COVER STORY
MONEY
Investors learn the hard way about hazards of highflying hedge funds Besides market risks, investigations highlight potential for fraud

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Richard S. **Roon** indulged himself with luxuries befitting a highflying hedge fund manager: A jaunt to Europe on the Concorde, a Lexus sport-utility vehicle with rear-seat video screens, a New Jersey seashore home.

Unbeknownst to his clients -- top fashion models, dentists, even a former Wall Street CEO -- his perks often came at the expense of their investments. **Roon** tapped his Nidra Capital to maintain a high- roller lifestyle even as the New Jersey-based fund tanked, prosecutors say. He hid the losses with phony profit statements, they say.

By the time investors found out, the 41-year-old father of three had blown through almost $2 million in an audacious securities scheme, prosecutors say. **Roon**, who pleaded guilty to mail fraud earlier this year, was sentenced Wednesday to one year **and** one day in prison.

His rise **and** precipitous fall is part of a miniboom in alleged hedge fund fraud. At least seven new court cases or investigations in the last year have tarnished the fast-growing industry by exposing schemes that siphoned hundreds of millions from investors.

Investigators attribute the surge to rapid expansion of the largely unregulated hedge fund industry, combined with increased risk- taking by an expanded pool of investors eager to share in the 60%- plus gains produced by top-performing funds.

About 4,000 hedge funds, often volatile investments whose managers can sell short -- selling borrowed stock on a bet the stock will fall -- **and** use other complex trading strategies, now vie for investors. Participants generally must have at least $1 million in assets or income of at least $200,000 for the two most recent years. Many of the funds set a minimum investment of $250,000.

With amounts that high at risk, the cases of alleged fraud "emphasize the importance of knowing who you're dealing with," says Peter H. Bresnan, an assistant chief litigation counsel for the Securities **and** Exchange Commission.

At his federal court sentencing in Trenton, N.J., **Roon** indicated through his attorney that he did not begin with the aim of defrauding anyone.

"I have emotions of deep regret for what happened," **Roon** told U.S. District Court Judge Mary Cooper. "I got caught up in something, **and** I let it happen."

To those who risked their savings in Nidra Capital, **Roon** seemed capable of producing the 62.5% cumulative gain he boasted about in investor statements after he launched the fund in 1996. After all, he was introduced to several Nidra investors by Marshall Manley, a well- known New York City lawyer who would later find himself among the victims.

And the professional background **Roon** listed in Nidra's private placement memorandum was studded with jobs at respected firms, such as PaineWebber. It noted that **Roon** majored in international finance **and** banking at American University in Washington, D.C.

The memo also boasted of **Roon**'s "Knowledge Advantage," a process that it said provided him with "insight into a company, good or bad, that the vast majority of analysts **and** investors are unable to ascertain."

If the vagueness of that claim was a potential red flag, many Nidra investors never noticed.

Looking for a solid investment

Manley's introduction, **Roon**'s background **and** the fund's use of respected market maker Spear Leeds & Kellogg as clearing broker helped sell Patricia Hartmann **and** Nicholas Constantino.

The spouses, young models whose faces have graced fashion magazines in ads for L'Oreal, the Gap **and** other companies, were looking for an investment that would provide them with a comfortable income when their days in front of the camera end. They put up a combined $775,000 **and** gave **Roon** trading authorization for a separate stock account.

Constantino says they joined the hedge fund "because we were told they were safer **and** could ride out the ups **and** downs of the market." **Roon** told them they had invested wisely, reassuring them at a Christmas celebration where he gave them Bacarrat crystal candlesticks, Constantino says.

Roon's longtime dentist, Dr. Frank Navarro, says he gradually invested a total of $277,000 after receiving assurances that up to 85% of the hedge fund's assets were often left in cash, thus limiting risk exposure.

"He was painting a very rosy picture for me," Navarro recalls. "I figured he wouldn't possibly screw me. I'd known him for all these years."

That brand of salesmanship also convinced Howard Silverman, the second-generation Polish-American who helped build Manhattan-based Gruntal & Co. into a securities titan **and** once served as the company's chief executive. Silverman, who declined to be interviewed for this story, invested $250,000, court records show.

Even Manley, once a partner in the now defunct national law firm Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey, invested $525,000 in the hedge fund, the records show.

In exchange for **Roon**'s advertised expertise, the approximately 15 investors who joined Nidra Capital during its 1996-98 existence guaranteed him a $20,000 total monthly fee, regardless of the fund's total balance in the hedge funds' accounts.

