COMPLIANCE UPDATE
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Nebraska Bankers Association

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SUPERVISORY NON-OBJECTION PROCESS FOR STATE MEMBER BANKS SEEKING TO ENGAGE IN CERTAIN ACTIVITIES INVOLVING DOLLAR TOKENS

I. BACKGROUND

The Board of Governors of the Federal Reserve System (Board) previously issued a Policy Statement on section 9(13) of the Federal Reserve Act clarifying that the Board generally presumes that it will exercise its discretion under section 9(13) of the Federal Reserve Act to limit state member banks and their subsidiaries to engaging as principal in only those activities that are permissible for national banks — in each case, subject to the terms, conditions, and limitations placed on national banks with respect to the activity — unless those activities are permissible for state banks by federal statute or under 12 CFR part 362.

In Interpretive Letter 1174, the Office of the Comptroller of the Currency (OCC) specifically recognized the authority of national banks to use distributed ledger technology or similar technologies to conduct payments activities as principal, including by issuing, holding, or transacting in dollar tokens. However, the OCC conditioned the legal permissibility of these activities on a national bank demonstrating, to the satisfaction of its supervisors, that it has in place controls to conduct the activity in a safe and sound manner.

II. NON-OBJECTION PROCESS FOR DOLLAR TOKEN ACTIVITIES

A state member bank seeking to engage in activities permitted for national banks under OCC Interpretive Letter 1174, including issuing, holding, or transacting in dollar tokens to facilitate payments, is required to demonstrate, to the satisfaction of Federal Reserve supervisors, that the bank has controls in place to conduct the activity in a safe and sound manner. To verify this requirement has been met, a state member bank should receive a written notification of supervisory non-objection from the Federal Reserve before engaging in the proposed activities.

A state member bank seeking to engage in such dollar token activities, including for the purpose of testing, must notify its lead supervisory point of contact at the Federal Reserve of the bank's intention to engage in the proposed activity and should include a description of the proposed activity. Federal Reserve supervisory staff may follow up with the bank to seek additional information in order to better understand the proposal and the control framework that the state member bank has put in place. After receiving a written notification of supervisory non-objection, state member banks will continue to be subject to supervisory review and heightened monitoring of these activities.

To obtain a written notification of supervisory non-objection, a state member bank should demonstrate that it has established appropriate risk management practices for the proposed activities, including having adequate systems in place to identify, measure, monitor, and control the risks of its activities, and the ability to do so on an ongoing basis. Federal Reserve staff will focus on the risks discussed in the preamble to the Policy Statement with respect to dollar tokens, including, but not limited to:

- **operational risks**, including those risks associated with the governance and oversight of the network; clarity of the roles, responsibilities, and liabilities of parties involved; and the transaction validation process (e.g., timing and finality of settlement of transactions, potential irreversibility of transactions, and the central authority of transaction records);
- **cybersecurity risks**, including risks associated with the network on which the dollar token is transacted, the use of smart contracts, and any use of open source code;
- **liquidity risks**, including the risk that the dollar token could experience substantial redemptions in a short period of time that would trigger rapid outflows of deposits;
- **illicit finance risks**, including risks relating to compliance with Bank Secrecy Act and Office of Foreign Asset Control requirements, which include requiring banking organizations to verify the identity of a customer, perform due diligence to understand the nature and purpose of the customer relationship, and perform ongoing monitoring to identify and report suspicious activity; and
- **consumer compliance risks**, including risks related to identifying and ensuring compliance with any consumer protection statutes and regulations that apply to the specific dollar token activity.

Federal Reserve staff will also assess whether the bank has demonstrated that it understands and will comply with laws that apply to the proposed activities.

III. CREATION OF NOVEL ACTIVITIES SUPERVISION PROGRAM (FRB SUPERVISED BANKING ORGANIZATIONS)

A. Introduction

The Federal Reserve has established a Novel Activities Supervision Program (Program) to enhance the supervision of novel activities conducted by banking organizations supervised by the Federal Reserve. The Program will focus on novel activities related to crypto-assets, distributed ledger technology (DLT), and complex, technology-driven partnerships with non-banks to deliver financial services to customers. The Program will be risk-focused and complement existing supervisory processes, strengthening the oversight of novel activities conducted by supervised banking organizations.

B. Novel Activities Supervision Program

The Federal Reserve established the Program to ensure that the risks associated with innovation are appropriately addressed. The Program will enhance the supervision of novel activities conducted by supervised banking organizations, with a focus on the following activities:

- Complex, technology-driven partnerships with non-banks to provide banking services – Partnerships where a non-bank serves as a provider of banking products and services to end customers, usually involving technologies like application

programming interfaces (APIs) that provide automated access to the bank's infrastructure.
- Crypto-asset related activities – Activities such as crypto-asset custody, crypto-collateralized lending, facilitating crypto-asset trading, and engaging in stablecoin/dollar token issuance or distribution.
- Projects that use DLT with the potential for significant impact on the financial system – The exploration or use of DLT for various use cases such as issuance of dollar tokens and tokenization of securities or other assets.
- Concentrated provision of banking services to crypto-asset-related entities and fintechs – Banking organizations concentrated in providing traditional banking activities such as deposits, payments, and lending to crypto-asset-related entities and fintechs.

The Program will work in partnership with existing Federal Reserve supervisory teams to monitor and examine novel activities conducted by supervised banking organizations. Supervised entities engaging in novel activities will not be moved to a separate supervisory portfolio. Instead, the Program will work within existing supervisory portfolios and alongside existing supervisory teams. The Program will leverage current supervisory processes to the extent possible to maximize efficiency and minimize burden.

The Program will be risk-based, and the level and intensity of supervision will vary based on the level of engagement in novel activities by each supervised banking organization. The Federal Reserve will notify in writing those supervised banking organizations whose novel activities will be subject to examination through the Program. The Federal Reserve will periodically evaluate and update which banking organizations should be subject to the examination of novel activities through the Program, and banking organizations will be notified accordingly. In addition, as part of the Program, the Federal Reserve will routinely monitor supervised banking organizations that are exploring novel activities.

To help ensure the Program is informed by diverse perspectives and best practices in supervision and risk-management, it will be advised by a range of multidisciplinary leaders from around the Federal Reserve System. To stay abreast of emerging issues, technologies, and new products, the Program will engage broadly with external experts from academia and the banking, finance, and technology industries. The Program will incorporate insights and analysis from real-time data, market monitoring, horizontal exams, and proactive, intentional, and regular information exchange across portfolios, federal bank regulatory agencies, and other stakeholders.

Through this Program, the Federal Reserve will continue to build upon and enhance its technical expertise to better understand novel activities, the novel manifestations of risks of such activities, and appropriate controls to manage such risks. In addition to enhancing the supervision of risks associated with banking organizations engaging in novel activities, the Program will also inform the development of supervisory approaches and guidance for banking organizations engaging in novel activities, as warranted.

The Program will help ensure that regulation and supervision allow for innovations that improve access to and the delivery of financial services, while also safeguarding bank customers, banking organizations, and financial stability. The Program will also operate in keeping with the principle that banking organizations are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation.