Crisis in Hong Kong: A Review of U.S. Policy Tools

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Washington, DC
June 4, 2020
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**Introduction**

Chairman Crapo, Ranking Member Brown, and distinguished members of the Senate Committee on Banking, Housing, and Urban Affairs, I am honored to appear before you today to discuss the crisis in Hong Kong and review U.S. policy tools.

This is a precarious moment for the people of Hong Kong, and the United States has an important role to play in supporting them in the face of efforts by the Chinese Communist Party (CCP) to undermine their freedoms. Economic sanctions can be an impactful part of a comprehensive U.S. effort to support the peaceful, pro-democracy forces in the city. However, we need to have realistic expectations about their effectiveness. Sanctions will be unlikely to restore many of the freedoms that the CCP seeks to take away from the people of Hong Kong. They can, however, give the CCP pause.

To achieve this objective, sanctions must be carefully calibrated to both apply pressure on the CCP and those materially contributing to the erosion of rights in Hong Kong, while minimizing the costs to the people of Hong Kong and mitigating the risks to the international financial system and U.S. businesses. Such tools must also provide the Trump administration—and future administrations—with the flexibility to apply this pressure in smart ways.

The Hong Kong Autonomy Act (“HKAA”), introduced by Senators Toomey (R-PA) and Van Hollen (D-MD), is a good step towards this aim. As I discuss below, the legislation is designed to pressure the CCP, entities contributing to the undermining of rights in Hong Kong, and financial institutions that do business with them. It is structured to deter these entities and financial institutions from continuing to support this assault on the people of Hong Kong. I believe there are a number of additional modifications to the legislation that would make it even more effective, increasing its impact while limiting downside risk.

I will focus my testimony today on four key issues to consider when weighing a response to China’s intervention in Hong Kong. First, I will address how economic pressure can help the United States achieve realistic objectives. Second, I will discuss some of the risks of ramping up U.S. coercive measures on China. Third, I will analyze the Hong Kong Autonomy Act, noting how it can place pressure on China in a way that may deter further aggression. Finally, I will make a number of recommendations to enhance the legislation to ensure the administration has appropriate flexibility.

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1 The views expressed in this testimony are my personal views and do not represent the views of the Foundation for Defense of Democracies, K2 Intelligence/Financial Integrity Network, or the Treasury Department. Pursuant to legal and ethical obligations, I cannot discuss internal deliberations that occurred during my tenure at the Treasury Department.
I. Using Economic Power to Achieve U.S. Policy Objectives Toward Hong Kong

As Secretary of State Michael Pompeo rightly noted when declining to certify that Hong Kong remains autonomous under Section 301 of the Hong Kong Policy Act, “No reasonable person can assert today that Hong Kong maintains a high degree of autonomy from China, given facts on the ground.” Indeed, over the last year, in concert with local authorities, the CCP has moved aggressively to curtail the rights historically enjoyed by the people of Hong Kong, including:

1) In 2019, the Government of Hong Kong, acting with the support of the Government of China, introduced an extradition bill that would have permitted Hong Kong to detain and transfer people wanted in countries with which it has no formal extradition agreements, including the Chinese mainland.

2) Following the introduction of the extradition bill and robust protests by the people of Hong Kong, authorities in the city, with apparent assistance from the CCP, violently cracked down on protesters.

3) In May 2020, China introduced and passed legislation that would ban acts in Hong Kong that endanger China’s national security, including subversion and separatism. This legislation, which is on the way to being enacted, would likely permit China’s security services to operate in Hong Kong, further eroding the city’s historical independence from the CCP.

These actions have substantially undermined the Sino-British Joint Declaration (the “Joint Declaration”) and the Basic Law. They signal that China is increasingly aggressive in exercising...
political control over the city despite the “one country, two systems” principle.\(^7\) Indeed, as President Donald Trump said last week, it increasingly looks like “one country, one system.”\(^8\)

The people of Hong Kong, despite turning out in the streets in massive numbers last year, have thus far been unable to successfully push back on China’s renewed efforts to subsume the city into the mainland’s framework for political and social control. Likewise, U.S. efforts to deter China’s encroachment have been unsuccessful to date. Despite the passage of Hong Kong Human Rights and Democracy Act of 2019,\(^9\) the CCP appears to have concluded that usurping Hong Kong is worth the economic cost that may result from sanctions imposed by the United States.

