Michael G. Hiles of 10XTS

Speaker1: [00:00:04] This is the Investor Connect podcast program. I'm Hall Martin. I'm the host of the show in which we interview Angel Investors, venture capital, family offices, private equity, and many other investors for early stage and growth companies. I hope you enjoy this episode. Investor Connect is a 501 C three nonprofit dedicated to the education of investors and startups for fundraising. Please consider donating $100 to the program to help others in their investor and entrepreneur journey. You can find the donate button on the Investor Connect org website.

Speaker2: [00:00:44] Hello, this is Hall Martin with Investor Connect Day. We're here with Michael Hiles, founder and CEO at ten x ten Acts Helps Capital Market Participants leverage the emerging global decentralized capital market infrastructure. Michael, thank you for joining us.

Speaker3: [00:00:59] Hey, thanks. I appreciate the opportunity to talk to your audience.

Speaker2: [00:01:02] All right. And so where are you calling from today?

Speaker3: [00:01:06] So we're based out of Cincinnati, Ohio and southwestern Ohio area.

Speaker2: [00:01:09] All right. Well, let's talk about security token offerings. Can you give us a short overview of the market around those and how they work?

Speaker3: [00:01:18] Sure. So security tokens are essentially an application of blockchain technology wherein there's no question the token itself represents an actual underlying security instrument. And so the unit of account and the tracking of the security is done either through book entry or through a form of electronic certificated token as a share or a unit of an LP is that the account is designated by a blockchain token and then subsequently operates 100% on regulatory market infrastructure and through licensed intermediaries using a blockchain framework as the actual market infrastructure.

Speaker2: [00:01:57] Great. And can you talk about the problem it solves and how it's actually being used today?

Speaker3: [00:02:03] Yeah, it's a laundry list of problems that it solves. And when you really peel the onion, you know, it's interesting because you even talk to securities attorneys and even principle 24 broker dealers that don't necessarily have a deep understanding of the inner workings of market infrastructure from a post-trade settlement process standpoint in our how things get settled and cleared. It's just one of those legacy dark arts inside of the markets. And there's a number of problems that really, if you think about it in terms of modern market infrastructure, really hasn't advanced. Certainly electronic trading came online in the early eighties, which was a Cincinnati invention, I might add. Cincinnati Stock Exchange was the very first to pioneer electronic trading. So we've got a nice fintech legacy history here in the area. But when securities trade and settle, even if they're publicly listed, there's still this monolithic legacy infrastructure of information services providers, clearing agencies as just a monstrous undertaking. And it really comes down to the inefficiency of information. And today, if you buy and sell shares of Apple stock through your electronic broker, it still takes a couple of days to actually settle and clear the transaction and the technology of blockchain and tokens and cryptocurrency. Well, we've proven that you can have a near real time settlement process end to end on a global basis using the technology that's immutably provable transaction record ation.

And so it really calls into question, well, why are we waiting two days to settle and clear a securities transaction, a traditional securities sense that can even be longer in alternatives, for example. And it could take several days to weeks to clear. You might require somebody to get in their car and drive down to their bank branch and get a medallion signature guarantee to send off to the transfer agent your bank to actually get a physical signature on paper. And then you have the issue of liquidity itself, particularly in private markets, alternative assets. These these are illiquid assets will typically trade at a significant discount over valuation simply because of the illiquidity issues. And I think that there's an uprising of swelling up in the market that understands that if we can tokenize these traditional assets, can we improve liquidity, can we run fractional liquidity models, for example? Do I need to dispose of the entire asset? If I tokenize an asset, I don't have to dispose of the entire asset. I can only dispose of a percentage of that asset unnecessarily. So there's a lot of emerging benefits and you can even get into the asset class and real estate.

For example, can the token facilitate a increase evaluation of the equity because somebody is looking for yield and they're willing to buy buy up the fractional ownership and buy down the cap rate effectively on the piece of property. And the market's in a better position to make those decisions around price discovery. You've got even emerging opportunities across multiple liquidity and trading pools where a asset could be listed and traded on multiple exchanges and settle simultaneously. I believe within the next 3 to 5 years you're going to see a complete emergence of arbitrage within an alternative markets just running across exchange liquidity pool, you know, arbitrage, trading models for best execution and smart order routing. So immense amount of benefits that can come. Most of all, it puts the power back in the hands of the offering issuer and their investors, because ultimately our vision, our approach to what we do is it's their asset that's at risk. It's their investors money that's at risk, and the capital inefficiencies. Every time someone extracts a fee out of that intermediary layer of the market directly negatively impacts the performance of the investment and the capital efficiency. And I think we can start to see some compression in those intermediary and transfer settlement fees.

Speaker2: [00:06:07] So who is the ideal customer of this security token offering? Who would it be best for?

