is vital that those conducting risk analyses of the situation, both in Taiwan and elsewhere, learn important lessons from Hong Kong's recent history.

However, it is not our intention to imply that the Hong Kong and Taiwan situations are identical. As the purpose of any comparative study in the political sciences is to draw out lessons both on similarities and differences, we want to pay attention to the areas where Taiwan and Hong Kong differ as well. After acknowledging these, we'll underline several key areas in which Hong Kong provides insight into Taiwan's current political circumstances.

There is very little historical comparison when it comes to the prospect of a massive mainland military invasion of Taiwan. The last such invasion was arguably in [1683](#), when the Kangxi Emperor of the Qing Dynasty invaded Taiwan to eliminate the remnants of the Ming Dynasty. Although it was [in no position](#) to threaten the authority of the Qing Dynasty, the Ming Dynasty was enough of a nuisance for the Qing court to act. At that time, there was, of course, no international community or United States Pacific Fleet.

In terms of international legal status and sovereignty, Hong Kong and Taiwan differ greatly. Hong Kong was ceded to the British under the Treaty of Nanjing in 1842, and it was returned to PRC's sovereignty in 1997 via the Sino-British Joint Declaration, signed in 1984. There is no question about Hong Kong's sovereignty after 1997. This contrasts with Taiwan's uncertain status under international law. Formosa (i.e., Taiwan) and the Pescadores were ceded to Japan under the Treaty of Shimonoseki, signed in 1895. When the Republic of China (ROC) declared war on Japan, they unilaterally annulled all previous treaties with Japan. On December 1, 1943, the U.S., U.K., and ROC jointly announced the Cairo Declaration, stating that "... all the territories Japan has stolen from the Chinese, such as Manchuria, Formosa, and the Pescadores, shall be restored to the ROC. Japan will also be expelled from all other territories which she has taken by violence and greed." In the Japanese Instrument of Surrender, Japan accepted the Potsdam Proclamation, which required adherence to the Cairo Declaration. Both the Cairo Declaration and Potsdam Proclamation were declarations of intentions during wartime and did not have the legal status of an international treaty. As Professor Anthony Saich of Harvard pointed out the CCP only became interested in Taiwan once the end of war negotiations took place (i.e., Cairo). Before that the CCP did not include Taiwan in its maps and stamps as a part of China. It did include Outer Mongolia, however.

Japan formally renounced all rights, titles, and claims over Formosa and the Pescadores under the Treaty of San Francisco and the Sino-Japanese Peace Treaty (the Taipei Treaty), signed in 1951 and 1952 respectively. However, the two treaties did not address and/or deliberately left open the question of



which “China” received Taiwan and the Pescadores. When [former Foreign Minister of the ROC Yeh Kung-chao](#) was questioned in the ROC legislature on the status of Taiwan, he said:

Formosa and the Pescadores (Penghu) were formerly Chinese territories. As Japan has renounced her claim to Formosa and the Pescadores, only China has the right to take them over. In fact, we are controlling them now, and undoubtedly, they constitute a part of our territories. However, the delicate international situation makes it that they do not belong to us. Under present circumstances, Japan has no right to transfer Formosa and the Pescadores to us; nor can we accept such a transfer from Japan even if she so wishes . . . In the Sino-Japanese Peace Treaty, we have made provisions to signify that residents, including juristic persons of Formosa and the Pescadores, bear Chinese nationality, and this provision may serve to mend any future gaps when Formosa and the Pescadores are restored to us.

In August 2019, as tanks [amassed](#) in Shenzhen, there were genuine concerns that the situation in Hong Kong might lead to another Tiananmen Square-style massacre. Hong Kong had no army and its police force remained willing clients of the Chinese Communist Party. The will of the people mattered little because Beijing held all the power and all the cards.

Taiwan, by contrast, is a de facto sovereign nation with its own democratically elected civilian government and a modern army, which has been [relatively well-resourced](#) by the United States government. When combined with the island’s geography, any thought of mass invasion poses an extremely serious risk for Beijing.

The [interests](#) of Japan, Australia, and the U.S. make it particularly hard for Beijing to take over Taiwan through force. [Japan](#), [Australia](#), and the U.S. have too much to lose if the PRC takes over Taiwan. From the centrality of the country to [critical supply chains](#) to what an invasion would signal about power in the region, the risks are too great for Asia’s regional powers to allow Taiwan to fall without any engagement as European powers have done in Crimea. Any decision to intervene in Taiwan by Xi would therefore almost certainly be met with either a military response or severe economic conflict, which would have major fallout domestically in China.

Tensions between Taipei and Beijing have simmered for decades, but there are clear reasons that war has been avoided to date. Therefore, the stakes are higher in Taiwan than they were in Hong Kong; while Chairman Xi calculated that the rest of the world would roll over in Hong Kong, he cannot make the same assumption in Taiwan. The conflict in Ukraine shows the West’s willingness to take meaningful economic countermeasures in the contest of conflict. If there is open conflict across the Taiwan Strait, Beijing knows that the United States and its allies in the region would inevitably be drawn in. The risks of conflict could escalate and quickly spread across the South China Sea, an international maritime trade crossroads that sees approximately [\\$3 trillion worth](#) of trade every year and hosts the [undersea internet cables upon](#) which the world depends.

These differences between Taiwan and Hong Kong perhaps mitigate the potential risk of a near-term conflict, but other differences ramp it up. For a start, Taiwan has a greater significance in the minds of both the Chinese public and those who formulate policy in Zhongnanhai, the central headquarters of the CCP. It was [with Taiwan in mind](#) that “one country, two systems” was first invented, and the collapse of Hong Kong is paving the way for a new confrontation. Furthermore, Taiwan is the great prize in Xi’s mind; it is probably his best chance to secure his legacy if he wants to be president for life and have his portrait up on Tiananmen alongside Mao’s. This will only become more relevant as the Communist Party struggles to justify its legitimacy in the coming years based on raising living

standards and an ever growing economy. Hard lock down measures in Shanghai and beyond further destroys the basis of this social contract. Going forward, Xi will have to resort more and more to nationalism as a way to bind the country together under his leadership. The crackdown on Hong Kong and the ‘foreign forces’ behind the protests appealed exactly to this kind of growing sense of nationalism.

Economists are already pointing to the headwinds and the [involution](#) of the Chinese economy, created by the high levels of corporate debt to GDP ratio ([currently standing at 200–300% of GDP](#)). Six hundred million Chinese people still live on [less than RMB 1,000 per month](#). As such, Xi Jinping’s “[common prosperity](#)” policies are aimed primarily at those who lack upward mobility and are not reaping the benefits of economic reforms. However, forcing Jack Ma and the like to [donate billions](#) to the state in the name of “common prosperity” is not going to be enough. The Communist Party is likely to need a rallying force to justify its rule. The seizure of Taiwan can mobilize people into devotion to the Communist Party far more readily than the reabsorption of Hong Kong ever could. It plays powerfully into the hands of the Chinese nationalistic psyche and its desire to see China made strong once again.

Accordingly, a clear-eyed risk analysis of the situation in Taiwan and the potential for a catastrophic crisis is absolutely critical. The reality of cross-strait relations has clearly shifted in the last several years. It is no longer a static situation. Xi Jinping’s administration has openly signaled that they are no longer willing to accept the status quo, and policymakers in Taiwan and the United States must acknowledge that the old ways of looking at this issue—whether that be the 1992 Consensus or the American doctrine of “strategic ambiguity”—are no longer sufficient to address this brewing crisis.

### 3. The Lens of Hong Kong

We now turn to consider what insights those watching Taiwan can glean from Hong Kong’s story. Hong Kong is often rightly called a canary in the coal mine. Events in Hong Kong reveal four key insights. The first is that the words of Xi Jinping must be taken seriously as statements of his intentions and that pragmatism is no longer a prime feature of Chinese foreign policy. Second, the failures of Hong Kong’s moderate Democrats show why the KMT’s attempts to broker compromise are unlikely to succeed and may even backfire if they push the Taiwanese political culture toward the type of polarization that was seen within Hong Kong. A third lesson is that the 2019 events in Hong Kong marked a watershed moment in the attitudes of liberal democratic countries and international businesses toward China, and this will inform the way China responds to aggression and possible conflict over Taiwan. Finally, we can see that Hong Kong demonstrates the dangers of the growing power of red capital (Chinese conglomerates in the region), both domestically for Taiwan and for international businesses as they face the possibility of greater geopolitical risk.

#### 3.1 Pragmatism Is Out, Follow the Chairman’s Words: What Hong Kong Shows about How We Should Read Xi Jinping

For the first 20 years after the city’s 1997 handover, Beijing was able to hold back—at least on a superficial level—from exercising all of the powers it held under the “one country, two systems” model. But this model was like the 1992 Consensus: deeply fragile and riddled with inherent contradictions. Thus, a belief developed among moderate Hong Kong pro-democrats that relations with Beijing required a sort of steely pragmatism toward the city’s realities.

In a similar manner to those who today deny that the status quo in Taiwan is coming to an end, Hong Kong’s moderate pro-democrats tried to work within the system for as long as possible, dismissing threatening Chinese statements and offering good-faith political deals with Beijing for the sake of preserving “one country, two systems.” But the events of 2019 and 2020 laid bare the differences between Beijing’s worldview and most Hong Kong people, who believe in freedom and liberty. And when one

system—the mainland system—stopped tolerating the political differences between itself and its counterparts, it quickly moved to destroy the “one country, two systems” status quo.

We can trace the roots of the events of 2019 and 2020 back to some five years earlier, when the Chinese government first released a white paper that introduced the concept of “[comprehensive jurisdiction](#)” to Hong Kong. This wholly new interpretation of the “one country, two systems” model posited Beijing’s total authority over all matters in Hong Kong, from legislation to administration. And although legal professionals [strongly opposed](#) this interpretation of the “one country, two systems” model, protesting it as completely alien to the constitutional framework of Hong Kong’s Basic Law, too many observers of the situation simply dismissed the white paper as overblown rhetoric from Beijing. As with the current dismissal of Xi Jinping’s alarming statements about reunification with Taiwan, many political observers in 2014 continued to cling to the idea that Beijing would not do away with an agreed-upon status quo and violate the legal consensus that emerged after the Sino-British Joint Declaration.