While President Trump announced last week that the administration may take additional measures under the Hong Kong Policy Act, including tightening export control restrictions on certain U.S. goods going to Hong Kong and increasing customs and tariffs on goods coming to the United States from the city, it is not clear whether these measures will impact CCP decision-making.\(^10\) But influencing China’s future actions toward Hong Kong is exactly what Congress and the administration should now consider.

It is unrealistic to expect China to reverse the steps it has taken over the last year. The CCP has made it clear, through the recent passage of legislation potentially permitting China’s national security agencies to operate in Hong Kong, that it is willing to pay a price for its aggression. The administration and members of Congress should therefore maintain realistic expectations that any efforts, including economic pressure, will not convince the CCP to reverse course on the legislation or otherwise restore the freedoms it has revoked from the people of Hong Kong.

However, the United States can and should support the people of Hong Kong, and our primary objective should be deterring the CCP and local authorities from further cracking down on the pro-democracy citizens of Hong Kong. At the same time, Washington should work to ensure both that Hong Kong is not further pushed into Beijing’s control and that U.S. companies operating in Hong Kong are protected as much as they can be.

Achieving these three objectives will be challenging. Congress and the Administration must carefully calibrate economic pressure on Beijing to do so. Too much economic pressure could

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\(^7\) The relevant language of the Joint Declaration states that “the Hong Kong SAR (HKSAR) will be directly under the authority of the Central People's Government and will enjoy a high degree of autonomy except in foreign and defence affairs which are the responsibilities of the Central People's Government;” and that the “the social and economic system in Hong Kong before the resumption of the exercise of sovereignty by China will remain unchanged, and so will the life-style. Rights and freedoms, private property, ownership of enterprises, legitimate rights of inheritance and foreign investment will be protected by law.” Government of the Hong Kong Special Administrative Region, Constitutional and Mainland Affairs Bureau, “The Joint Declaration,” accessed June 1, 2020. (https://www.cmab.gov.hk/en/issues/joint2.htm)


further isolate Hong Kong from global markets, hurting Hongkongers and causing U.S. and other foreign companies to downsize their exposure in Hong Kong or even leave the jurisdiction altogether. This would have an outsized impact on the financial health of U.S. businesses and could lead to significant fallout in financial markets. It could also lead to a damaging response from Beijing.

However, too little pressure may not move the needle enough. A weak response could signal to Beijing that it has the green light to increase its aggression, crack down on the pro-democracy movement, and further erode the freedoms enjoyed by those in Hong Kong.

Properly calibrated economic sanctions can help deter the CCP. In the fall of 2019, the Trump administration’s threat of international sanctions to deter Turkey from engaging in sustained, widespread aggression in northern Syria prevented a significant humanitarian crisis. Thanks to the issuance of Executive Order 13894, the accompanying designations, and the clear threat by the administration to impose both primary and secondary sanctions on wide swaths of the Turkish economy,11 Turkey quickly ended its incursion.

Likewise, the United States and the European Union imposed sanctions in 2014 to deter Russia from engaging in additional destabilizing activities in Eastern Europe. Of course, deterrence is always difficult to measure. However, evidence suggests that Russia was planning to broaden its overt military action in eastern Ukraine to wrestle key cities and territories away from Ukrainian government control, but thought twice after biting sectoral sanctions took effect.12

The lesson here is that carefully calibrated sanctions designed to deter additional encroachment on Hong Kong’s freedoms can create a deterrent impact. These tools should be coordinated, to the extent possible, with other countries that share U.S. interests in Hong Kong, particularly the United Kingdom.

At the same time, we must acknowledge that over time, Hong Kong may lose its luster as one of the world’s preeminent financial centers. With the city increasingly under CCP control, it is likely that global financial institutions, particularly those based in the United States, will find Hong Kong a less attractive place to do business. This is not a given; global financial institutions with deep ties to Asia and Hong Kong, particularly those based in Europe, may try to maintain a significant presence in the jurisdiction. Nevertheless, it will likely be more challenging to do so. While other policy tools, such as visas for Hongkongers looking to leave the jurisdiction, are outside the scope of my testimony, these measures should be considered by the administration and Congress as the situation develops.

