

BITFINEX Alpha



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EXECUTIVE SUMMARY

The US economy is facing a multi-faceted challenge with a widening [trade deficit](#), a slight improvement in wholesale inventories, and a slowdown in the services sector. While factory order data out last week looked positive, the overall economic outlook reflects the precarious balance the economy is in. So far the market is still positioned for a pause in rate increases at this week's FOMC meeting.

April saw the US trade deficit widen to its largest gap in eight years, leaping by \$14.0 billion to hit \$74.6 billion. This increase - the biggest since April 2015 - is ringing alarm bells for economists who fear it could chip away up to 2.5 percentage points from Q2 GDP, should the trend persist. Resurgent imports of goods coupled with dwindling energy exports is being held responsible for this surge.

The silver lining comes in the form of an improved performance in [wholesale inventories](#). The latest data suggests a less pronounced decline in April than anticipated, potentially indicating wholesalers are restocking in anticipation of increased future sales.

However, this positive note is tempered by the US [services sector's](#) sluggish growth in May. Although the non-manufacturing PMI reported a reading of 50.3, indicating slight growth, the pace has been significantly slower than earlier in the year. While still above the contraction zone, dwindling services PMI, coupled with an ongoing contraction in the manufacturing sector, heralds caution.

The market is undoubtedly keen to see how these divergent economic indicators will play out in the wider economic landscape. Will the modest improvement in wholesale inventories be able to offset the troubling trade deficit and provide a boost to GDP? Or will the slowdown in the services sector and the weak manufacturing output throw a spanner in the works? The answers to these questions will significantly shape the policy responses from the US government and the Federal Reserve in the months to come. As they grapple with these complex economic dynamics, monitoring the evolving landscape remains crucial.

In crypto markets, Bitcoin is looking increasingly [undervalued](#) when stacked against the S&P 500 index, according to a revealing Ordinary Least Squares regression analysis conducted over the past 200 days. Despite the AI-fuelled rally in US equity markets, Bitcoin is trading at around \$25-26,000, stubbornly below its estimated fair value of \$27,550, suggesting an unseemly discount of over eight percent.

However, even though Bitcoin's correlation with the S&P 500 has cooled, historical trends demonstrate this should not last long. In historical terms, it has only been this low a handful of times, and is taking place as the BTC correlation with gold has been increasing. Historically, a move higher in the BTC-Gold correlation precedes a similar move in the BTC-S&P500 correlation, heralding hope for a reconciliation between Bitcoin and S&P 500, and potentially triggering a 'catch-up' rally in the coming months.

That said, the sharp downward moves in BTC last week, following the legal action by the SEC against Binance and Coinbase, triggered the [largest long liquidations](#) in USD terms, so far this year, totalling \$348 million. The news flow clearly disrupted the market, but taking the behaviour of options traders, it has not had a long lasting impact. Analysing the movement of historical volatility in relation to implied volatility indicates there has not been a significant move in the positions taken by options traders, who do not expect much movement in the price for short dated options.

The news flow in the last week of course has been riveting, as law enforcement and regulatory agencies in the US take action against several centralised exchanges.

Aside from the [SEC's attack](#) against Binance and Coinbase, in which we go into considerable detail, we also saw the US Department of Justice oppose the request by the now bankrupt exchange [Bittrex](#) to let its customers withdraw their locked funds, citing concerns over the need to prioritise some creditors over others. The Bittrex hearing on its bankruptcy plan is due this week, which will be a crucial signal for how customer assets should be treated in the case of a bankruptcy.

More positively though, in El Salvador [Volcano Energy](#) announced it was raising \$1 billion to invest in energy production from solar and wind sources, to add to the national grid and provide power for Bitcoin mining. Attracting such a large amount of investment and harnessing renewable energy to grow the country's energy sector is immensely promising. The initiative provides a pathway for more sustainable Bitcoin mining, and bats away any environmental concerns over the industry, It also demonstrates the huge benefit that El Salvador's decision to adopt Bitcoin as legal tender is having on the country.
Happy trading!

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GENERAL MARKET UPDATE



US Trade Deficit Widens, Posing Challenges for Economic Growth

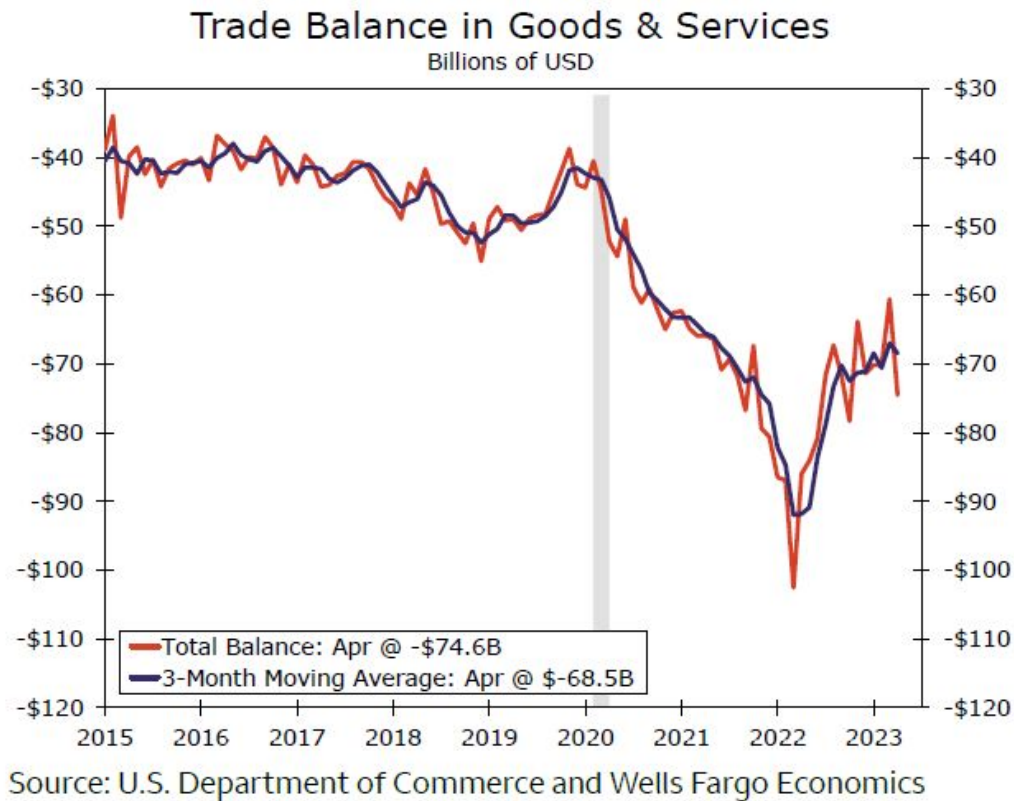
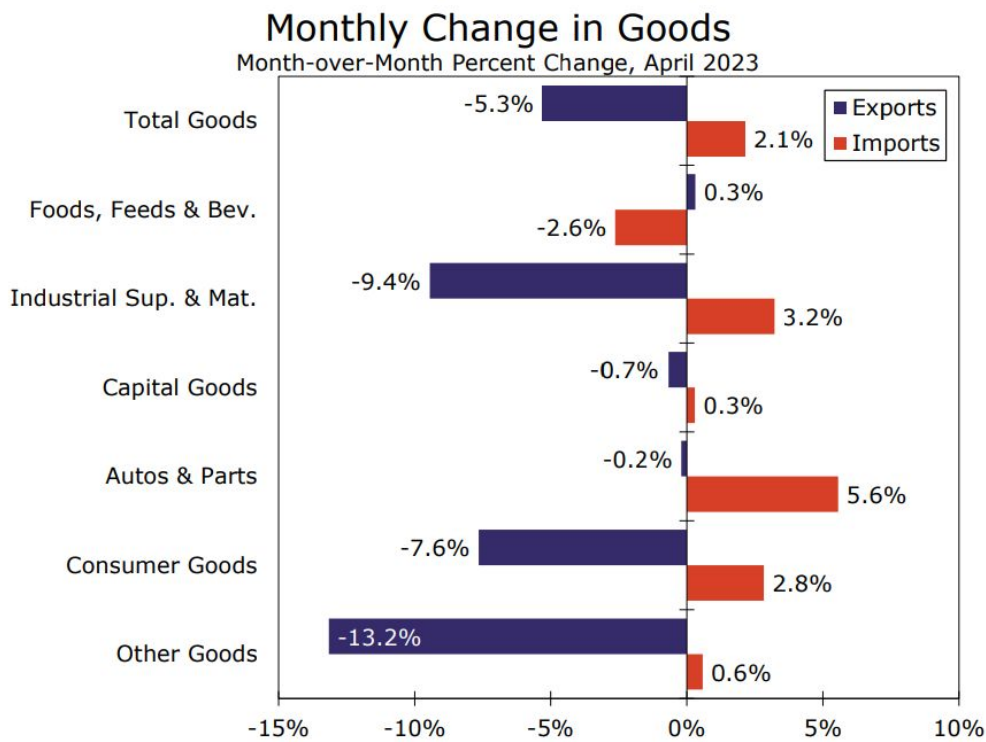


Figure 1. Trade Balance in Goods and Services (Source: US Department of Commerce, Wells Fargo Economics)

The trade deficit in the United States has seen its most significant rise in eight years, broadening by \$14.0 billion to hit \$74.6 billion in April, as reported by the US Department of Commerce on Wednesday, 7th June. This surge in the trade gap, spurred by a revival in goods imports and a decline in energy products exports, could potentially obstruct economic growth in the second quarter, should this trend persist. A trade deficit occurs when the value of a country's imports surpasses the value of its exports, in over a month. Essentially, a trade deficit signifies that a country is purchasing more goods and services from the rest of the world, than it is selling.

