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978-1-107-00480-1 - A Financial Centre for Two Empires: Hong Kong's Corporate, Securities and Tax Laws in its Transition from Britain to China

David C. Donald

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1

History's marks on Hong Kong law: from British colony, to Chinese SAR

A Hong Kong's historically driven component culture

1 *The endowments of an international financial centre*

International financial centres, like internationally active trading ports, are outward looking. Their domestic prosperity depends on the ability to attract foreign capital, goods and the deals connected to them. Although the volume of solely domestic transactions may be dwarfed by that of transactions conducted with wholly foreign legs, it is the domestic institutional environment and available skills that draw in these funds, goods and deals. Since its creation in 2007, the Global Financial Centres Index has placed four cities with very different economic and political positions – London, New York, Hong Kong and Singapore – in the top four slots globally.¹ During this period, New York was also the domestic financial centre for the world's largest economy, while London served a like function for an economy with a ranking between sixth and eighth, and both Singapore and Hong Kong served domestic economies of negligible size whose GDP amounted to barely 10 per cent of the UK's. Thus, as international financial centres, both London and New York are divided: they are both national financial centres for their large domestic economies (of different sizes) and centres for activity that spans the globe without significant link to either the UK or the US domestic economy. Regardless of whether transactions in these cities are purely domestic, purely foreign or somewhere in between, they are drawn to the financial centre by an economic and institutional condition that reflects the institutional characteristics of the nation itself. In New York, it will be the American economy, institutions and laws, and in London, the corresponding support elements of the UK.² The same domestic institutions and laws facilitate

¹ Z/Yen Group, The Global Financial Centres Index, nos 1–13, 2007–13.

² London might be thought of as having four concentric circles in this respect, with the City of London serving first the UK domestic economy, second the EU internal market (whose

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both domestic and purely foreign transactions. These respective sets of institutions and laws have developed within the larger context of the nation, received legitimacy from the power of that nation's state, and yet gained their support for international usage from and among persons based in other countries. While performing very similar functions, Hong Kong and Singapore present a dramatically different origin and composition. They inherited their legal systems from the British Empire, developed their international orientation as trade hubs of the same, and have achieved their status as leading financial centres significantly free of the (lacking) dimension of their domestic economies (which themselves are composed in good part of international financial services). Hong Kong, however, presents a geopolitical dimension not found in Singapore. Hong Kong was carved out of Chinese territory in 1841 and returned to it 156 years later, which means that Hong Kong – unlike Singapore – is hard pressed to present itself as the neutral 'Switzerland of Asia',³ but is very well placed to play the role of China's 'New York' – integrally tied both economically and politically to one of the largest economies in the world while separate from it and primarily outward looking.

Hong Kong serves the domestic economy of mainland China, yet its institutions did not spring from Chinese soil. This chapter will show how Hong Kong was built up as a colonial trading centre of the British empire, and Chapter 3 will show how, since the 1980s, it has reinvented its legal and regulatory framework to become the international financial centre of China employing mainly British tools. Moreover, the merely factual division between domestic and international found in New York and London becomes a real political boundary in Hong Kong under the 'one country, two systems' model.⁴ We are presented with the unique phenomenon of a foreign, offshore financial centre operating a British-origin legal system within the Chinese state. These characteristics endow Hong Kong with unique comparative advantages in serving as China's international financial centre. From its inception, Hong Kong was designed as a gateway between the local and the international and a component of a larger whole. It was built to be a gateway controlled by the British facilitating

financial institutions can legally operate in the UK), third Commonwealth member states (whose companies populate the UK stock markets), and finally the rest of the world.

³ Ben Steverman, 'Cashing in on the New Gold Rush', Bloomberg.com (12 November 2012).

⁴ This is enshrined in Article 5 of the Basic Law of the Special Administrative Region of the People's Republic of China ('Basic Law'): 'The socialist system and policies shall not be practised in the Hong Kong Special Administrative Region, and the previous capitalist system and way of life shall remain unchanged for 50 years.'