When Xi visited Hong Kong in 2017 to celebrate the 20th anniversary of Hong Kong’s handover to the mainland, he marked the occasion by laying down three red lines for the Hong Kong people in his speech. First, no one must threaten national security; second, no one must challenge the authority of the Central People’s Government and the Basic Law; and third, no one must use Hong Kong as a base to undermine and subvert the state. Xi laid down the three red lines: no one must endanger national security, challenge the authority of the Central People’s Government and the Basic Law, and use Hong Kong as a base to subvert the stability in the Mainland. “[三条「底线」](#)：不能容许任何人从事任何形式危害中国国家主权安全的活动；不容许挑战中央的权力和香港《基本法》的权威；以及不容许利用香港对中国内地进行渗透、颠覆的活动，破坏内地社会政治稳定。”

Despite analysts’ assurances, six years after the white paper and two years after Xi’s speech in Hong Kong, Beijing has fully followed through on its rhetoric. Chinese authorities have imposed the National Security Law, completely [changed](#) Hong Kong’s electoral system, and [wiped out](#) pro-democracy political parties. [Apple Daily](#) has been destroyed, and its owner, Jimmy Lai, has been imprisoned. Political arrests—not just of opposition leaders but of journalists, independent media like [Stand News](#), radio hosts, and even [cartoonists](#)—have become commonplace. It is as if Xi’s words of warning in 2017 had to come to bear on the city.

Under the leadership of Deng Xiaoping and his two immediate successors, [pragmatism](#) was the central driving factor behind China’s many policies since the late 1970s. From economic development policies to foreign policy (including policy about Taiwan and Hong Kong), the Chinese Communist Party displayed strategic patience and pragmatism. Most did not predict the recent events in Hong Kong because they assumed Beijing would deem it irrational to exert total political control over Hong Kong at the expense of ruining its international reputation and at the risk of killing the “[golden goose](#).” But the underlying assumptions have changed, and Beijing is now willing to take on those risks.

From Hong Kong’s example, we must learn that today’s Chinese politics are defined not by considerations that Western readers consider to be the rational dictates of realpolitik but by domestic political needs. We can no longer expect Beijing to abide by the kind of pragmatism expressed by previous Chinese leaders.

We must read Xi’s statements on Taiwan in the context of rising Chinese nationalism, especially since the past several years have seen a rise in nationalist fervor encouraged by the government. The Battle of Lake Changjin has become China’s [highest-grossing film](#). The Korean War-focused propaganda film’s showings have been [accompanied](#) by mass expressions of nationalist sentiment, deliberately orchestrated by the state: crowds of women leaving theaters crying, Chinese youth posing solemnly before posters, audiences saluting screens as credits roll. As maudlin or dramatic as this all

might seem, Western policymakers would be foolish to ignore a powerful domestic political force in China, one with the potential to drown out almost any other influence on China's leadership.

Even outside of this dangerous intersection of foreign policy and nationalism, all of Xi's marquee policies, from his crackdown on [tech](#) and [private education](#) to his government's political campaign against prominent [actors](#) and [pop singers](#), are defined not by rational policy analysis but by domestic political needs and the desire to build popular support for his continued rule. As Xi continues to [alienate elite stakeholders](#) within the Communist Party, he has moved to make up for these political deficiencies by appealing to the support of the masses—in many cases, the support of the [nearly 600 million people in China](#) who earn less than RMB 1,000 per month. The political desires of these citizens, who look at Xi's treatment of Chinese tech billionaires, private education companies, and celebrities and see a redistributive, populist, common-prosperity model of governance aimed at addressing China's social ills, are more likely to shape Xi's priorities than any objectively rational economic or diplomatic consideration.

An inability to understand this reality helped blind many analysts to what was going on in Hong Kong. Hong Kong, they argued, was too important as a financial center; China could not move against it without risking economic disruptions. There were serious flaws with this analysis. First, many analysts failed to fully appreciate that what mattered more in the end was Xi Jinping's domestic political narrative, which required China to crush the foreign forces inciting protest in Hong Kong. Rational considerations, like the risk to China's diplomatic relationships or the international reputational costs of suppressing protests, became secondary considerations, if indeed they were considered at all. Incidentally, following the crackdown on Chinese technology companies in 2021, the Hong Kong capital markets took a nosedive, with many planned initial public offerings dropped. The market sentiment is now averse to the risks associated with Chinese companies in key industrial sectors.

As an aside, the economic narrative was also oversimplified and failed to properly account for the importance of the rise of red capital in Hong Kong. [At the beginning of 2020](#), around 60% of the companies listed in Hong Kong were mainland companies, and they accounted for about 70% of the market capitalization (see section 4 for a longer discussion of this). As a result, Beijing knew that they could politically control large swathes of the economy and that many Western firms in the city were so dependent on red capital that they would kowtow even if political events cut against their direct interests. These types of nuances, particularly with regard to the operation of red capital in Taiwan, are worthy of greater study. Academics focusing on Taiwan must consider where facts on the ground—whether economic, military, or political—have changed the risk calculation. Later in this study, we consider in more detail the risks posed to international business by the rise of red capital and their corresponding loss of leverage in shaping political events.

Combined with domestic considerations, the strength of red capital and China's economic muscle ensure that the China of the past, which carefully managed foreign perceptions, no longer exists. Now, unlike in 1997, China has long since joined the WTO and can position itself as a key global player. Beijing believes that it is strong enough to ride out any international criticism and perhaps even that such criticism might bolster Xi Jinping's domestic political standing as he positions himself as a bulwark against foreign hostility.

In the last several years, Xi Jinping has made it clear that he is willing to back up his rhetoric with actions. Hong Kong's political observers ignored Beijing's 2014 white paper at their peril, refusing to take the document as a serious outlining of Xi's priorities or otherwise pretending that the white paper did not, in a literal sense, mean what it said about comprehensive jurisdiction in Hong Kong. The same applies to the three red lines laid down in Xi's 2017 speech in Hong Kong.

We must not make this mistake again with Taiwan. When Xi Jinping says that he will not leave the Taiwan question to the next generation of Party leadership and that the rejuvenation of China's civilization must include the reunification of Taiwan, the international community must take these statements seriously and literally.

### 3.2 The Handover of Hong Kong and False Expectations

On June 30, 1997—the night of the handover of Hong Kong to the PRC—there were no mass protests on the streets of Hong Kong. Hong Kongers were glued to the news as reporters detailed the last steps of the British withdrawal. The heavy rain, the departure of Hong Kong's last British governor and his tearful daughters, and the goose-stepping of PLA soldiers would forever be etched into the collective memory of the Hong Kong people. Some were nervous about what was to come, but most were quietly hopeful that the new constitutional arrangement would work. After all, Hong Kongers are known for their pragmatism. They were willing to wait and see whether their new masters in Beijing would honor the new deal to allow the Hong Kong people to rule themselves through a democratic system of government. They were eager to experience the freedom guaranteed to them by the rule of law.

The Hong Kong people were [purposely excluded](#) from the handover negotiations at the insistence of Beijing. The British [agreed](#) to this exclusion for fear of angering Beijing, and they did not want troubling voices from the Hong Kong people demanding things such as a referendum. Despite these circumstances, the Hong Kong people, though they had no say over the whole transfer of sovereignty, largely accepted the terms of the deal in good faith, hoping for the best (although many Hong Kongers [emigrated abroad](#) to obtain Canadian or Australian citizenship as insurance policies). This good faith had existed even amongst the mainstream democratic camp in Hong Kong, which believed with some skepticism that Beijing would honor its words. History would go on to show that most Hong Kongers, as well as the international community that supported the transfer of Hong Kong to the PRC, were far too naive.

The Sino-British Joint Declaration, signed in 1984, is an international treaty [registered](#) with the United Nations. The treaty itself provided [no mechanism](#) for redress should China back out of its commitment to Hong Kong. The British had [refused](#) to offer British citizenship to the majority of Hong Kong people back in 1997 and did not think it necessary to build in a dispute resolution mechanism, which would have provided some form of check on the Chinese state to ensure that it would not walk back on its words—especially on the promises of freedom, rule of law, and democracy. Why did the international community believe an authoritarian state would honor these commitments without the need for some form of redress or guarantee? This is a question for historians and a lesson for the international community. Realists in the field of international relations have [long argued](#) that international bodies and treaties without an arbiter or binding dispute resolution mechanism are essentially meaningless. Hong Kong is a good example.

The Hong Kong people's good faith led their moderate pro-democracy camp to make the mistake of reaching out to Beijing with pragmatic gestures, and good-faith concessions, in the hope that they would be reciprocated. Over the course of many years, Hong Kong's pro-democrats slowly and painfully learned that PRC officials' negotiations regarding universal suffrage and other governance issues were not carried out in good faith; instead, they were a ploy to maneuver for maximum leverage over Hong Kong on all other fronts. This led to internal divisions within the democratic camp, which weakened the Hong Kong people's collective will to see the threat that was to come.

### 3.3 Beijing's Change in Policy toward Hong Kong since 2008

When Xi visited Hong Kong in 2008 as vice premier, he gave a speech calling on all three powers (executive, legislative, and judicial) to work together in cooperation known as (三權合作論) i.e., co-operation amongst the three branches of power. This was of course controversial at the time because

Hong Kong's constitutional structure was based on the separation of powers, which is a key concept in the common law tradition. To disavow the separation of powers is tantamount to dismantling the constitutional structure of Hong Kong. At the time, this was brushed aside as a benign sentiment merely lost in translation or an unintentionally inflammatory remark by the then-new national leader.

As early as 2008, an [internal research document](#) penned by Tsao Er Bao, the head of the Research Department in the China Liaison Office, revealed Beijing's interest in developing a two-tiered governance structure for Hong Kong. The outer layer would be the Hong Kong government and its officials, led by a core group of officials from the China Liaison Office and the Hong Kong and Macau Affairs Office from Beijing. This is akin to the governance structure of a mainland province, where the provincial government is checked and controlled by a party secretary sent from the central government. Tsao argued that Hong Kong never had autonomy under British colonial rule, and therefore its status should not be any different after the handover. According to Tsao, there were certain matters that Hong Kong could not handle on its own, hence the need for intervention from the Central People's Government.

