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Fund Managers Lift Results With Timely Trading Sprees

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By JASON ZWEIG and TOM MCGINTY

The stock of [Iridex Corp.](#), **IRIX -0.25%** a maker of lasers used to treat visual ailments, had been hovering around \$3.43 all day on June 29. At 3:55 p.m., five minutes before the market close, it took off.

It moved to \$3.65, then \$3.80. Less than a half second before the trading day and calendar quarter ended, Iridex jumped 4% to \$4.17, capping a nearly 22% rise for the day.

Scott Shuda, a managing director at BlueLine Partners, an investment firm in Danville, Calif., and Iridex's largest shareholder, saw the stock jump. "Is it unusual for these little companies to move a lot?" he asks. "No. Is the timing suspect? Yes. I saw it and I thought, 'Somebody wants to move this stock up today.'"

The next trading day, July 2, Iridex dropped 10%—and it didn't hit \$4 again until late October.



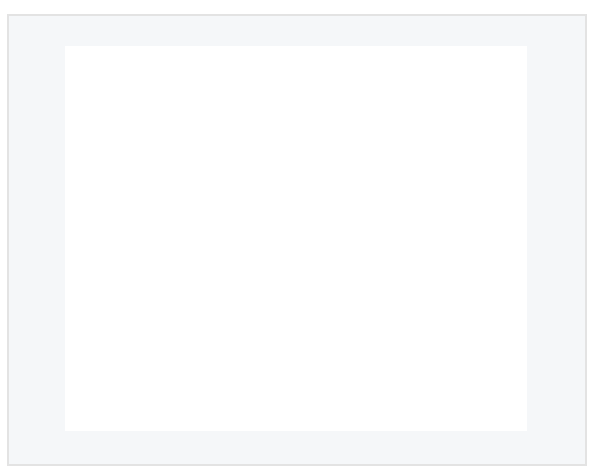
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What happened to Iridex isn't unusual. A Wall Street Journal analysis of daily trading in roughly 10,000 stocks since 2004 found that on the final trading day of each quarter, there was a sharp increase in the number of stocks that beat the market by at least five percentage points, then trailed it by three points or more the next trading day.

The Journal's analysis compared the performance of those 10,000 stocks to the one-day return of the Standard & Poor's 500-stock index. On days that didn't end the quarter, an average of 217 stocks beat that index by at least 5 percentage points then trailed it by at least three the next day. But on the final trading days of quarters, an average of 280 stocks did.



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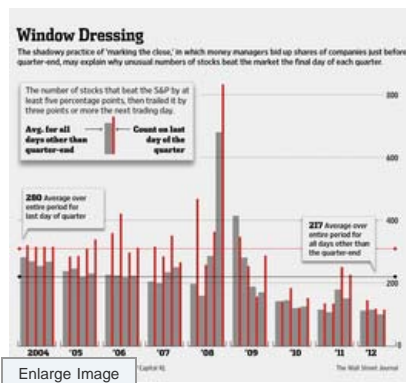
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Regulators and market analysts have an explanation for the unusual pattern. They say some money managers wait until the waning moments of the quarter to bid aggressively for more shares of a stock they already own, which drives up the value of their entire position in the stock. That, in turn, boosts their performance at the very moment when they report results, making their funds look more appealing to potential investors. Even if the jump in stock price is only temporary, the managers can attract new money and earn higher fees.

The practice, known as "marking the close" or "portfolio pumping," is a form of "window dressing"—a term for a variety of techniques employed by asset managers to make their results look better at the end of the quarter. Some forms of window dressing, such as selling losing stocks right before reporting quarter-end holdings to investors, are perfectly legal. But regulators say marking the close violates prohibitions on deceptive trading in the federal securities laws.

Window dressing can distort prices in the U.S. stock market, long considered one of the most transparent in the world. If stock prices are pushed up deliberately, they might no longer reflect the fundamental value of companies, exposing investors to greater risk of a sudden decline.

It isn't easy to spot or prove the window dressing of stocks. Regulators like the Securities and Exchange Commission generally can't match trades to the traders who placed them without first making a detailed examination of confidential records. And regulators must show that the trading was a deliberate attempt to distort prices, which can be difficult to prove, experts say.



Since the beginning of last year, the SEC has brought at least three cases against money managers for allegedly window dressing stocks in their portfolios. SEC spokesman John Nester says window dressing is an area of "ongoing interest" in the agency's investigations. Outgoing SEC chairman [Mary Schapiro](#), speaking about securities fraud in general, said in an Oct. 11 speech that the regulator is "using newly developed analytics to

identify suspicious trading patterns and relationships among multiple traders and across multiple securities."

The number of stocks that met the Journal's test for potential window dressing was greater on the final day of this year's third quarter than on 82% of the quarter's other trading days. Across all 35 quarters in the Journal's analysis, the quarter-end counts were greater than on 85% of the other trading days, on average.