Roon was also entitled to a 15% share of investment profits. The percentage was low compared with the compensation for some hedge fund managers. But, based on the $15 million-plus in Nidra funds that **Roon** allegedly said he was managing, it helped explain his luxurious lifestyle.

If there were any doubts, **Roon** reassured investors with constant phone calls about how much money they had made in the market on a given day. Nidra's written earnings statements reinforced the message. One, issued in mid-1998, stated that the fund had generated a 19.7% year-to-date gain in part through "a continued focus on mergers **and** acquisitions."

Navarro, Manley **and** other investors say they did not press **Roon** for more specific explanations of his investment strategy **and** trading. Instead, they zeroed in on the bottom line on Nidra's profit statements. The numbers were consistently so good that Navarro cashed out a stock investment so he could increase his hedge fund stake. He even invested his dental office pension fund into Nidra Capital.

"I started by investing $100,000. In two years, it grew to $157,000, according to the statements he sent me," Navarro said. "That was pretty impressive."

Losses **and** more losses

Too impressive, as the dismayed investors learned in autumn 1998. A few of the hedge fund participants sought to withdraw portions of their investments. **Roon** ignored most of the requests, prosecutors said after the guilty plea.

Then the investors' mail brought a different kind of statement. Nidra Capital had declared bankruptcy. So had **Roon.**

The profit statements? Smoke **and** mirrors, according to prosecutors **and Roon**'s guilty plea. The hedge fund manager had concocted earnings numbers to cover disastrous stock **and** options trades.

For instance, he sent Hartmann **and** Constantino statements showing only minor losses in their stock accounts. The couple eventually discovered that losses totaled $486,000.

Instead of the 62.5% gain **Roon** boasted about, investigators discovered that Nidra Capital had lost $700,000 from 1996 through 1998. Combined with hundreds of thousands **Roon** had withdrawn under his salary **and** expenses agreement, the fund had liabilities of more than $2.6 million **and** stood on the verge of collapse.

Several investors confronted **Roon**, who provided few answers. Constantino **and** Hartmann hired lawyers to sue **Roon and** a private investigator to check his personal **and** financial background.

The findings were almost as stunning as the profits **Roon** had claimed. **Roon** had attended American University, but dropped out after two years, he acknowledged in sworn depositions. He had worked for PaineWebber, but had to repay a loan to the firm when he left. He once had a broker's license, but it lapsed **and** he never renewed.

Then there were issues **Roon** had avoided mentioning. He started his investment career at First Jersey Securities, the once notorious **and** now defunct company that pushed investments in penny stocks.

He was indicted during the 1980s in connection with a tennis court construction firm that owed money to creditors for incomplete work. While the charges were later removed from the court record, he had been forced into bankruptcy in the aftermath of that case, too, **Roon** said in a sworn deposition.

Federal investigators discovered that **Roon** had also paid himself $380,000 above the amount he was allowed under his Nidra agreement. He withdrew $110,000 in 1997 for the down payment on a contemporary home in Wall Township, N.J., just a few miles from sandy Atlantic beaches, bankruptcy court records show.

He also tapped Nidra Capital to cover expensive leases on a top- end Mercedes Benz, along with the Lexus SUV worth an estimated $52,000. **Roon** ultimately acknowledged he'd used Nidra funds to hop the Concorde for a trip to Monte Carlo. But he refused to identify his traveling companion or disclose the reason for the jaunt when questioned during a deposition.

Partial restitution

After initially stalling investors, **Roon** cooperated with federal prosecutors investigating the fraud. On Wednesday, assistant U.S. attorney Alain Leibman called **Roon**'s cooperation "extraordinary." Cooper cited that cooperation in giving **Roon** a lenient sentence.

A bankruptcy trustee so far has recovered more than $1 million from the hedge fund manager, enough to repay some of the fraud victims about 42% of their losses. Still, the outcome so far has amounted to a sobering financial jolt for several investors.

Constantino says he **and** his wife will probably have to work years longer than they had planned before retiring as they try to recoup losses with other investments.

"I hope to get the rest of my money back, eventually," says Manley, who acknowledges having arranged several investor introductions for **Roon**. So far, he has recouped only part of his investment.

Navarro, who says he's recovered just $30,000 of his $277,000 Nidra stake, has had to tap other savings to make up thousands of dollars he says he lost from the pension fund for his present **and** former office employees, including his ex-wife.