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trade in goods with China and after some modification now serves as a gate independent from (yet controlled by)⁵ Beijing facilitating both investment into China, and to a lesser extent outward-bound investment transactions. Although all international financial centres shape their laws and institutions to a certain extent as services to meet the needs of clients based outside the jurisdiction, Hong Kong has always known a government designed to be responsive to the needs of its international commercial activity.⁶ This characteristic is also shared by the fellow, former colony of Singapore, although Singapore's political, cultural and geographical circumstances present a very different picture than Hong Kong, which clearly serves the Chinese economy. In this regard, we can see that the analogy of Singapore as the 'Switzerland of Asia' does have some merit, whilst Hong Kong more closely resembles New York and London in legal stature and outlook. London is a financial centre first to Britain, then to Europe and finally to the world; New York serves first the United States and North America, then the rest of the world; Hong Kong is oriented first of all to China, then the remainder of Asia and finally to the global economy. Because it was built as a trade centre, has law originating from one of the world's most respected legal traditions, yet works within China as a Special Administrative Region, Hong Kong presents a package of structural and geopolitical factors that make it a more natural financial centre than any of its three peers. This is quite an endowment, but what has Hong Kong done with it? That is one of the questions this book has been written to answer.⁷ A good starting point in the project to understand whether Hong Kong has the measures necessary to successfully build on and address dangers from this inherited base is to understand the shape and content of the base: Hong Kong's socio-economic and legal structure in the context of the historical path by which its natural endowment was formed. That will be the function of this first chapter.

⁵ As will be discussed in following, 'control' arises first of all from the fact that China is Hong Kong's primary client for financial services, with the companies directly or indirectly controlled by the Chinese state constituting about 45 per cent of its market capitalization. Second, the Hong Kong constitution gives final power over its legislative enactments and judicial interpretation of its Basic Law to the Chinese 'National People's Congress' (see Articles 17 and 18 of the Basic Law). As such, Hong Kong is independent, but only up to a limit.

⁶ This characteristic would of course be shared by Singapore, although Singapore's current client base is more multilateral than that of Hong Kong.

⁷ As noted at the outset, this text is the outcome of a Public Policy Research Project funded by the Hong Kong Research Grants Council. The project, conducted from 2009 to 2012, was entitled 'Anatomy of a Financial Centre: A Systemic Analysis of Hong Kong's Legal and Regulatory Framework for its Securities Market'.

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[More information](#)*2 Accidental haven with unintended consequences*

The Crown Colony and later Special Administrative Region of Hong Kong has, from inception, served as a component of a larger whole, providing a portal from one culture, economy and political system to another. Like other coveted, strategically important locations, the struggle for control over Hong Kong reflected the relative power of two nations – Great Britain and China – over time. Unlike most disputed territories, however, Hong Kong brought two dramatically different cultures into close contact, and eventually formed a deep bond of friendship between the two. While serving this function, the particular composition and governance structure of Hong Kong has amalgamated many aspects of British public administration and rule of law with Chinese culture, creating a unique form of civil society. Originally just another strategic port seized as the spoils of war, Hong Kong became a safe haven for millions of Chinese, who comprised nearly all of the British colony's population, and this occurred during some of China's darkest hours, times of occupation, revolution and restructuring. An imperial power of exploitation thus took on a relatively beneficent caretaker role for a large population of Chinese refugees who generally accepted – or, perhaps more accurately, did their best to ignore – British rule during the 150 years plus that it governed Hong Kong. It has been repeatedly observed that the non-democratic structure of the colonial management over the populous mirrored the various forms of paternalistic government found in China itself during the period.⁸ Yet although the Hong Kong Chinese found themselves in a government in which they had no say, they also experienced a form of authority that stressed law, individual rights and procedural mechanisms to protect those rights. The result was that the people of Hong Kong were presented with a general framework of government displaying extensive formal congruity with their authoritarian home in China, yet they were contemporaneously exposed to a very foreign ideology and social structure stressing rights and a proud exercise of the rule of law as standing above government authority.

Seen from the perspective of what economists and legal theorists call 'path dependence',⁹ the British chose an administrative caretaker structure, resembling the existing path in the Chinese Empire for a number of

⁸ See, e.g., Tsang (2004: 198–9). For further discussion of the scholarship on this question, see Goodstadt (2007: 218–22).

⁹ See North (1990: 93) for a discussion of the origins of this term.

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reasons: it was a standard colonial format that they had employed at least since American independence, linguistic barriers made greater interaction with Chinese subjects extremely difficult, and the colonial managers consciously employed tools that could be translated quickly into the authority symbols of their subjects' native culture.¹⁰ For similar reasons, a judicial system with high independence and expectations of competence was introduced to administer a body of law introduced mainly through a targeted collection of ordinances that set out rules for public order and the protection of private property.¹¹ This was the English legal system adjusted for colonial administration and the only one the colonial power had at its disposal. It was introduced for this reason, not because Great Britain was preparing to school millions of Chinese in the Western legal tradition.¹² As discussed below, however, the unanticipated result has been the creation of a *Chinese* polity with a greatly English core in public matters and an economy that sets global standards for excellence according to a wide range of *Western* indicators.

