

GUIDANCE DOCUMENT

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NEBRASKA FINANCIAL INNOVATION ACT
STATEMENT OF POLICY #2

SAFETY AND SOUNDNESS

The Nebraska Department of Banking and Finance (“Department”) sets forth Statement of Policy #2 regarding the determination of safe and sound operations by a Digital Asset Depository Institution or a Digital Asset Depository Department (collectively referred to as “charters”). All statutory citations are to the Nebraska Financial Innovation Act (the “Act”).

Pursuant to Neb. Rev. Stat. § 8-3004, the Director shall have general control and supervision over charters under the Act. Additionally, Section 8-102 of the Nebraska Banking Act provides that charters are quasi-public in nature and subject to regulation and control by the state.

Accordingly, the Department is tasked with the regulatory duty of ensuring that charters under the Act operate in a safe and sound manner, and in accordance with all applicable state and federal laws and regulations. By doing so, the Department works to maintain trust, confidence, and stability in the financial industries of the State of Nebraska. Pursuant to the Act, this responsibility also encompasses oversight and supervision of applicable holding companies, affiliates, subsidiaries, and service providers of a charter, where appropriate.

While charters under the Act may operate differently than traditional financial institutions, many of the existing, and well-established, frameworks and sets of guidelines covering bank supervision, and safety and soundness more broadly, are still generally applicable and will help to guide and shape the manner in which the Department examines and regulates these charters. The Department generally utilizes a risk-based approach to examination and supervision, complemented by specific and targeted reviews. Though charters under the Act may offer and provide a variety of products and services, from issuing stablecoins to acting as a custodian of digital assets, the Department’s approach will provide for consistent, yet scalable supervisory practices.

Unsafe or Unsound Practices or Conditions

An unsafe or unsound practice encompasses any action, or lack of action, by a charter, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would result in abnormal risk of loss or damage to a charter, its shareholders, or its customers. Additionally, these actions, or lack of actions represent marginal risk management practices that generally fail to identify, monitor, and control the abnormal risk exposures.

While not an exhaustive list, the following types of actions or conduct are generally found

to be unsafe or unsound in the operation of a charter:

- Operating with inadequate capital levels;
- Operating with inadequate liquidity relative to the charter's operations, and where applicable, relative to its outstanding value of issued stablecoins;
- Operating without appropriate internal controls; an appropriate audit program, an information security program; or a risk management program that is commensurate with the charter's risk profile;
- Engaging in investment practices that do not adequately account for the level of speculation or risk associated with those practices;
- Paying excessive dividends in relation to the charter's capital, earnings, and assets;
- Taking actions identifiable as self-dealing, such as paying excessive compensation, defined as compensation that is unreasonable and disproportionate to the services performed, to any executive officer, employee, director, shareholder, or third-party engaged by the charter; and
- Operating in a non-compliant manner, as to state and federal laws, rules, and regulations

Additionally, the failure of a charter to act or to undertake certain actions may also be deemed unsafe or unsound operations. Some of these failures include, but are not limited to:

- Failing to provide adequate supervision and direction over officers and management;
- Failing to keep accurate books and records; and
- Failure to implement an adequate compliance management system.

Charters must also seek to avoid operating in a manner that would create an unsafe or unsound condition. An unsafe or unsound condition is a condition that, if continued without remediation, would result in an abnormal risk of loss or damage to the charter or to its customers. Unsafe or unsound conditions are assessed based on virtually every aspect of the charter's operations and position, including evaluations of its "CAMELS" component ratings: Capital, Assets, Management, Earnings, Liquidity, and Sensitivity. Some conditions which are generally found to be unsafe or unsound include, but are not limited to:

- Maintaining unduly low net interest margins;
- Maintaining excessive overhead expenses; and
- Maintaining excessive volumes of nonearning assets.

Newly issued charters or de novo charters without other institutional support or infrastructure may often face significant challenges in the first years of their operations. This, in turn, can lead to an increased failure rate amongst charters, which poses significant risk to the financial industry in the state. Accordingly, newer charters are expected not to unreasonably deviate from their Department-reviewed business plans. Additionally, newly issued charters should be aware of, and seek to prevent or mitigate, common risk factors

present at most troubled or failing financial institutions. Some of these common risk factors may include:

- Inadequate risk management controls;
- Unrestrained, unsupported, and/or rapid growth;
- Concentrations in high-risk assets;
- Over-reliance on volatile funding sources;
- Problematic third-party relationships;
- Weak compliance management systems;
- Unchecked and unsupervised officers and management; and
- Inability to maintain capital through profitable operations.