The Journal's test doesn't capture all instances of potential window dressing. For example, the SEC has brought at least one case in which a trader allegedly swooped in near the end of the final trading day of a quarter to keep a falling stock from declining even further.

Window dressing occurs much more frequently in small, thinly traded stocks, whose shares tend to swing widely, according to trading and securities-law experts.

Iridex has a market value of \$36 million, making it about one-twentieth the size of the average U.S. "micro-cap" small stock. The day before Iridex's June pop, the stock had been down 22% for the quarter. Thanks to its last-minute surge, it closed the quarter down just 5.4%. Just like that, the company's market value rose

growth and inflation forecasts, and its president signaled that

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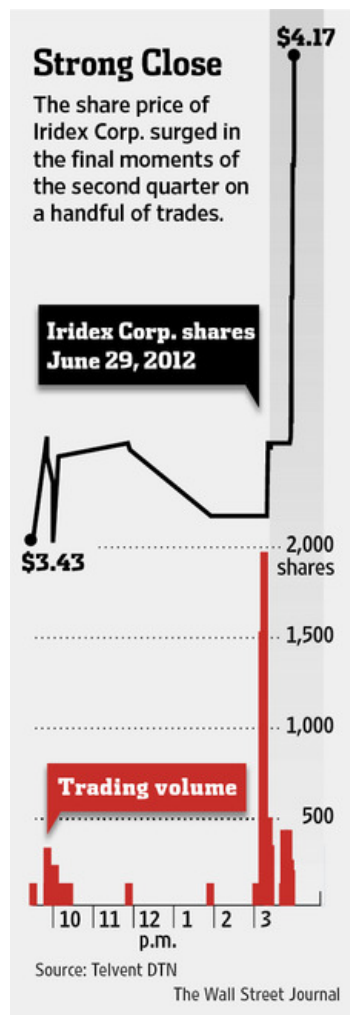
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No

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to more than \$37 million, from less than \$31 million the prior day. Almost all that nearly \$7 million gain came in the last five minutes of June 29.

A price jump at least temporarily benefits everyone who owns a stock, regardless of who caused it. It isn't possible to determine from public records who traded Iridex that day. Several money managers who hold Iridex say they had nothing to do with its rapid rise.

BlueLine Partners holds 29% of the company's stock. Mr. Shuda says the firm didn't trade the stock then, and that federal regulations on insider trading for large shareholders restrict BlueLine from buying or selling at the quarter's end.



Other beneficiaries of the stock's rise included Paragon Associates, a hedge fund in Dallas with more than 8% of the stock; Kennedy Capital Management of St. Louis, with a nearly 8% position; and Heartland Advisors of Milwaukee, which holds 5.5%.

Will Nasgovitz, a portfolio manager at Heartland, says his firm wasn't the buyer that day and doesn't know who was. "Someone wanted to own it," he says. For such small stocks, "it doesn't take much to move the needle."

Bradbury Dyer III, general partner at Paragon, says the buyer "certainly wasn't us, but it etched itself in my memory."

Richard Sinise, a portfolio manager at Kennedy Capital, says that for hedge funds whose fees are linked to performance, "there can be that urge on the last day to put all your cash into your stocks and get them to the price you think they should be at." He says Kennedy doesn't run any hedge funds and "it was not us" who traded Iridex that day.

According to SEC filings and the managers, none of these firms have reported selling any Iridex shares since that day. James

Mackness, Iridex's chief financial officer, said in an email that he is "not aware of anything" that could explain the jump in price on June 29.

A stock jump on the final day of a measurement period can boost a money manager's fees. Hedge funds typically collect annual fees equivalent to 2% of total assets and 20% of profits. Regulators and industry experts say a fund that already has a substantial holding in a small stock can drive up the value of its entire position by purchasing as few as 100 additional shares at a premium to their market price in the final moments of trading at the end of a measurement period. That can be enough to boost the entire fund's performance for the month, quarter or year—potentially attracting performance-chasing investors.

On the first day of the new measurement period, when the buying pressure subsides, the manipulated stock is likely to fall back to its previous level. But hedge funds generally don't report returns more often than monthly, so any subsequent decline in the manipulated stock doesn't show up until the next report.

The smaller the stock and smaller the fund that holds it, the more a fund manager stands to gain from manipulating it. Even an extra fraction of a percentage point of performance can be enough to nudge an investment fund into the top quarter of performers—the group most prospective clients prefer.

That can mean millions of dollars' worth of future inflows, and more fees, says Rabih Moussawi, a finance researcher at the Wharton School at the University of Pennsylvania who has studied window dressing. In a study slated for publication next year in the *Journal of Finance*, he and his colleagues found that the stocks most heavily owned by hedge funds outperformed the market by an average of 0.3 percentage points on the final day of the quarter—and underperformed by 0.25 points on the following trading day.