"That's a problem for me, as you might imagine," says the chagrined dentist, who adds he's also had to work harder to pay his daughter's college tuition.

Beyond the dollar loss, the Nidra investors say **Roon** robbed them of a sense of financial security they may never recover.

"I personally will never invest my money with any group like this. I'll probably invest my own money," Constantino says. "It's a nerve- racking experience when you find out the person you trusted was lying to you."

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More hedge their bets

Hedge funds manage $350 billion to $400 billion in assets. Definitive numbers don't exist because many funds don't disclose their holdings. Here's a breakdown of the year-end increases in total assets for 2,200 funds tracked by a top hedge fund industry analyst (in billions):

'93$50 '94$57 '95$72 '96$99 '97$145 '98$154 '99$197 '00 (1)$206

1 - estimate; through June<HR>

A sampling of hedge fund horror stories

The Nidra Capital case is among a spate of alleged hedge fund frauds in which investigators filed civil or criminal charges or obtained convictions during the last year. Several stemmed from disastrous short-selling of tech stocks before the market for those stocks crashed last spring. A look at the cases:

Michael W. Berger, former manager of Manhattan Investment Fund, pleaded guilty on Nov. 28 in a scam that cost investors an estimated $400 million. Victims included about 280 international investors, banks **and** private funds. Berger, 29, an Austrian-born investment manager, sold technology stocks short from mid-1996 to early 1999, betting they would drop in value. When they didn't, he falsified financial statements of his New York City-based fund to show profits, prosecutors say. The case has spawned lawsuits against Berger's clearing broker, Bear Stearns; auditor, Deloitte & Touche (Bermuda); **and** broker-dealer, Financial Asset Management.

David M. Mobley Sr., 43, manager of Naples, Fla.-based Maricopa Investment Fund, was accused in February of defrauding hedge fund investors of at least $59 million. Prosecutors say Mobley, who claimed he generated annual returns of 51%, diverted investors' money to buy a $98,000 Porsche, a $2 million vacation home in Colorado **and** several houses for relatives **and** other purchases. He also allegedly lost money on failed personal investments in a Florida cigar bar, country club development **and** golf course-stadium complex. Mobley allegedly refused to allow fund audits, claiming oversight would jeopardize a secret investing strategy. Investigators say he simply concocted profit reports. He is fighting the fraud charges.

Mark Yagalla, 23, manager of Ashbury Capital Partners, was arrested last month **and** charged with defrauding investors, who put at least $8 million in his hedge fund. Prosecutors say Yagalla siphoned money from the fund, which had offices in New York City **and** Delaware, to buy three homes costing more than $1 million each, plus two Ferraris **and** other luxury cars. Investigators say Yagalla also tapped the fund for political contributions, including almost $300,000 in soft money donations to national Republican election committees. GOP officials plan to refund that money. Yagalla has a preliminary court hearing this month.

John C. Natale pleaded guilty in March to cheating about 180 investors of more than $40 million in his Cambridge Partners **and** Cambridge Partners II funds. The New Jersey hedge fund manager sold short on Internet **and** technology stocks from 1992-1999, losing millions when the stocks rose in value. Authorities say he sent phony profit statements to investors, claiming assets of more than $50 million. In reality, the funds held less than $3 million when Natale went to New Jersey authorities **and** confessed. He awaits sentencing.

Michael T. Higgins pleaded guilty to securities fraud in July for a scheme that cost investors in his San Francisco-based Ballybunion Capital Partners fund about $7 million. Higgins sold short on tech stocks, then covered up losses with false profit statements. By March 2000, the fund's assets had dwindled to $750,000, barely one-tenth the amount Higgins reported. He is to be sentenced this month.

William Pangrass Jr. received a six-year prison term in June for stealing hundreds of thousands of dollars from his Pangrass Family Hedge Fund. Pangrass used money stolen from the Pennsylvania-based fund to pay personal expenses, including his daughter's wedding. He covered up losses of more than $1 million with phony statements, prosecutors say.

GRAPHIC, Color, Elizabeth Wing, **USA TODAY**, Source: TASS Investment Research (BAR GRAPH); GRAPHIC, Color, Keith Simmons, **USA TODAY**; PHOTO, B/W, Jeff Zelevansky, AP; Caption: Sentenced: **Roon** leaves federal court Wednesday. "I have emotions of deep regret for what happened."

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