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Why the US Wants to Strip Hong Kong of its Special Trade Privileges

As an entrepôt for U.S.-China trade, Hong Kong is a gateway for PRC entities to access U.S. technology, something the Trump administration is keen to stop

By Vincent Chow

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U.S. President Donald Trump speaks as Mike Pompeo, U.S. secretary of state, left, listens during a news conference in the Rose Garden of the White House in Washington, D.C., U.S., on Friday, May 29, 2020. Photographer: Yuri Gripas/Abaca/Bloomberg

Amidst growing hostilities with China, the Trump administration has now set its sights on Hong Kong for its latest salvo of measures targeting Chinese access to U.S. technology. The city's famed status as an entrepôt for U.S.-China trade has finally caught up with it amid decoupling between the world's two largest economies in various areas including technology supply chains.

This poses challenges to companies in China, the U.S. and Hong Kong. For PRC entities, what is at stake is their ability to access U.S. technology via Hong Kong, where import restrictions are looser than the rest of China. Meanwhile, U.S. suppliers face uncertainty in their ability to tap the vast Chinese market through distributors and business partners in Hong Kong. And for Hong Kong companies themselves, the latest chapter in the saga of U.S.-China decoupling threatens to undermine their roles as connecting agents between U.S. suppliers and PRC customers.

On May 29, President Donald Trump announced that he will begin stripping Hong Kong of its special trade privileges in response to Beijing's controversial national security legislation for the city. Although Trump's announcement was not followed up with concrete measures, the declaration of intent was enough to send shockwaves around the business and legal communities on both sides of the Pacific.

“Our understanding is that the first tranche of policy changes are likely to include export controls,” said Benjamin Kostrzewa, a Hong Kong-based registered foreign lawyer at Hogan Lovells and former assistant general counsel at the Office of the U.S. Trade Representative (USTR) under the Obama administration.

“The combination of the need to have a policy response to the national security legislation with the added emphasis of trade policy towards China means that the U.S. likely needs to do something as it relates to export control laws for Hong Kong,” he said.

Indeed, the Trump administration’s plans to revise export control rules related to Hong Kong preceded the recent national security legislation controversy. They are part of a broader series of U.S. initiatives responding to China’s adoption of a military-civilian fusion policy. In 2016, China laid out, in its latest five-year plan, strategies to integrate the country’s military and civilian sectors to further its military capabilities and national security goals.

[It’s been an irritant \[for the U.S.\] for a long time where Hong Kong has become a platform for the reexport of U.S. goods to end-users in mainland China](#)

In April, the Commerce Department’s Bureau of Industry and Security (BIS), which oversees the U.S. export control regime, published two rule changes targeting the military-civilian fusion initiative. First, it removed the license exception for Civil End-Users for exports of certain controlled items such as semiconductors and sensors to China, which previously allowed these exports to proceed without BIS approval. Second, it expanded the definition of military end-user and end-use as they apply to China, thereby extending a presumption of denial for the license applications of more exports to China.

“It used to be that you had to have something that was going directly for a military end-use, now the rule covers things going to support a military end-use. That’s a new and somewhat ambiguous requirement,” said Amanda DeBusk, chair of Dechert’s global trade and government regulation practice and a former Assistant Secretary for Export Enforcement at the BIS. She gives the example of standard testing machines used in hospitals, which previously could be exported to even military hospitals in China as that did not qualify as military end-use. Now the fact that it is a military hospital means the machines cannot be exported there.

Although these final rules, which will come into effect June 29, do not target Hong Kong *per se*, Kostrzewa says that they do indicate the areas being targeted by the Trump administration and therefore hint at what might be on the horizon for Hong Kong.

“It’s been an irritant [for the U.S.] for a long time where Hong Kong has become a platform for the reexport of U.S. goods to end-users in mainland China. Hong Kong entities use these license exceptions to bring in the goods, then they send them over the border. So this may be a chance to clean that up,” he said.