In his text, *Capitalism with Chinese Characteristics: Entrepreneurship and the State*, MIT political economist Yasheng Huang has recently argued:

China's success has less to do with creating efficient institutions and more to do with permitting access to efficient institutions outside of China ... China is fortunate enough to have the most laissez-faire economic system at its doorstep. Hong Kong is a safe harbour for some of the talented Chinese entrepreneurs and an alternative to China's poorly functioning financial and legal systems. It is only a slight exaggeration to say that [the computer manufacturer] Lenovo benefited as much from the British legacy as from the grown opportunities within China itself. China is unique in that some of its capable entrepreneurs have the option of accessing one of the most efficient financial markets and legal institutions in the world.¹³

Leaving aside for the moment Huang's judgement that China's 'inefficient' institutions survive thanks to use of 'efficient' institutions just across the border, Huang does succinctly highlight Hong Kong's salient

¹⁰ For a discussion of these efforts, see Section C.3, below.

¹¹ These ordinances are discussed in Section C.1, below.

¹² This conception of the colonization was of course raised by some at the time as moral justification for British rule, but there is no evidence that it was ever taken seriously by the colonial administration or the Crown, particularly as the original, primary purpose of Hong Kong was to import opium into China and provide a base to allow the military to ensure that the Chinese government could not stop such imports. See the discussion in Munn (2001: 34–7).

¹³ Huang (2008: 6).

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characteristics: safe harbour (it is 99 per cent peopled by 'immigrants' into Hong Kong and their offspring);¹⁴ on China's doorstep (it is linked economically and infrastructurally to Shenzhen, a Chinese city of some 11 million);¹⁵ laissez-faire (ranked the world's freest economy 20 years in a row);¹⁶ and efficient financial market (consistently ranked a 'global leader' among the world's financial centres).¹⁷ Yet Hong Kong also earns a prominent place in books with titles like *Asian Godfathers: Money and Power in Hong Kong and Southeast Asia*,¹⁸ because of the economic power and prominence of a small group of families, locally called 'the tycoons', as the following phrasing from Hong Kong's *South China Morning Post* exemplifies: 'Tycoons and their business empires pervade every corner of our city; their importance to the government in providing employment and tax revenue sometimes gives the impression that the playing field is tilted in their favour and that their actions and behaviour are governed by a different set of rules.'¹⁹ In addition, like many international financial centres, Hong Kong is seen as catering to the needs of multinational enterprises and foreign interests instead of the immediate needs of its own citizens.²⁰ Yet even today, many Chinese see emigration to Hong Kong as an alternative more attractive than remaining in China,²¹ where prosperity may indeed be arriving, but basic civil rights and their exercise are still uncertain. Thus Hong Kong is seen as orderly and efficient, a desirable haven for Chinese seeking a safer and more just society, yet accused by many of being unfairly twisted in favour of powerful interests.

There is also an important temporal axis to the shape of the Hong Kong economy: its function regionally and globally has changed in adaptation

¹⁴ As discussed below, Hong Kong Island was inhabited by about 2,000 fishers and farmers when the British arrived and now has a population of about seven million. Fittingly, its very name, 香港, means 'fragrant harbour'.

¹⁵ This is a figure for registered residents, as provided by the Shenzhen government on its website (<http://english.sz.gov.cn/gi> (accessed 15 March 2014)). As at 2013, unofficial estimates approached 16 million for all residences, registered and unregistered.

¹⁶ The Heritage Foundation (2014: 4). Hong Kong officially champions this laissez-faire position, although, as will be discussed in Section D.2, history shows that the Hong Kong government does intervene to guide the market and correct market failures, and has done so increasingly in recent years.

¹⁷ Z/Yen Group (2011, 2012, 2013). ¹⁸ Studwell (2007).

¹⁹ 'Richard Li Raid Sends out an Equality Signal', *South China Morning Post* (1 April 2010).

²⁰ See, e.g., Goodstadt (2007: 218–19).