Speaker3: [00:06:13] Right now we're seeing a lot of corporate issuance, private equity, the real estate markets really starting to lean in tokenization of real estate, not through necessarily the tokenization of the ownership of the title per se, because at present, exactly zero county recorders in the United States of America recognize a blockchain token as a form of deed, but placing the asset within a special purpose vehicle and fractionalized the interest in that SPV has become a very popular, regulatory compliant path to fractionalized ownership in commercial real estate. In particular, we're seeing deals as low as feasibly to maintain compliance really gets tough when you're sub 5 million on deals. I think over time you'll start to see the automations kick in and you'll start to see even early stage companies, rigs that are raising a million bucks, for example, sub million dollar 506 instruments. Right now, it's still relative cost of capital because of the technology expense in the middle. But contrast that with hiring. A traditional broker dealer is going to charge you seven and seven front and back on the money from a traditional broker dealer standpoint. Certainly corporate issuer, any issuer that's looking to organize and raise capital for a project. If you can get cost of capital sub 500 basis points, that's probably a pretty good deal.

Speaker2: [00:07:40] Right. So what do you need to set up a fund here? What does it take to put one in action?

Speaker3: [00:07:45] We start with the law. I mean, there's a lot of folks that are still very enamored with the technology piece of it. And certainly the technology is a differentiating factor. No amount of cool technology is going to ever it's never going to compensate for a bad deal. You know, you've seen, I think, a fair amount of that just in the blockchain market. There's been a lot of razzle dazzle, you know, glitter. And, you know, the sachet of the new tech is at this stage, I think in the evolution of the market, it's just simply not there. I think you're seeing a lot more sophisticated institutional folks leaning in. They're not afraid of tokenization and tokenized assets by any stretch. But it first and foremost is a security offering. So you start with a process we've kind of defined, we call it the atop the asset tokenization lifecycle process. And that really stems from our background in traditional records management, governance, risk compliance from the life cycle of records and how an asset is created and goes through a primary offering goes into the secondary market trading and listing, but there's structured steps each step of the way. And of course it starts with a primary offering. You need to structure your offering with your law firm and engage all of your service providers because it's a security. And so anyone, whether it's a startup that's trying to raise regulation, crowd funding or a506 private placement or even a sophisticated family office, it's looking to convert on some existing assets through some form of five or six or private equity offering, you know, limited partnership.
It really starts with a savvy law firm that is certainly knowledgeable and up to speed on the technology. And then it moves into the normal process of a primary offering. Know, depending on your registration or your exemptions, what you can do.

Can you open openly solicit for that offering?

We try to automate that upfront process from an investor experience standpoint. So all of the KYC, AML, identity verification, accredited investor checks, sub doc, subscription agreements, all of that workflow payment facilitation for the actual allocation, you know, try to bundle that up into a seamless process for that upfront investor. We grab all of that data and then tokenize that as a metadata layer. And then at that point you're in position to generate what we call layer one token, which is a public blockchain token that converts from a book entry from whether it's an issue or managed cap table or a transfer agent managed cap table. We convert that book entry into a certificated form of transferable unit of account, and then it moves into the secondary market ecosystem, listing on the ETFs and exchanges, and then moves in a regulatory compliant fashion through the, you know, the custody system. The SEC has absolutely articulated a three step process for regulatory compliance of secondary market trading of these tokenized instruments. So but it starts with your law firm, starts with a traditional PM and all of the look that would entail the securities offering.

Speaker2: [00:10:51] So what's the most common mistake people make with security token offerings?

Speaker3: [00:10:56] It's interesting question. You know, aside from just thinking that the technology is going to fix their crappy deal of being overly focused, enamored by the technology in general, the fact that it's a token is really irrelevant. It's just a unit of account. It's a fancy blockchain, a fancy distributed spreadsheet. It's a ledger. And I think that there's been a push early entrants into the space, some great pioneering projects that got a lot of press. But then there were a whole bunch of projects very early on, generated layer one, public blockchain tokens called them, you know, shares of a company or units of a limited partnership. But then it got caught in that market infrastructure slog and prematurely focusing on a layer. One token is probably the biggest mistake. Tokenization, creating a smart contract that generates a blockchain token that comes several steps down the road. Right? You still got to bake your actual offering. You've got to go through the normal primary offering process that has nothing to do with blockchain. It's it's subscription agreements, it's traditional subscriptions, payment facilitation. And all of that metadata has to be associated in some way with that token so that that token is now provable as the security that it's being claimed, as it's supposed to represent. And I think premature focus on that token, just because of the engagement with the technology and the glitter and the razzle dazzle and I like to call it the fact that it is blockchain. Yeah, it's cool. It's I mean, I'm all in, right? I burned the bridges behind me as CEO of our company. At the same time, it's really boring because it's market infrastructure. It's how license intermediaries communicate information back and forth with each other. And aside from having your metamask wallet, you open it up and look at it. Cool. There's some tokens in there. It's really not that meaningful.