Summary	New regime	Old regime	Products affected	Status
Expansion of military end user and end use restrictions	<p>“Military end use”: any item that supports or contributes to the operation, installation, maintenance, repair, overhaul, refurbishing, development, or production, of military items</p> <p>Restrictions on “military end users” will now include China</p> <p>Additional Electronic Export Information filing requirements</p>	<p>“Military end use”: any items intended for incorporation into, or designed for the “use,” “development,” or “production” of, certain military items</p>	<p>Materials processing, electronics, telecommunications, information security, sensors and lasers, etc. (Supplement No. 2 to Part 744 of EAR)</p> <p>New items added: mass-market encryption software, semiconductor technology, aircraft parts, etc. (17 new ECCNs)</p>	Final rule, in effect June 29
Elimination of License Exception Civil End-Users (CIV)	<p>Exports reliant on CIV exception now subject to licensing requirements</p> <p>“Presumption of denial” for license applications</p>	CIV exception permits exports of national security-controlled items for civilian end uses in China without a license	Electronics, telecommunications equipment, radar systems, gas turbine equipment, advanced anti-friction bearings, semiconductors, etc.	Final rule, in effect June 29
Revision to License Exception Additional Permissive Reexports (APR)	Reexports from certain third-countries reliant on APR exception now require separate U.S. licenses	APR exception authorizes reexports of items subject to U.S. export control from certain third-countries without a U.S. license provided that the reexport is authorized by the third-country	Reexports of U.S. controlled items from Hong Kong and 42 Wassenaar countries	Proposed rule, soliciting public comments until June 29

Source: <https://www.dlapiper.com/en/us/insights/publications/2020/05/bis-announces-three-new-rules-that-place-significant-restrictions-on-exports-to-china/#1>

The BIS regulates exports of U.S. technology through the Export Administration Regulations (EAR). Under the 1992 Hong Kong Policy Act, Hong Kong is treated as a separate destination from China for trade and export control purposes, and therefore enjoys preferential licensing requirements under the EAR. For example, Hong Kong has greater access than China to controlled dual-use technology (those with both military and civilian applications) such as integrated circuits and encryption software.

Crucially, Hong Kong must enforce U.S. export control laws for any reexports of U.S.-origin goods and technology to China. Over the years, the Commerce Department and the Hong Kong government have worked together to prevent unauthorized diversions of controlled items to PRC end-users, but they have not always been successful. In a [report](#) last year, the U.S.-China Economic and Security Review Commission pointed out that diversions of controlled items in Hong Kong are cause for concern due to the “high risk of transshipment to the Mainland.”

In April, along with the two new final rules, the BIS proposed to scrap a provision of license exception Additional Permissive Reexports (APR), putting the decision down to variations in how the U.S. and its allies, including Hong Kong, perceive the threat posed by China’s military-civilian fusion. The APR exception allows for reexports of certain controlled U.S. items from Hong Kong to China without need for U.S. approval so long as the reexport is approved by the Hong Kong authorities. Under the proposed rule change, for which industry feedback is being solicited until June 29, these reexports will require separate approval from the U.S. government in the future.

The proposed APR rule change is not the BIS’ s first attempt at tackling Hong Kong’ s reexport issues. In 2017, the agency tightened export control rules for Hong Kong, requiring exporters or reexporters there secure either a license or proof of a license exception from the Hong Kong authorities in addition to a U.S. license or license exception.

Reexports are crucial to Hong Kong’ s status as a gateway for U.S. exports to reach China, said Wendy Wysong, Hong Kong managing partner at Steptoe & Johnson and a former Deputy Assistant Secretary for Export Enforcement at the BIS, as over half of Hong Kong’ s reexports go to China. According to [Hong Kong government figures](#), the U.S. exported around \$9 billion worth of goods to China via Hong Kong in 2017.

Reexport Loopholes

A major thorn in the side of the U.S. enforcement regime has been front companies set up in Hong Kong by PRC entities. The [2020 State Export Report](#) by the U.S.-China Business Council (USCBC) accused the Chinese government of using Hong Kong-based companies such as subsidiaries of PRC companies to “exploit legal loopholes and uneven enforcement in U.S. export controls” in order to access space capabilities that U.S. export controls prohibit China from purchasing outright.

More broadly, Hong Kong has a large infrastructure of corporate secretary firms and forwarding companies acting as intermediaries for PRC entities due to lax business registration requirements, according to John Haberstock, the BIS’ s export control officer (ECO) in Hong Kong overseeing enforcement.