Promoting Safety and Soundness

The Department will assess the whole of a charter in determining if it is operating in a manner that promotes safety and soundness. Within this assessment, there are four key areas that a charter should focus on developing and maintaining a strong position in. These four areas include: operational controls, financial condition, compliance with applicable laws and regulations, and risk management practices.

Operational Controls

A charter should establish controls to ensure that it has the capacity for continued safe and sound operations. These operational controls should provide for robust and sustainable data governance and controls to ensure data quality and the maintenance of system integration, segregation of duties combined with dual controls, an expansive audit function, and strong board and management oversight.

The sophistication of governance and controls framework should align with the charter's size, complexity, and risk profile. Expectations for governance and controls will be higher for more complex firms, but they will also vary based on each firm's unique risk profile. The business activities, products, services, and third-party relationships will all factor into a charter's unique risk profile.

Maintaining robust and sustainable governance and control systems includes the development and continuous support for an effective audit function. The audit function should include internal and external audit coverage, tailored to the complexity of the charter, and based upon an accurate, enterprise-wide assessment of the charter's risk profile. An internal audit system may be narrowed or broadened depending on this analysis; however, each internal audit system should provide for:

- Adequate monitoring of the system of internal controls through an internal audit function;
- Independence and objectivity;
- Performance by qualified persons;

- Adequate testing and review of wholesale and retail payments, the AML/CFT program, IT programs, and information systems programs;
- Adequate testing and review of third-party risk management programs;
- Adequate documentation of tests and findings, and any corrective actions;
- Verification and review of management actions to address material weaknesses;
- Review by the charter's audit committee or board of the effectiveness of the internal audit system; and
- Open lines of communication with regulators.

The charter's board of directors, along with the charter's selected management, must possess the capacity, expertise, and adequate information to fulfill risk oversight and governance responsibilities appropriately. At all times, a capable board must be maintained to ensure the board has the experience, competence, and trust of the communities in which the charter operates, while also establishing clear plans for succession and development of future board members, when vacancies occur. Members of the board should receive regular and ongoing training to ensure that they have the knowledge, skills, and abilities to handle the responsibilities and legal duties that they are tasked with. Board members must act in the best interests of the charter and have sufficient independence, authority, and autonomy to avoid policy dominance by one or a small number of board members.

The charter's board is expected to ensure that the charter has long-term, strategic goals, but that it is also capable of conducting daily operations in such a manner as to meet those long-term goals. These expectations may be met through the board undertaking tasks such as:

- Setting a clear, aligned, and consistent direction for the charter's strategy and risk appetite;
- Directing senior management and requiring appropriate levels of reporting up to the board level;
- Overseeing senior management and providing for accountability, as appropriate;
- Implementing policies and procedures, including a Code of Ethics;
- Developing committees of specialized areas to handle and review specified matters and topics;
- Supporting the independence and stature of independent risk management and internal audit procedures; and
- Maintaining a capable board.

Committees should be established by the board to ensure that directors stay informed, divide labor, and handle matters that require more detailed review and in-depth consideration. While the committees that are established should be tailored to the needs and risk profile of the charter, charters are expected to establish key committees, such as an Audit Committee, a Risk Committee, a Compensation Committee, an IT/Steering Committee, an AML/CFT Committee, and, if appropriate, based upon the activities of the charter, a Trust Committee or Custodial Committee.

The charter's management must ensure that the charter's day-to-day operations are being conducted in accordance with all policies and procedures of the charter, and in compliance with all state and federal laws and regulations, to ensure that the charter is able to accomplish the long-term goals and strategies put in place by the board.

Financial Condition

Department examiners, as a part of the continuous examination process for charters, will conduct an ongoing review of the financial condition of the charter, including a heightened focus on capital and liquidity positions. As the Department will utilize a traditional CAMELS rating component, the financial conditions of the charter will be critical to informing the Department of the ongoing safety and soundness of a charter, and will help guide the supervisory strategy of the Department and the expectations placed upon an individual charter.