This could result in an outflow of US dollars to foreign markets, potentially causing a depreciation of the currency, if it continues. On the other hand, it may also indicate that US consumers and businesses are confident enough in their financial situation to increase their spending on foreign goods and services. However, an enduring trade deficit could also lead to job losses in certain sectors, particularly in manufacturing, as domestic firms may struggle to compete with foreign competition. The overall impact of a trade deficit on an economy can be complex, but if deficits continue, it could have significant implications for the US economy.

This increase in the deficit is the largest since April 2015, and it is now at its highest level in six months. Economists are concerned that trade could subtract as much as 2.5 percentage points from the US Gross Domestic Product (GDP) in the second quarter unless imports reverse course. However, reversing imports might be challenging, due to the persistent strength in domestic demand. Additionally, a strong dollar and slowing global demand could further impede exports.



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 2. Monthly Change in Goods (Source: US Department of Commerce and Wells Fargo).

Imports rise

Goods imports rose by two percent to \$263.2 billion in April, driven by increased imports of motor vehicles, parts, and engines. Imports of industrial supplies and materials also experienced a rise, although petroleum imports fell to their lowest level since August 2021.

Imports of consumer goods surged by \$1.8 billion, primarily due to cell phones and other household goods. However, food imports reached their lowest level since December 2021. On the other hand, imports of services decreased from \$60.8 to \$60.4 billion, mainly influenced by declines in transport and travel. Overall, imports increased by 1.5 percent to \$323.6 billion.

Exports fall

In contrast, exports of goods saw a significant plunge of 5.3 percent, the most considerable drop in three years, to \$167.1 billion. This decline in exports can be attributed to slowing global demand. Although the US dollar had previously weakened due to interest rate increases by the Federal Reserve, it has recently gained ground against the currencies of major trade partners. This trend could potentially reduce the competitiveness of US-made goods in the global market in the upcoming months.

Export declines were especially prominent in industrial supplies and materials, with crude oil and fuel oil exports experiencing a significant decrease. Notably, an overall decline in consumer goods exports was also apparent.

On the bright side, service exports increased by \$0.2 billion, achieving a new high of \$81.9 billion, driven by growth in the travel and other business services sectors. Despite this, financial services and government goods and services saw a decline in exports.

Trade flows are anticipated to remain unstable in the upcoming months. The resilience of the US economy may hold off an immediate recession, but an increase in imports can be expected in the near term. Concurrently, the growth in exports is likely to be slower due to the strong US Dollar.

This combination of rising imports and slower export growth could put pressure on the US trade deficit, possibly causing it to widen further. Economic policies, as well as the global economic situation, will significantly influence these trends. It will be essential to monitor these factors closely in the coming months.

March trade deficit data was also revised, indicating that the trade gap narrowed to \$60.6 billion as opposed to the previously reported \$64.2 billion. This revision suggests that the first quarter's trade deficit was not as substantial as initially estimated, which is an encouraging development.

A less substantial trade deficit in the first quarter implies that net exports likely contributed more to GDP during this period, than was previously thought. As a result, the government's GDP growth estimate for the first quarter is anticipated to be revised upwards. This is because a smaller trade deficit or a larger surplus, all else being equal, contributes to higher economic growth.

It will be interesting to see how these revisions will shape economists' views of US economic growth and how it will impact policy responses from the government and the Fed. However, the primary concern still lies in the continuing trend, as April's widened trade deficit might still pose a challenge to the US economy's growth in the second quarter.

US Wholesale Inventories Show Slight Improvement, Boosting Economic Growth Prospects

Wholesale inventories (refer Figure 3 below) saw a less pronounced decrease in April, than initially projected, according to a report from the US Commerce Department released on Wednesday, June 8th

This suggests a greater accumulation of unsold goods than expected, and is indicative of either decreased demand, or an overestimation of demand by wholesalers. However, it could also mean that businesses are restocking in anticipation of increased future sales, which would be a positive sign for the economy. As always, interpreting these data points requires consideration of the broader economic context.

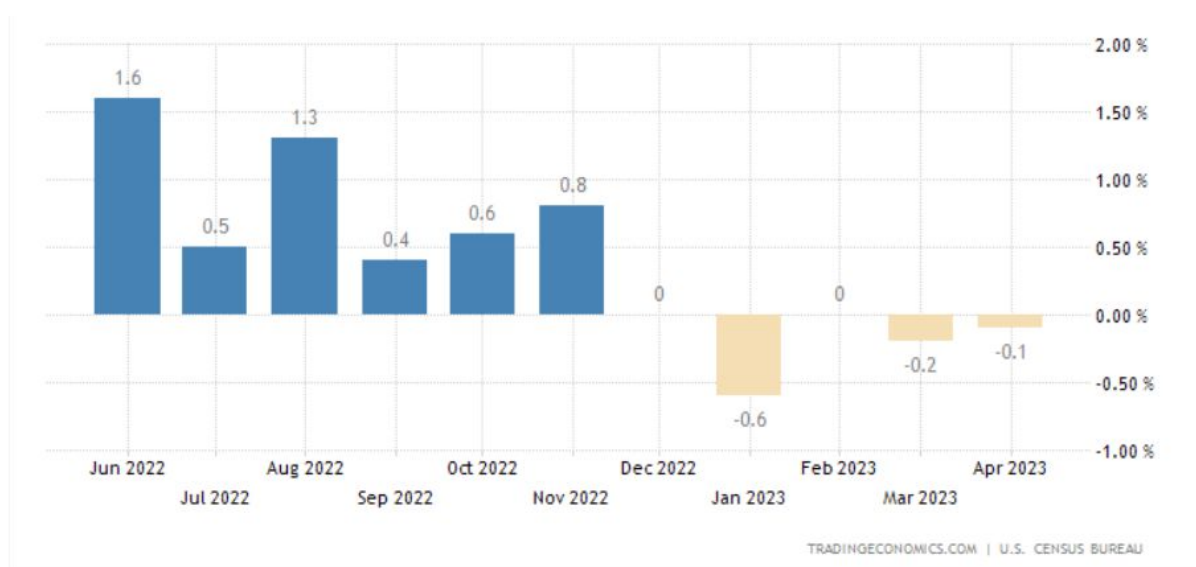



Figure 3. Wholesale inventories in the US (Source: US Census Bureau)

According to the Commerce Department's data, wholesale inventories slipped by only 0.1 percent in April (refer to Figure 3), a milder decline than the previously reported 0.2 percent drop for March. The consensus forecast was that inventories would remain unchanged in April.

Wholesale inventories refer to the stock of goods held by wholesalers, which are intermediary businesses between manufacturers and retailers. This economic indicator tells us about the level of inventory accumulation or depletion in the wholesale sector, providing insights into the strength of demand, production levels, and future investment trends in the economy. It is a crucial measure that reflects economic activity, production, and potential shifts in business investment.



Wholesale inventories play a crucial role in the calculation of the nation's GDP too. In April, there was a year-on-year increase of 6.3 percent. However, private inventory investment, which includes wholesale inventories, rose at the slowest pace in one and a half years during the first quarter. This factor contributed to the limited GDP growth rate of 1.3 percent on an annualised basis for that three-month period.

While wholesale motor vehicle inventories saw a 0.3 percent rise in April, following a 2.0 percent increase in March, other categories such as furniture, lumber, computer equipment, and professional equipment experienced declines. Machinery inventories, on the other hand, increased by 2.1 percent.

Excluding automobiles, wholesale inventories dipped by 0.1 percent in April, which is a component that factors into the GDP calculation. This adjustment provides a clearer picture of inventory trends.

The report also highlighted that sales at wholesalers rebounded by 0.2 percent in April, recovering from a 2.7 percent decline in March. At the current sales pace, it would take wholesalers approximately 1.40 months to clear their shelves, slightly shorter than the 1.41 months it took in March.

