Down On the Bayou

It isn't the first time something like this has happened, and it certainly won't be the last. But it's all over the news right now – just Google "Bayou" – and the way it's playing out, the eventual repercussions of the Bayou Management, LLC regulatory investigation could easily lead to sweeping changes in the ways hedge funds are regulated, and in the ways traders can legally do business.

Bayou is but one hedge fund among 8,000, and the estimated $400 million that has seemingly vanished in the Bayou debacle is insignificant compared to the more than $1 trillion that those other 8,000 hedge funds manage. So we can safely say that this is an aberration, that despite this one blip on the radar the overwhelming majority of hedge funds provide a positive investment vehicle for experienced, savvy investors. Still … this case is too sexy.

Changes in the legal landscape don't happen based on theoretical notions of right and wrong, and they don't happen when the underlying story is boring. Generally, most cases about investments are dull and tedious. Which the Bayou story should have been: a hedge fund fraudulently reports its "success," and then fails to return any of its investors' funds, leading to regulatory investigations and lawsuits. The Bayou story, however, already has a suicide letter from Daniel Marino (Bayou's CFO, not the Hall of Fame quarterback) containing allegations that Bayou's founder, Samuel Israel III, at one point held a gun to Marino's chest. Mr. Marino is still alive, although according to the news reports, understandably not in the best of spirits.

The suicide letter alone is enough to keep this case in the headlines, where otherwise a tale of murky financial accounting practices and account losses might get buried and forgotten. The authorities have to accomplish something here, or risk looking bad in the press. So far the U.S. Attorney, FBI, Connecticut State Attorney General, state banking authorities and the local police are all investigating. Investor lawsuits are on the way, although it's unclear what, if anything, will be available for investors to collect.

Critically, Bayou – unlike most hedge funds – also operated a securities brokerage business. This allowed Bayou to earn hefty commissions for the fund's trading, and also meant that the brokerage arm, at any rate, was regulated by the NASD and SEC. This gave Bayou the veneer of transparency, luring wary investors who ironically feared sending large blocks of money into murky, unregulated hedge funds. Bayou successfully marketed itself as a safe investment vehicle *precisely because* the NASD could always walk in and conduct a surprise audit. Whether any NASD audits ever took place, they certainly failed to safeguard Bayou investors. Which brings me back to my original point – the Bayou debacle could lead to sweeping changes in the way regulators treat hedge funds.

With February, 2006 fast approaching, hedge funds were facing impending required registration anyway. With an engaging and scintillating case that will continue making headlines and has the potential to embarrass regulators, the SEC and federal prosecutors have an acute incentive to make an example of the Bayou case. Traders should expect to face heightened regulations, along with more reporting and compliance obligations. Penalties for violations stand to be greater. The Bayou case is bad for the industry in any event, but in light of the surrounding circumstances, the timing couldn't have been much worse.