For charters that issue stablecoins, that charter is required to maintain segregated unencumbered liquid assets, denominated in U.S. currency, equal to the value of its outstanding issued stablecoins. Accordingly, a continuous monitoring of the reserves and outstanding issued stablecoin will be required both as a component of the financial condition review of a charter and of the compliance review of the charter.

Compliance

As failure to comply with applicable laws not only creates abnormal and outsized risk of loss or damage, but also subjects a charter to fines, penalties, or other monetary impositions that may jeopardize the continuing operations of a charter, compliance is an important aspect of safety and soundness. As a part of the Department's supervision of charters, Examiners will monitor the policies and procedures, operations, and conduct of the charter, to confirm that it is acting in compliance with applicable state and federal laws and regulations. As charters are a part of the wider financial ecosystem and operate on a national, and sometimes international, scale, their business activities will invariably be subject to both Nebraska laws and regulations, as well as federal laws and regulations. Depending upon the financial products and services being offered, and the individuals or companies that they are available to, the laws and regulations of other states may also apply. Charters should carefully consider and develop policies and procedures to ensure that their practices are compliant with existing laws and regulations, and that they are continuously monitoring the jurisdictions that they operate in for changes in laws or regulations that may impact their business.

Risk Management Practices

Proper risk management is essential for safe and sound operations. Charters, based on

the nature of their business activities, will not only be subject to the common risks that traditional financial institutions face but also to the specific risks posed to companies that utilize and are reliant upon innovative technologies.

As a part of ensuring safe and sound operations and business practices, charters are expected to develop and maintain policies and procedures that address and mitigate risk. While these specific policies and procedures will vary on an institution-by-institution basis depending upon the size, scope, and complexity of the individual charter, each charter should have adequate and formalized policies and procedures that address both common risk factors and business specific risk factors that the charter expects to encounter within its operations. Some of the common risks that must be addressed within the policies and procedures of a charter include, but are not limited to:

- Credit risk;
- Interest rate risk;
- Liquidity risk;
- Price risk;
- Operational risk, including third-party risk;
- Compliance and legal risk;
- Strategic risk; and
- Reputational risk.

Some of the risks specific to charters, which will vary widely depending upon the business activities, products, and services of the individual charter, could include, but is in no way limited to:

- Custodial risk;
- Payment system risk;
- Legal and compliance risk relating to classification of particular digital assets or stablecoins as commodities, securities, or assets that require additional licensing, chartering, or registration;
- Technology and security risks associated with either the creation and maintenance of first-party wallets or the access and utilization of third-party wallets;
- Specialized compliance issues relating to AML/CFT laws and regulations, specifically related to Know Your Customer, or “KYC” issues;
- Risks inherent in the choice of blockchain or distributed ledger that will be utilized by the charter, and whether that blockchain is public or private; and
- Risks that may be specific to the individual digital asset being custodied, or of the stablecoin being issued. Such risks will inherently be specialized on an institution-by-institution basis and will require special attention to address and mitigate.

Additionally, as technology continues to advance and new innovations are utilized by both the individual charter and the industry as a whole, charters are expected to continuously update their policies and procedures to ensure that they remain up-to-date, relevant, and mitigate against risks appropriately.

Examination Frequency, Scope, and Procedures

The Department employs an ongoing risk-based supervision approach, focused on evaluating risk, identifying material and emerging concerns, and requiring charters to take timely corrective action before deficiencies compromise their safety and soundness. As a result, the Department will examine charters on a continuous basis, similar to the manner in which large financial institutions, or those with assets of \$10 billion or more are examined. Supervision in this manner is designed and intended to enhance resiliency, lower the probability of failure, and reduce the impact on the whole of the financial industry, and on the individual charter's customers, should the charter experience failure or other material weaknesses.

Continuous examination of charters involves Department Examiners assessing risk and reviewing the charter's operations on an ongoing basis. These continuous assessments and reviews are supplemented by periodic full-scope, targeted, or focused examinations, which may be conducted on-site. Continuous examination assessments and reviews will provide the necessary information and context about the charter's operations to inform the Department as to necessary changes regarding ratings, supervisory strategy, and/or the need for corrective action.

Where applicable, the Department will seek to coordinate with federal agencies, state-based regulators, and foreign jurisdictions, based on supervisory agreements or shared regulatory authority. Additionally, these coordinated efforts are aimed to promote financial stability, ensure consistent standards, protect consumers, and limit supervisory duplication.

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