CLIFFORD CHANCE

FINTECH IN 2023: FIVE TRENDS TO WATCH

– THOUGHT LEADERSHIP

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Last year was a tough one for fintech with the collapse of a number of high-profile industry players, as well as wider economic pressures including the war in Ukraine, supply chain challenges and high inflation. Following the bold predictions we made last year, we highlight the five key trends for fintech in 2023.

1

DLT is coming of age

2022 was arguably the most difficult year for crypto to date, with the failure of major industry players and significant price volatility. This highlighted the necessity of new crypto regulations being developed globally, with regulators under pressure to ensure that new frameworks, such as the EU's Markets in Crypto-Assets Regulation (MiCA), are sufficiently robust to ensure early warning systems are in place and to prevent widescale industry contagion.

What's next?

- For market players, we will see a move from "Bitcoin to blockchain" – away from volatile products in favour of focusing on increasingly sophisticated distributed ledger technology (DLT) financial markets infrastructure projects. There will be much greater due diligence into counterparties and potential acquisition targets – see our crypto resources for market participants in times of distress or get in touch for our crypto distress issues list.
- Regulatory expectations for managing operational and other risks arising from uses of DLT are maturing and regulators will increasingly require market players to operate with more stringent risk controls. Expect more co-ordinated global action following the Financial Stability Board's October 2022 consultation on regulation and supervision of crypto. Jurisdictions which have limited their focus to stablecoins (including the UK and Japan) will be rushing to expand their frameworks. Regulators will be considering the intersection of cryptoasset services regulation with insolvency and restructuring frameworks and, whether specific regulation is needed to facilitate restructurings or orderly wind-downs of centralised crypto exchanges in particular, e.g., with ring-fencing or resolution planning requirements similar to those for banks.
- There will be even greater focus from regulators on the resilience of firms when engaging with, and holding exposures to, cryptoassets following finalisation of the new global bank prudential standard for cryptoassets in December 2022. Expect to see regulators across the world introducing specific prudential standards for non-bank crypto service providers in addition to requirements for banks – the EU is the first to lay out its approach through MiCA.
- In the US, issues around the regulatory treatment of tokens and other areas of the crypto markets will remain unsettled absent legislative action by Congress. We expect that the jurisdiction of relevant authorities will not be clarified in the near term, leading to continued boundary disputes between the Securities and Exchange Commission, Commodity Futures Trading Commission and others, heightened by high levels of enforcement activity.

For more, see our articles Banks' exposure to crypto – what do you need to know? and the EU's MiCA Regulation.

2

Sustainable digital finance

Sustainable digital finance describes the intersection of the use of technology in finance with environmental, social and governance (ESG) objectives. Fintech solutions can provide value in terms of social inclusion and practical implementation of environmental ambitions. However, fintech products also raise a number of challenges around sustainability including the carbon footprint of technologies and the cultural and ethical issues raised by developing products using personal data or AI.

What's next?

- We expect to see a tech-powered reignition of the voluntary carbon credit market, given the continued regulatory focus on exaggerated claims around reductions in carbon impact. DLT will be used to help develop a transparent and verifiable carbon market by monitoring commitments to these projects against standards, as well as facilitating tokenisation to broaden access to the credits for a wider pool of investors. The BIS Innovation Hub and Hong Kong Monetary Authority are already working with financial institutions on Project Genesis, a green finance project using DLT to facilitate the tracking of carbon credits for climate-related bonds in real time.
- Following the highly anticipated "Ethereum Merge" last year which shifted from energy-intensive proof of work (PoW) to more environmentally friendly proof of stake consensus mechanisms, and New York State's November 2022 Bill introducing a two-year ban on non-renewable PoW crypto mining, we'll see more regulatory sticks and carrots to encourage further moves away from PoW mining to ensure more sustainable blockchain networks.

For more, read our articles Ethereum Merge – What is at Stake? and How data and DLT can accelerate sustainable finance.

Digital capital markets

3

Last year we saw further exploration of how DLT might transform the issuance, trading and settlement of debt securities, with, for example, the European Investment Bank issuing its first euro-denominated digital bond on a private blockchain in November. We also saw the development of regulatory initiatives to stimulate the use of DLT in financial services, including the EU Pilot Regime and the UK's proposals for a sandbox for financial market infrastructures.

What's next?

- From March 2023, we'll see the first projects launched under the EU Pilot Regime. It will allow operators of financial market infrastructures such as trading venues and securities settlement systems to experiment with DLT in issuance, trading and post-trade processes within a sandbox environment that will last for 3 years. Global regulators and the wider market will be watching and we might see similar initiatives offered in APAC and the Middle East. El Salvador is taking a step further with its new digital assets issuance law, establishing a legal framework that will facilitate its proposed issuance of a Bitcoin-backed "Volcano Bond" that it plans to use to repay sovereign debt and build "Bitcoin City".
- The market will move towards enhanced legal certainty. UNIDROIT is currently consulting on a set of draft principles for digital assets and private law which aim to improve the clarity around conflict of laws issues, among other things. In the UK, we will see the outcome of two consultations, with a Legal Statement on the Issuance and Transfer of Digital Securities due from the UK Jurisdiction Taskforce, and the UK Law Commission due to report on digital assets to offer greater clarity.
- We'll see a global increase in digital bond issuances following 2022's successful pilots, with international exchanges keen to participate and build a DLT track record. For issuers keen to launch digital bonds there are existing routes to market internationally, independent of the upcoming sandbox schemes.

For more, listen to our podcast the role of fintech in the future of debt capital markets and read our article DLT developments in debt capital markets.