²¹ Taking advantage of a judicial interpretation of the Basic Law that gave permanent residency to children born in Hong Kong, in 2011 approximately 40,000 mainland Chinese women took the extraordinary measure of travelling to Hong Kong to give birth, with effects so severe on the public health system that the practice was eventually banned. See

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to the activities that China was able to perform, at times serving to replace the functions of a mainland China that was closed off to the world, and at other times supplementing a China that was less than efficient, much as Huang describes above. Following an initial period of slow growth,²² Hong Kong became the southern hub of British activity in China, connecting the treaty ports of the north with Malaysia and Singapore.²³ China was experiencing the decline of its Qing Empire, together with the many political and social woes that this brought,²⁴ and was a source of products for export and customers for imports, but not a serious competitor in international trade. Hong Kong grew into a thriving trading hub for import into and export from China. There was a chance that this could have changed during the short life of the Republic of China, but this period was also rocked by political unrest and finally collapsed into Japanese invasion.²⁵ During Japanese occupation, Hong Kong was once again under the same ruler as mainland China, but the city was stripped and looted, losing most of its population and economic activity.²⁶ Following the four years of post-War and Civil War in China, Hong Kong then entered into a 30-year period in which it came (along with Taiwan and Japan) to fill the void left in manufacturing and services as China retreated from the world.²⁷ When China reopened its doors for business in the 1980s, manufacturing then migrated out of Hong Kong into neighbouring Guangdong, and Hong Kong shifted its efforts towards logistics and finance. It appears that in 2013, the Port of Shenzhen overtook the Port of Hong Kong in volume processed,²⁸ and it remains to be seen just how much of this economic activity will permanently return to the mainland in the long term. Hong Kong's shift to finance, which is a central focus of this book, has led it to become one of the world's leading financial

Ella Lee, 'Public Hospitals May Act on Mainland Mothers', *South China Morning Post* (14 August 2012).

²² This period is discussed in detail in Section B.1, below.

²³ See, e.g., Tsang (2004: 57–8). ²⁴ See, e.g., Spence (1990: 167–91).

²⁵ See, e.g., Spence (1990: 267–83).

²⁶ See, e.g., Tsang (2004: 127–8), explaining that the population dropped from approximately 1.5 million to approximately 600,000 and that hundreds of corpses were collected weekly from the streets, having died of both starvation and violence at the hands of the occupation troops.

²⁷ Tsang (2004: 162–7); Goodstadt (2007: 97–103).

²⁸ Zhong Nan, 'Shenzhen Set to be World's 3rd-largest Container Port', *China Daily* (22 October 2013) ('Container flow through Shenzhen reached 17.28 million 20-foot equivalent units of containers in the first nine months, while Hong Kong handled 16.34 million TEU of containers, according to data released at the 2013 China (Shenzhen) International Logistics and Transportation Fair').

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centres. One of the underlying questions posed in this book is whether Hong Kong is undertaking what it can to ensure that such financial activity does not eventually migrate back to Shanghai, the historically prominent financial centre of China.

During its various manifestations as entrepôt, manufacturing hub and financial centre, Hong Kong has received both high accolades for efficiency and criticism for inequality. What aspects of Hong Kong's character attract such strong praise and disconcerting criticism? The key appears to lie in the colonial 'caretaker structure' of Hong Kong's political and economic system and its simultaneous internalization of the British system of rights and procedural justice at the level of public discourse. The former arrangement fed directly into a laissez-faire economy in which governmental and economic leaders are free to give distant interests, whether they arise in London or in Beijing, a central place in policy making, potentially ignoring negative local impact. The latter, however, provides a fair system of public law and efficient avenues for the resolution of private disputes within this open-ended economy. Just as strategic and economic goals have been imported from afar through channels of power and finance, so too has law been brought in through statutory linkage and subsequent adjustment. Through the century and a half of the colony's link to the English legal system, principles of English law gradually merged into Hong Kong Chinese culture to synthesize a truly unique blend of rights-based and relationship-based dealing. Hong Kong's judicial system has continued to operate well after the SAR's return to China, and receives praise from disinterested observers for the quality of its adjudication.²⁹

Institutional quality, whether that of a colonial trading entrepôt or an international financial centre, is judged by meeting the needs of merchants on the one hand or the international financial community on the other, regardless of whether this function might override and neglect some needs of local citizens.³⁰ Nevertheless, the private lives of most Hong Kong citizens would have had little interaction with these characteristics

²⁹ For example, the World Justice Project (WJP) Rule of Law Index 2012–2013 ranked Hong Kong above France, Belgium and the United States for access to civil justice. WJP (2013: 27).

³⁰ At the level of policy making, prosperous trade or financial activity would theoretically bring with it jobs and increased tax revenue that help all residents. Problems can arise, however, when a zero-sum context occurs, such as the use of space to build offices for international financial firms, which in turn makes that available for housing scarce, driving up the cost of living for average residents.

