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Letter admits years of fraud at Bayou, police say

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Eric Dillon, a money manager from Seattle, flew east on Aug. 16 and took a limousine to the Stamford, Conn., offices of Bayou Management LLC. The hedge-fund firm had abruptly said three weeks earlier it was shutting down its funds, but investors hadn't yet gotten their money back. Mr. Dillon had an appointment to discuss the matter with Bayou's chief financial officer, Daniel Marino.

No one responded to Mr. Dillon's persistent knocking on the entrance to Bayou's offices in a cream-colored cottage on the Connecticut waterfront, so he entered through an open back door, say the local police. On Mr. Marino's desk, he found a typed six-page letter that began, "This is my suicide note and confession," says Stamford Police Sgt. Gary Perna, who responded to Mr. Dillon's subsequent 911 call.

The letter asserted that Mr. Marino, along with Bayou founder Samuel Israel III and a former partner named James Marquez, had "defrauded all these investors" from "about 1998 to now," Sgt. Perna adds.

The sergeant says he tracked down Mr. Marino and took him to a hospital for psychiatric evaluation. Reached by telephone over the weekend, Mr. Marino sounded weary and referred a reporter to his attorney, who declined to comment. Messrs. Israel and Marquez didn't return calls, nor did Mr. Dillon, the Seattle investor. A note taped to the door of Mr. Israel's large house in Westchester County, N.Y., said in part: "Please be patient. Bayou is not insolvent."

Mr. Marino's letter is now a key exhibit in a widening probe by federal and Connecticut law-enforcement agencies of what investigators believe may be a fraud involving hundreds of millions of dollars. Bayou claimed it had $440 million in assets earlier this year, and at one point last year put the figure at more than $500 million.

Bayou is the latest of several hedge-fund traumas in the past year that have prompted fraud investigations. While the industry doesn't appear to be rife with such problems, Bayou underscores the risks associated with these funds, after years of explosive growth in this loosely regulated corner of the investment industry. Wealthy individuals and institutions, lured by the promise of outsize returns, have flooded into the private partnerships. More than 8,000 hedge funds now oversee an estimated $1 trillion, more than double the number of funds and the sum under management five years ago.

Bayou's troubles offer a sharp lesson for investors. Clients entrusted millions of dollars to the firm despite several red flags that some research on the Internet or a bit of asking around might have unearthed.

For instance, Mr. Marino, also Bayou's chief operating officer, is the registered agent for an accounting firm that Bayou told investors was doing independent audits of its books.

Bayou also used an affiliated firm as its broker, Bayou Securities LLC. In 2003, Connecticut banking regulators fined the brokerage arm $7,500 for having incomplete records. The same year, an estranged partner in the business sued Bayou in federal court in Louisiana, alleging $7 million was missing from a trading account and that he'd seen evidence of potential securities-law violations.

There was a precipitous decline of money and activity in Bayou's accounts over the past 18 months at a big Wall Street firm that cleared trades for the firm, a person familiar with the matter says. Late last year, a person who had raised money for the fund told investors he was taking his own money out because he was worried about Bayou's direction.

Marketing materials distributed by Bayou say Mr. Israel, 46 years old, was once head trader for Omega Advisors, a characterization disputed by that prominent hedge-fund firm's well-connected founder, Leon Cooperman.

Yet sophisticated investors filled Bayou's coffers. Some say they were told privately by Bayou executives that its funds at one point approached $1 billion in assets under management. A significant portion of them came from two big New York investment advisory firms that spread client money among hedge funds, say customers of these "fund of funds."

Among Bayou's biggest investors, these clients say, is an investment adviser called Hennessee Group, which declines to comment. Other investors say they had put their retirement savings in one of the funds.

Bayou also glided below the radar of regulators at the National Association of Securities Dealers, which had the right to examine its books because Bayou also had a broker-dealer arm registered with the NASD. Instead of helping flag problems, however, the NASD affiliation, cited by Bayou marketing materials, comforted investors.

In the hedge-fund industry, officials say Bayou is an aberration. "This case is an outlier," says Stephen McMenamin, executive director of the Greenwich Roundtable, a Connecticut-based group of hedge-fund investors. "Hedge funds have had an overwhelmingly positive effect on our members' portfolios. And this is not typical of the experience that we've had with hedge funds."

Bayou was founded in June 1996 by Mr. Israel, a scion of a prominent New Orleans family who attended Tulane University -- "hence the name Bayou," marketing materials say. His namesake grandfather was a coffee importer who built the family business into a commodity-trading powerhouse that eventually merged into the brokerage firm Donaldson, Lufkin & Jenrette. The senior Mr. Israel and his wife, Merryl Aron, a onetime champion golfer who remarried after her husband died in 1982, were major donors to Tulane, where the environmental-sciences building is named for them.

In a brief conversation on the porch of her pink two-story townhouse in New Orleans's garden district Sunday, as she prepared for Hurricane Katrina, Mrs. Aron said she knew nothing of Mr. Israel's business.

