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June 8, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Subject: File No. 265-23

Dear Mr. Katz:

This written statement is submitted for consideration at the public meeting of the SEC's Advisory Committee on Smaller Public Company to be held on Thursday, June 16, 2005, and Friday, June 17, 2005, at Columbia Law School, Jerome Greene Hall, Room 103, 435 West 116th Street, New York, New York.

I represent Wynnefield Capital, Inc., which, together with its related investment partnerships, is a significant investor in the securities of smaller public companies. I also represent eight institutional investors who submitted a petition to the Securities and Exchange Commission on July 3, 2003, to change the definition of "holder of record" contained in Rule 12g5-1 under the Securities Exchange Act of 1934 (the "Exchange Act") to include all beneficial owners, thereby accurately reflecting their direct economic interest in the issuer's performance. *See* Public Petition for Rulemaking 4-483.

The Disease Infecting the Capital Markets

The archaic definition of Exchange Act Rule 12g5-1 is a disease infecting the capital markets for smaller public issuers. As discussed in more detail below, the rule is intended to determine when an issuer's size and number of shareholders render it sufficiently public so that it should be required to provide uniform, timely and continuous public disclosures. However, the rule fails to accurately reflect the economic interests of beneficial owners in an issuer's performance. Smaller public issuers are taking advantage of this definitional anomaly under the Exchange Act and exiting its disclosure regime in droves, blaming Sarbanes-Oxley. In fact, the true causes of this phenomenon are not only Sarbanes-Oxley expenses, particularly those related to Section 404, but the arcane definition of "holder of record" that no longer reflects the realities of modern market operations. These deregistration strategies are a symptom of the disease. The deterioration of the capital markets in the securities of smaller public companies is the ultimate result of the disease.

Deregistered securities becomes toxic for institutional and fiduciary investors who cannot perform their fiduciary duties in the absence of uniform, timely and continuous disclosure about the companies in which they invest.

Professor Loss has famously observed that the regulation of smaller issuers has been a "perennial conundrum" of the securities laws. Louis Loss and Joel Seligman, *Securities Regulation 3d*, ß 3-C-6 (2004). Strong regulation is needed to protect investors because historically a substantial amount of fraud has been perpetrated by the promoters of smaller public companies. On the other hand, there are great economies of scale in securities regulation. Accordingly, the cost of regulation bears most heavily on smaller companies, providing large companies with a significant competitive advantage. No one argues that it should be more difficult for smaller firms to raise capital; something should be done to balance the scales.

Regulation intended to improve disclosure standards should not result in less disclosure to investors. There is no question that Section 404 of Sarbanes-Oxley, as currently applied, represents a proportionately greater burden for smaller public companies. We think that the costs have been greater than necessary to achieve compliance with this rule. Much can be done to lessen the burden of disclosure on smaller public companies, while still providing investors with the uniform, timely and continuous disclosure required to protect their economic interests and the markets. On the other hand, most of the other protections offered under Sarbanes-Oxley involve negligible costs, yet are essential to protect investors in smaller public companies. Sarbanes-Oxley's prohibitions on loans to officer and directors eliminate an historical problem of self-dealing that is widely perceived among investors as characteristic of smaller companies. The loan prohibition may actually reduce the cost of capital-raising for smaller companies by prohibiting an abusive practice that increases investment risk. The cost of the CEO's and CFO's certification of the integrity of public disclosure amounts to the ink flowing from the officer's pen, but provides beneficial reassurance to public investors.

In contrast, the disease of Exchange Act Rule 12g5-1 has put a thumb on the scales for smaller public companies, disadvantaging investors. The great promise of Exchange Act regulation to investors in public companies is that they shall receive uniform, timely and continuous disclosure. That promise is now broken, to the great detriment of investors, our capital markets and ultimately, the smaller public issuer.

It is true that issuers generally would much prefer to limit disclosure to those moments when capital is being raised; disclosure at other times represents a cost for which the issuer receives no corresponding capital-raising benefit. Of course, no one seriously contends that an issuer of securities to the public should issue securities to the public and have no further disclosure obligations. In the first place, efficient secondary markets are essential to primary capital markets because investors are much more willing to invest in initial offerings if they know that the securities purchased in such offerings can be readily sold in a secondary market. But, the secondary market cannot function properly without good disclosure. So, uniform, timely and continuous disclosure is essential, not only for secondary markets, but to encourage investors to purchase securities in initial offerings. Secondly, it is simply unfair for an issuer to provide disclosure to investors to lure them into making an investment in an initial public offering and then fail to keep them informed through uniform, timely and continuous disclosures about the business in which they have invested.

To protect public investors and the secondary markets, the Exchange Act rejects this economic preference of issuers, requiring uniform, timely and continuous disclosure by public companies, whether or not they are currently in the process of raising capital. Unfortunately, this time-tested principle that has made our capital markets the envy of the world has been degraded by Rule 12g5-1, which has not evolved to reflect the realities of modern market operations. The unfortunate result is that smaller issuers can make disclosures when necessary to raise capital and then can cease to make uniform, timely and continuous disclosure soon thereafter.