The figures for wholesale inventories, along with the rebound in sales, provide a more positive outlook for the second quarter's economic growth. These indicators suggest a potential boost to overall GDP performance, building on the recovery momentum. However, the previously reported widening of the trade deficit resulting from increased goods imports and decreased energy exports can have a negative effect on the GDP for the second quarter of this year.

The overall impact on GDP will depend on the magnitude of these factors and their interactions with other components of the economy, such as consumer spending, investment, and government expenditure.

US Services Sector Shows Sluggish Growth in May, Factory Orders Rise

According to the Institute for Supply Management (ISM), the US services sector experienced minimal growth in May, primarily due to a decline in new orders. The non-manufacturing PMI reported a reading of 50.3 while the consensus forecast was 52.2.

The ISM Services Purchasing Managers' Index (PMI) is a leading economic indicator, meaning it can provide a signal of future economic activity. A reading above 49.9 indicates that the services sector is expanding, while a reading below 49.9 suggests that it's contracting. Thus, even though the index is falling (refer Figure 4), the US services sector is still growing albeit at a much slower pace than earlier in the year.



Figure 4. The ISM Services PMI in the past 12 months (Source: TradingEconomics, Institute for Supply Management)

The Services PMI is based on surveys of more than 400 purchasing and supply executives in over 60 different sectors. The index is made up of 10 sub-indexes: business activity, new orders, new export orders, backlog of orders, inventory change, inventory sentiment, imports, supplier deliveries, employment, and prices.

This slowdown has resulted in a decrease in the measure of prices paid by businesses for inputs, reaching a three-year low. ISM revealed that its non-manufacturing PMI fell to 50.3 in May from 51.9 in April, indicating sluggish expansion in the services industry. The consensus forecast for the non-manufacturing PMI was a slight increase to 52.2.

Although the index is still above the crucial 49.9 level, indicating continued economic growth, the slowing trend is a concern and points towards a potential risk of recession. ISM also reported that its manufacturing PMI has stayed below the critical threshold for the seventh month in a row as of May, signalling an ongoing contraction in the manufacturing sector.

This persistent downturn in manufacturing PMI, coupled with the general economic deceleration, can be seen as warning signs of a looming recession.

In our May 8th issue of [Bitfinex Alpha](#) we discussed that the services sector had previously benefited from a shift in consumer spending habits during the pandemic, with people diverting their expenses from goods to services.

However, given the continued increase in interest rates since March 2022, consumers may now start to be focusing more on essential needs. Figure 5 below shows that the momentum in the services sector has diminished, with the ISM readings in the past three months being the weakest since January 2010, excluding the sharp drop during the pandemic lockdowns.



Figure 5. United States ISM Services PMI (Source: TradingEconomics, Institute for Supply Management)

The decline in new orders received by services businesses, from 56.1 in April to 52.9 in May (refer to Figure 7, blue box), has led to a cooling in services inflation. This development aligns with the Fed's efforts to manage inflation and bring it down to its target of 2 percent. The prices paid by services businesses for inputs also saw a decline, dropping to 56.2, the lowest level since May 2020, from 59.6 in April (refer to Figure 7, red box)

The services sector plays a crucial role in the battle against inflation, as prices in this sector tend to be less responsive to interest rate hikes. The ISM services prices paid gauge is seen by some economists as a reliable predictor of personal consumption expenditures (PCE) inflation, which the Fed monitors for its monetary policy decisions. Currently, financial markets predict a more than 70 percent chance of the central bank maintaining its policy rate at its upcoming meeting in June.

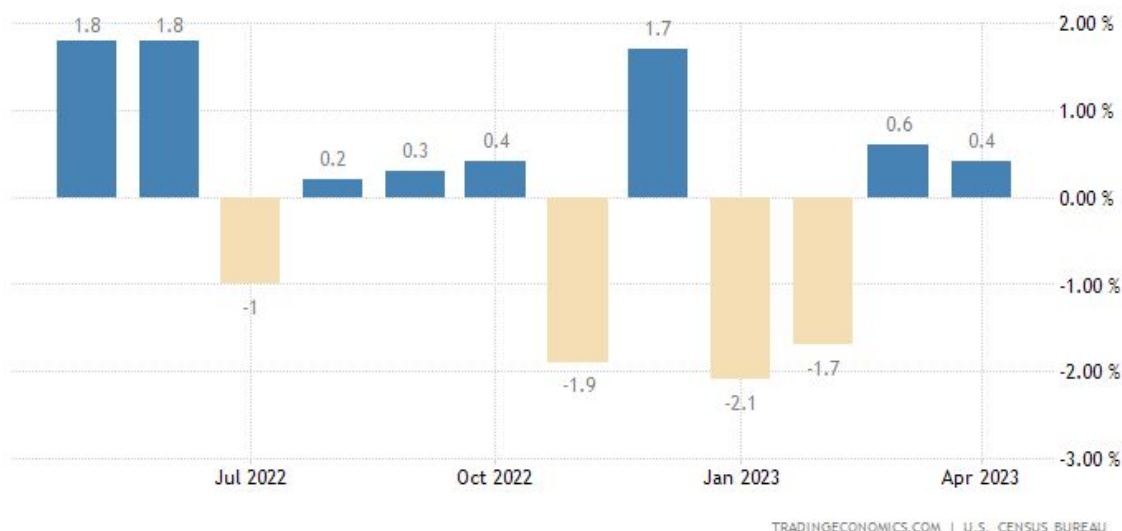


Figure 6. US Factory Orders (Source: US Census Bureau)


In contrast to the services sector, factory orders experienced a second consecutive monthly increase, in April. The US Census Bureau reported on Monday, June 5th - the same day as the ISM PMI reported - that overall factory orders had seen a 0.4 percent rise, following a 0.6 percent gain in March (refer to Figure 6). New orders for US-made goods rose largely due to defence spending.

However, excluding defence, the manufacturing industry continued to struggle under the weight of higher interest rates. Orders were down 0.4 percent, while orders excluding transportation, which were significantly influenced by military orders, fell by 0.2 percent (refer to Figure 7, orange box)

Related	Last	Previous	Unit	Reference
Business Confidence	46.90	47.10	points	May 2023
Non Manufacturing PMI	50.30	51.90	points	May 2023
Factory Orders Ex Transportation	-0.20	-1.00	percent	Apr 2023
Factory Orders	0.40	0.60	percent	Apr 2023
Ism New York Index	37.20	35.50	percent	Mar 2021
Chicago PMI	40.40	48.60	points	May 2023
ISM Non Manufacturing Prices	56.20	59.60	points	May 2023
ISM Non Manufacturing New Orders	52.90	56.10	points	May 2023
ISM Non Manufacturing Employment	49.20	50.80	points	May 2023
ISM Non Manufacturing Business Activity	51.50	52.00	points	May 2023

Figure 7. Summary of Institute for Supply Management Report and Related Data (Source: Trading economics)

Overall, the US economy is experiencing a divergence between the service sector, which continues to show stable but slower growth, and the manufacturing sector, which remains in a slump. While Americans have been spending significantly on services such as dining out and travel, economists anticipate that higher interest rates introduced by the Fed to control inflation might slow down the economy and increase unemployment rates.



The upcoming release of more data on the jobs market and next week's consumer price index report will be crucial in determining the Fed's course of action regarding interest rates in June. As consumer confidence remains subdued and labour market sentiment hits a two-year low, policymakers face the challenge of promoting economic recovery while addressing concerns surrounding inflation and recessionary pressures



WHAT'S ON-CHAIN THIS WEEK?