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II. The Risks of Using of Economic Power

While economic pressure may limit further CCP efforts to undermine freedoms in Hong Kong, three significant downside risks exist: Chinese retaliation; isolating Hong Kong and pushing it further into China’s orbit; and the potential negative impact to U.S. companies operating in Hong Kong. Caution is therefore necessary in developing a sanctions program against those responsible for the erosion of rights in Hong Kong.

First, China will likely respond to economic pressure on Chinese persons and financial institutions over Hong Kong. In recent years, China has become increasingly aggressive in using its own tools of economic coercion. The United States should expect that China will respond in kind to U.S. pressure. The CCP has a range of options, including but not limited to:

- **Adding U.S. Companies to the Unreliable Entity List/Counter-Sanctions.** In May 2019, China announced the creation of an Unreliable Entity List. In response to the addition of Huawei to the U.S. Commerce Department’s Entity List, the measure was designed to intimidate U.S. firms from cooperating with U.S. export controls. The exact modalities of the Unreliable Entity List are unclear but could include national security investigations of activities by U.S. firms or other restrictions. China could use the Unreliable Entity List to identify U.S. companies and direct Chinese firms to cease doing business with them.

- **Accelerate Efforts to Undermine Hong Kong’s Freedoms.** China could accelerate its efforts to pacify Hong Kong, including by more aggressively cracking down on the pro-democracy movement and implementing the new national security law.

- **Selective Law Enforcement Measures.** China could respond with politically motivated arrests of U.S. citizens, corporate officers of U.S. firms, or other Westerners. The arrests of Canadian citizens Michael Kovrig and Michael Spavor in retaliation for the detention of Meng Wanzhou are an example of this strategy.

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14 The criteria for a U.S. firm being added would include (i) if it is boycotting, cutting off supplies to Chinese companies, or taking other specific discriminatory actions against Chinese companies; (ii) whether these actions are taken for noncommercial purposes, in violation of market rules or in breach of contractual obligations; (iii) whether these actions cause material damage to the legitimate interests of Chinese companies and relevant industrial sectors; and (iv) whether these actions constitute a threat or potential threat to China’s national security. Lester Ross and Kenneth Zhou, “China’s Unreliable Entity List,” *WilmerHale*, July 29, 2019. ([https://www.wilmerhale.com/en/insights/client-alerts/20190729-chinas-unreliable-entity-list](https://www.wilmerhale.com/en/insights/client-alerts/20190729-chinas-unreliable-entity-list))


• **Additional Tariffs/Abrogation of the U.S.-China Trade Deal.** China could abrogate parts of the Phase One trade deal. The United States has not indicated it would leave the Phase One trade deal as a result of the current tension over Hong Kong. Nevertheless, China could increase its tariffs across-the-board on U.S. goods or, while not formally leaving the deal, appreciably slow its purchases of U.S. goods. There is some evidence that this may already be occurring.

While China’s response will likely depend on the level of economic and political pressure the United States imposes, any such U.S. actions should be taken with reprisals in mind.

Second, too much economic pressure could push Hong Kong further into China’s orbit. If the United States ramps up sanctions on Hong Kong, U.S. and international companies may seek to reduce their exposure and move their operations elsewhere. This would likely lead to a significant reduction of businesses based in Hong Kong as a global financial center and thus could spawn a major departure of the Hongkongers and Westerners who support the freedoms and rights they have historically enjoyed. This would leave behind a population in Hong Kong that is more willing to accept China’s draconian security measures and less willing to stand up for their rights.

Third, sanctions on foreign persons and foreign financial institutions in Hong Kong could have blowback effects on U.S. companies operating in the city, particularly in the financial sector. Approximately 1,300 U.S. firms, including 726 regional operations, have a physical presence in Hong Kong, and there are approximately 85,000 American residents living in the city. Likewise, U.S. financial institutions have a substantial presence in Hong Kong and often work closely with systemically important Chinese banks operating both in the city and on the mainland. All of this should inform the types of sanctions being considered and the targets of those sanctions. If not done properly, imposing sanctions could have a deleterious impact on U.S. companies in Hong Kong and could prompt them to move their operations and business elsewhere.

These downsides are significant. They must be taken into account when considering sanctions pressure. Punitive measures must be carefully calibrated. They must limit the downside impacts on Hong Kong and U.S. companies, and they should be considered with a clear understanding that China will likely respond.