In short, Hong Kong should still be governed like a colony, just under different masters. After this document came to light, there was an outcry in Hong Kong's political circles. The Liaison Office quickly dismissed it as pure academic postulation by a researcher. Most Hong Kong people did not notice or dismissed it as typical communist rhetoric. But 12 years later, Tsao's model of governance for Hong Kong became a reality. The directors of the China Liaison Office and the Hong Kong and Macau Affairs Office now openly instruct the chief executive and [newly elected Legislative Council \(LegCo\) members](#) on what to do and focus on.

In 2012, as a gesture to signal pro-democrats' pragmatism and good-faith negotiation, the Democratic Party in Hong Kong—over the objections of many pro-democracy Hong Kongers—[accepted a compromise constitutional reform package](#) proposed by the Chinese government. Despite expectations that this would mellow Beijing's attitude toward the Democratic Party, no such change occurred; within six months, the Chinese Liaison Office in Hong Kong was back to smearing the Democrats as “[running dogs](#)” of foreign powers. This led to a loss of credibility on the part of the Democratic Party and created deep internal splits within the pro-democracy camp. The concessions gained by pro-democrats were very limited, with the price paid by the Democratic Party far exceeding any political benefit. This, in our view, was a deliberate ploy on the part of Beijing to divide the democratic camp.

Looking back, in the many so-called dialogues with Beijing over universal suffrage or other key issues under “one country, two systems,” where key Democrats were invited to attend meetings in Shanghai and Shenzhen, the Hong Kong people were naive to believe that real progress would emerge. The Central People's Government had no genuine desire to find real solutions and move forward with options that would be acceptable to the majority of the Hong Kong people. Through Beijing's many actions to divide and rule the Hong Kong polity, it successfully sowed seeds of division amongst the pro-democrats by dividing the camp into “moderates” and “localists.” Traditional Democrats were [criticized](#) heavily by localist groups as ineffective sell-outs. Such divisions were natural after the 2014 Occupy Central movement, when peaceful protests failed to achieve democratic reform. This [division](#) was then exploited by the pro-Beijing camp in Hong Kong to gain serious ground in local elections. Moderate Democrats suffered a significant loss of credibility through this division, playing straight into the hands of Beijing.

Over the years, there were opportunities for Beijing to mend its relationship with the Hong Kong people, but they were seldom taken, especially not under Xi's leadership. Following the divisive years under C.Y. Leung's term as Hong Kong's chief executive, the Hong Kong people were looking for a leader who could bring about a more harmonious approach to governing. The pragmatic John Tsang, the former financial secretary of Hong Kong and a pro-establishment figure, was a compromise. Tsang



was known for his more liberal and hands-off approach toward governance, and he remains a trusted figure in the financial and business community. In 2016, polls showed over 50% of the Hong Kong population supported Tsang. Moderate Democrats deliberately did not file their own candidate so that they could use their votes in the Election Committee for the chief executive to nominate and support Tsang. That decision was a strategic gesture to show goodwill and a desire to heal the wounds of society after several turbulent years under the disastrous leadership of C.Y. Leung.

But instead of taking this opportunity to heal the divide, Beijing insisted on choosing Carrie Lam, a candidate known for her bureaucratic and arrogant attitude in governance, as the next chief executive for Hong Kong. Beijing's decision indirectly led to the anti-extradition protests that emerged when Lam pushed for a piece of deeply unpopular extradition legislation opposed by a majority of Hong Kong people. Had Beijing listened to the voice of the Hong Kong people and chosen a less controversial leader, history would have been quite different. But Beijing made a conscious choice not to do so.

### 3.4 What Happened in 2019 in Hong Kong?

Many asked whether Lam was behind the 2019 extradition bill or if it was a demand from Beijing. We can ascertain the answer to this question based on conversations between one of the authors and his colleagues within the LegCo and political circles around March 2019, when the bill was first raised. He was informed that when the business and pro-establishment leaders were attending the annual National People's Congress in March 2019, they visited all the relevant departments in Beijing, enquiring whether it was Beijing's decision to push forward with the extradition bill. These departments included the Hong Kong and Macao Affairs Office, the Liaison Office in Beijing, the National Security Commission, and the Ministry of Public Security. At the time, no one in Beijing had any idea about the extradition bill. Lam decided unilaterally to push ahead with the bill because she felt that Beijing wanted it, and she could win brownie points for her re-election campaign. Domestically, she felt she could dominate the political scene by riding on the back of recent by-election victories by the pro-establishment camp.

After strong opposition from both the local and international community in [May](#), Beijing decided to double-down, backing Lam to push full speed ahead with the bill. With Beijing and Xi's personal backing, Lam soldiered on with the extradition bill until the first week of June 2019. Then, on June 9, 2019, the protests began, with one million people marching against the bill's passage. The turnout shocked everyone, including those within the democratic camp. The images of the march caught the world's attention. However, two hours after the peaceful march, Lam issued a [statement](#) saying that they would carry on with the passage of the bill three days later. This further inflamed the Hong Kong people and brought about [massive clashes](#) outside the LegCo on June 12. The pro-Beijing members of LegCo hid in a secret location, afraid of entering the legislative chamber, which was surrounded by riot police and protestors.

On June 15, democratic legislators [met privately](#) with Lam in the government headquarters in a last-ditch effort to persuade the government to withdraw the extradition bill. During the closed-door meeting, Democratic Party leader Wu Chi Wai and others pleaded with Lam to listen to the voices of the people. Wu said the situation was still salvageable if the government was willing to take one step back and save Hong Kong from the brink of disaster. In response, Lam defiantly insisted she did nothing wrong, condemning the rioters and refusing to withdraw the bill. On June 16, two million [people came out](#) to protest. Their main [demands](#) were full withdrawal of the bill, a judge-led inquiry into the events on June 12, and a resumption of democratic reforms. Lam rejected all these demands. Wu and others are now in jail, facing the charge of subversion under the National Security Law imposed by Beijing one year after the protests began. The Chinese State media painted the narrative of foreign forces

instigating the protests and riots in Hong Kong, when it was a genuine Hong Kong people's movement to protect their freedom.

These episodes highlighted that at every juncture, Beijing was more concerned with asserting its authority than good governance in Hong Kong. Did Beijing ever intend to truly implement “one country, two systems” as originally promised to the Hong Kong people? It is hard to answer this question without firsthand knowledge of the internal discussions amongst successive generations of Chinese leaders. But having closely observed the events of Hong Kong over the past 25 years, we argue that in the first five years after the transfer of sovereignty, the CCP was at least unsure what to make of Hong Kong. The city was too sophisticated and developed, and the CCP also needed Hong Kong as a financial center to draw in foreign capital, as Shanghai and Shenzhen were not yet developed. Additionally, the CCP must have felt at that time that it needed to honor the Sino-British Joint Declaration to earn “most favored nation” trading status (made permanent in 2001) and gain entry into the World Trade Organization (to which it acceded in the same year).

After achieving these international goals, and with the success of the 2008 Beijing Olympics and the emergence of a much stronger Chinese economy, we argue that from that point on, the CCP began to fundamentally shift its calculations and policies toward Hong Kong. Under this new model, the CCP's commitments under the Sino-British Joint Declaration became more and more of an inconvenience. This is evident from Xi's words in 2008 as well as the secret plans drawn up within the Liaison Office. It is clear that the events of 2020 (i.e., implementing the National Security Law, changing the election system, and taking over Hong Kong's governance) were planned at least 12 years ago.

The events in Hong Kong in 2019 helped deliver a landslide victory for President Tsai, who, only a year ago, was suffering from low popularity after the disastrous [2018 local election](#) results for the Democratic Progressive Party (DPP). Tsai's opponent at the time, the KMT's Han Kuo-yu, made a fatal mistake when he visited the China Liaison Office whilst in Hong Kong, shortly before the anti-extradition protests. Han completely failed to address the Hong Kong issue. The election slogan of the DPP was “Hong Kong Today, Taiwan Tomorrow,” a dire warning to Taiwanese voters if they voted for the KMT. Some Hong Kong protestors even traveled to Taiwan to campaign for the DPP and Tsai.

### 3.5 Hong Kong and Transitions in Taiwanese Attitudes

If these sobering events have a silver lining, it is in how they have caused many people in Taiwan to look to Hong Kong's example and realize that the “one country, two systems” model is wholly unacceptable to anyone invested in Taiwan's continued freedom.

President Tsai Ing-wen, a DPP stalwart who [rejects](#) the 1992 Consensus, was [reelected by nearly 20 points in 2019](#). Some [84% of Taiwanese people](#) now support the DPP's official position that PRC-Taiwan relations should be conducted without political preconditions; [92% feel strongly](#) that the future of Taiwan should be decided by Taiwan's people. We should recognize these supermajorities for what they are: a clear repudiation of both the 1992 Consensus and the “one country, two systems” model.

Yet holdouts in Taiwan continue. Although recent events have forced even the most conservative camp in the KMT to stop toying with the idea of reunification under “one country, two systems,” the KMT has remained in a holding pattern rather than stating a clear position on cross-Straits issues. Where the DPP has unambiguously rejected both “one country, two systems” and Chinese preconditions for cross-Straits exchange, the KMT remains reluctant to let go of their past positions. When President Xi recently wrote a letter congratulating current KMT chairman Eric Chu on his election, Chu wrote back that he hoped China and Taiwan could continue to “[求同尊異](#),” that is to agree to disagree, on the issue of “which China.” Many in mainstream Hong Kong society held this same attitude. It ultimately failed the Hong Kong people when they belatedly realized that the concept of “mutual respect between unequal parties” does not exist for the CCP.



Again, Hong Kong's past contains lessons for Taiwan's future. The KMT now finds itself in a remarkably similar position to the one faced by Hong Kong moderate Democrats several years ago, who indeed suffered deep political costs for their insistence on holding to "one country, two systems," even as younger, more radical localists argued that the principle was failing. And it was. But the moderates in Hong Kong were unable to admit that and call for a more radical stance. This is partly due to historic reasons. The moderates within the democratic camp embraced the transfer of sovereignty back to the mainland due to their faith in the idea of "民主回歸," that is reunification with the motherland on the basis of democracy. Many clung to this idea without having the courage to admit they were wrong in their assessment; some from the 1989 Tiananmen generation were still hoping that Hong Kong would become the beacon of democracy for mainland China. The moderates were also largely restrained by the many Hong Kongers who wanted the status quo under the Basic Law framework to work. However, they were continually confronted with political reality. Like moderate Democrats in Hong Kong, KMT leadership now seems to be stuck in the past, not knowing how to move forward with the situation without betraying their political roots.

