LoyaltyOptions
https://LoyaltyOptions.com; 647 945 6604; 17 Grove Park Crescent, Toronto, Ontario M2 J 2C7

The Power of the Secondary/Mini Market

Written by: Ramy Taraboulsi, *P.Eng, M.Sc., MBA, CFA*

Introduction

This article explains how private companies can implement a secondary/mini market for their shareholders. The article starts with an explanation of what a mini market is and why private companies should have it. The article then talks about the mini market process and how companies can establish it.

What is a secondary/mini market?

A secondary/mini market is a mechanism that allows shareholders of a private company to trade shares among each other at a price set by the company. The trades are done among the shareholders in an anonymous manner, and the company facilitates the share exchange.

The mini market is not a stock exchange because:

- Stock exchanges have bid and ask prices, whereas the company sets the mini market trading price; this trading price is normally the latest valuation price for the company.
- The mini market does not require a broker and the company manages the share transactions.
- The stock exchange trades do not require the company approval of the trade whereas the company needs to approve the mini market trades; This approval may be implicit in the company shareholders agreement.
- The stock exchange trade starts with either the buy or sell order, whereas the mini market trade is triggered by a sell order.
- The stock exchange trade happens when the bid and ask prices match, whereas the mini-market trade happens at a set time with no matching.

The above differences justify that *the private company does not need to be governed by the securities commissions when implementing their mini market*.

The Benefit of a the Mini Market for Private Companies[1]

Private companies with employee ownership plans and no mini market have a serious problem related to the liquidity of the shares and the punitive tax treatments when selling the shares back to the company.

Following is the explanation of how the mini market address these two problems:

(1) The shares will have higher liquidity, and this will increase the perception of the value and flexibility of employee ownership plan.

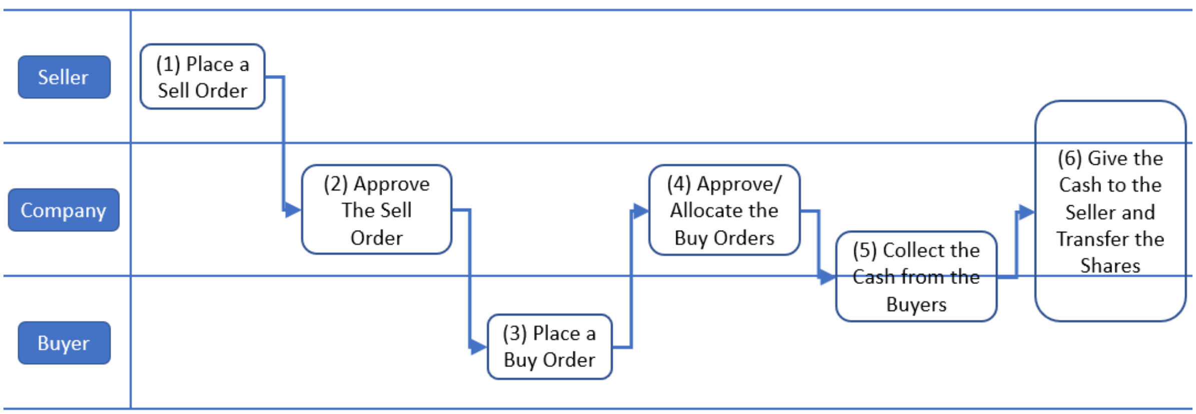
[1] This section discusses the taxation benefits from a Canadian perspective which may not be applicable to other countries.

(2) Selling shares to other shareholders has a massive tax advantage compared to selling the shares back to the company. The benefits *for a Canadian Controlled Private Company, CPPC*, come from three perspectives:
   a. The gain on the sale of the shares to a third party (e.g. another shareholder) is considered a capital gain (lower tax rate) compared to the dividend that is deemed if the company buys back the shares.
   b. The shareholder selling the shares to a third party can be eligible for the lifetime capital gain exemption.
   c. The calculation of the gain for a sale to a third party will be based on the purchase price for the average cost base instead of the paid-up capital, PUC.