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III. The Hong Kong Autonomy Act: Carefully Calibrated to Deter Further Chinese Efforts to Undermine Hong Kong’s Freedom

The Hong Kong Autonomy Act, introduced by Senators Toomey and Van Hollen, is narrowly crafted to create deterrent pressure on China and incentivize those penalized under HKAA to cease their malign activities. With certain modifications, the HKAA can provide the administration with sufficient flexibility and limit the downside risk to U.S. companies and those of our partners and allies.

The HKAA is designed to incentivize persons materially contributing to the failure of the Government of China to meet its obligations under the Joint Declaration and the Basic Law to cease those actions. The legislation creates that incentive by increasing economic penalties for continued bad behavior. The sanctions become more certain and more intense over time if those persons do not cease their malign behavior. The HKAA works as follows:

1. 90 days after the enactment of the legislation and annually thereafter, the secretary of state must determine in a report whether a foreign person is materially contributing to the failure of the Government of China to meet its obligations under the Joint Declaration. As part of that report, the secretary will also include an explanation for why that foreign person has been included and identify any foreign financial institution that knowingly conducts a significant transaction with that person.

2. On the date that the report is submitted, the president may impose sanctions on any foreign person. These sanctions include blocking that person’s property or visa revocation. If that person is included in two reports (for example, the first report issued 90 days after the enactment of the HKAA, and then the subsequent report one year later), the president must impose sanctions on that foreign person.

3. For foreign financial institutions, one year after inclusion in the first report, the president shall impose five out of 10 penalties stipulated. As discussed below, this language could be further sharpened to make clear that if the foreign financial institution ceases conducting knowing and significant transactions with the listed foreign person any time after the issuance of the first report (before the year one marker is hit), any time between year one and year two, or any time after year two, such sanctions will be lifted.

Four important points stand out about this legislation. First, it targets both those persons materially contributing to China’s failure to uphold its obligations under the Joint Declaration and those foreign financial institutions doing business with those persons. This is broad, but it is also likely to ensure that the sanctions have teeth. Designating natural persons or companies (such as CCP members, government officials in Hong Kong who have undermined the city’s freedoms, or companies supporting their activities) is important symbolically as a show of support for the pro-

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21 These penalties include: a prohibition on loans from U.S. financial institutions; a prohibition on designation as a primary dealer in U.S. government bonds; a prohibition on service as a repository of U.S. government funds; a prohibition on foreign exchange; a prohibition on certain banking transactions through the U.S. financial system; blocking sanctions; a restriction on exports; a ban on U.S. persons’ investment in equity or debt; the exclusion of corporate officers; and sanctions on principal executive officers.

22 As discussed below, this language could be further sharpened to make clear that if the foreign financial institution ceases conducting knowing and significant transactions with the listed foreign person any time after the issuance of the first report (before the year one marker is hit), any time between year one and year two, or any time after year two, such sanctions will be lifted.
democracy forces in Hong Kong but is unlikely to change China’s willingness to intervene. Broadening the sanctions to include financial institutions that do business with these persons will be more likely to have an impact. It would put pressure on those institutions to cease doing business with those persons or risk losing access to the international financial system.

Second, the HKAA’s structure creates a deterrent impact and an incentive for a positive change in behavior over time. The annual reporting requirement and potential sanctions on foreign persons listed in the reports creates a powerful incentive not to materially contribute to China’s failure to meet its obligations. Foreign persons will not want to be included in these reports, as inclusion triggers discretionary sanctions, and therefore at least some will likely think twice before engaging in any actions that could lead to them appearing in the report. Likewise, foreign financial institutions will not want to conduct knowing and significant transactions with entities that may be included in these reports, deterring them from supporting such activity.

In addition, the legislation provides a clear incentive for foreign persons and foreign financial institutions that are included in the reports to change their activity over time or suffer increasingly certain or worse penalties. For example, for foreign persons included in the first report, the president has discretionary authority to impose blocking sanctions on these persons. However, if those persons appear on a second report, the president must impose blocking sanctions. As a result, the foreign person identified in the first report has a substantial incentive to cease contributing to the crisis in Hong Kong; if he or she does not, blocking sanctions are certain.