At a [conference](#) in 2017, Haberstock cited a case study involving the export of a controlled technology item to Hong Kong with the help of a license exception. A Hong Kong address was provided in the end-user disclosure statement. However, it was later revealed that the address belonged to a freight forwarding business that forwarded packages for the ultimate end-user, which was in fact a company headquartered in the PRC. These kinds of Hong Kong-based intermediaries pose a “[m]ajor challenge for ECO Hong Kong to determine the ultimate end user and end destination of U.S. items,” he said.

[Trading companies in Hong Kong are finding it increasingly difficult to import and reexport U.S. technology](#)

Meanwhile, as the Trump administration ramps up its measures tackling these issues, the Hong Kong companies that legally import U.S. technology may also be inadvertently harmed. Most Hong Kong-based importers act as legitimate intermediaries between U.S. suppliers and PRC customers. For example, they function as technology distributors or embed it into their own products, which they then sell to PRC customers, says Casper Sek, a Beijing-based partner at Jin Mao Partners. These intermediaries are subject to U.S. export control rules so long as they are part of a supply chain involving U.S. technology, regardless of the exact role they play in that chain.

Dymek, a Hong Kong-based distributor of foreign-made high-tech equipment to PRC entities such as Chinese telecom giant Huawei, has already seen its sales fall as a result of U.S. tariffs as well as changes to export control rules. U.S. exports to Hong Kong fell 16.2% in 2019 because of the U.S.-China trade war, according to the USCBC’ s report.

“Mainly due to the release of the U.S. government blacklist, many of our suppliers have tightened their scan and documentation of their end-users. Hence, this led us to put a lot more time on qualifying a customer,” Dymek’ s director Kevin Wong said, referring to the BIS’ s Entity List, which includes Huawei and other customers of the company.

For U.S. suppliers, the Trump administration’ s actions threaten to undermine their ties with Hong Kong business partners, which help them access PRC customers. Trading companies in Hong Kong are finding it increasingly difficult to import and reexport U.S. technology; Dymek, for example, has imported more high-tech equipment from its suppliers in Europe and Southeast Asia in recent months and is looking to further diversify its global supplier network away from the U.S.

“It’ s just more time-consuming on the filtering and customer screening part [when importing U.S. technology],” Wong said. This is likely to become even more arduous as the Trump administration adopts an increasingly broad view of what constitutes military end-use, driven by fears of China’ s military-civilian fusion.

[Hong Kong reexporters are likely to have the least bargaining power in contractual negotiations with U.S. suppliers on one side and PRC customers on the other](#)

Leading Hong Kong reexporters also face the possibility of being made an example of now that Trump has firmly placed Hong Kong in its crosshairs, says Ali Burney, a Hong Kong-based partner at Steptoe & Johnson. And for those that want to continue doing business with U.S. suppliers, they can expect their U.S. counterparties to be much more demanding during contractual negotiations on obligations such as pre-acquisition due diligence – especially as emergency clauses such as *force majeure* provide little respite for U.S. suppliers in the event of a BIS enforcement action.

“For example with the [proposed] APR rule change, what will happen in practice is if the U.S. exporters are now burdened with getting the license, they will push down a lot more contractual obligations and promises on the Hong Kong importer [or] reexporter,” Burney said, pointing out that Hong Kong reexporters are likely to have the least bargaining power in contractual negotiations with U.S. suppliers on one side and PRC customers on the other.

Nonetheless, U.S. suppliers would still be held liable for any violations of export control rules. “Most U.S. exporters at a minimum are required to do what is called ‘red-flag’ and ‘know your customer’ due diligence. Even they cannot just shift the burdens by contract alone [to the Hong Kong reexporter],” Burney said.

Dymek’s Wong believes that the U.S. government is trying to better track where U.S. exports are going rather than blocking sales. In the past, U.S. officials have called on the Hong Kong government to improve tracking of controlled items to prevent diversion of such items to China. They have also instructed U.S. exporters to be “particularly sensitized” when it comes to conducting pre-shipment red-flag due diligence for exports to Hong Kong.

“What [the U.S. government] is expecting is that companies will hone and sharpen the due diligence that they’re putting on items that are going to China,” said Wysong, whose firm Steptoe opened its office in Hong Kong in January. “So when we’re talking with companies, we’re saying you need to increase your controls. If you get it wrong, we’ll help you walk it back. But [the U.S. government] is definitely trying to increase the pressure.”

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