Recent cases brought by regulators show the difficulties of documenting that the shadowy practice causes material damages to other investors.

In April 2011, the SEC filed an enforcement action alleging that Donald L. Koch, a member of the board of overseers at Stanford University's Hoover Institution, had marked the close of three bank stocks in 2009 in accounts he ran for clients of his money-management firm, Koch Asset Management.

An SEC administrative judge recommended this May that Mr. Koch be barred from the investment-management business and ordered to pay \$75,000 in civil penalties. Mr. Koch denies any wrongdoing and is appealing the initial decision. Through his lawyer, he declined to comment.

One stock Mr. Koch traded, according to the SEC, was [High Country Bancorp](#) [HCBC +3.17%](#) of Salida, Colo., which trades on the over-the-counter market then known as the "Pink Sheets."

According to the SEC, on Dec. 28, 2009, Mr. Koch told his broker at Huntleigh Securities Corp., in an email: "Please put on your calendar to buy HCBC 30 minutes to an hour before the close of market for the year. I would like to get a closing price in the 20-25 range, but certainly above 20." The stock was then at \$15 per share. It was so illiquid that no shares at all had traded since Dec. 16.

The SEC alleged that Mr. Koch's broker at Huntleigh bought 3,200 shares, making his final trade, two minutes before the end of the trading day, at \$19.50, where the stock closed. That lifted the total market value of High Country to \$16.8 million, from \$12.9 million, and boosted the value of the nearly 85,000 shares in Mr. Koch's clients' accounts to \$1.6 million, from \$1.3 million, according to the public filings.

High Country didn't trade again until Jan. 6, 2010, the third trading day of the next year, when it fell back to \$15.

According to the SEC, the temporary boost to the prices of High Country and another small financial stock, [Carver Bancorp](#), [CARV -2.34%](#) inflated the management fees Mr. Koch charged his investors by \$4,169.78.

The SEC reached a settlement with Huntleigh and Mr. Koch's former broker. Huntleigh and the broker didn't respond to requests for comment.

In another SEC case, Eric Wanger, a Chicago-based hedge-fund manager, in July was ordered to pay a \$75,000 civil penalty and barred from the securities industry for one year. The SEC alleged that Mr. Wanger had submitted artificially high buy orders in thinly traded stocks at the close of the final trading day of the month or quarter. As a result, the SEC alleged, the clients of his \$14 million fund paid \$2,269.81 in excess fees. Mr. Wanger agreed to the settlement without admitting or denying the allegations.

On March 31, 2009, the SEC alleged, he drove the price of Woodbridge Holdings Corp., a home builder that is no longer publicly traded, to 62 cents, from 40 cents, a half-hour before the market closed. On Sept. 30, 2010, the SEC said, he pushed the price of [AltiGen Communications](#), [ATGN +11.60%](#) an Internet phone provider, to 75 cents, from 60 cents, less than two hours before the close.

"There are 15 alleged instances out of hundreds of purchases and no sales, resulting in an increase of less than \$2,300 in management fees over 33 months," says Mr. Wanger's lawyer, Jim Kopecky of Chicago. "I don't think this is a case the SEC should have brought."

In April, the SEC filed a civil complaint against RKC Capital Management of Salt Lake City, alleging the firm had inflated the value of its \$6 million hedge fund by repeatedly jacking up the price of a tiny stock, Global Pari-Mutuel Services, on the last day of the month, often "in the last few seconds or minutes of the day."

As a result, the SEC alleged, the fund's assets under management were 2% to 20% greater than they otherwise would have been, and RKC's fees were elevated by an unspecified amount.

Russell Cannon, the former portfolio manager of RKC, says he has shut down the fund and returned the capital to investors. The SEC allegations are "ridiculous," he says. "There was no scheme.... It was such a thinly traded stock that any trade that anybody placed could move it, and it was always a battle to find the correct closing value."

He says that even if the allegations, which he denies, were true, he couldn't have earned more than \$7,200 in extra fees. The case is pending in federal district court in Utah.

Suspicious-looking trades continue to pop up. On the last day of the second quarter, the American-traded shares of Chinese food company [Le Gaga Holdings](#) Ltd. [GAGA -0.78%](#) climbed almost 16% to close at \$4.90. Most of the gain came in the final 22 seconds of trading, when nine trades totaling 2,000 shares were executed. The final trade of 100 shares, which came in as the closing bell rang at 4 p.m., accounted for more than one-quarter of the day's gain.

Le Gaga's stock dropped 8.2% the next day and hasn't come close to \$4.90 since.

Auke Crossen, Le Gaga's chief financial officer, said in an email that "there was no news nor any developments at the company that may have contributed to this jump."

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