Bitcoin Is Now Undervalued In Comparison To The S&P 500

Bitcoin (BTC) is currently undervalued compared to the S&P 500, based on a metric that conducts an Ordinary Least Squares (OLS) regression analysis of the relationship between Bitcoin and the S&P 500 over the past 200 days. (refer Figure 8 below)

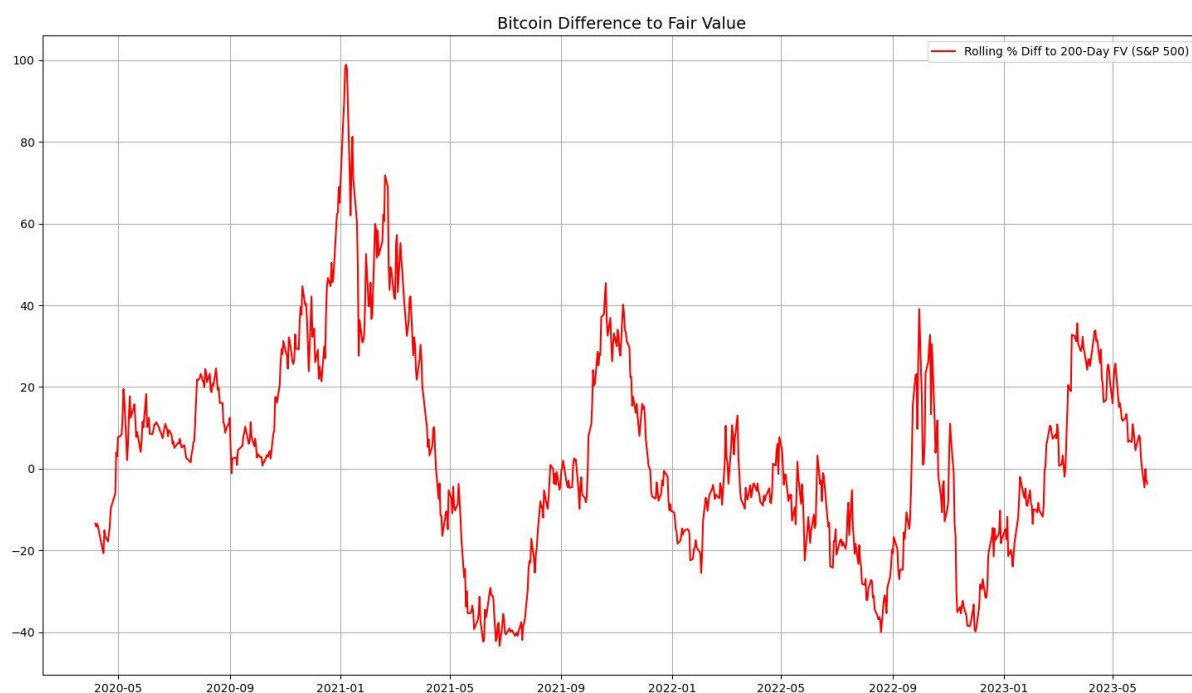


Figure 8. Bitcoin Difference To Fair Value In Percentage.

Ordinary Least Squares (OLS) is a statistical technique used to estimate the relationships among variables. It is called "least squares" because it minimises the sum of the squares of the residuals (the differences between the observed and predicted values).

In the context of financial assets, OLS regression analysis can be used to understand the relationship between the returns of two assets. The goal of this metric is to estimate a fair value for Bitcoin's price based on the current S&P 500 price.

This analysis, which applies an OLS regression to the prices of Bitcoin and the S&P 500 over the past 200 days, yields a fair value for Bitcoin of \$27,550.

However, Bitcoin's current price, hovering in the mid-\$25,000s (at the time of writing), is nearly \$2,500 lower than this fair value estimate. This price difference represents an undervaluation of Bitcoin of more than eight percent compared to the estimated fair value.

This undervaluation is the most significant since mid-February, indicating that Bitcoin's current price may not fully reflect its perceived value based on its relationship with the S&P 500 over the past 200 days.

US equity markets have recently witnessed a surge, primarily driven by a sharp uptick in big tech stocks, and in particular growing optimism on the ability of artificial intelligence (AI) technology to substantially enhance productivity and profitability.

Historically, BTC prices and US stock indices have shown a significant correlation. As stocks rally while BTC's price remains static, the potential for a compensatory surge in Bitcoin's value increases. In other words, the current rally in stocks, particularly tech stocks, coupled with BTC's stagnation, may set the stage for a "catch-up" rally in Bitcoin.

However, it is worth noting that the BTC correlation with stock indices has lost traction recently.

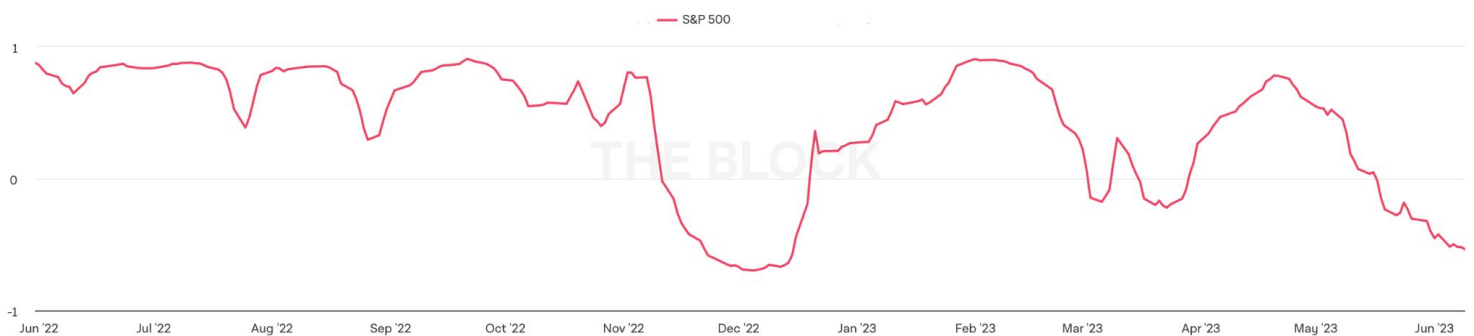


Figure 9. BTC Pearson 30-Day Correlation Metric. (source: TheBlock)

The Pearson metric is a running correlation metric that is measured over the past 30 days between two assets or indices. The current value stands at -0.54 (refer Figure 9 above), and this indicator has only gone below the current reading just once in the past twelve months and only a handful of times in the asset's history. Another reason why we believe that a rebound in the correlation is possible is that there have been phases of negative correlation for extensive periods of time in the past but normally, after a reading this negative, it is usually followed by a rebound within 30-60 days.

Another factor supporting the case for BTC- S&P500 correlation rebound, is the behaviour in the correlation of BTC with Gold. (refer Figure 10)

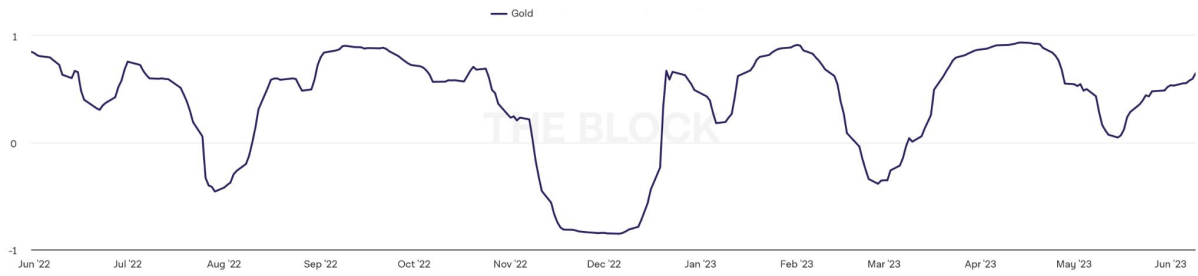


Figure 10. BTC vs Gold Pearson 30-Day Correlation Metric. (source: TheBlock)

The above metric usually precedes any rebound in the correlation with the S&P500. The current reading of 0.65 is after a month long increase in correlation between the two assets.

A rebound in the correlation metrics would mean the “catch-up” rally for BTC comes into play for the next couple of months if historical time frames are respected in this particular scenario, while the stock market remains stable at current prices.

Bitcoin's Largest Long Liquidation Of The Year So Far

On June 10th, the BTC price fell to the mid 25,000s resulting in the largest liquidation of long positions in USD terms, so far this year, amounting to a total of \$348 million. (refer Figure 11 below)



Figure 11. Total Liquidations vs BTC price. (source: Coinglass)

Recent weeks have witnessed escalating concerns, following the lawsuits issued against leading cryptocurrency exchanges, Binance and Coinbase. Yet, an analysis of several crucial crypto market metrics suggests a state of relative stability, as traders have largely maintained their positions despite the negative newsflow.

In this chapter, we explain the moves in the options market on June 6th when the news of a restraining order against Binance and Coinbase by the SEC was initially made public. The market took a downturn following that and then prices continued to decline into the weekend.

The onset of the Binance and Coinbase lawsuits marked an upward tilt in historical volatility (HV), often seen as an indicator of sudden short-term price movements. As the news of the lawsuits became public, a marked jump was observed in the crypto market's historical volatility (refer Figure 12 below).

