InvestmentNews

Bayou collapse sends a warning signal

By Sara Hansard
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WASHINGTON - Financial planners who invest client assets in hedge funds are bracing for more calls for regulation as a result of the well-publicized collapse of Bayou Management LLC.

Indeed, an official at the Securities and Exchange Commission was quick to use Bayou, which is the subject of investigation by a number of regulatory and law enforcement agencies, as evidence of the wisdom of former Chairman William Donaldson's decision to push through hedge fund registration requirements over strenuous opposition.

"We're paying very close attention to this to evaluate what went wrong, why it went wrong and to what extent there are implications for policy," said Robert Plaze, associate director of the SEC's division of investment management.

The case "raises interesting questions about the distribution of hedge funds and consultants, and their interests," he added. "We need some oversight here."

The SEC currently is being sued over its 2004 rule requiring hedge fund advisers to register. Stamford, Conn.-based Bayou was not registered with the SEC. Founder Sam Israel in August announced that he was liquidating the approximately $500 million fund but didn't return any money to investors.

"Instances like this do change the regulatory environment and add more pressure on additional disclosure and more clarity on the part of regulators or these hedge funds," said Joe John Duran, chief executive of United Capital Financial Partners Inc. in Newport Beach, Calif.

The problem is that investors don't read all the disclosures they get, he added.

United Capital, which owns four financial planning firms around the country, manages about $500 million for affluent clients, including a "respectable amount" in hedge funds, said Mr. Duran, a chartered financial analyst. He would not disclose the amount his firm invests in hedge funds.

Mr. Duran acknowledged that there is not enough public information about hedge funds.

"Nobody knows where the money is, how it's invested or even what the results are, typically until weeks after the end of the quarter," he said.

Bayou's apparent mismanagement of its funds demonstrates that ordinary investors need help in dealing with hedge funds, Mr. Duran said. But the groups that have held themselves out as helping investors deal with hedge funds are under closer scrutiny as a result of the problems with Bayou.

New York-based Hennessee Group LLC, which had been advising its clients to invest in Bayou, now is doing damage control.

Last week, Hennessee managing principal Charles Gradante e-mailed a letter to clients in which he detailed the steps taken last month by the adviser to hedge fund investors to track down Mr. Israel and others associated with Bayou.

Hennessee officials contacted the SEC, the FBI and "every other federal and state authority we thought might have jurisdiction over the matter," including Washington-based NASD, the Connecticut attorney general's and U.S. attorney's offices, Mr. Gradante wrote in the e-mail. He said that it also filed an action with the New York State Supreme Court to freeze Bayou's assets.

Mr. Gradante, who did not return phone calls seeking comment, was traveling last week, Hennessee spokesman Alex Smith-Ryland said.

The e-mail defended the 1% advisory fee Hennessee receives for advising clients on hedge funds, which has been criticized as a conflict of interest.

"We do not raise money for hedge funds, do not receive compensation from hedge funds for raising money for them, do not receive secret fees and do not believe that we have a conflict of interest when we evaluate hedge funds for you," Mr. Gradante wrote in the e-mail.

Clients have the option of requesting that the hedge funds pay some or all of the fees the clients owe to Hennessee, the e-mail stated. The fees can be directed as brokerage commissions to Hennessee or they can be made to Hennessee as cash payments, a payment option that is "identical to thousands of commission recapture arrangements."

The payment arrangements, which are disclosed and must be agreed to by the hedge funds, do not create any incentive for Hennessee to recommend particular funds, the e-mail said, since the advisory fee remains 1% of assets per year. The firm is considering a libel action against the New York Post for publishing incorrect information, the e-mail said.

Bayou's situation should have been apparent, said Michael Markov, chief executive and director of research at Markov Processes International LLC in Summit, N.J., which produces technology for institutional investors to conduct due diligence on hedge funds and other investments.

"The numbers they presented to investors were very strange, unusual," he said.

"The results that they were showing were incredible," Mr. Markov said. "It's like someone would have 100% results in baseball."

Markov Processes has been doing more work on hedge fund analysis recently because there has been more interest by their institutional investors, he said. Hedge fund assets have jumped from some $600 billion in 2003 to well over $1 trillion, said Michael Tannenbaum, a director of the Washington-based Hedge Fund Association and a partner at New York law firm Tannenbaum Helpern Syracuse & Hirschtritt LLP.

Bayou is "an isolated situation," in which the amount of money managed was relatively small and there was a small investor base, he said, predicting that the effect will be "very short lived."

For most institutional investors doing due diligence, the fact that Bayou's accounting firm had an economic connection to Bayou would have raised a red flag, Mr. Tannenbaum said.

Heightened awareness

Financial advisory firms that use hedge funds say the Bayou case has not changed their approach, but it has heightened their awareness.

"It's the big bombs like that that make the front pages, so the client's more apt to talk about it," said Michael Steiner, wealth manager at RegentAtlantic Capital LLC in Chatham, N.J., which uses hedge funds within the funds of funds they offer clients.

"It just really reinforces the importance of due diligence and making sure one does not get too comfortable with due diligence," he said.

"It's just another warning sign that hedge funds are not quite so simple or safe as they're presented to be," said Harold Evensky, chairman of Evensky & Katz Wealth Management in Coral Gables, Fla., which uses the Rydex SPhinX Fund, a hedge fund based on the Standard & Poor's 500 stock index. "Merely going into a respected name isn't a guarantee."