Even as some within the KMT try to cling to the fantasy that the 1992 Consensus and reunification under "one country, two systems" remain relevant, we can observe Tsai Ing-wen's DPP beginning to chart a new path. In a recent statement, President Tsai told the Taiwanese people that the Republic of China and the People's Republic of China are not subordinate to each other—a new political commitment that rather provocatively recognizes the existence of both Taiwan and the mainland as separate political entities.

This is, of course, a far cry from a hasty declaration of independence or anything close to it. But we can see in Tsai's statement a dedication to deciding the future of Taiwan in accordance with the will of the Taiwanese people, in many ways a position quite close to the one held broadly by the pro-democracy camp in Hong Kong prior to the passage of the National Security Law.

### 3.6 The Democracy Factor

The British colonial government and the U.K. Foreign Office deliberately pushed back on introducing democracy to Hong Kong until the 1990s, when then-Governor Chris Patten tried to reverse this policy—albeit too late. Thus, the democratic traditions in Hong Kong were short-lived and never had time to take root in society. Elections at the highest level remained within a small circle of elites, and the legislature was rigged with an arcane system of functional constituencies, which made it easy for Beijing to control most of the seats in the Hong Kong LegCo.

Now, under the new electoral system introduced in 2021, Beijing has complete control over every level of government in Hong Kong. Through the weaponization of the legislative oath system by way of a tendentious interpretation of Article 104 of the Basic Law, all public officeholders in Hong Kong, from civil servants to politicians and judges, are potentially removable on a summary basis if any of them are deemed to be "unpatriotic," with patriotism defined strictly by Beijing. Once removed, the officeholder is liable to repay millions in salary and risk losing their pension. All these changes were made possible because Hong Kong never had a fully democratic system that would allow the people to push back against their government. When millions took to the streets to ask the government to withdraw the extradition bill, it laid bare the democratic deficit in the system. Because the government only needed Beijing's support, it could simply ignore such overwhelming dissent.

The Hong Kong people effectively had no voice in the face of authoritarianism. When the Hong Kong people used the local council elections in November 2019 as a de facto referendum to express their collective will (district council elections in Hong Kong used to be the most democratic ones), the

Democrats won over 90% of the seats. Within 12 months, the government had weaponized the oath system, arrested many district councilors, and [overturned](#) the election results.

In Hong Kong, the establishment of democracy was a key component of the city's political conflict with its Chinese overlords. Had the British installed fully democratic institutions in Hong Kong before the handover, the events of 2019 and 2020 would likely have turned out very differently. Internal British Foreign Office documents reveal that successive Whitehall officials and governors conscientiously [pushed back on introducing democracy to Hong Kong](#) for fear of angering the Chinese government. The respectable efforts made by the last governor of Hong Kong, Chris Patten, were too little too late. All of the modest gains such reforms achieved shortly before the handover were quickly reversed after 1997. Beijing was able to reverse them with little protest from the Hong Kong people because those reforms had not taken root in Hong Kong society. The seeds were sowed but never had the time and space to grow.

Due to a lack of functional democratic institutions, civil and political society in Hong Kong were unable to respond to China's effective campaign to split the city's society in two. Without democracy to help develop a democratic consensus, two decades of Chinese leverage and infiltration allowed Beijing to make short work of what could have been a more united front in Hong Kong, sowing division by splitting people into blue (pro-government) and yellow (pro-democracy) camps and inundating society with [disinformation](#). The Democrats within the LegCo became a [permanent minority](#) despite receiving the [majority](#) of the popular vote at every LegCo election since 1997. Their ability to oppose legislation or propose private members' bills was also hampered from the beginning by the internal restrictions of the Basic Law. The Democrats in Hong Kong never had a chance to grow into a serious governing force. Funding for political parties in the democratic camp was always a problem, as corporate donors were afraid to anger Beijing. This in turn led to a permanent sense of disappointment and disempowerment amongst the democratic camp's many supporters.

At the same time, the open nature of Hong Kong's society was being systematically exploited by decades' worth of CCP United Front tactics. Before the handover, Beijing had already sought to influence Hong Kong societal opinions through various channels, including [state-owned media](#), such as *Tai Kung Pao* and *Wen Wei Po*, and various [pro-Beijing political parties and business tycoons](#). They only managed to have a limited effect on public opinion, as pro-Beijing media and political parties generally lacked credibility in the eyes of Hong Kongers. This began to change when mainstream media outlets were [bought out](#) by Beijing or its proxies. From established print media, both in English and Chinese, to TV stations and digital media, Beijing began to indirectly control a wide variety of media sources that grew to dominate news reporting in Hong Kong starting at least a decade ago. The [China Liaison Office](#) would often summon media owners and editors to talk about the direction of their media outlet and how it should better serve the narrative of the state. In the past year, [Apple Daily](#), [Cable TV News](#), China team, [Stand News](#), [Citizen News](#), and [Radio Television Hong Kong](#) were either shut down or completely changed from within.

In Taiwan, [there are open threats of hostility and signs of similar Beijing-directed attempts to destabilize local society](#), including threatening Taiwanese businesses who [place commercial advertising](#) on media platforms that are critical of the CCP. To respond to these threats, Taiwanese politicians must lean on the strength of their democratic system. Democratic debate and democratic institutions can help Taiwan move toward a consensus on how to deal with the existential PRC threat to the island, drawing on the fact that most Taiwanese do not want to see the end of a free Taiwan. One key difference between Taiwan and Hong Kong's systems is that Hong Kong's people were never allowed to elect their leader; as a result, the majority view was hijacked by the top political elites.

However, the danger of polarization in partisan politics, which plagued Hong Kong, remains a clear concern. In the face of United Front infiltration tactics from Beijing, the DPP and KMT are far from building the much-needed consensus that will help safeguard the survival of the island and its people's way of life. The political infighting reminds one of similar infighting within Hong Kong's political scene. As the KMT's position on reunification becomes more and more untenable, it has turned its focus by constantly attacking the DPP for its mismanagement of the economy, the party's unpopular energy policies (and the resultant power shortages), and COVID-19 mishandling. In a recent set of referendums on a host of domestic issues some sponsored or supported by the KMT, all were defeated. This is ostensibly [another blow to the KMT](#) and a clear mandate for the DPP.

Nevertheless, further analysis of the referendum results shows that the "for" and the "against" sides remain equally divided. It appears that the KMT will be further marginalized by the voters in national elections when it cannot come up with a coherent and convincing position on China. But like the pro-Beijing parties in Hong Kong, who were deeply unpopular amongst the Hong Kong people (as shown in the last democratic election in November 2019, where the Democrats won 90% of the local council seats), the KMT continue to be heavily funded and supported through connections with business elites, who have substantial interests in the mainland, as well as directly by the China Liaison Office.

For example, at a fundraiser organized by a pro-Beijing party in Hong Kong, [the calligraphy of Zhang Xiaoming](#) (then director of the China Liaison Office in Hong Kong) was auctioned and bought by a businessman for HK\$18 million. Similar, though less blatant, support is also given to the KMT. But as the KMT becomes more electorally irrelevant and disconnected from ordinary Taiwanese, the middle ground in Taiwanese politics will erode, leading to further polarization. We saw similar polarization in Hong Kong's political scene after the Occupy Central Movement. With the mainstream Democrats' credibility questioned and their ability to lead the movement damaged, the infighting with localists over the direction of the democratic movement became more severe, leading to splits within the camp. This played right into the hands of Beijing, which is highly skilled in exploiting such internal conflicts.

## 4. How Hong Kong Has Changed Geopolitical Dynamics and the Attitudes of Liberal Democracies

The trends in Hong Kong can also inform our understanding of likely outcomes in Taiwan in the arena of geopolitics. For many years after the handover, Hong Kong began to fade out from the international arena. The rise of the mainland economy and developments in places like Shanghai and Shenzhen often caught the attention of the international community much more so than Hong Kong. So, Hong Kong became part of the backdrop against the larger China story. No one expected the 2019 events that unfolded in Hong Kong to capture the world's attention and ultimately change the conversation on China.

One of the key turning points in the anti-extradition bill protests came when the European Union issued a [diplomatic demarche](#) against the Hong Kong government in May 2019, warning of the consequences of pushing forward with the extradition bill. It is rare for the European Union to speak with one voice, and much less so on an issue such as Hong Kong. The images of millions of Hong Kong people marching down the streets of Wanchai and Admiralty shook the world, forcing its way to the forefront of international media. Around the world, people began to ask: what was Beijing doing?

Events in Hong Kong, along with the crackdown on the Uyghurs and the COVID-19 outbreak, have consolidated a bipartisan consensus in the United States (and to a lesser extent in other Western capitals) about the threat posed by the Chinese Communist Party. The upshot of this has been [increased U.S. military activity in the region](#) and a historic deterioration of the relationship between the United States and China.

Whereas in the United Kingdom, the historic legacy of Britain's colonial empire drove the response to the situation in Hong Kong, the story was different in the United States and Europe. Both authors have spoken with congressional aides and foreign policy experts across the U.S. Congress and Brussels, and they've underlined that Hong Kong was considered particularly salient precisely because of the precedent the crackdown could potentially set for Taiwan. There is an acute awareness of the strategic importance of Taiwan—symbolically, as one of the leading democracies in the region; geopolitically, as a bulwark against Chinese dominance in the region, especially from Japan and Australia's perspectives; and economically, as the home of the world's foremost semiconductor manufacturing firm. The policy levers used in response to events in Hong Kong, and those reserved for future scenarios, were informed by wider strategic priorities, with Taiwan being foremost in mind.