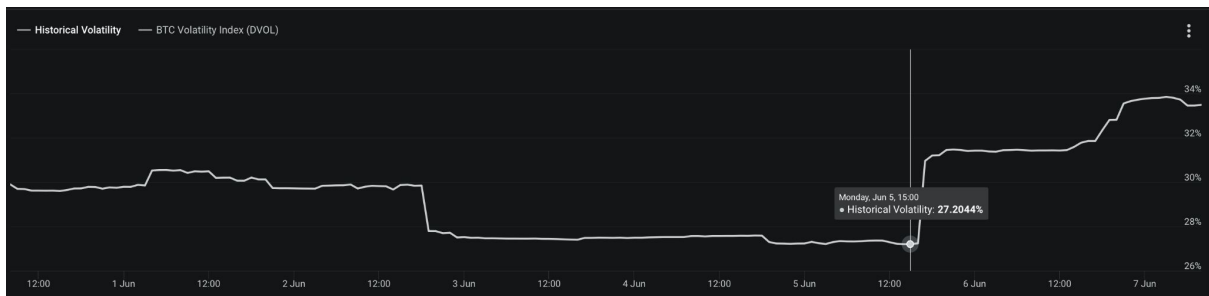


Figure 12. Historical Volatility for BTC. (source: Deribit Dashboard)

However, intriguingly, this development has failed to trigger a substantial rise in the BTC implied volatility (IV) for options contracts expiring in the following seven days (refer Figure 13 below).

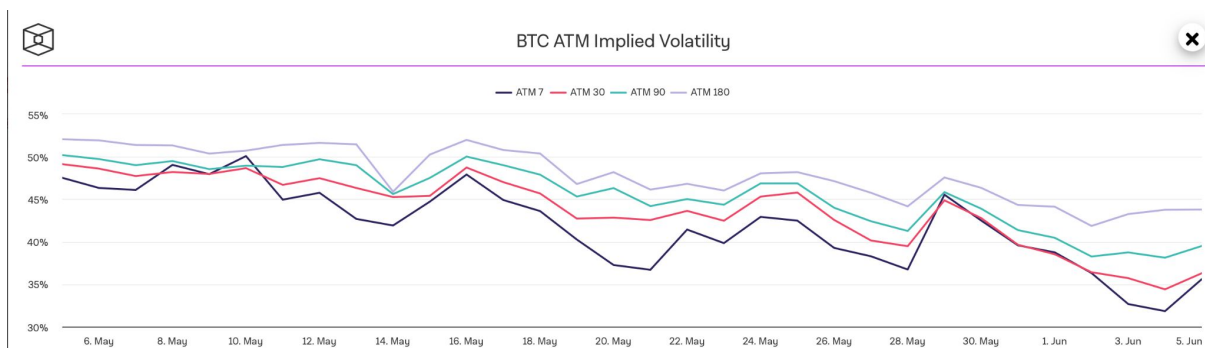


Figure 13. BTC ATM Implied Volatility for options expiring weekly, monthly, quarterly and semi-annually. (source: TheBlock)

BTC implied volatility had experienced a minor jump in options contracts expiring in the next seven days but no significant increase after the Binance and Coinbase lawsuit news. However, the historical volatility (HV) metric experienced a decent amount of increase.

If IV is greater than HV, then options traders expect prices to be different from current price at the expiry date. No change in IV with HV increasing implies that even though prices have fluctuated in the short term, large numbers of options traders don't expect it to be far off from the current prices. The current IV reading for weekly expiry is also at 36.6 percent which means that the outlook for the week or month has not changed. In fact, volatility expectations have even worsened since the negligible jump in IV on June 6th. This means that any knee-jerk reactions to anticipating volatility have since settled.

An examination of the standard deviation of the IV value shows that the latest monthly options-expiry IV reading sits at about -1.7 standard deviations away from its yearly mean. In layman's terms, despite the slight uptick, we're far from mean values; the IV reading is only a whisker away from its lowest point in about a year.

marked in the figure below has become a strong resistance level that the BTC price must get over before any kind of bullish market outlook can come into place.

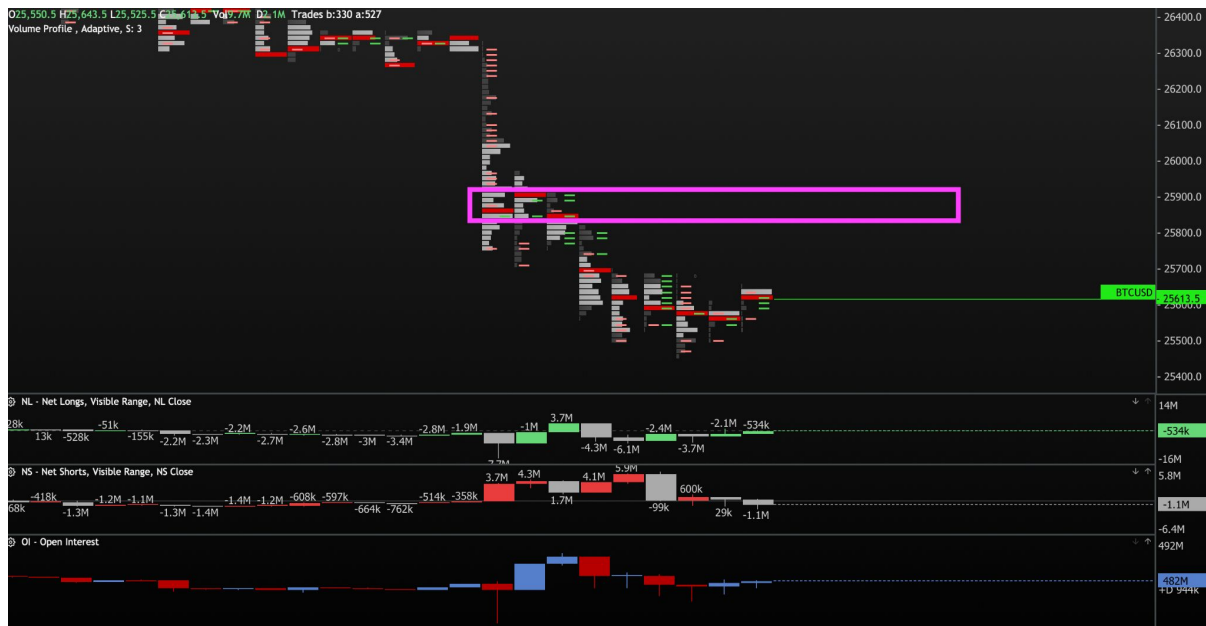


Figure 14. BTC/USD futures Orderflow chart. (source: exocharts)

The important levels to the downside include \$24,000 which is the max pain price for BTC options that are expiring at the end of June. (refer Figure 15 below)

While the Put/call ratio has continued to remain below the 0.5 threshold for almost two weeks now, this level being lower than the current price places even more emphasis on the \$24,000 level.



Figure 15. BTC Options Open Interest By Strike Price. (source: Coinglass)



NEWS FROM THE CRYPTO-SPHERE




US Justice Department Opposes Bittrex's Proposal for Customer Withdrawals in Bankruptcy Case



Figure 16. US Justice Department Opposes Bittrex's Proposal for Customer Withdrawals in Bankruptcy Case

- **The US Justice Department has objected to proposals from bankrupt crypto exchange Bittrex to allow customers to withdraw their funds, citing concerns about prioritising certain creditors and the premature nature of the motion.**
- **Bittrex, which faced charges for sanctions violations and a lawsuit for operations concerning alleged unregistered securities, filed for bankruptcy and presented a plan to compensate customers, but now faces legal opposition from the US government.**

The United States Justice Department (DOJ) has voiced its objection to bankrupt cryptocurrency trading platform, Bittrex's motion to permit customers to withdraw their cryptocurrency and fiat holdings. According to court filings, the US Treasury's Office of Foreign Assets Control (OFAC) is the largest creditor of Bittrex but would have its claim subordinated under the proposed plan.



Bittrex faced charges from OFAC and the Treasury's Financial Crimes Enforcement Network (FinCEN) in October for sanctions violations. These violations involved allowing individuals from Crimea, Cuba, Iran, Sudan, and Syria to conduct transactions on the platform between 2014 and 2017. OFAC and FinCEN imposed penalties of \$24 million and \$29 million, respectively.

Although Bittrex expressed satisfaction in resolving the charges earlier, its troubles persisted. In April, the US Securities and Exchange Commission (SEC) filed a lawsuit against Bittrex for operating as an unregistered securities exchange, which could lead to additional monetary penalties. Subsequently, Bittrex filed for bankruptcy in May in the US Bankruptcy Court for the District of Delaware and proposed a plan to compensate its customers.

The DOJ, however, contested the Bittrex proposal in a filing on June 7th, claiming that it improperly prioritises certain creditors over others. The DOJ argued that if the OFAC and FinCEN debts cannot be fully paid through the plan, the US should have an opportunity to establish ownership of the cryptocurrency assets and potentially reclaim them from customers. Furthermore, the DOJ argued that the motion was premature since the Bittrex bankruptcy had yet to be confirmed by the court. The bankruptcy hearing is scheduled for June 14th.

Bittrex's proposal to allow customer withdrawals without resorting to litigation now faces legal opposition from the US government. The government, which is owed \$5 million by Bittrex's US arm through FinCEN, contends that treating creditors differently would be unjust. It argues that determining ownership of cryptocurrency assets should be postponed until the bankruptcy plan is confirmed.