Marketing materials say Mr. Israel was a "third-generation trader" with 20 years' experience with hedge funds. They say he met Mr. Marino, now 45, in 1990 at a firm called HMR Investors. Mr. Marino is a certified public accountant who earlier specialized in audits as an employee of Coopers & Lybrand (now part of PricewaterhouseCoopers), the documents say.

The marketing materials also say Mr. Israel worked for Omega Advisors from 1992 to 1996, managing more than $400 million as head trader. Omega's founder, Mr. Cooperman, called that description overstated. "He worked for me from January 1994 to June 1995," Mr. Cooperman said. "He had no trading discretion." Someone who worked at Omega with Mr. Israel described him as a fast-talking trader with a slight southern drawl who sometimes would lie on the office floor for long stretches to ease back pain.

Mr. Israel leveraged contacts from New Orleans and his trading days when he opened Bayou, "to attempt to provide ... steady, above-average market returns while maintaining a lower risk profile," the marketing materials say. He is Bayou's chief executive and chief investment officer.

Mr. Marino was chief financial officer from the start, the materials say, and the fund opened to investors in January 1997, managing well under $50 million for several years. Its marketing materials depict it as a day-trading outfit, saying it "derives a substantial part of its results from trades which last for less than two days," possibly much less. "Bayou rarely holds significant positions overnight," the materials say.

The fund claimed a return of more than 30 percent its first year and of 38.55 percent between June 1998 and September 1999. Assets under management began to surge in 2001, to more $350 million by April 2004, the materials say.

Unlike most hedge funds, Bayou didn't charge a management fee. It took an incentive fee of 20 percent of its gains, as is common. But it also profited via commissions for trading through its own brokerage arm. The marketing documents cautioned that fees it paid for trades are "not arm's length," are "not necessarily the lowest cost" and are "profitable to the manager even if the funds should break even or incur losses."

Bayou told investors, however, that its brokerage unit offered them added protection. The unit "is audited ... on a periodic and surprise basis by the NASD and the SEC," the materials say. They say that because the hedge funds and the brokerage unit "are affiliated, regulators have the right to examine the books and records of each Bayou Fund."

Among risks listed in the materials is "employee fraud or malfeasance." While Bayou is insured, the materials say, "there can be no assurance that this insurance will cover all potential liabilities."

A chart tells clients that $1,000 invested in 1997 would have grown to more than $3,500 by April 2004, but to just a bit more than $1,500 if invested in the Standard & Poor's 500-stock index.

An early partner was Mr. Marquez, also a Louisianan. A former trader for billionaire hedge-fund manager George Soros, Mr. Marquez had a good reputation and connections. He left the fund some years ago.

Bayou's staff included some less-experienced people, including a college graduate and a former math teacher. Key to the operation were several salespeople who had ties to wealthy investors and were sprinkled across the country, investors and the marketing materials say.

The materials cite several salespeople, including one in Maryland, Howard Kra, a former financial adviser focusing on wealthy customers. Mr. Kra says he worked for 25 years at traditional brokerage firms and wanted the "opportunity to raise money for a hedge fund whose performance looked OK."

Don MacShane, retired proprietor of an investment advisory firm from Washington, D.C., says he invested in Bayou in early 2003, having learned of it from an email newsletter and the financial Web site TheStreet.com. After checking Bayou employees' records with the NASD and finding a clean record, he decided to entrust the firm with some of his retirement savings and advised some clients to invest, too. He was comforted that Bayou was regulated by the NASD, as a registered brokerage firm. "I figured it would be audited regularly and problems would surface," he says. Based on account statements he received from Bayou, he believes his account should now total $850,000.

The firm said it would be "diversified among sectors" and sometimes focused on exchange-traded funds, or ETFs -- baskets of securities that track indexes and trade like stocks. In a May report, Mr. Israel said he had been buying shares of an ETF that tracks the S&P 500 index and sometimes shorting them, that is, selling them in hopes of replacing the shares after they have fallen in price.

Mr. Israel comforted clients with weekly updates plus conference calls two or three times a year. He said he believed in only a "limited use" of borrowed money, a tactic many hedge funds use to magnify gains.

On March 26, 2003, Paul T. Westervelt Jr. and Paul T. Westervelt III, a father and son who worked for Bayou, filed suit in federal court in New Orleans. The suit said a deal had been negotiated under which the senior Mr. Westervelt would become a 25 percent Bayou partner and be paid $800,000 a year. It said there was talk of him opening a Louisiana branch in Covington and that the son would be paid $90,000 a year, plus a bonus.

The suit alleged Messrs. Israel and Marino "actively prevented" the father from having access to key financial information, and the father "discovered what he perceived to be possible violations" of federal securities rules. It said he feared being exposed "to criminal charges, professional censure and civil liability."