Ultimately, many of the more powerful levers that the United States could have used to respond to the crackdown in Hong Kong were left untouched. When the United States revoked Hong Kong's special status [as "autonomous" from Beijing, it was a watershed](#), but it was not the financial or economic "nuclear option" that some analysts described. The Hong Kong Policy Act did not provide an on-off switch deeming Hong Kong "autonomous" or identical to China; instead, declaring Hong Kong no longer autonomous gave Secretary of State Mike Pompeo discretion to decide which of Hong Kong's privileges to revoke and which were still strategically valuable. Then came the passage of the Hong Kong Human Rights and Democracy Act, which gave the U.S. State Department power to impose sanctions on individual officials responsible for human rights violations. However, the city is still treated distinctively differently from the rest of China in myriad ways—consider its [continuing seat at the WTO](#) or the [separate status](#) in global stock indices of Hong Kong stocks. The United States government has not yet used the full powers laid out in the Hong Kong Autonomy Act. Beijing may well calculate that their gamble in the city paid off handsomely.

Events in Hong Kong did provide State Department and Treasury officials the time to assess the full breadth of potential options should an even greater crisis occur. In the heat of the crisis, United States policymakers started to consider their varied areas of leverage in Hong Kong and comparative advantages in spheres ranging from technology to finance. It is worth remembering that the United States could essentially make China a global financial pariah by using American power over access to [dollar clearing through the Swift system](#). According to 2020 Swift data, 40% of global transactions are denominated in dollars and cleared through American banks, giving the United States legal jurisdiction. [In the words of The Economist](#), "America is uniquely well-positioned to use financial warfare in the service of foreign policy." [A report from MERICS rightly points out](#) that the United States does not have total control over dollar access, as it is the world's reserve currency. Despite this, real financial decoupling would cause Beijing considerable pain. The debates about Hong Kong forced United States policymakers to begin to consider the full meaning of what [financial decoupling might look like](#) while also consolidating the bipartisan consensus on China, which significantly increases the likelihood that they use these levers in the case of confrontation in Taiwan.

If Hong Kong started the conversation about the potential use of a broad range of sanctions and isolating authoritarian states from Swift, Vladimir Putin's invasion of Ukraine brought home how likely it is that this sort of leverage would be used in the context of a Taiwan invasion. [The sanctions imposed by the United States and European allies on Russia](#), including bans on energy imports, the use of Swift dollar clearing, and sanctions on financial institutions and the wealth of powerful individuals, have shown the willingness of Western countries to take serious economic countermeasures in times of serious geopolitical strife.

Given that Taiwan holds an ever-greater strategic significance than Ukraine in the minds of American leaders, it is reasonable to assume that the United States would use all of the economic and financial

weapons in its arsenal in the event of military confrontation over the Taiwan Strait. The Taiwan Strait and the surrounding region would effectively enter lockdown, with massive decoupling from trade and disruption of economic systems, from supply chains to finance. Mainland-style capital restrictions would be applied to Hong Kong. International travel to and from the region would come to a halt.

Are foreign offices around the world forecasting these potential risks? They should be, because the implications for Western economies would be greater than the imposition of sanctions on Russia. Still, it is striking how little attention is paid to Taiwan in Europe. “A faraway country about which we know little” is the attitude from London to Berlin. But the risks of this being the next source of major geopolitical confrontation are high, and the implications of how Hong Kong shifted U.S. attitudes toward China deserves much greater attention in the international community.

## 5. What Hong Kong Shows about the Rise of Red Capital and Growing Risks for Business

Red capital and economic coercion lie at the heart of China’s influence strategies and United Front work in both Hong Kong and Taiwan. Red capital is shorthand for the investments of state-owned enterprises and private Chinese firms. China’s hybrid state capitalist system creates a unique set of incentive structures for these firms, requiring them to leverage relationships with political elites in Beijing in order to succeed and be profitable. This in turn makes them useful political agents in contexts like Hong Kong and Taiwan. The rise of red capital in Hong Kong has two key implications, which we will consider in turn. First, it shifted the political dynamics in the city: structural economic change and the rise of red capital was the precursor to the political purge. Taiwanese policymakers must learn from this. Moreover, it weakened the hand of international and local business elites, making them more vulnerable to a geopolitical shock.

### 5.1 The Implications of the Rise of Red Capital for Domestic Power Dynamics

The post-handover social contract in Hong Kong involved a partnership between the city’s business elites and property tycoons with the government in Beijing. The coalition that held together the “blue” camp, which supported the government, in Hong Kong politics drew together Beijing’s interests and those of the business sector. Together, they governed Hong Kong, often at the expense of the pro-democracy movement.

But events in 2003, when the business sector sided with the pro-democracy movement to veto the passage of [Article 23 national security legislation](#), led Beijing to change its calculation and begin a steady process of changing the economic power dynamics in Hong Kong. The Closer Economic Partnership Agreement (CEPA) was signed in 2003 and [paved the way](#) for the economic integration of Hong Kong into the mainland economy. Between 2003 and 2013, Hong Kong’s trading volume with China tripled, and there was a disproportionate increase of both inward and outward investment from China vis-à-vis other jurisdictions.

Subsequently, the constituent make-up of Hong Kong’s economy dramatically changed; today, mainland firms dominate the Hong Kong stock exchange. [At the start of 2020](#), 60% of the companies listed in Hong Kong were mainland companies and red capital accounted for 82% of the IPOs in Hong Kong. In recent years, the Hong Kong government has consistently worked with the mainland government to ensure that there are incentives for mainland firms and firms with significant red capital stakes to invest in Hong Kong’s strategic industries. To do this, they have both [amended regulations](#) to make them more favorable to firms with major red capital stakes as well as offered major subsidies to mainland firms and developed policy that favors mainland companies. Additionally, they’ve spent significant

amounts on a range of “[white elephant](#)” projects, which primarily serve the interests of red capital rather than local Hong Kongers.

Bending rules to accommodate red capital is common in Hong Kong’s financial sector. From [rule changes](#) to the Hang Seng Index to ensure the incorporation of Chinese internet giants like Alibaba, Xiaomi, and Meituan Dianping, to Citic Group entering the Hong Kong Stock Exchange through a “[backdoor listing](#)” via Citic Pacific in 2014, Hong Kong’s financial rules are increasingly bent to give discretion to red capital. Perhaps the most notable example of this was in the [case study](#) of the Belt and Road Initiative as well as the Greater Bay Area. The city’s position as a key hub in both schemes has resulted in regulations being glossed over or ignored. The report finds that “In recent years, the Hong Kong Government has consistently worked with the mainland Government to ensure that there are incentives for mainland firms, and firms with significant red capital stakes, to invest in Hong Kong’s strategic industries. To do this, they have both amended regulations to make them more favourable to firms with major red capital stakes, as well as offering major subsidies to mainland firms and developing policy which favours mainland companies. Significant funds have been spent on a range of ‘white elephant’ [infrastructure] projects which primarily serve the interests of red capital rather than local Hong Kongers.”

Corruption and graft have a long history in Hong Kong, preceding the large influx of mainland money into the city. Since 1997, one chief executive and one chief secretary have been imprisoned, and this [doubtless only scratches the surface](#). Further, the process by which government officials hand out contracts has always been opaque. What has changed in recent years is the increased privileging of red capital. From rule-bending in the auditing industry to cronyism and controversial contracts being consistently handed to mainland firms at uncompetitive prices, Hong Kong Watch’s 2021 report on the rise of red capital in Hong Kong underlines the myriad ways that the Hong Kong government favored red capital.

Why is this important? [Heidi Wang-Kaeding and Malte Kaeding](#) (2019) note that red capitalists are mobilized as a part of broader United Front strategies, with one distinguishing feature of red capital being the “synergy between economic measures and political will . . .” And they are correct. The transformation of Hong Kong’s economy to the point that mainland capital is in the ascendancy has tipped the political balance in favor of the government, and Xi Jinping’s regime is consciously choosing to ensure that these businesses are agreeable enforcers of the government’s political will.

Businesses have been politicized in recent years and United Front Work Department activity has spiked. Talking to one of this paper’s authors, one senior economist at a state-run bank described the changing approach. His insider’s view of the changing behavior of one of China’s SOEs in the Special Administrative Region brought with it a simple insight: “everything changed with the rise of Xi Jinping.”

Chairman Xi came to power in the wake of the 2008 recession, when Western economies were pummeled, and China remained resurgent. This economist, Mr. Wong (not his real name to avoid reprisal), described the way that employment practices changed over time: “They sent their people to sit in top positions. Top management started changing more and more rapidly.” Firms with significant red capital stakes are opting to recruit mainlanders who are prominent Communist Party members to be board members. Sun Hung Kai Properties, MTR Corporation, HK Electric, TVB, and PCCW [have all in recent years](#) hired mainlanders onto their board of directors. In the case of the Hong Kong media-based company TVB, the company recently appointed Chinese media mogul [Li Ruigang](#) as its vice chairman, citing the need to improve their business. Dubbed the “Rupert Murdoch of China,” Li previously headed the office of the Shanghai Municipal Party Committee.

But it is not only in top management positions that companies have begun to prioritize recruiting mainlanders. Increasingly, Chinese companies based in Hong Kong have introduced advanced



screening processes when it comes to recruitment, which are designed to favor hiring mainlanders over their local counterparts.

There is a political element to these changing recruitment practices, too. The state increasingly requires the loyalty of “red firms.” In the 2016 LegCo election, the Bank of China and China Resources Land Limited [instructed](#) employees to vote for candidates that “love China and love HK.” Additionally, the Hong Kong Chinese Enterprises Association distributed voting instructions to its 1,000-member companies. Pro-Beijing hardliners like Junius Ho and C.Y. Leung were direct beneficiaries of this process. Such practices have been ongoing for many years but have become much more blatant since 2012.

During the Umbrella Movement and anti-extradition protests, Beijing’s central government mobilized red capital to oppose protestors. In August 2019, [Apple Daily reported](#) that the Bank of China, the Industrial and Commercial Bank of China, China Construction Bank, and the Agricultural Bank of China took a register of attendance and refused to grant staff leave during the city-wide strike over the extradition bill. In the same month, Haitong International reminded its staff that they were banned from any unapproved political activities during office hours other than those listed in the employee handbook.

Since the Chinese Communist Party announced its intention to enforce national security legislation on Hong Kong, employees at red firms have increasingly found themselves under pressure to support the new law. At many companies, including the [Bank of Communications](#), ICBC International, Haitong International, Guotai Junan Securities, and SPDB International, many Hong Kong staff members were encouraged to sign a petition. [In the case of China Mobile](#), the company’s staff committee simply endorsed the law on behalf of all employees in Hong Kong. Managers at Chiyu Banking Corporation, a local bank owned by Xiamen International Bank, sent a WhatsApp message to employees asking them to sign a petition, according to a complaint filed by the Hong Kong Financial Industry Employees General Union. Once employees had done so, the complaint said, they were told to screenshot their signature and share it. Similar instructions were sent to employees at Wing Lung Bank, according to the union.