As a summary, not having a mini market for a private company is akin to forfeiting significant opportunities for the company shareholders.

The Mechanics and Process of a Mini Market

The process for the mini market can be simplified by the six steps that are depicted in the following swimlane diagram:



Source: Created by Author

Here is a brief description of the steps:

(1) **Place a Sell Order:** The shareholder (seller) places an order to sell a specific number of shares that they own.
(2) **Approve the Sell Order:** The company administrator reviews the sell order and approves it. Shareholders would be able to see that there are shares available for sale only after the approval.
(3) **Place a Buy Order:** The different shareholders place the orders (each bid can be up to the number of offered shares) for buying the shares.
(4) **Approve/Allocate the Buy Orders:** The company administrator will review all the placed buy orders for the specific sell order and allocate the shares to the different buyers.
(5) **Collect the Cash from the Buyers:** Based on the company standards and the shares allocated, the company administrator would communicate with the buyers and collect the cash or the share purchase from each.

(6) **Give the Cash to the Seller and Transfer the Shares:** The company administrator will transfer the cash collected from step-5 to share seller. The company then proceeds with officially transferring the shares based on the company standards identified in the shareholders' agreement.

Please note that the steps above are just an example of how the mini market would work. Variations can be made to the above model, but the general flow should remain the same.

Points to Consider

Following are some points that need to be taken into consideration when setting up a mini market for a private company:

- **Privacy needs to be maintained**; The buyers should not know who the seller is and the seller should not know who the buyers are.
- The trades need to be made based on **the stock price determined by the latest company valuation**. There are no bid and ask prices.
- The company may have a trading (or blackout) window for placing the buy and sell orders.
- The **collection of the cash** has to be done very close to the time of allocation of the shares to the different buyers.
- The company may put a **restriction on the amount of shares** each individual may sell or buy.
- Depending on the company policy, **third parties** who are not current shareholders may be able to place orders for buying shares.
- The **system used** needs to have the following basic functionality:
    - Maintain anonymity: Sellers should not know who the buyers are and the buyers should not who know the sellers are. Only the administrator would be able to know the buyers and sellers.
    - Provide the seller with the details of the average cost base used for calculating the gain/loss on the sale.
    - Is fully integrated with the company capital summary.
    - Provide automatic allocation of the shares to the different shareholders based on different allocation methods (e.g. proportional, manual, first-in-first-win, lowest amount win, …).
    - Keep track of the cash collected from the buyers and distributed to the sellers.
    - Generate the appropriate paper forms associated with the share transfers.

How can a company introduce a mini market?

To introduce a mini market, the company needs to take the following steps:

(1) Secure a software provider that supports a mini-market based on the above criteria.
(2) Set up the standards for running the mini market based on the points mentioned above.

(3) Identify the blackout and/or trading windows for the shares; This is normally set by the Board of Directors. While not typical, shareholders of some companies can put requests for selling their shares at any time.
(4) Create a pilot implementation of the mini market for a select number of shareholders.
(5) Establish a communication plan for the shareholders.
(6) Start the mini market.

About the Author

Ramy Taraboulsi is the CEO of VeritableSoft Innovations Inc., the parent of LoyaltyOptions (https://LoyaltyOptions.com), the software product that manages all aspects of administration and accounting of stock-based compensation and employee ownership plans, including mini markets.

Prior to founding VeritableSoft, Ramy held different executive positions including Chairman and CEO at SyncBASE, CIO at Insurance Bureau of Canada, VP - Internet Strategy and Development at Fidelity Investments, VP - Internet Strategy at Merill Lynch and Chief Systems Architect at Mercer Human Resources Consulting. Ramy has also held and is currently holding various directorship positions.

Ramy is a Professional Engineer who holds an M.Sc. in Computer Science, MBA and he is a Chartered Financial Analyst (CFA). Ramy has been practicing different forms of martial arts for 40 years, and is currently actively practicing Karate. He also plays music and enjoys reading, writing and traveling around the world.