Likewise, foreign financial institutions have an incentive to cease conducting transactions with foreign persons listed in the report. If they continue doing business with a listed foreign person one year after the initial listing, they will be subject to five of 10 penalties. However, if they continue conducting such transactions for another year, they will be subject to the full 10 penalties (some of which are particularly powerful, such as blocking provisions). In short, if they do not change behavior, they will face a broader range of economic pressure.

Third, the HKAA provides the administration with substantial flexibility. Under the reporting requirement, the president may decline to include a foreign person on the report who otherwise materially contributes to the crisis in Hong Kong if those contributions do not have a significant and lasting negative effect, are not likely to be repeated in the future, and have been reversed or otherwise mitigated through positive countermeasures taken by that foreign person. Combined with determining what specific actions fall under the definition of a material contribution, as defined in Section 5(f) of the HKAA, these provisions provide the president with significant leeway when deciding which entities are included in the report.

Likewise, the same language applies to foreign financial institutions identified in the report. Furthermore, the president actually has more flexibility with foreign financial institutions, which must conduct knowing and significant transactions with the identified parties in order to be included in the report. In particular, the “significant” qualifier has allowed successive administrations to refrain from imposing draconian sanctions when it believed doing so was unwarranted or would otherwise cause undesirable impacts.23

23 The Office of Foreign Assets Control (OFAC) at the U.S. Department of the Treasury generally considers a number of factors when determining whether a transaction is “significant,” including: (1) the size, number, and
In addition, the legislation contains a waiver provision whereby the president may waive the sanctions on foreign persons and foreign financial institutions if he or she determines that doing so is in the national security interest of the United States. There may be, for example, good national security reasons for declining to penalize foreign financial institutions, particularly as some of them may be systemically important. The legislation, however, does contain a resolution of disapproval provision, which could complicate such a waiver (see below).

Fourth, the HKAA is narrowly scoped to avoid causing a massive shock to the international financial system or undue harm to U.S. businesses. The legislation targets only those foreign persons and foreign financial institutions engaged in specified activity. It is not a comprehensive program broadly targeting foreign persons or foreign financial institutions operating in Hong Kong. This, coupled with the flexibility discussed above, should help this administration and future administrations effectively manage potential economic blowback on U.S. companies and those of our allies and partners.

IV. Suggested Modifications and Recommendations

While this legislation can play an important role in deterring future Chinese efforts to undermine Hong Kong’s freedoms, it should be sharpened. Doing so can help limit the risk of further isolating Hong Kong and negatively impacting international financial markets and U.S. companies, while ensuring the executive branch retains significant flexibility.

This can be done in two primary ways. First, the legislation as drafted targets foreign financial institutions, regardless of whether their transactions with the foreign persons directly involve the undermining of rights in Hong Kong. As discussed above, this provision is designed to increase the economic impact and make companies think twice about contributing to China’s malign activities. However, this provision may be overbroad in that it targets foreign financial institutions whose business relationships with listed foreign persons do not involve their efforts to undermine freedom in Hong Kong.

For example, if a financial institution provided general banking services to a company listed in the report but had nothing to do with that company’s efforts to undermine freedom in Hong Kong, that financial institution could still be subject to U.S. secondary sanctions. This provision would likely have the unintended consequence of accelerating U.S. and global financial institutions from exiting Hong Kong. Some may conclude that maintaining substantial operations in the jurisdiction is too risky given the sanctions exposure and could decide to either slim down their business presence or exit altogether. This would likely be a painful proposition for these financial institutions, and such a shift could further isolate Hong Kong and push it closer to the mainland.

frequency of the transaction(s); (2) the nature of the transaction(s); (3) the level of awareness of management and whether the transaction(s) are part of a pattern of conduct; (4) the nexus between the transaction(s) and a blocked person; (5) the impact of the transaction(s) on statutory objectives; (6) whether the transaction(s) involve deceptive practices; and (7) such other factors that the secretary of the treasury deems relevant on a case-by-case basis. See: FAQ 542 in U.S. Department of the Treasury, Office of Foreign Assets Control, “OFAC FAQs: Other Sanctions Programs,” accessed June 1, 2020. (https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_other.aspx#ukraine). The HKAA uses a modified set of factors.
As a way to mitigate this outcome, this committee might consider limiting the scope of the foreign financial institution restriction to activity directly tied to the undermining of rights and freedoms in Hong Kong. For example, the sanctions could apply to foreign financial institutions that knowingly conduct significant transactions with foreign persons in furtherance of those foreign persons’ material contribution to China’s failure to fulfill its obligations under the Joint Declaration and Basic Law.