Again, Hong Kong is the canary in the coalmine, demonstrating how Beijing uses economic coercion and co-opts red capital to further its political goals. Beijing is seeking to adopt a similar strategy in Taiwan, and it is vital that politicians in Taiwan stem the tide before it is too late.

As Wang-Kaeding and Kaeding note, red capital is used for united front purposes, which can be observed domestically, across the Belt and Road, as well as in sensitive contexts, such as Taiwan, Hong Kong, or, in the case of technology firms, Huawei. For instance, in Taiwan, Wang-Kaeding and Kaeding state, “Through economic integration, the Chinese authorities cultivate local agents [Taiwanese business and political elites], purchase Taiwanese media to manufacture public opinion, and create cross-strait interest groups to influence legislation and policy implementation.”

In Taiwan, Beijing has sought to mirror the major influx of red capital that began with CEPA in Hong Kong through two agreements: the [Economic Cooperation Framework Agreement \(ECFA\)](#), which was signed in 2010, and the Cross-Strait Service Trade Agreement ([CSSTA](#)), which caused considerable controversy after it was signed in 2013 and has since lapsed following major protests. A further parallel between Hong Kong and Taiwan is that too much mainland capital and investment actually drove more resentment from ordinary people. In both Hong Kong and Taiwan, [mainland capital](#) led to a rise in real estate prices and the transformation of their local communities, creating the [localist](#) movement against the PRC.

Both agreements were designed, like CEPA, to further integrate the economies of the two territories. ECFA opened portions of Taiwan’s economy to Chinese investment, which would have been expanded by the CSSTA if it had passed. By forging ever-closer ties with the mainland economy, the

CCP was offering Taiwan a share of the “Chinese Dream” touted by Xi. Similar to Hong Kong, further integration with the mainland economy has produced [localism and resentment](#) amongst the residents in Taiwan. With the rise in property prices; change in grassroots communities, such as shops catering only to mainlanders; and over-capacity hospitals, Hong Kongers soon began to have serious doubts about the benefits of CEPA.

As in Hong Kong, businesses play a central role in Beijing’s United Front strategies in Taiwan. Businesses that have serious exposure across the Strait are particularly vulnerable to co-option. This is seen in a range of areas, most notably the media. In Hong Kong, much of the pro-democracy media has already been bought out.

Critics of the CSSTA pointed to the various pitfalls within CEPA to argue against it, including outsourcing jobs to the detriment of small businesses, the widening poverty gap in Hong Kong, and Beijing’s strengthened hand in the city’s politics. In the words of the former deputy defense minister of Taiwan, Lin Chong-pin, Beijing had come to realize that it would be [“cheaper to buy Taiwan than to attack Taiwan.”](#)

The Sunflower Movement of 2014 demonstrated that the Taiwanese are aware of the Hong Kong case study. [Activists occupied the Legislative Yuan](#) in the spring of 2014 to protest the Kuomintang’s failure to allow proper legislative scrutiny of the CSSTA. [Activists, scholars, and the opposition](#) were worried that the bill would strengthen the influence of red capital on Taiwan’s economy to the detriment of both national security and Taiwanese small and medium-sized businesses. [Polls showed](#) that the vast majority of the Taiwanese public agreed that the country should withdraw from the CSSTA.

[Polling by the Taiwan Indicators Survey Research](#) showed that the two leading reasons for opposition to the deal were “worry about how the deal would affect their jobs or businesses” and “worry that Taiwan would become the same as Hong Kong.” More than half were also concerned about how the deal would damage Taiwan’s democracy. With the media already dominated by mainland capital, there were considerable concerns about the potential implications of greater mainland Chinese dominance in areas of the economy.

The success of the Sunflower Movement in drawing Ma to pull out of the CSSTA, and the repudiation of his leadership in the [2016 election](#), demonstrates that the Taiwanese are aware of many of the risks associated with Hong Kong. However, [unhealthy](#) dependencies [continue](#) to exist. Much of the mainstream media is owned by red capital—or at least by capital sympathetic to Beijing. Mainland China is Taiwan’s greatest trading partner and its most important export market. In 2020, [China received 44% of Taiwan’s exports](#). While in some areas, particularly electrical machinery and semiconductors, Taiwan’s exports reflect China’s [“supplier dependency”](#) on Taiwan, these deep ties mean they remain vulnerable to the type of pressure that we have seen exerted through red capital in Hong Kong and the co-option of Hong Kong businesses that are reliant on access to the mainland.

Taiwanese policymakers must focus on strengthening their resilience to the influence of red capital and China-dependent local capital. Otherwise, they risk facing similar pressures to those exerted in Hong Kong as a result of the influence of red capital. DPP attempts to [diversify trade relations](#) are important and must remain a priority. Like-minded liberal democratic governments should consider ways that they can cooperate with Taiwan in order to reduce Taiwanese dependence on their mainland economic ties. One potential opportunity could be the [inclusion of Taiwan](#) in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

## 5.2 Caught in the Crossfire: International Businesses and the Dangers of Geopolitics

China’s growing economic power and the strength of red capital has another key implication. Western and local businesses in Hong Kong are increasingly as dependent on the Communist Party for their



access to mainland markets as their red capital contemporaries. As a result, they appear to have little resilience to geopolitical shocks or political sway.

It has not always been this way. In Hong Kong, the business elites were once key power brokers whom Beijing relied on for political control. In 2003, [James Tien](#), whose Liberal Party had the backing of the local Hong Kong tycoons, refused the unpopular national security legislation. The business sector and the democratic movement formed a temporary alliance to defeat a draconian piece of legislation that countered the interests of both groups.

The National Security Law debates in 2020 showed how fast things had changed. Tien's key backers, the nine richest Hong Kong real-estate tycoons, with a combined net worth of US\$140 billion, [endorsed](#) the National Security Law in June. Leading players involved with [Standard Chartered Bank](#), [Swire Pacific](#), [Galaxy Entertainment Group](#), [HSBC](#), and [Jardine Matheson Holdings](#) issued similar endorsements. These endorsements came despite the 2020 law being significantly more draconian than its 2003 equivalent.

While some of Hong Kong's business elites may have endorsed the legislation out of genuine aversion to the instability caused by the protests and others had been boxed in by the increasingly polarized political debate in the city, the majority had not had a sudden Damascene conversion to Chinese state capitalism. They knew full well that the erosion of "one country, two systems" cut against their direct interests. During the protests of 2019, there was a brief window of opportunity, when many of the city's elites publicly hinted at their ongoing commitment to Hong Kong's autonomy and the pre-National Security Law status quo. International [chambers of commerce](#) repeatedly underlined the importance of the rule of law and fundamental freedoms for business in the city. Li Ka-shing was [vilified](#) for his enigmatic positioning toward the protests by the Chinese state media.

Consider HSBC. The British bank was forced into the uncomfortable position of being one of the Chinese Communist Party's most reliable enforcers in the wake of the passage of the National Security Law. Taking [two-thirds of its profits in Hong Kong](#), it could ill afford to anger Beijing. The bank's head in the city endorsed the National Security Law. They [froze the assets](#) of pro-democracy funds, a church leader, and exiled legislator Ted Hui (as well as his family). While the "world's local bank" might like to be a bridge between East and West, when push comes to shove, the future of the Hong Kong and Shanghai Banking Corporation looks red.

Once Beijing made the acceptance and endorsement of the National Security Law a red-line issue for businesses, the choice became endorsing the new norm or saying goodbye to Hong Kong. While there might have been some capital flight, the ultimatum carried force because most businesses domiciled in Hong Kong are either mainland firms or dependent on access to China.

For many international firms, there is no meaningful choice in the face of what Chris Patten, the last British governor of Hong Kong, has described as [China's "mafia-style" tactics](#). Beijing demands obedience and acquiescence; otherwise, it will isolate and punish individual businesses. The plight of Swire Group's Cathay Pacific exposes the risks of transgression. Following staff participation in protests in 2019, Beijing [threatened](#) to bar Cathay planes from Chinese airspace. Like many businesses based in Hong Kong, Cathay's business model relies on the goodwill of the Chinese government. The pressure was too much. The CEO of [Cathay](#) was forced to step down and the staff members were purged. HSBC and others who now endorse the National Security Law have simply taken preemptive precautions.

Of course, it is not only in Hong Kong that these types of considerations are increasingly relevant. Chinese neo-nationalism is increasingly putting international firms and companies in a precarious position. From [Sony China](#) being fined RMB 1 million for launching a product on a sensitive anniversary date to [Mayer Brown](#) being caught in a bind over whether to represent Hong Kong University in a contentious legal case, and from [LinkedIn](#) facing eviction from China to PRC data laws making life

difficult for international firms to comply with rules in other jurisdictions, there are more and more areas where the globalization status quo is coming unbound and international firms are finding it hard to sit on the fence. China is now beginning to target Taiwanese companies that operate in the mainland and punish them for their support of DPP in Taiwan. For example, the Global Times (a hawkish PRC state media outlet), alleged that the [Far Eastern Group](#) donated US\$2 million to the DPP. This amounts to supporting secession and must be put down, the paper argued. More Taiwanese companies will no doubt come under pressure in the months and years ahead. The interesting point about Far Eastern Group is that it donates to both the KMT and the DPP and is not regarded as a “pan-green pro-DPP” business. As Taiwanese expert [Professor Shelley Rigger](#) pointed out in a recent seminar hosted by the SOAS China Institute, as long as a business entity has a presence in Taiwan, the PRC could weaponize it into a pressure point against the DPP.

This situation should provide a warning call to Western businesses and investors as well as those in Taiwan who are heavily reliant on access to the mainland. A geopolitical confrontation in Taiwan would see many of these firms caught in the crossfire. The economic repercussions would be many orders of magnitude greater than those stemming from the Hong Kong political crisis of 2019. Instant global decoupling would be the greatest shock to the world’s economy in living memory. The odds of Western investment being held hostage by China seems high. Supply chains would fall apart in an instant. Banks like HSBC could easily find themselves choosing whose sanctions to enforce, with a newfound appreciation for the old adage that you cannot serve two masters.