Speaker2: [00:12:59] Right. Well, what should someone expect who's putting a security token offer together? How long is it going to take and what's it going to require? And maybe the gotchas there.

Speaker3: [00:13:09] Well, I spent an awful lot of time with attorneys and law firms, and I love them dearly because they are earnestly many are leaning in to the space and learning blockchain in all forms. It's exciting and it's exciting times, but I have the saying it's kind of derogatory but not. And I think everybody will know exactly what I'm talking about. It's business at the speed of law firm, so the faster your counsel can get your offering structured and out the door, then the meat and potatoes can start from a technology standpoint. You're not necessarily talking about a lengthy process unless you're trying to do something at the institutional level with a lot of custom enterprise integrations, with existing line of business systems, accounting systems, like if you're trying to tokenize a rete, for example, and you've got to contemplate, you know, thousands of K ones for token holders, you know, and you don't want to have to reinvent the wheel on generating these things. You want to be able to dump those out of your your dynamics or whoever using is accounting system. You've got to contemplate those types of integrations. And so you're usually anywhere from 60 to 180 days in terms of organization from a primary. And then as it moves into the secondary or secondary markets are, you know, pursuant to your registration and your exemption, in particular, you're 140 for a restrictions on the transfer of a secondary market. Security can certainly radically affect the time frame of listing. The token on exchanges could be as much as a year right to season at 144 under the law, which has nothing to do with the technology. So you have plenty of time to contemplate listing agreements with ATS and getting your custody situation with the banks all arranged. Even if you file a form ten and reduce that 144 from a year to six months, that's from the close, the primary offering. So however long it takes you to market and I guess proportionate to size of raise any other securities offering that you're putting on the table?

Speaker2: [00:15:02] Great. So just to switch gears a little bit, what online information source you might find most helpful in this area?

Speaker3: [00:15:10] I read a lot. I mean, there's a lot of great resources that are out there. I lurk on Twitter pretty heavily. I think the Twitter really does have the near real time finger on the pulse for breaking information and news. Twitter and Reddit are probably the two. Just tracking blockchain cryptocurrency finance trends because it's really an amalgamation. It's not just one competency. You're talking about a whole bunch of really complicated and nerdy and boring vocabularies all combined into one. You've got finance, you've got law, you've got your regulatory and legal, you've got, you know, of course, the technology side of it. And that crosses over into traditional crypto and monetary policy and economics. It's it's really, you know, you kind of got to cover a lot of ground coindesk obviously, you know, the the block know in the crypto space and we've got some really great publications that are focused specifically on the the cryptocurrency and the blockchain side of it. There's not a lot in the security token space per se, because it is still such an emerging, very small Twittersphere. Next evolution of the markets. I anticipate that you'll see a lot of growth, particularly as more and more projects come online, billions more in, assets start pouring in, you'll start to see even traditional traditional outlets start to maintain analysis and coverage of the, you know, the tokenized asset classes.

Speaker2: [00:16:36] Right. Well, there's a lot going on in this space. If you could start a business tomorrow, what would that business be in this area?

Speaker3: [00:16:43] Yeah. I really thought about this because it's tough. We bit off a big bite when we said we're going to tackle the regulatory compliance side of the discussion. Right. And that all by itself means that for the folks that said, no, I'm going to ask for forgiveness as opposed to asking for permission. Many of them are out there. Many of them have seen the inside of a courtroom. But then there are many others that have also paid their fines and danced on down the road with their billions in their bags. So if I were to start over again, maybe find a little bit of a balance between the regulatory and the non regulated use cases of the space, maybe not even outside of finance. Know I'm looking at like supply chain and there's great projects in a lot of those spaces. Health care information is information trust technology like blockchain, the ability to create a consortia of data that's used by multiple common enterprises that need to share that common data. It's a fantastic use case. I mean, it's a marvelous use case. It's to me, it's one of the only use cases. Why have a distributed ledger of common a single source of truth data? And there's so many applications of that across so many use cases.
And I was talking to a colleague of mine about even Iot sensing devices on mesh network from an FCC and a UL C certification, you know, just on the operation and the logging of the proper operation of electronic devices on a network. Right. And just simply aggregating at scale millions and millions of messages a second, you know, across a wide area or a mesh network. I think there's so many use cases in the same technology that we took the hard route because it does

require the law and the regulators. And but I think that in the end of the path that we've chosen has been great. It's been a long time coming. I think 2022 is definitely the year of securities tokens and tokenized assets. Without question. I think the market is finally awakened when I see very large buy side alternatives institutions that are looking actively for offerings to acquire in this space. I think that you're going to see a radical expansion in that space, which is good because it's been quite the journey.