Bittrex's US arm currently holds \$50 million in customer cash and \$250 million in customer cryptocurrencies, while its Maltese operating company, which has also declared bankruptcy, possesses \$120 million in customer cash and cryptocurrency. Bittrex's legal representatives have previously assured the court that there are sufficient assets to honour customer withdrawals.

Past examples show the impact that government intervention has on cryptocurrency bankruptcy cases. The SEC's opposition to a proposed acquisition by Binance of the assets of defunct crypto lender Voyager, led to the abandonment of that deal. The SEC argued that the proposed agreement would absolve the involved parties of any breaches of tax or securities law. Subsequently, the SEC filed a lawsuit against Binance.

A hearing to decide on Bittrex's proposal for customer withdrawals is set to take place on June 14th, where the court will consider the arguments put forth by the DOJ and other involved parties.

Full Story: Explaining The SEC's Attack On Crypto




Figure 17. Full Story: Explaining The SEC's Attack On Crypto

The United States Securities and Exchange Commission (SEC) has initiated enforcement action against Binance, the world's leading cryptocurrency exchange. This action, which came to light on May 8, has triggered questions about whether the target is primarily Binance or its US-based entity, Binance.US.

A subsequent lawsuit filed by the SEC on June 5 against Binance and its CEO, Changpeng "CZ" Zhao, alleges violations of securities laws. This legal action has sent shockwaves throughout the cryptocurrency market. In this article we attempt to cut the clutter and detail the sequence of events surrounding the SEC's case against Binance, offering insights into the charges, Binance's responses, and the SEC's request for an asset freeze.

To begin, it is crucial to understand the specific charges levelled against Binance. The SEC alleges that Binance, under CZ's leadership, has violated securities laws. While the details of the violations are yet to be fully disclosed, the seriousness of these charges is underscored by the SEC's request for an asset freeze.



Binance has responded to these charges with a strong denial. In a public statement, CZ stated that Binance is committed to full compliance with all relevant laws and regulations, and that they are ready to cooperate with the SEC to resolve this matter.

The SEC's request for an asset freeze adds another layer of complexity to the situation. If granted, it would effectively halt Binance's operations, a prospect that has rattled the cryptocurrency market.

The resolution of this legal dispute carries significant implications for Binance, the broader digital asset industry, and regulatory approaches towards cryptocurrencies. If the SEC's charges hold, it could result in substantial penalties for Binance and set a precedent for the enforcement of securities laws in the cryptocurrency industry. Conversely, if Binance successfully defends against these charges, it could push regulatory bodies to reassess their approach towards cryptocurrencies.

May 8, 2023

On May 8, 2023, the first rumblings emerged that the United States Securities and Exchange Commission (SEC) was launching enforcement action against Binance. At the time, it was unclear whether the actions were directed at Binance itself or its American affiliate, Binance.US.

This move by the SEC was part of a broader trend of regulatory scrutiny targeting crypto exchanges. Other prominent platforms, including Coinbase, Bittrex, and Kraken, had already faced similar actions. Additionally, other entities within the cryptocurrency sector had also come under the SEC's spotlight.

This heightened scrutiny also underscores the SEC's ongoing determination to ensure consumer protection and prevent fraudulent practices in the cryptocurrency space. Even though multiple sources were reporting the news, it was mostly considered rumours at this point.

June 5, 2023

The [SEC files a lawsuit](#) against Binance Exchange and its CEO, Changpeng Zhao (CZ), alleging violations of US securities laws. The SEC unveils 13 charges against Binance. The accusations range from operating illegally within the United States to misleading customers. More provocatively, the SEC alleges that the following crypto tokens are securities: Cardano (ADA), Polygon (MATIC), and Solana (SOL). It should be noted that the SEC has been ambiguous in providing the definition for such tokens in the past. This classification of cryptocurrencies as securities is notable, as it suggests that their trading may be subject to additional regulatory obligations.

Following the SEC's announcement, Binance's native digital token, Binance Coin (BNB), experienced a marked downturn. It fell by over 9 percent on the day of the news release and, as of June 8, 2023, traded at around \$260. This substantial decline exemplifies the sensitivity of cryptocurrency prices to regulatory news, reflecting investor uncertainty about the potential impacts of these enforcement actions on Binance's operations and the broader cryptocurrency market.



Figure 18. BNB price dropped when news of SEC filing was released and dropped further on news of asset freeze. (Source: Tradingview)

CZ took to Twitter to reassure the community, stating that Binance's systems, including withdrawals and deposits, are stable. He mentions that Binance will issue a response once they have reviewed the SEC's complaint but notes that the media received the information before the company did.



Figure 19. Tweet from @cz_binance reassuring the community that all systems are stable.

June 6, 2023

Binance publishes an [official response](#) to the SEC filing, expressing disappointment in the SEC's decision to file a complaint and seek emergency relief. Binance highlights its active cooperation with the SEC throughout the investigations, as well as its efforts to address the regulator's concerns and engage in good-faith discussions for a negotiated settlement. Binance criticises the SEC for its refusal to provide clarity and guidance to the digital asset industry and its reliance on enforcement and litigation rather than a more thoughtful approach.

The company pledges to vigorously defend its platform against the SEC's allegations and emphasises that user assets on Binance and its affiliate platforms, including Binance.US, are secure and not at risk.

June 6, 2023

On June 6, 2023, the U.S. Securities and Exchange Commission (SEC) escalated its actions against Binance and Binance.US, requesting a temporary restraining order to freeze the assets of both entities, including their cryptocurrency holdings. In an even more severe move, the SEC also sought to freeze assets owned by Binance's CEO.

The SEC alleges that CZ and other executives at Binance misappropriated customer funds for personal use. Some of the more extravagant claims include the purchase of an [\\$11 million yacht](#) and usage of Binance USD (BUSD), a stablecoin pegged to the U.S. dollar that crypto firm Paxos issued, before it also suspended these operations.

The SEC argues that the asset freeze is necessary to protect customer assets and prevent Binance and CZ from concealing their personal wealth. It's argument highlighting their alleged history of regulatory non-compliance, disregard for US laws, and concerns about financial transfers and custody of customer assets.

The SEC also sought court permission to allow Binance.US customers to redeem their holdings from the company. At this stage, Binance and CZ face civil charges only.

Additionally, the SEC requested that Binance's holding company, Binance.US's holding company, and CZ provide sworn, verified accounting. This would be the first comprehensive and potentially public disclosure of the financial status of the Binance group of companies. Binance had previously released a partial accounting of its finances conducted by Mazars Group but faced criticism for failing to disclose its liabilities.

CZ immediately clarified that if the Temporary restraining order to freeze assets is granted by the court, it will only affect Binance US and does not affect Binance.com.



Figure 20. Tweet @cz_binance clarifying that if Temporary Restraint is granted by court, it will only affect Binance US

It remains to be seen how the court will respond to the SEC's request for an asset freeze and other related orders.

June 7, 2023

In a series of leaked chat logs, conversations between Sam Lim, former compliance lead at Binance, and Alvin Kan, previous head of Business Development, have come to light through a tweet by [Adam Cochran](#) (@adamscochran). These chat logs shed light on discussions about equity bonuses, compliance concerns, and questionable practices within the cryptocurrency exchange.

The first conversation revolves around equity bonuses, with Lim warning Kan about the risks associated with holding Binance Coin (BNB). Lim advises Kan to convert his BNB bonus to USDT, stating that it would be unwise to hold onto it. The chat logs reveal concerns expressed by Lim that the compliance side of Binance is akin to a sinking ship, drawing a comparison to the ill-fated Titanic. Expressing dissatisfaction, Lim mentions that the risk-reward balance is skewed and that he would not feel comfortable signing off on OFAC (Office of Foreign Assets Control) compliance if he were the Chief Compliance Officer (CCO). The two also discuss the challenges of hiring an American lawyer to fill the CCO position.

In another exchange, Lim discloses that Wei Zhou, Binance's Chief Financial Officer (CFO), urged him to assume the CCO role and sign off on compliance matters in exchange for double pay. Lim reportedly refused this request, stating that Wei and CZ are fully aware of the reasons why individuals are reluctant to sign off on OFAC reporting. Notably, Lim, who held a prominent compliance position within the company, asserts that there is substantial evidence indicating that Binance is far from "clean" in terms of compliance.

The chat logs also delve into concerns about the training practices within Binance's customer support (CS) department. Lim alleged that CS staff were being taught how to circumvent procedures, and that compliance takes a back seat to business priorities during training. Additionally, an unsettling strategy regarding BNB is exposed, with Sam suggesting that the plan is to "survive for two years and then exit abruptly."