The late 1990s were a time of bountiful capital markets. Issuers were delighted to incur the cost of disclosure to float initial public offerings to enthusiastic investors. The capital markets have been much less generous and more skeptical in the last few years. As a result, many smaller public issuers who raised capital from public investors in good times have exploited the current archaic "record holder" rule to escape from their Exchange Act obligations to provide uniform, timely and continuous disclosure to investors. We believe the Commission is charged to protect investors from the vagaries of such "bait and switch" tactics. Investors who purchased stock in public offerings, reasonably believing that federal regulations promised uniform, timely and continuous disclosure, should not find themselves suddenly cast into darkness by the exploitation of an archaic and obscure rule that facilitates easy avoidance of disclosure obligations by smaller public companies.

Investors have reacted predictably by being less willing to fund new ventures, witnessed by a much lower number of initial public offerings despite the resumption of a bull market in securities. New financing of smaller public companies today is accomplished almost entirely by private equity and venture capital, which demand rigorous continuous disclosure, monitoring and auditing requirements in private contractual arrangements as a condition to financing. The large private equity and venture capital industry builds in the expense of monitoring private contracts in determining a desired investment return. These private monitoring and auditing expenses increase the cost of raising capital for smaller issuers more than would be the case if investors could depend on federal regulations to guarantee uniform, timely and continuous disclosure.

Critically, secondary markets for the securities of smaller issuers have ceased to operate efficiently. Fiduciaries cannot hold stock when there is not sufficient information about a company for them to satisfy their prudent investment duties. Analysts cannot cover companies for which there is no disclosure. Investors lose interest. Liquidity vanishes. Values decline.

It is worthwhile to consider the origins of this disease infecting our capital markets.

The Origins of the Disease

Prior to 1964, issuers were required to provide uniform, timely and continuous disclosure under two circumstances: First, if they elected to list on a national securities exchange. Second, any issuer that had ever offered securities in a registered public offering was required to provide annual, quarterly and periodic reports (10Ks, 10Qs and 8Ks) during any year in which, on the first day of its fiscal year, there were more than 300 holders of record of such securities. As a practical matter, listed companies provided regulated uniform, timely and continuous disclosure, while companies whose securities traded over-the-counter did not.

Ultimately, frauds in the over-the-counter market led to a national crisis, causing Congress in 1964 to adopt Section 12(g) of the Exchange Act. That statute generally requires any company with a class of securities owned by more than 500 "holders of record" and more than $1 million in total assets to register, effectively requiring such companies to provide the same sort of uniform, timely and continuous disclosure required of listed issuers. Once registered, an issuer must have less than 300 "holders of record" to deregister.

In 1965, the Commission promulgated a rule that interpreted the term "holders of record" to include only those shareholders listed in the issuer's stock record. Exchange Act Rule 12g5-1. As a practical matter, this means issuers need only count as shareholders persons who are issued stock certificates. This was primarily a rule of convenience for issuers because the stock record was readily available to them. In 1965, shareholders almost always held stock certificates in their own names.

Since that time, the clearing and settlement of securities has changed dramatically. For the last 35 years, responding to a crisis in 1970, the Commission and the securities industry have undertaken a series of initiatives to encourage shareholders to relinquish their stock certificates and hold with their broker in "street name." It is now uncommon for shareholders to hold stock certificates, and this is particularly true for the shareholders of issuers who first became public companies in the 1990s. Reflecting these developments, the proxy rules have been updated so that the number and identity of beneficial owners is now readily available to issuers.

In contrast, the rule for counting "holders of record" has not been modernized to reflect these changes in clearing and settlement. Thousands of an issuer's shareholders may have brokerage accounts at Merrill Lynch, but they collectively count as one.[1] As a result,

[1] Merrill Lynch does not hold stock certificates in its name, either, and is not listed on the issuer's stock record. Instead, all of the stock held by the various brokerage firms and other clearing agents is held by The Depository Trust Company (DTC), which is represented on the issuer's stock record as CEDE & Co., its nominee. Nonetheless, the Commission requires issuers to count each of the brokerage firms holding stock

issuers with thousands of beneficial owners may have many less than 300 holders of record. This is particularly true of companies who issued stock in the mid-1990s, when the Commission's efforts to encourage stockholders to hold in "street name" were bearing fruit. The rule therefore denies recognition to the many beneficial owners (who always outnumber record holders). Market operations have changed, not the need for investor protection.

There has been a rush to the exits in recent years as issuers have counted the number of their record holders (as opposed to beneficial owners) and deregistered, thereby ceasing further uniform, timely and continuous disclosure to public investors. The results have been drastic for the shareholders of smaller public companies, who have seen the value of their investments deterioriate, even for those companies experiencing strong profits. Shareholders may be forced to sell into an illiquid market, which generates inferior prices. Management and other insiders may exploit deregistration to drive the market price of securities down, or may simply take advantage of the lack of liquidity and decline in value, and then use their superior access to information to buy securities from less-knowledgeable outside investors on the cheap, a form of "creeping privatization."