Evolving risk for financial AI

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The use of AI and machine learning technologies is governed by a growing patchwork of overlapping legislative and regulatory initiatives, from data privacy, consumer protection and cybersecurity to new and developing AI-specific regulations, many of which have extraterritorial effect. This makes using AI lawfully increasingly challenging for businesses. Financial institutions must also consider the additional overlay of relevant financial regulation.

What's next?

- The EU's AI Act will be a game-changer in terms of how AI will be regulated in the EU and beyond, introducing a risk-based framework for governance of the entire AI supply chain, with extra-territorial reach and significant sanctions. The EU's AI Liability Directive is being negotiated in parallel to introduce harmonising measures on civil liability and compensation for damage caused by AI. Important concepts under both, including how tightly AI is defined, remain to be confirmed through negotiations. Similar far-reaching AI legislation will follow from other global regulators, so close monitoring is required.
- Financial regulators will focus on systems and controls and how well financial institutions are managing the practical implications of AI use. Crucial topics to consider include AI systems' fitness for purpose, accurate marketing, testing and accuracy. Firms should focus on consumer impact to avoid censure.
- Even ahead of new legislation coming in, financial and data regulators globally are increasing enforcement action to demonstrate the cost of not complying with existing law and regulation. Reputational concerns are becoming increasingly important in the face of growing enforcement activity. There will also be an increased antitrust enforcement focus on businesses using AI and data and we will see more AI dispute cases heard in local courts, which are critical to build out the limited existing body of case law.

For more, watch our international expert panel discussion Managing AI in an evolving legal landscape.

5

Financial services in the metaverse

Although the metaverse continues to attract lots of attention, sceptical voices are growing louder. For example, much of the poor share performance of Meta has been attributed to the significant investment the group is making in metaverse development. However, we anticipate that creativity and commercial growth by a range of metaverse developers will continue in 2023.

What's next?

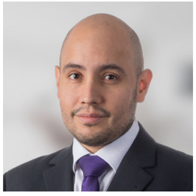
- In 2023, legislators and regulators will continue to play catch-up with the metaverse, making the first steps towards specific laws and regulations. The EU Commission has already identified an "initiative on virtual worlds " as a 2023 priority. Attempts to regulate the metaverse might follow the existing patchwork of international tech regulation with a focus on regulation of the online environment and specific rules for large service providers, with a finance-specific overlay for financial institutions.
- We will start to see the first specific metaverse-related arbitrations and court cases considering legal issues, e.g., which forum will have jurisdiction over virtual disputes, where are taxes due, and how general laws will be interpreted in relation to the technical characteristics of the metaverse.
- Financial services providers will continue to explore the commercial potential of the metaverse, with focus expanding to the possibilities of the first successful financial services being B2B (business to business) rather than B2C (business to consumer). We'll see some high-profile metaverse projects from financial institutions and investment firms, including tokenisations, further launches of metaverse investment funds, and acquisitions of or joint ventures with emerging metaverse-focused fintech firms.

For more, read our briefing The metaverse: risks and opportunities for businesses.

CONTACTS

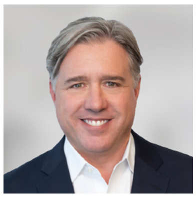
Laura Nixon
Knowledge Director
London
T: +44 207006 8385
E: laura.nixon@
cliffordchance.com

Marc Benzler
Partner
Frankfurt
T: +49 69 7199 3304
E: marc.benzler@
cliffordchance.com



Diego Ballon Ossio
Senior Associate
London
T: +44 207006 3425
E: diego.ballonossio@
cliffordchance.com

Simon Crown
Partner
London
T: +44 207006 2944
E: simon.crown@
cliffordchance.com



Steven Gatti
Partner
Washington, D.C.
T: +1 202 912 5095
E: steven.gatti@
cliffordchance.com

Jack Hardman
Partner
Dubai
T: +971 4503 2712
E: jack.hardman@
cliffordchance.com

Devika Kornbacher
Partner
New York
T: +1 212 878 3424
E: devika.kornbacher@
cliffordchance.com

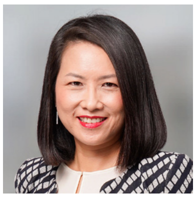
Frédérick Lacroix
Partner
Paris
T: +33 1 4405 5241
E: frederick.lacroix@
cliffordchance.com

Paul Landless
Partner
Singapore
T: +65 6410 2235
E: paul.landless@
cliffordchance.com

Kimi Liu
Counsel (Shanghai He Ping Law Firm)
Shanghai
T: +86 10 6535 2263
E: kimi.liu@
cliffordchance.com

Rocky Mui
Partner
Hong Kong
T: +852 2826 3481
E: rocky.mui@
cliffordchance.com

Jesse Overall
Associate
New York
T: +1 212 878 8289
E: jesse.overall@
cliffordchance.com



Lena Ng
Partner
Singapore
T: +65 6410 2215
E: lena.ng@
cliffordchance.com

Simon Persoff
Partner
London
T: +44 207006 3060
E: simon.persoff@
cliffordchance.com

Monica Sah
Partner
London
T: +44 207006 1103
E: monica.sah@
cliffordchance.com

Dessislava Savova
Partner
Paris
T: +33 1 4405 5483
E: dessislava.savova@
cliffordchance.com

Marian Scheele
Senior Counsel
Amsterdam
T: +31 20 711 9524
E: marian.scheele@
cliffordchance.com

Kate Scott
Partner
London
T: +44 207006 4442
E: kate.scott@
cliffordchance.com

Alexander Tollast
Counsel
Paris
T: +33 1 4405 5157
E: alexander.tollast@
cliffordchance.com

Kate Vyvyan
Partner
London
T: +44 207006 1940
E: kate.vyvyan@
cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

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