Furthermore, the leaked chat logs contain discussions involving Catherine Coley, the former CEO of Binance US. These indicate that international staff members converted USD to BUSD, although the reason behind this remains elusive.

These revelations are significant as they come directly from the former head of compliance at Binance, raising serious questions about the company's adherence to regulatory standards and the nature of its operations. Binance has yet to respond to the leaked chat logs and the allegations made within them.

SEC Filing

The following is the breakdown of the SEC filing which is yet to be proven:

1. Binance and its affiliated company, BAM Trading, have been accused of offering important securities market services without following the necessary registration process with the SEC. These services include acting as an exchange, broker-dealer, and clearing agency on the Binance Platforms. By not registering, they avoided regulatory oversight designed to protect investors and the market. However, it must be noted that many experts have alleged that SEC has failed to provide a clear pathway for companies to register as a broker dealer for a Crypto platform and there is significant ambiguity in this area.
2. Binance and BAM Trading are also alleged to have conducted sales of crypto asset securities without proper registration. This includes selling Binance's own crypto assets like "BNB" and "BUSD," as well as profit-generating programs such as "BNB Vault" and "Simple Earn." Investors were not provided with important information about the risks and trends associated with these investments.
3. Since around 2018, Binance, under the leadership of CZ, is said to have developed a plan to avoid complying with U.S. securities laws, and have openly expressed their desire to remain unregulated.

4. As part of their efforts to evade regulation, CZ and Binance established BAM Management and BAM Trading in the U.S., the SEC said, claiming that these entities operated independently for the Binance.US Platform. However, it is alleged that CZ and Binance were actually controlling the operations and providing crypto asset services for the platform. This level of control limited the freedom of BAM Trading employees, leading to feelings of manipulation and restricted business conduct.
5. As another part of their plan, CZ and Binance publicly stated that the Binance.com platform did not serve U.S. customers, while secretly allowing certain high-value U.S. customers to continue trading on the platform. Binance assisted these customers in bypassing controls meant to block US customers, all while aiming to keep these actions hidden. Their goal was to minimise losses and avoid U.S. regulatory authorities.
6. By evading regulatory oversight, Binance and CZ allegedly put billions of dollars of U.S. investor capital at risk. They had the freedom to transfer investors' cryptocurrency and traditional currency assets as they wished, sometimes mingling and redirecting them in ways that regulated entities would not be able to do. For instance, large sums of U.S. dollars from both Binance Platforms were allegedly mixed in an account controlled by CZ's entity, Merit Peak Limited, and subsequently transferred to a third party for cryptocurrency transactions.
7. The defendants are accused of failing to implement adequate trade surveillance and controls against manipulation on the Binance.US platform, despite claiming to have such measures in place. They did not meet the requirements of registered exchanges to prevent fraudulent and manipulative activities. Wash trading and self-dealing occurred on the Binance.US Platform, involving Sigma Chain AG, which is owned and controlled by CZ, the SEC said. These practices artificially increased the trading volume of crypto asset securities.
8. CZ, as a control person, is also accused of being responsible for the violations committed by Binance and BAM Trading. BAM Trading and BAM Management were said to have obtained money or property through false statements and engaged in fraudulent practices in the offer and sale of securities. The SEC said it aims to permanently restrict Defendants from further violations and sought disgorgement of their gains with prejudgment interest.

SEC Requests Asset Freeze on Binance and Binance.US Following Allegations of Misconduct




Figure 21. SEC Requests Asset Freeze on Binance and Binance.US Following Allegations of Misconduct

- **The SEC has requested a temporary restraining order to freeze assets, including cryptocurrencies, held by Binance, Binance.US, and their owner Changpeng Zhao (CZ), following allegations of misconduct and misuse of customer funds.**
- **The SEC also seeks orders for asset repatriation, document preservation, and the appointment of a receiver, while Binance.US vows to defend itself in court and assures users that their assets are safe and secure.**

The U.S. Securities and Exchange Commission (SEC) requested a temporary restraining order to freeze the assets of Binance and Binance.US, including cryptocurrencies, as well as the assets belonging to their owner, CZ. This follows the SEC's initial enforcement action on June 5, which also sought an asset freeze against the entities involved.

The SEC's request for an asset freeze is based on accusations that CZ and Binance executives redirected customer funds for personal use, including for the purchase of an \$11 million yacht and BUSD (Binance USD). These allegations bear resemblance to similar claims made against FTX, Alameda Research, and former CEO, Sam Bankman-Fried. Notably, Binance and CZ currently face civil charges, but no criminal charges have been filed thus far.



The SEC argues that the asset freeze is necessary to protect customer assets and prevent Binance and CZ from concealing their wealth. They highlighted the defendants' alleged history of regulatory non-compliance, disregard for U.S. laws, evasion of oversight, and concerns surrounding financial transfers and the custody of customer assets. The SEC also sought the court's permission to allow Binance.US customers to redeem their holdings from the company.

Additionally, the SEC requests that Binance's holding company, Binance.US's holding company, and CZ himself provide sworn, verified accounting. This would be the first comprehensive and potentially public disclosure of the financial status of the Binance group of companies. Binance had previously released a partial accounting of its finances conducted by Mazars Group but faced criticism for failing to disclose its liabilities.

The SEC has further asked the court to order the repatriation of assets, expedite the discovery of relevant documents, preserve evidence, and appoint a receiver for the assets of Binance, Binance.US, and CZ.

In response to the filing, Binance.US expressed disappointment, stating that it believes the action is unwarranted and primarily aimed at gaining an advantage in litigation rather than genuine concern for the safety of customer assets. The company emphasised its readiness to defend itself in court.

The SEC's move to freeze assets tied to Binance.US was filed in the D.C. District Court, seeking to freeze assets connected to BAM Management US Holdings and BAM Trading Services, the holding and operating firms for Binance.US. The SEC's lawsuit against Binance.US, Binance Global, and CZ alleges various compliance and control failures, including allegations of unauthorised access to funds belonging to Binance.US customers by entities associated with Zhao.

The SEC's filings also seek orders to prevent the destruction of records, demand a preliminary injunction, and repatriate assets held for the benefit of BAM Trading customers.

Binance.US reassured its users via Twitter that their assets remain safe and secure, adding that its legal team has addressed concerns regarding fund safety with the SEC. The SEC, in a memorandum of law accompanying the temporary restraining order application, reiterated its claims from the original lawsuit, including Binance's access to Binance.US funds and the expressed intention of Binance and CZ to evade U.S. regulators.

The SEC's lawsuit alleges that Binance allowed two companies connected to CZ - Sigma Chain and Merit Peak - to access significant amounts of customer funds held by BAM Trading. In response, Binance released a statement affirming the safety and security of user funds on Binance.US and vowing to vigorously defend against the allegations.


Volcano Energy Secures \$250 Million to Launch Bitcoin Mining Farm in El Salvador



Figure 23. Volcano Energy Secures \$250 Million to Launch Bitcoin Mining Farm in El Salvador

- **Volcano Energy has received an initial investment of \$250 million out of a total commitment of \$1 billion to establish a Bitcoin mining farm in El Salvador's Metapán region.**
- **The mining farm will be powered by a 241-megawatt power generation park utilising solar and wind energy, addressing concerns about the environmental impact of Bitcoin mining. The project involves the Salvadoran government, external investors, and Tether, the issuer of stablecoin USDt**

Volcano Energy, a public-private partnership in El Salvador, has received an initial investment of \$250 million out of a total commitment of \$1 billion for the development of a Bitcoin mining farm. The funds will be used to establish a 241-megawatt power generation park in El Salvador's Metapán region, employing solar and wind energy to power the mining operation.



The investment marks a significant step in the adoption of renewable energy in the Bitcoin mining industry, addressing concerns raised by environmentalists about the excessive energy consumption and environmental impact of mining practices. The power generation capacity of the park will be divided between 169 MW of photovoltaic solar energy and 72 MW of wind energy.

Tether, the issuer of stablecoin USDT, is [among the investors](#) in the project, although the exact investment figure remains undisclosed.

The Salvadoran government will play a crucial role in the planning and execution of the initiative, securing preferred participation equivalent to 23 percent of revenues. External investors will own 27 percent of the venture, with the remaining 50 percent being reinvested to expand energy production capacity and further advance Bitcoin mining in the country.

Volcano Energy's Chairman, Max Keiser, who is also an adviser to President Nayib Bukele, emphasised that the project demonstrates the ongoing innovation and growth of the Bitcoin mining industry, challenging traditional financial norms.

El Salvador, which became the first country to adopt Bitcoin as legal tender in 2021, continues its efforts to promote the adoption and integration of cryptocurrencies within its economy.

The mining farm in El Salvador aims to harness renewable energy sources to power the mining operation, offering a pathway toward a more sustainable future for both Bitcoin mining and the country's energy sector. This initiative could also attract further investment in the region as mining companies seek opportunities outside of North America for expansion and development.