The disease of an antiquated definition is causing a loss of confidence in the market. The bond of trust between an issuer and its outside investors that makes the capital markets work is broken. Capital-raising for smaller companies is more expensive and difficult.

The negative effect on shareholders from deregistration has been well documented in academic studies.[2] Without good disclosure, volatility increases as stock prices are influenced by rumor, innuendo and fear. Pension funds and other fiduciary investors begin to liquidate their holdings because of concerns that a lack of good information makes it difficult to establish the prudence of an investment. Value diminishes; liquidity vanishes.

The negative effect of deregistration on shareholders is demonstrated by the case of Niagara Corporation.

Niagara Corporation

On April 28, 2004, Niagara Corporation announced record earnings. It's net income per share doubled. On the same day, Niagara announced that it was deregistering its stock

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through DTC for purposes of Rule 12g5-1 on the grounds that DTC did not exist in 1965, when the regulation was promulgated.

[2] Leuz, Triantis and Wang, "Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations," November 2004 (not yet published study sponsored by Pennsylvania's Wharton School and Maryland's Robert H. Smith School of Business); Marosi and Massoud, "Why Do Firms Go Dark," July 2004 (not yet published study sponsored by the University of Alberta).

under the Exchange Act. The market for Niagara's stock, considering the effect of both announcements, dropped 30%.

Niagara is a specialty steel producer with total assets greater than $100 million. At the time of deregistration, its stock was actively traded on NASDAQ. However, the Company first went public in the 1990s, at the same time that shareholders were actively encouraged to give up their stock certificates by the Commission. So, Niagara never had many record holders, representing primarily control stock held by the Company's affiliates. On April 28, 2004, when Niagara shocked the markets by deregistering, immediately after announcing the most profitable quarter in its recent history, it certified only having 124 record holders, much less than the 300 holders of record needed to deregister under the Exchange Act.

Niagara maintains that deregistration will enable it to avoid the expense of Sarbanes-Oxley. Undoubtedly that is true. But that statement must be weighed in its context. More than 50% of Niagara's stock is held by its management and affiliates, giving them a very free hand. Good information about the Company and its prospects is readily available to management. Only outsiders need the protection of the Exchange Act.

Niagara's outside shareholders have fought back, attempting to increase the number of record holders by requesting stock certificates. Niagara has responded by engineering reverse and forward splits to reduce the number of record holders. There are lawsuits in federal and state courts.

Niagara has made some disclosures to the public in the form of press releases. Its most recent "annual report" appears to mimic the disclosures required by Form 10K. Most interesting, however, is the information management selectively chose to omit from the Form 10K disclosure requirements. There is no discussion about management compensation, except for a stated minimum for one executive, or related party transactions. Yet, in a company dominated by management, outside shareholders are very concerned about compensation arrangements, loans and business arrangements with insiders that might indicate whether their investment is being used or abused.

In the meantime, while prudent fiduciaries have reduced their holdings, members of Niagara's management have bought more shares in large block trades, raising questions about their motives. It seems quite possible that deregistration and management's continued efforts to remain deregistered are part of a scheme by management to buy the company at cheap prices once the current cyclical boom in steel manufacturing ends.

Niagara's common stock has failed to participate in the cyclical boom in steel equities over the past 18 months. Niagara's common stock is trading at prices approximately 50% below those of its industry peers on a price-earnings, enterprise value to EBITDA, or book value multiple basis.

The Need for Good Continuous Disclosure

It is said that those who have not learned from history are doomed to repeat it.

The historical record amply demonstrates that good uniform, timely and continuous disclosure is essential for an efficient secondary market in over-the-counter securities. In the absence of good disclosure, the secondary market is much less efficient. Without an efficient secondary market, investors will avoid purchasing over-the-counter securities in public offerings. Smaller companies will have an increasingly difficult time raising capital.

History also tells us that fraud flourishes in the absence of good disclosure. Fraud, like bad money, chases away the good.

We continue to wait for a response from the Commission that would cure the disease inflicted by archaic Exchange Act Rule 12g5-1. Meanwhile, Sarbanes-Oxley continues to serve as a blind for issuers that would deny uniform, timely and continuous disclosure to outside shareholders of smaller public companies. While we discuss ways to lessen the burden of Sarbanes-Oxley on smaller public companies, a worthwhile goal, our great capital markets continue to deteriorate. Rome burns, while we fiddle.

We urge the Committee to consider the effects of deregistration on investors in smaller public companies. While it may be appropriate to lessen the disclosure burden on smaller companies to equalize the capital-raising burden with larger companies, it is essential that the easy escape route from disclosure be closed. Companies with more than 500 shareholders, counted as beneficial owners, should be required to make appropriate disclosures to investors, and should not be entitled to avoid disclosure until the number of beneficial owners drops below 300. Companies that raise capital from the markets through public offerings in good times should not be able to place shareholders in the dark when capital-raising prospects are more difficult.

We appreciate the Committee's time and attention on this important issue involving smaller public companies and would be pleased to answer any questions or provide any additional information that would be helpful.

Very truly yours,

Stephen J. Nelson