Hong Kong shows that Beijing has absolutely no qualms about holding Western investment or businesses hostage if it serves a geopolitical end. Whether you place the likelihood that cross-Straits relations unravel over the next 10 years at 20% or 90%, greater work needs to be done to ensure that these risks are properly factored in. The inability of multinational corporations to anticipate the situation in Hong Kong suggests that the geopolitical risks analysis of many of the leading firms is shaky at best. Governments have a duty to correct these mistaken perceptions.

## 6. Conclusion and Implications

We hope that Hong Kong’s experience can help those concerned with the direction of Chinese foreign policy both in Taiwan and abroad determine a clear path forward. Xi Jinping’s words should be taken seriously, as a guide to his intentions, by international policymakers, meaning that the dangers of escalation in Taiwan should not be underestimated. The domestic politics of the Communist Party should be studied in greater depth because decision making often responds to the priorities of the Chinese people and not the rational dictates of international realpolitik. The growing dominance of red capital and the strength of businesses that the Communist Party controls must be understood by political risk analysts, as it weakens the hands of Western businesses in China while strengthening the power of Beijing in Taiwan.

The shift in policy toward Hong Kong is also a sign that Beijing now feels confident enough to abandon its previous assumptions about how the world works. The policy toward Hong Kong held by previous generations of Chinese leaders has always adhered to a strategy of “[長期打算 充分利用](#),” i.e., plan long term, make full use of Hong Kong. This was what held the PLA back from marching into Hong Kong in the 1950s. Beijing knew it had to make use of Hong Kong in the long term; therefore, it had to display strategic patience. In many ways, Beijing’s recent actions are a significant departure from this principle of strategic patience and long-term planning. Xi Jinping (and many elites in China) feel that China is now strong enough to depart from this self-imposed restraint and that humility is not worthy for a nation as strong as present-day China. In their view, the China of 2020 is stronger and will not

be pushed around by foreign forces meddling in their territory—a repetition of the narrative heavily pushed by the state media over Hong Kong.

The same thinking lies behind the departure from the “hide your strength, bide your time” principle that guided China’s foreign policy since Deng. This strategic change is in part reflected in China’s new policy toward Hong Kong. The same thinking will be applied to the Taiwan issue. Unlike the handover of Hong Kong to the PRC in 1997, where most Hong Kong people accepted the new status quo, the Taiwanese people, especially younger citizens, feel very disconnected from the Chinese national identity. Most people in Taiwan feel more [Taiwanese](#) than Chinese. The concept of “reunification” with the mainland is not only [repugnant](#) to them but tantamount to an invasion by an alien force. This attitude has only been reinforced by the events in Hong Kong and the PLA’s aggressive military posturing in recent months.

In internal party speech, Xi has urged his CCP comrades to not shy away from struggles and conflicts, arguing that when it comes to important questions, they must not be afraid “to draw their swords” ([敢於亮劍](#)). Under Xi’s leadership, the CCP has certainly demonstrated this spirit in its policies toward crushing Hong Kong and [Xinjiang](#), the [militarization](#) of the South China Sea, the blatant [hostage diplomacy](#) over the Canadian Michaels, [wolf-warrior](#) diplomacy, and much more. We do not see room for any exception to this change over the Taiwan question—as Xi Jinping said, the CCP views it as central to the rejuvenation of the Chinese civilization. For China to remain a “divided nation” simply does not sit well with Xi’s narrative and vision.

In our view, nationalism and Xi’s political ambition are by far the most influential factors in the PRC’s policy over Taiwan. We believe other considerations, such as taking over the manufacturing capabilities of the Taiwan Semiconductor Manufacturing Company Limited (TSMC), are at best subsidiary and certainly not central to Beijing’s calculations. Even though TSMC accounts for over 50% of the global supply, the [manufacturing chain of high-end semiconductors](#) is far too complicated, with intellectual properties and other critical components and technology held by the West. The PRC will not be able to achieve its goal of being technologically self-dependent by simply taking over the manufacturing sites of TSMC in Taiwan. Beijing knows this well.

Beyond Taiwan, what does Beijing’s failure to adhere to an international treaty signal to the international community? When Beijing [applies to join](#) the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, can members trust that China will honor its terms? (Members would be better placed considering Taiwan as a possible member of the partnership.) The same goes for the [EU-China Comprehensive Agreement on Investment](#). And on climate change, the United States and China issued a [joint declaration](#) in Glasgow vowing to cut emissions. Does that mean China will scale back on its construction of coal power plants both at home and abroad? The Hong Kong experience offers important insights into these global questions.

The 1978 Joint Communiqué between the United States and the PRC [states that](#) “neither [*China nor the U.S.*] should seek hegemony in the Asia-Pacific region . . .” Forty-three years later, this is precisely how the two countries feel about each other’s intentions. The United States (and its allies in the region) sees China’s military expansion into the South China Sea, the aggressive takeover of Hong Kong, and threats against Taiwan and over the East China Sea as acts with hegemonic intention. On the other hand, Xi’s China sees the need to implement its own version of the Monroe Doctrine by pushing United States interests out of the Asia-Pacific region at a time of “[Western decline](#).” Chinese scholars believe that [China’s new status as a world power](#) cannot be reconciled with United States dominance. This has caused the United States and its allies, such as Japan and Australia, to see the importance of defending Taiwan from the perspectives of their own security interests.

That rising nationalism in the PRC overrides other pragmatic policy considerations when it comes to Taiwan is evident in the recent case of Beijing's sanctions on firms from Lithuania. Beijing [downgraded](#) diplomatic ties with Lithuania and suspended consular services there after the country permitted a Taiwanese Representative Office to open in November 2021. Beijing delisted Lithuania as a country of origin, meaning goods from the country cannot clear customs. And China is not just blocking all trade with Lithuania. It is also blocking all products containing components made in Lithuania, causing a huge headache for foreign investors in the country.

It is striking that Beijing is pursuing such an aggressive course of action, one which potentially puts the integrity of the EU single market in jeopardy. This approach points to the fact that Taiwan is a red-line issue of China's sovereignty, and nationalism is the overriding priority in their approach to issues surrounding the territory—at the expense of other priorities, including potentially the passage of the EU-China trade deal. Europe's response to these events will be an interesting litmus test as to whether European states will roll over when Beijing uses strategies of economic coercion for its geopolitical ends in the future.

If Lithuania is forced to back down by its EU counterparts, Beijing will take this as a sign of the bloc's weakness and factor that into future considerations on Taiwan. On the other hand, if the bloc uses this as an opportunity to demonstrate solidarity and economic strength, it would send an important signal. The weakness of the EU's response to economic and political coercion in Hong Kong suggests that strong coordinated counter-actions are currently unlikely. However, observers in Taiwan and the global community, whether they be KMT politicians or American climate negotiators or EU trade policy officials, should keep these Hong Kong lessons in mind. If the Hong Kong people's belief that Beijing would honor its obligations under an international treaty was never repaid, why believe that trying the same strategy again will see a different response?

Ultimately, we believe that whether the PRC would use military measures against Taiwan in the foreseeable future comes down to domestic political needs. Politically, Xi will most certainly be able to achieve his aim of securing a third term at the next Party Congress to be held in November 2022. He will use this interim period to consolidate power by putting Party members loyal to only him in all the provinces and military; he will also build a Central Committee and Politburo with pure loyalists. Xi [failed, in part, to achieve](#) this goal in the 19th Congress in 2017. The continuous [purge in the upper ranks](#) of the CCP elites is a sign that there are still [disloyal elements within](#). From now until the 20th Congress, there is no political need (and far too many risks) for Xi to do anything radical over Taiwan. In the meantime, in terms of foreign policy, Xi will try to lower the level of hostility with the United States on the surface without fundamentally changing any of his core objectives. President Biden's hopes for diplomatic and institutional guardrails on key issues like Taiwan are unrealistic.

Matters beyond November 2022 will be increasingly volatile and unpredictable with the 2024 presidential election in Taiwan approaching. The DPP is likely to capture another term of the presidency unless the KMT can fundamentally change its position on the China question, which is unlikely. If the DPP wins another four-year presidential term, the situation will continue to run away from Xi's "rejuvenation and reunification" agenda, creating a political state of affairs that may force him to take some form of action. Military measures by the PRC could take many forms, from flying military airplanes into Taiwan's air defense zone to a full-scale amphibious invasion; there are also many options and scenarios in between. Xi would most likely use the "in between" options to first test the resolve of the United States and its allies. These actions may include invading the Matsu Islands, deploying a physical blockade, and/or targeting the [undersea internet cables](#) that connect Taiwan with the rest of the world.

China now has the largest navy in the world, with 355 ships, and its [naval presence](#) is increasingly active in southern Japan and eastern Taiwan. Former CCP General Secretary Hu Yaobang [remarked](#) in

1985, “If we have the strength to enforce a blockade and if Taiwan vehemently opposes reunification, we shall have to consider enforcing a blockade.” The Taiwanese parliament recently passed a bill to increase its [defense budget by US\\$8.6 billion](#) for the next five years. Both Western and Chinese analysts are predicting that everything will “[come to a head](#)” by [2027](#) or sooner. 2027 is the milestone date Xi set for the PLA to ensure the achievement of the centennial military building goal.

Supporters of the Chinese regime often point to the “historic” fact that China will always be an expansionist power. Leaving aside the historical inaccuracy of that claim, Chinese leadership does not regard the reunification of Taiwan as foreign expansion. In their minds, there is nothing “foreign” about the island of 23 million, which has always been part of China (a claim that many Taiwanese people are diametrically opposed to, especially amongst the younger generation). This point is important to understand, as this is how the Taiwan question is framed in the Chinese political mindset. The same goes for the takeover of Hong Kong in 2020. They believe it is their right to do so.

