Algorithmic stablecoins

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An algorithmic stablecoin maintains its peg through a mechanism that expands and contracts supply in response to price, with little or no collateral. Terraform Labs' UST was the leading example until it collapsed in May 2022, wiping out roughly USD 40 billion of value and triggering the chain of failures that brought down Three Arrows Capital, Celsius, Voyager and eventually FTX. UST's mechanism relied on holders being able to swap UST for a fixed dollar value of LUNA, Terraform's volatile governance token. When confidence failed, the swap mechanism minted LUNA without limit and both tokens fell to zero within days.

The legal lesson is that an algorithmic stablecoin is a stablecoin in name only. It carries no redemption promise from any person and is backed by nothing but the market's belief in the mechanism. Both regulators now treat the category with open hostility. FINMA's 2019 supplement had already noted that a token stabilised by algorithm alone is a payment token with elevated risk. MAS excluded algorithmic designs from the SCS framework and has stated that it does not regard them as stablecoins. MiCA's requirements for ARTs are, in practice, impossible for an algorithmic token to meet.[1]

Practice note

A client who proposes to issue any token described as "stable" should be asked to state, in one sentence, who is legally obliged to pay the holder what, when and from which assets. If no one is obliged, the token is a payment token with a marketing claim attached and the client should say so in every document. If someone is obliged, that person is accepting deposits in Switzerland or issuing e-money or an SCS in Singapore and must be licensed accordingly. There is no third option. Design choices described as "algorithmic", "hybrid" or "partially collateralised" do not create one.

Notes

1. On the Terraform collapse see the US Securities and Exchange Commission's complaint in SEC v Terraform Labs Pte Ltd and Do Kwon, SDNY, filed 16 February 2023, and the Singapore proceedings discussed in Part N, Chapter I. Terraform Labs was a Singapore-incorporated company, which is why Part I, Chapter III treats the episode as a turning point in MAS policy.

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