Speaker2: [00:19:01] Right? When the last few minutes that we have here, what else should we cover that we haven't?

Speaker3: [00:19:05] I know your audience is largely focused on investing and early stage and angel investing from an activity focused standpoint. This is a phenomenal shift that you're seeing right now because of that advent of the technology. It's really radically impacting venture that I'm seeing the writing on the wall, traditional venture while it's still running at all time highs. You're starting to see some very interesting projects that are forming distributed autonomous organizations. Daos. People are buying into the DAO and getting governance tokens and then making democratic decisions on allocation of the funds to acquire assets and invest in projects. I don't know if you saw sometime back that there was a DAO that was formed to try to buy the one of the only copies of the Constitution, and they called it Constitution. Dao And I see the democratization of investing really shifting, and I think it's going to put a lot of pressure on investors that focus on early stage to really. You know, refine their thinking and what their hypothesis is, investing in these types of projects and how early stage technologies are funded, and what does the capital formation project look like and the early stage angel space and the early stage investing space. And I think that there's just as much opportunity as there is risk for smart, forward thinking investors that are looking at even forming funds. I'm starting to see early stage fund projects that are now organizing around these types of hypotheses, and I think that it's really a bellwether moment in the venture capital space in particular, that it's going to be, you know, that digital transformation things great when you're talking about investing in a portfolio company.
But is it as great when it's threatening your own core business model is as an institution? You know, it's like, well, you know, the inevitability is here. So so that's that's one area that I would encourage your listeners to really lean in and pay attention to the really there's some really cool projects, you know, there's been some really novel, there's a lot of bright people in the space.

And, you know, the rethinking of capital formation is really underway right now. And even at the regulatory level, the SEC, I mean, you're starting to see the SEC rattling the sabre about wanting to rethink the 2000 investor rule special purpose vehicles and peeling the onion on the number of shareholders under 12 G. And a lot of those things are really going to become more and more mainstream discussion over the next months years. Another area I'd like to see revisited. Back under the Obama administration, the SEC had taken up a conversation around venture exchanges, and there was a lot of discussion around liquidity and early liquidity for LPs that are in venture funds that have ten year horizons. You know, how can we rethink the secondary market when it comes to venture exchange projects? And I think that you're seeing finally the technology and the acceptance of the broad market to embrace alternatives. And at what level does the National Venture Capital Association and the Angel Capital Association and all players in the space, do they need to revisit the SEC conversation about secondary markets for particular equity VC funds? From an exchange standpoint, I think that that's an interesting opportunity that can reemerge.

Speaker2: [00:22:42] All right. Well, I agree. I think security token offers, you know, their time has come and we're going to see a great uptake here this year as well. So looking forward to seeing the roll out of the market in a bigger way. So how best for listeners to get back in touch with you?

Speaker3: [00:22:57] I'm pretty easy to find at Michael Hale's on Twitter, on LinkedIn. You can always reach us through our site connects dot com. I'm pretty easy to get a hold of. The team is growing and building and I sadly losing touch with my my audience for direct. They got to keep the CEO off in the corner and don't talk to anybody but but always happy to engage folks and learn about your project and figure out how we can really help facilitate whether it's at the fund level. We spend a lot of time in institutional discussions right now, less so on the startup offering side, but lots of really cool conversations are going with the groups and the equity funds VCs. There seems to be a fair amount of interest in shifting. Forming a new fund is always a lengthy process in and of itself and fund formation. But if you're contemplating a tokenization strategy, you need to start thinking about that as you're planning the offering. You can't wait. And I always say Blockchain's not like a Christmas ornament that you hang on the tree after the fact. It's like kind of the it's the trunk of the tree. You got to you got to contemplate it at the base and you just don't hang on, hang blockchain on like an ornament. It's got to be architected in from the get go. And that requires buy in from the law firm, the auditors and everybody across the board. And it has been around long enough. Now there are successful models to point to. And from a risk mitigation standpoint, I think that folks are looking for those kinds of strategies. We do a lot of advisory and we're here to answer questions and help.

Speaker2: [00:24:36] Right. We'll include your contact details in the show notes. Thank you for joining us today and hope to have you back for a follow up soon.

Speaker3: [00:24:43] Always happy to chat. Appreciate it.

Speaker1: [00:24:47] Investor Connect helps investors interested in startup funding. In this podcast series Experience, investors share their experience and advice. You can learn more at Investor Connect Talk. Martin is the director of Investor Connect, which is a 503 nonprofit dedicated to the education of investors for early stage funding. All opinions expressed by hall and podcast guests are solely their own opinions and do not reflect the opinion of Investor Connect. This podcast is for informational purposes only and should not be relied upon as a basis for investment decisions.