From a risk assessment point of view, advance deterrence from the United States and its allies would force China to reassess its options. The China of today is still vulnerable in three key aspects: –its dependency on foreign fossil fuels, high-end semiconductor chips, and the international financial markets. In making any decision, the risks of bifurcation with the international community are something that China cannot ignore. The CCP leadership is acutely aware of these risks, and it explains why China is so anxious about closing these national security gaps. The [China-Iran Investment Deal](#) will see US\$400 billion invested into Iran in exchange for a steady supply of oil. Under a new cooperation arrangement, Russia’s [coal exports to China](#) will be doubled by 2023. On February 4, 2022, Russia agreed to a [30-year contract](#) to supply gas to China via a new pipeline to further bolster the energy alliance. In 2020, the investment in Chinese semiconductor firms amounted to [US\\$35.2 billion](#), a staggering increase of 407% from the previous year. Last but not least, the complete takeover of Hong Kong in 2020 means that the Central People’s Government could now access and utilize Hong Kong’s US\$500 billion in foreign reserve, and US\$115 billion in government fiscal reserves, all in the name of national security. China and Russia have agreed to develop a “[shared financial structure to deepen economic ties in a way that will not be affected by pressure from third countries](#).” Both are trying to develop an alternative to Swift in order to lessen the punitive effects of U.S. sanctions. Shortly before the Winter Olympics, Xi and Putin jointly declared that the friendship between the two countries has “[no limits](#).”

To the Chinese leadership, the war in Ukraine will confirm that any steps to invade Taiwan will be met with coordinated countermeasures by the West, and this could potentially be devastating. Certainly, this is likely to have some bearing on the calculations that the CCP leadership makes in the coming years. However, these factors should not be overstated. [China’s central place in the world economy](#) means that sanctions like those imposed on Putin would hurt everyone and most likely trigger a global recession. The Chinese leadership knows this and is likely to calculate that Western countries will think twice before plunging their economies into a supply chain meltdown. And regardless, they are aware that they would be better placed to weather any future storms than Putin. It is unlikely that their calculations on the issue of Taiwan—which they view as an “internal” matter—will change a great deal. Russia’s invasion of Ukraine will be treated as a prelude and a test case for Beijing. The united response of the international community may have surprised Beijing’s leadership, but Xi will not allow these developments to deter his alliance with Putin, let alone severing ties even as Russia becomes a pariah. Even though Beijing does not outright support Russia’s invasion of Ukraine, it is clear which side the PRC state media and social media are leaning toward.

PRC officials have recently signaled that they are looking toward changes in the language of the Taiwan Strait policy. Sun Yafu, the former director of the PRC’s Taiwan Affairs Office, has [announced](#) that several policy changes are on the table at this year’s 20th Party Congress, the first of which involves

rebranding the PRC's cross-Straits strategy as “the Party's Overall Strategy for Solving the Taiwan Issue in the New Era (新时代党解决台湾问题的总体方略).” We have yet to see the substance of this “New Era” policy. However, this reminds us of the change in language over the policy direction toward Hong Kong in the State Council's white paper issued in 2014.

As the former prime minister of Australia Kevin Rudd put it in his book the ‘Avoidable War’, Taiwan is “the holy-grail of CCP politics.” If Xi is to be able to achieve this only piece of unfinished business left by Mao's Revolution, he would be able to claim the life-time leadership and silence the critics within the Party. Anniversary dates are important in CCP's political calendar. This year marks the 25th Anniversary of Hong Kong's handover since 1997. Xi is able to obtain complete control over Hong Kong. Coming up is 2024, an important year marking the 75th anniversary of the founding of the PRC.

Xi acquiring a third term is sometimes erroneously [referred to in the Western media](#) as president for life. To stay in power for life, the 69-year-old will need to go on and secure his fourth, fifth, sixth, or perhaps even seventh term—something that would be increasingly hard to achieve unless he could claim ownership of a lasting political legacy. For Xi to achieve this and continue to dominate the domestic political scene, he needs to bring about the “rejuvenation” of Chinese civilization or be seen trying both domestically and abroad. The Taiwan question, therefore, looms large on the horizon. In Xi's own words, he cannot “leave it to the next generation.”

A PUBLICATION OF THE

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## Outside Counsel

# New Risks Facing Companies Operating in China and Hong Kong

If a military conflict over the Taiwan Strait occurs, in addition to the resulting global instability, a host of complex legal issues will need to be confronted. Supply chain and other contractual relationships will be immediately impacted. Given Russia's invasion of Ukraine, and the announcement of the "no-limit" close relationship between China and Russia, this eventuality should no longer be viewed as remote or hypothetical. The impact of such a conflict would be further complicated by the ever-evolving situation in Hong Kong, a major center for international finance and dispute resolution. International businesses and their attorneys would be well served by considering now the



By  
**Dennis  
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And  
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substantive and procedural challenges these matters present.

### Developments in the PRC

Last month, the Chinese Leader Xi Jinping signed into effect a new military order containing regulations that govern the use of the People's Liberation Army (PLA) in "military operations other than war." While the full text of the regulations has not been published, according to PRC State media, *"the [regulations] will standardize, and provide the legal basis for Chinese troops to carry out missions like disaster relief, humanitarian aid,*

*escort, and peacekeeping, and safeguard China's national sovereignty, security and development interests."* What caught the readers' eye is the mentioning of both military operations and the safeguarding of China's national sovereignty and security. The use of the term "military operation" by Xi coincides with how Russian President Putin described the invasion of Ukraine. In other words, if the PLA were to invade Taiwan or conduct military operations over the Taiwan Strait or the South China Sea, it would not be regarded as an "act of war" from the Chinese perspective, but rather a special military operation entirely within China's domestic territory aimed *"at safeguarding national sovereignty and security."* What's more, at about the same time, China's Foreign Ministry announced that the PRC has sovereignty, sovereign rights

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and jurisdiction over the Taiwan Strait and called it “*a false claim when certain countries call the Taiwan Strait international waters.*”

This further changes the political as well as the legal landscape for companies operating in the Greater China region.

### ‘Act of War’?

Most commercial contracts and insurance policies have exclusionary clauses dealing with the parties’ legal relationship in the event of an “act of war.” These standard clauses typically deal with situations in the event of wars, invasions, insurrections and revolutions. After Sept. 11, 2001, these exclusionary clauses were expanded to include terrorist acts caused by private individuals and organizations. In a typical contract, an “act of war” is usually defined as any act occurring in the course of a declared war or an armed conflict, whether or not war has been declared, between two or more nations. Some contracts or statutes may carry more extensive definitions, but many do not go beyond the basic common law understanding of an “act of war.” International laws under the United Nations mechanism would be unhelpful on this question, as China (and Russia) would veto any resolu-

tion under Article 39 of the UN Charter. Notably, Taiwan is not regarded as a sovereign nation state.

If the PRC undertakes special military operations over the Taiwan Strait or the South China Sea, international trade and supply chains would be severely affected. According to the United Nations, 60% of maritime trade passes through Asia, with the

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International businesses and their attorneys would be well served by considering now the substantive and procedural challenges these matters present.

South China Sea carrying an estimated one-third of global shipping. Taiwan is not regarded by the United States (nor the EU and UK) as a sovereign nation due to the “One China” policy. Under the new regulations signed by Xi, the use of PLA forces over Taiwan would arguably not be regarded as an “act of war,” but a special military operation purely domestic and internal within China. Chinese counterparties would surely take this stance if it benefits them before a tribunal. This claim may now have legal backing under Chinese law. If the operative provisions of a contract are governed by Chinese law, this presents a serious legal

problem for the foreign party in the event of a military conflict.

Most people think of “war” in terms of a large scale military invasion scenario. In the case of a military conflict over the Taiwan Strait, security experts are already pointing to a whole range of options which are open to Xi, including the partial taking over of Taiwan’s outlying Matsu islands, physical blockade, embargo, cybersecurity attack, and the sabotaging of undersea internet cables. As with Ukraine, if United States and EU governments are to sanction China over its actions, China has laid the groundwork for its response by passing the Anti-Foreign Sanctions Laws in 2021, which among other things includes the confiscation of foreign assets on PRC soil. Further, The Financial Times reported that in April of this year, the top banking officials in China called a special meeting to demand that all Chinese banks take measures to safeguard assets in the event of potential western sanctions.

These complex scenarios may overlap with one another. When combined with the uncertain status of Taiwan under international law, these factors create a host of legal questions that may not be fully answered by the text of most

standard “act of war” exclusionary clauses. International companies and in-house counsel should review their Greater-China region related contracts and legal relationships with these specific issues in mind.

### **Hong Kong’s National Security Law**

The forum for resolving disputes pertaining to “act of war” clauses presents additional challenges. Many companies who operate in the Greater-China region use Hong Kong as an international arbitration center. In 2020, Beijing imposed the National Security Law (NSL) on Hong Kong, which substantially changes the legal landscape of the former British Colony. Basic rights once guaranteed under the City’s mini constitution are now overridden by the NSL. The independent authority of the Hong Kong courts have been substantially undermined by the law’s many provisions. Article 47 of the NSL empowers the Chief Executive of Hong Kong to certify any matter to be of “national security and a state secret.” This certification is binding on the Hong Kong courts. No private party can question the use of such power by the Hong Kong government.

Article 47 applies to any court

proceedings in Hong Kong, potentially including the enforcement of an arbitral award. Article 6(2) of the NSL is broad enough to cover an arbitration tribunal, whether seated in Hong Kong or elsewhere. Article 38 gives the NSL global jurisdiction over any person whether in or outside of Hong Kong, irrespective of whether that person is a Hong Kong resident. The NSL prevails over all other local laws in Hong Kong, including the Arbitration Ordinance which is the main legislation governing Hong Kong arbitrations.

In addition, “national security” under PRC laws encompasses everything from economic security, technological security, financial security, data security to cultural security. Any commercial contracts that deal with major transactions or economic areas could fall into the realms of “national security,” whether intended to or not by the parties. The PRC State or the Hong Kong government could intervene in a litigation at any time using its overriding powers under the NSL. If there is a military conflict over the Taiwan Strait, any commercial transactions or arbitration proceedings with companies from “hostile” foreign states are likely to fall within the PRC’s defi-

nition of “national security.”

If parties sign a contract today, disputes may not arise until several years down the line. The venue for resolving these disputes will present very sensitive issues for international companies. The political and legal landscape in Hong Kong will no doubt continue to change going forward. The Hong Kong government has already announced, with the incoming administration that began July 1st, that a new set of national security laws targeting foreign espionage, foreign organizations, “fake news” and cybersecurity will be enacted. These laws will be in place by the end of 2022 or early 2023. International companies need to take these developments into account and plan ahead.