This or a similar modification would narrow the impact of sanctions while directly targeting the undesirable activity. It would also give the sanctions increased credibility, as the designations would be clearly linked to illegitimate efforts by China’s government to undermine Hong Kong’s special status.

Second, the HKAA contains a congressional review component for when the president is considering a national security waiver or terminating sanctions under the legislation. This resolution of disapproval mechanism, which is similar in concept to Section 216 of the Countering America’s Adversaries Through Sanctions Act (“CAATSA”), would provide Congress with additional oversight and would limit the president’s flexibility when considering the imposition or lifting of sanctions.

The committees of jurisdiction have an extremely important role in ensuring that U.S. sanctions programs are being properly implemented and that these programs are effective. Assessing their efficacy is critical, as administrations continually view sanctions as tools of first resort. Congress should continue to conduct aggressive oversight of their use. At the same time, Congress should balance the need for oversight with a desire to provide administrations with a degree of flexibility. As noted above, this flexibility is critical in ensuring administrations can take the most impactful actions possible.

As this body observed in the winter of 2018, when the Trump administration indicated its intent to delist Rusal and EN+, two companies designated for being owned or controlled by Russian Specially Designated National (“SDN”) Oleg Deripaska,24 a review can thrust a largely technical discussion into the more heated realm of politics.

As a general rule when considering including aggressive disapproval mechanisms, Congress should follow two maxims. First, Congress should be reluctant to insert itself into working-level decisions, such as whether to issue licenses or waivers for specific companies, absent a compelling national security rationale. While there certainly are circumstances where aggressive intervention is appropriate and justified, a considered decision to refrain can often be beneficial for U.S. sanctions.

Second, Congress should include disapproval mechanisms in legislation only when there is a serious, sustained policy disagreement with an administration. For example, while the review mechanism specified in Section 216 created heated debates both during the passage of CAATSA and during the Rusal/EN+ delisting episode, the justification for including the review provision in

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the legislation was understandable. There was substantial concern in Congress at the time that the incoming administration was going to prematurely lift U.S. sanctions on Russia.

In the case of Hong Kong, however, such a disagreement does not appear to exist. As was made clear by President Trump last week, the administration is willing to take action against China as a result of the CCP’s interventions. This generally accords with Congress’ inclination to raise the pressure on the CCP for its aggression. Including a disapproval mechanism in this case does not provide much benefit to congressional oversight, as it seems unlikely that the administration would waive or terminate sanctions in an untimely fashion or for an unjustified reason. Including this mechanism could, however, come at a cost, particularly if the administration were forced to consider sanctioning a large, systematically important company. In such an instance, providing the administration with the appropriate amount of flexibility is critical. If such waivers are subject to review, particularly in a heated political context, the ultimate outcome could be detrimental to U.S. companies and global financial markets. I therefore recommend amending the legislative text to excise the disapproval mechanism.

Finally, certain language in the legislation should be clarified, particularly in the context of the penalties imposed on foreign financial institutions. For example, as currently drafted, it is unclear whether a foreign financial institution that ceases to conduct knowing and significant transactions with a foreign person identified in a report would no longer be subject to sanctions. Likewise, if that foreign financial institution ceased doing business with a listed entity after the first year (but before the second), it is unclear whether the foreign financial institution would still be under some, none, or all of the prescribed penalties. This language may be contained in the termination provision but should be explicitly incorporated into the provisions detailing the timing of the imposition of penalties.

Conclusion

Economic sanctions are not a panacea for countering China’s aggression in Hong Kong. We must temper our expectations for what they can achieve and consider the risks of their use. Nevertheless, a carefully calibrated and flexible sanctions program designed to deter future Chinese encroachment, as part of a broader strategy that includes aggressive diplomatic pushback on China’s intervention, close coordination with allies concerned about China’s measures, and supporting the peaceful democratic forces in Hong Kong, can increase the chances of ensuring that this democracy under siege is not completely subsumed by the mainland.

Thank you, and I look forward to your questions.