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of colonial government because they rarely came into direct contact with its institutions.³¹ They could live largely free of the colonial master while also being free of the various ills that affected life on the mainland. Public and private co-existed without significant demands between the two, thanks to the caretaker structure, and as will be discussed in more detail below, the ability of this caretaker structure to function throughout Hong Kong's history has greatly depended on a partnership between government and business, in which important governmental functions were either delegated directly to, or performed in close cooperation with, leading merchants, much as guilds functioned in medieval Europe and pre-communist China. Hong Kong's legal system both facilitated and reflected this basic structure, with a core of local ordinances producing the minimum order necessary for Hong Kong to function, and the courts importing law on demand through a colonial network of courts that generated a rich corpus of case law.³² Moreover, as will also be discussed in the following, when this British system was applied to the actions of the colony's local inhabitants, the system's caretakers attempted to adjust it to the new environment in skilful and interesting ways.

B Forming Hong Kong's 'caretaker' government model

1 *Cutting in the middlemen*

Aside from the obvious fact of British rule over a primarily Chinese population,³³ the development of Hong Kong's socio-economic and legal systems was greatly shaped by external events that channelled immigration into the colony and encouraged these immigrants to remain in Hong Kong. This has been summed up with the dark expression that 'trouble in China was a "god-send" for Hong Kong'.³⁴ This was particularly true because, given the language barriers and the ratio of a few British colonial

³¹ Law Wing Sang makes the interesting argument that the missionary schools in Hong Kong provided a cultural basis through which the Chinese were able to understand and accept the British institutions. Law (2009: 31–56).

³² The application of English Common Law in Hong Kong will be discussed in Section C.3.

³³ The European population of Hong Kong ranged from a couple of hundred in the early years to a couple of thousand in 1870. See Munn (2001: Figure 2.1).

³⁴ Munn (2001: 49). This characteristic is shared with another political area constituted by refugees: the United States. The United States received wave after wave of immigrants with different sorts of characteristics, depending on the country they were fleeing and the particular kind of trouble (religious, economic or political) that their country of origin was suffering from.

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administrators to thousands of Chinese subjects, events forcing emigration from the mainland of a critical mass of influential Chinese who were able to understand the English language and the needs of colonial officials was a key to the colony's survival.³⁵ The type and extent of 'trouble in China' greatly determined the type and extent of emigration from China to Hong Kong, which then determined both the need for, and possibility of founding, an informal governing body of Chinese subjects in the colony. Further, the presence/absence and strength/weakness of the Chinese elite co-opted into government service had a significant influence on the development of Hong Kong's legal system as it progressed from a group of sparsely populated Guangdong fishing villages to a metropolitan area of about seven million.³⁶ As will be explained below, the development of Hong Kong's economy and legal system to this day generally follow the paths cut for them during Hong Kong's first half-century as an unruly entrepôt in which colonial administrators came to depend on a merchant elite to govern the safe haven on the edge of a decaying Chinese Empire.

The setting and circumstances of Hong Kong's founding and first decades were unusual in many ways. Hong Kong was a strategically unimportant piece of territory that Britain seized from a very large and proudly hostile Chinese Empire through military force in retaliation for Chinese officials confiscating 20,000 chests of illegal opium from British merchants in Guangzhou.³⁷ The initial, legal acquisition of Hong Kong in January 1841 was through an act of insubordination directly contravening Britain's official aim of acquiring trading access far to the north, near Shanghai, specifically one of the islands in the Zhoushan group.³⁸ The British Superintendent of Trade, Captain Charles Elliot, who negotiated the Chuenpi Convention (which was never ratified) providing for the acquisition of Hong Kong, was removed from office.³⁹ Because neither

³⁵ Goodstadt (2005: 98), Munn (2001: 372), Sinn (2003: 82), Tsang (2004: 68).

³⁶ The estimate of 2,000 original inhabitants is endorsed by Sinn (2003: 10), although Munn is more hesitant to specify an exact figure (2001: 69). The current population is provided on an up-to-date basis by the HKSAR Census and Statistics Department at www.gov.hk.

³⁷ Spence (1990: 154). In part to support its colony of India, and in part because China did not want to purchase British goods and this led to undesirable outflows of silver, the British East India Company brought opium into China, sold it locally and used the proceeds to purchase items such as tea, silk and porcelain, which it then exported to Europe. Given the effects of opium on Chinese society and on its balance of payments, China outlawed the opium trade in 1838. See Spence (1990: 151–66), Munn (2001: 24–31), Ferguson (2004: 139).

³⁸ Tsang (2004: 11).

³⁹ Lovell (2011: 168–78) provides a detailed history of this question, in which she cites both Queen Victoria and Prime Minister Lord Melbourne as seeing benefits in Elliot's