OneDegree
Group

Comments to the Securities and Futures Commission (SFC) on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the SFC (20 February 2023)

OneDegree Hong Kong Limited

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OneDegree Hong Kong Limited understands and agrees that our name and submission may be published.

We would like to respond to the consultation questions 4 and 5

Question 4: Do you have any comments on the proposal to allow a combination of third-party insurance and funds set aside by the licensed platform operator or a corporation within its same group of companies? Do you propose other options?

Question 5: Do you have any suggestions as to how funds should be set aside by the licensed platform operators (for instance, under house account of the licensed platform operator or under an escrow arrangement)? Please explain in detail the proposed arrangement and how it may provide the same level of comfort as third-party insurance.

As the only Hong Kong licensed insurance company offering third-party insurance for virtual assets, OneDegree already works with many existing and potential licence holders to satisfy their risk management needs. We offer insurance protection for virtual assets contained in both cold and hot storage as well as professional indemnity, directors & officers and cyber insurance to virtual asset sector participants. We believe that insurance will always play an important role in the risk management arrangements of licensed platform operators.

As the SFC recognises, however, the available insurance for virtual asset sector participants is limited by various factors. Few insurance companies or reinsurers are willing to offer protection that relates to virtual assets meaning that the available capacity in the market is still low. Premiums especially for hot storage coverage remain high given the perceived risks associated with virtual asset storage.

We believe that the SFC's proposed regulatory requirements for virtual asset trading platform operators offer an opportunity for Hong Kong to take a world-leading role in the development of innovative risk management practices in the virtual asset sector. Done successfully, this development could have a material impact on virtual asset adoption, driving the many potential benefits such as financial inclusion and innovation.

We see that Hong Kong licensed insurers can contribute in several ways, including:

- Knowledge building: The global insurance sector has a low knowledge base when it comes to virtual assets. Increasing this base is essential to attract more insurance capacity. OneDegree has already made significant contributions in this nascent field including co-authoring two academic papers with the Society of Actuaries[1]. Through

[1] Available to read here:
https://www.soa.org/4aa5c3/globalassets/assets/files/resources/research-report/2022/decentralized-ins-alt.pdf
https://www.soa.org/4aa5bb/globalassets/assets/files/resources/research-report/2022/decentralized-finance-protocols.pdf

its virtual asset regulation, we observe that the SFC has also obtained thought leadership in this field. We welcome all opportunities to collaborate and turn Hong Kong into a knowledge hub for virtual asset risk management.

- Capacity creation: Hong Kong general insurance capacity will certainly not be sufficient to meet the needs of the SFC licenced platform operators. Hong Kong insurers can act as a bridge between the platform operators and international insurance markets. By providing local, specialist knowledge, the Hong Kong insurers are well-placed to perform the necessary underwriting and due diligence to satisfy international capacity providers.
- Innovative structuring: The Hong Kong government's policy statement on the development of virtual assets in Hong Kong acknowledges that virtual assets have unique characteristics different from traditional assets. We believe that risk management structures for virtual assets must reflect these unique characteristics and should not necessarily follow the structures used for traditional assets. For this reason, we welcome the SFC's modified insurance / compensation arrangements. It is expected that most Hong Kong licenced platform operators would opt for a combination of third party insurance and a non-insurance alternative. In this response, we set out an example of a structure that may be appropriate for an SFC licenced platform operator.

Example risk management structure

It will rarely be cost-effective for platform operators to insure all client assets held by them. We believe it is important, however, for platform operators to obtain a policy covering certain risk layers because the ability to obtain such a policy demonstrates a high level of internal controls and risk management. In this regard, insurers act as another check and balance over platform operators in addition to the SFC.

Instead of a policy that covers the first layers of risk, "high deductible" insurance may be appropriate. This form of insurance requires the platform operator to bear the first portion of lost assets up to a certain amount (depending on the size of the platform, this could be millions of Hong Kong dollars). The insurance would then cover the excess up to the policy limit. This form of insurance is more cost-effective because it does not cover the relatively more likely loss events but only triggers in exceptional cases of very high loss.

The challenge then becomes managing the risk of the deductible portion.

We share the concerns of many stakeholders that requiring Hong Kong licensed platform operators to ring-fence too great an amount of funds is likely to make them uncompetitive against their peers elsewhere in the world.

To address this, we propose an arrangement whereby two or more platform operators pool their risk funds together. This arrangement would work as follows:

- An underwriting and actuarial assessment is carried out to assess the level of risk and identify the amount of risk funds that is required based on the number of participants and amount of uninsured client assets held by each. Hong Kong insurers would be able to assist with this assessment.
- The participating platform operators enter into a risk pooling agreement that governs the arrangement including the criteria for withdrawals from the risk pool in the event a participant suffers an incident (eg a hack), a commitment to replenish the risk pool in the event of a withdrawal, dissolution of the arrangement etc.
- A third-party entity holds the pooled funds on trust for the participating platform operators and agrees to follow the risk pooling agreement as regards withdrawals, dissolution etc.
- Upon a potential withdrawal event, a trusted third party advises the participants/trustee as to whether the event satisfies the criteria for a withdrawal from the risk pool. Again, Hong Kong insurers could assist with this stage.

An argument may be raised that this model would fail if the risks faced by the participating platform operators are highly correlated, because a single event could result in multiple participants making claims on the risk pool, thereby leaving a shortfall. Based on our detailed risk assessments of the virtual asset sector, we believe that correlation of these risks is in fact low and this can be demonstrated by our empirical studies on the loss incident history.

We acknowledge that there are many more details which would need to be provided in collaboration with the various stakeholders to realise this innovative risk pooling structure.

We would like to respectfully propose that SFC allows sufficient flexibility in the proposed regulatory requirements for such innovative structures to be explored and tested.

We are excited that Hong Kong is taking a global lead in virtual asset regulations and feel confident that the high level of knowledge and expertise here will allow all stakeholders to contribute to ground-breaking solutions.

We are available to discuss and provide more information at SFC’s convenience.