The suit contended Bayou's trading account at a Wall Street firm "had been depleted by more than $7 million in December 2002," including a $4.2 million withdrawal on the day after that Christmas. Mr. Westervelt asserted he sent the principals a letter demanding an explanation on March 9, 2003. The firm terminated the father's contract eight days later, and fired the son, the suit says. Later in 2003, a federal judge dismissed the suit and ordered the parties into arbitration.

One Bayou investor says Mr. Israel volunteered during a conference call that he was being sued but denied the allegations and accused the Westervelts of retaliating because he had fired the son for not being a disciplined-enough trader. Another Bayou investor says the suit caused him to rethink his investments, but he says his doubts were allayed when he heard the Westervelts had lost the case in arbitration. Another investor says he has been told that the arbitration is under way. The senior Mr. Westervelt declined to comment. His son couldn't be reached for comment.

That same year, the Connecticut Department of Banking launched a probe of Bayou Securities. In September 2003, the regulators said they had uncovered evidence the firm may have violated state rules by "maintaining records which did not fully reflect the securities business transacted," records show. The firm agreed to maintain accurate records and pay a $7,500 administrative fine, without admitting or denying the allegations.

Another red flag involved the accounting firm Bayou said audited its books, Richmond-Fairfield Associates. New York State records show Mr. Marino filed registration papers for the accounting firm in October 2000.

Business-information provider Dun & Bradstreet says Richmond-Fairfield had three employees and roughly $110,000 in annual sales as of January 2004. Records list locations in New York's Manhattan and Staten Island boroughs and at an apartment building in Stamford. The only listed phone number, for an office in downtown Manhattan, is out of service, according to a recording.

Bayou told investors in 2002 Grant Thornton did auditing work for it. A Grant Thornton spokesman said a preliminary check of records indicated it hadn't worked for Bayou since the late 1990s.

Mr. Kra, the marketer, says that in 2004 he pulled his own money out of the fund and quit. "It wasn't being managed the way I thought it should be," he says.

Messrs Israel's and Marino's relationship seems to have frayed. Mr. Marino alleged in his letter "physical altercations" with Mr. Israel over the years, says Sgt. Perna of the Stamford police. The sergeant said that in the letter, Mr. Marino claimed that Mr. Israel once "held a gun to his chest."

Though assets in some of the firm's trading accounts dwindled from millions to a few hundred thousand dollars in the last 18 months, a person familiar with the matter says, Bayou continued claiming success. In May 2005, it told investors funds were up 4.56 percent for the year, beating the S&P 500's 1.7 percent loss at the time.

William Nickerson, a Connecticut state senator and partner in a real-estate firm, says that in April he showed office space in Greenwich, Conn., to Mr. Marino, who said Bayou was expanding. A deal wasn't worked out.

Bayou clients say they didn't realize anything was amiss until July 27, when Mr. Israel announced the funds were closing at month-end. He cited his divorce and said he wanted to spend more time with his children. Mr. Israel's wife, Janice, filed for divorce in late 2003. The divorce records are under seal.

Investors began demanding their money. Mr. Israel sent another letter saying the process had been slowed by auditing work aimed at ensuring the funds closed with accurate books. In an Aug. 11 letter, he promised 90 percent of the money would be returned within a week or so and the rest by the end of the month. "So far, no one can find the money," says Ross Intelisano, a securities attorney representing some investors.

Ron Geffner, a former Securities and Exchange Commission attorney who represents some Bayou investors, says his attempts to get information were rebuffed. Bayou executives "were very defensive in their correspondence," he says. As for getting money back, "right now it does not look promising."

Connecticut Attorney General Richard Blumenthal on Friday said his office is investigating the "potential fraud." State banking authorities also are looking into the matter, as is the U.S. Attorney's office in Connecticut and the Federal Bureau of Investigation.

Sgt. Perna says Mr. Marino looked relieved on Aug. 16 when he arrived back at Bayou's office at the police officer's request. The sergeant says he turned the letter, which bore Mr. Marino's name, over to the police records room. He says he has received calls about it from the FBI and SEC.

Mr. Marino lives in Westport, Conn., in a 7,300-square-foot house with a pool on two acres with a gated driveway, says a person familiar with it. On Friday, the house sported a for-sale sign. The asking price: $3.5 million.

Swamped?

June 1996: Samuel Israel III starts hedge-fund firm Bayou Management LLC.

October 2000: Bayou executive Daniel Marino files registration papers for accounting firm that Bayou later says audits its books.

2004: Bayou tells investors its assets top $500 million.

July 27, 2005: Israel tells investors he's grappling with a divorce and "rebuilding my personal life," so he'll close the firm and return their money.

July 29: Israel says refunds may take four months, pending audit.

Aug. 11: Israel says 90 percent to be returned in a week, rest by month-end.

Aug. 16: A "suicide note and confession" is found on Marino's desk saying he, Israel and an ex-partner defrauded investors for years, Stamford, Conn., police say.

Aug. 25: State, federal investigations become known.

Aug. 26: Note on Israel's house says, "Please be patient. Bayou is not insolvent."

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