Global Counsel

Terra’s collapse has intensified U.S. regulatory scrutiny surrounding stablecoins. What’s next?

Blog post by Senior Associate Max Mandich, 17 May 2022

Last week’s price collapse of algorithmic stablecoin Terra has highlighted regulatory concerns surrounding stablecoins as U.S. policymakers have continued to examine potential policy frameworks for the growing asset class. As of this writing, Terra continues to trade well below its $1 target peg while sister token Luna has also plummeted in value, catalysed by a downdraft in broader cryptocurrency prices concurrent with the equity market selloff that has accelerated this month. With Terra serving as one of the largest U.S. stablecoins (its market cap was north of $15 billion before last week’s fall), its collapse has accelerated scrutiny of the U.S. stablecoin market and signifies a divide between how regulators view asset-backed (or “fiat”) stablecoins versus algorithmic stablecoins.

Terra’s collapse could raise the spotlight specifically on algorithmic stablecoins, which attempt to use market-based incentives to maintain parity – often in reference to other coins – while asset-backed stablecoins are explicitly by high-quality reserves. Currently released draft legislation from several lawmakers and U.S. congressional hearings have mostly centered around asset-backed stablecoins. While asset-backed stablecoin Tether also briefly lost its own $1 peg amidst the turmoil in the crypto market, the token was able to re-establish parity later in the week. The contrast between the two outcomes could lead lawmakers to focus more intensely on algorithmic coins.

Terra’s attempt to diversify its holdings could also signify the inherent risk of algorithmic coins. One consideration regulators may take when developing a regulatory framework is the attempt by Terra backers to purchase a substantial amount of Bitcoin to serve as a backstop for Terra’s peg. This action alone could be considered closer to how an asset-backed coin is structured with other assets of some type of value being held in reserve. While the majority of asset-backed coins typically hold non-crypto assets, the act of holding Bitcoin by Terra’s developers could signify to regulators that even supporters of algorithmic coins are concerned about potential runs.

The question if specific types of privately issued stablecoins can be considered a form of digital payment as opposed to a security remains a critical one. SEC Chairman Gary Gensler has previously described stablecoins as the “poker chips” that underpin the broader cryptocurrency and decentralized finance (DeFi) economy. The collapse of Terra could accelerate the pace of potential enforcement actions by the SEC in the stablecoin market particularly around high-yield products in which stablecoins are used. However, a coming debate will potentially centre around if some type of stablecoin, particularly those 100% backed by U.S. dollar reserves or other extremely liquid and high-quality assets, could be considered a digital payment mechanism as opposed to a security or commodity. Discussion drafts from both House and Senate lawmakers have attempted to classify a narrow type of “qualified or payments stablecoin” as a new type of digital asset. This will remain an important area of regulation to monitor as lawmakers potentially negotiate stablecoin legislation in the future.

Stablecoin run risk remains a major concern for US lawmakers, which the Terra collapse only intensifies. Throughout recent Congressional hearings and reports released by federal regulators, the risk of a bank-like run on a particular stablecoins was one of the most referenced potential risks related to the asset class. Terra’s collapse amplifies this risk as its structure was unable to prevent a price collapse. A correlation to money market funds in the 2008-2009 financial crisis can be drawn to the stablecoin market. Terra’s collapse does represent a “break the buck” moment in the cryptocurrency space similar to how the Reserve Primary Fund’s net asset value fell below $1 in 2008 - precipitated by its holdings of Lehman Brothers debt leading into the investment bank’s collapse. The Reserve Fund’s breaking the buck necessitated a federal backstop of the money-market mutual fund industry, and contributed to post-crisis regulation of money-market mutual funds involving greater transparency, liquidity requirements and regulation surrounding potential runs. While the remainder of the stablecoin market appears to have stabilised for the moment, lawmakers could use Terra’s collapse to argue for more robust regulation in the stablecoin industry.