Senators Question Meta CEO Mark Zuckerberg over Leaked AI Model, LLaMA, Citing Concerns of Potential Misuse

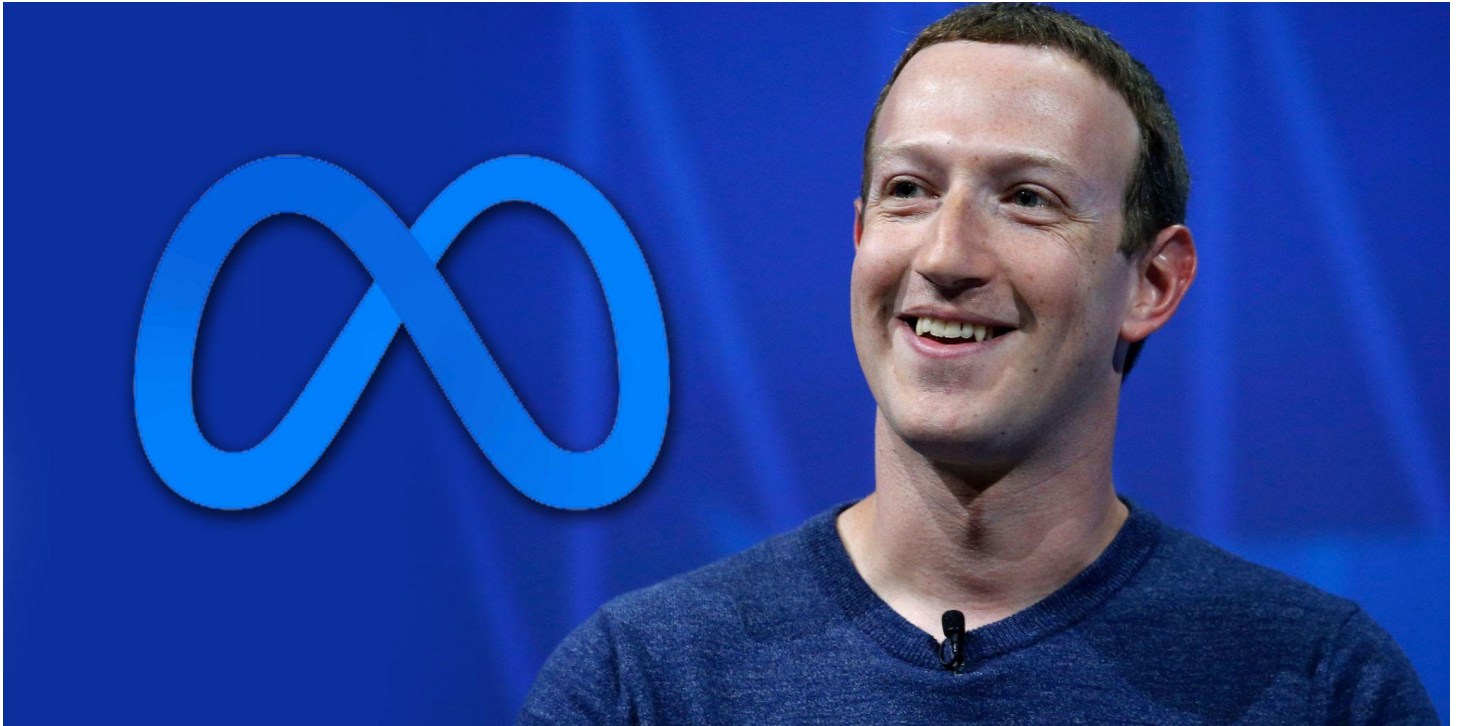



Figure 24. Senators Question Meta CEO Mark Zuckerberg over Leaked AI Model, LLaMA, Citing Concerns of Potential Misuse

- **U.S. Senators Blumenthal and Hawley question Meta CEO Mark Zuckerberg over the leaked AI model, LLaMA, expressing concerns about its potential misuse for criminal activities.**
- **The Senators criticised Meta's open-source release of LLaMA, highlighting its lack of adequate protections and potential risks associated with the dissemination of the AI model.**

Two United States Senators, Richard Blumenthal and Josh Hawley, raised concerns with Meta CEO Mark Zuckerberg following the "leaked" artificial intelligence model, LLaMA, and the decision to open source LLaMa.

The Senators believe that LLaMA poses potential dangers and could be exploited for criminal activities. They criticised Zuckerberg's decision to open source the AI, citing inadequate protections and Meta's "unrestrained and permissive" release of the platform.



Although the Senators acknowledged the advantages of open-source software, they argued that Meta's lack of thorough consideration of the consequences of widespread dissemination was a disservice to the public. LLaMA, initially intended for limited release to researchers, was leaked in its entirety on BitTorrent, making it accessible to anyone globally without any monitoring or oversight.

The two senators said that LLaMA could be easily adopted by spammers and cybercriminals, facilitating fraud and the dissemination of offensive content. To highlight the risks, they compared LLaMA with other closed-source models like OpenAI's ChatGPT-4 and Google's Bard. While ChatGPT-4 adheres to ethical guidelines and denies requests for generating abusive content, LLaMA readily produces such material, including responses involving self-harm, crime, and antisemitism, the senators said.

They posed several questions to Zuckerberg in a letter to him, including inquiries about risk assessments conducted before LLaMA's release, measures taken by Meta to prevent or mitigate damage caused by its misuse, and the usage of users' personal data for AI research.

The growing pressure from advancements in open-source models has prompted OpenAI to work on its own open-source AI model.

Open-sourcing an AI model allows others to modify it for specific purposes and encourages contributions from other developers. However, the leaked release of LLaMA has raised concerns about the potential for misuse and the need for stronger safeguards.

As the debate surrounding the risks and benefits of open-source AI models continues, all eyes are on the unfolding saga of LLaMA. The Senators' inquiry into Meta's actions reflects the increasing scrutiny on tech giants and their responsibility in handling powerful AI models that have the potential for both positive and negative impacts.

SEC Charges Coinbase For Operating As An Unregistered Exchange, Broker And Staking Service

On Tuesday, 6th June 2023, the U.S. Securities and Exchange Commission (SEC) filed a complaint against Coinbase, Inc, one of the largest crypto exchanges in the world, in the U.S. District Court for the Southern District of New York. The SEC accused Coinbase of operating its crypto asset trading platform as an unregistered national securities exchange, broker, and clearing agency, and for failing to register its staking-as-a-service program. The charges led to a 12 percent drop in Coinbase's stock on the same day.(refer Figure below)



Figure 25. SEC Press Release Caused Coinbase stock to gap down by over 12 percent on open.

The SEC alleges that since at least 2019, Coinbase has been unlawfully facilitating the buying and selling of crypto asset securities, making billions of dollars in the process. SEC Chair Gary Gensler stated that Coinbase, despite being subject to securities laws, had commingled and unlawfully offered exchange, broker-dealer, and clearinghouse functions.

Unregistered Offer and Sale of Securities in Connection with Staking-as-a-Service Program

In addition to the above charges, the SEC also accused Coinbase of failing to register the offer and sale of its crypto asset staking-as-a-service program. This program, which has been in operation since 2019, allows customers to earn profits from the "proof of stake" mechanisms of certain blockchains and Coinbase's efforts. Gensler added, "Coinbase never registered its staking-as-a-service program as required by the securities laws, again depriving investors of critical disclosure and other protections."

Repercussions of the SEC's Actions

Following the SEC's charges, Coinbase's stock fell by 12 percent on the same day. The SEC's complaint seeks injunctive relief, disgorgement of ill-gotten gains plus interest, penalties, and other equitable relief.

In response to the SEC's allegations, Coinbase's chief legal officer, Paul Grewal, stated on 6th June 2023, "The SEC's reliance on an enforcement-only approach in the absence of clear rules for the digital asset industry is hurting America's economic competitiveness and companies like Coinbase that have a demonstrated commitment to compliance."

The actions taken by the SEC against Coinbase and Binance have sounded an alarm for other U.S. crypto exchanges. Jason Allegrante, the Chief Legal and Compliance Officer at Fireblocks, a digital asset infrastructure provider, commented on 8th June 2023: "All U.S. exchanges should now be on notice that they may be subject to enforcement action if they permit, or have permitted, these tokens to be traded."

Moreover, these actions have provoked questions regarding the future trajectory of the crypto economy in the United States. Stuart Alderoty, Chief Legal Officer at Ripple, remarked on 8th June 2023: "I think what they are engaging in is a coordinated campaign to essentially destroy the crypto economy in the United States." This controversy underscores the precarious nature of the regulatory landscape for cryptocurrencies and the need for comprehensive regulatory guidelines to ensure the stability and growth of this burgeoning industry.



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