UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF PENNSYLVANIA

SECURITIES AND EXCHANGE COMMISSION,	:	
Plaintiff,	:	
v.	:	**Civil Action No. 08-cv-1269 (DSC)**
MARK D. LAY and MDL CAPITAL MANAGEMENT, INC.,	:	
Defendants.	:	

COMPLAINT

Plaintiff Securities and Exchange Commission ("Commission") alleges as follows:

SUMMARY

1. This matter involves fraudulent conduct by defendant MDL Capital Management, Inc. ("MDL Capital"), an investment adviser registered with the Commission, and its principal, defendant Mark D. Lay. Between approximately February 2004 and November 2004, MDL Capital and Lay defrauded their client, the Ohio Bureau of Workers' Compensation (the "Bureau"), by exposing Bureau funds to unauthorized and undisclosed risk in connection with the Bureau's investment in the MDL Active Duration Fund (the "Fund"), a Bermuda-based hedge fund affiliated with and managed by MDL Capital and Lay.

2. The Bureau, a public entity, had been an existing MDL Capital advisory client since 1998, long prior to its investment in the Fund in August 2003. As an investment advisory client, the Bureau invested solely in fixed income government bonds, largely U.S. Treasuries (the "Core Account").

3. Lay established the Fund to provide a conservative hedge against interest rate movements, using short positions, among other things, and the Bureau invested in the Fund to hedge its investments in the Core Account. In accordance with this philosophy, the Fund's agreement with the Bureau provided that leverage of the Bureau's principal investment could not exceed 150% of the Fund's assets. The Bureau was the sole shareholder of the Fund.

4. However, in violation of the agreement and their duties to their client, between February 2004 and November 2004, MDL Capital and Lay exposed the Fund's assets to enormous undisclosed risk resulting in substantial losses. During that time, MDL Capital and Lay defrauded the Bureau by consistently engaging in risky trading by exceeding the 150% leverage guideline, at one point using leverage of over 21,000%, and then failing to disclose this to the Bureau.

5. The greater leverage exposed the Fund to a very high level of risk. As a result of the increased leverage, the Bureau incurred losses of approximately $160 million.

6. During the course of the fraud, the Bureau made numerous requests to MDL Capital and Lay for explanations of the losses. Rather than admit the truth, Lay repeatedly lied to and misled the Bureau as to the reasons for and amount of the losses as well as the excessive leverage Lay was using.

7. As a result of the conduct described in this Complaint, defendants Lay and MDL Capital violated, and unless restrained and enjoined by this Court, will continue to violate, Section 17(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77q(a), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, thereunder, and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. §§ 80b-6(1) and 80b-6(2).

JURISDICTION AND VENUE

8. The Commission brings this action pursuant to Sections 20(b) and 20(d) of the Securities Act, 15 U.S.C. §§ 77t(b) and 77t(d), Section 21(d) of the Exchange Act, 15 U.S.C. 78u(d), and Sections 209(d) and 209(e) of the Advisers Act, 15 U.S.C. §§ 80b-9(d) and 80b(9)e), to enjoin such acts, transactions, practices and courses of business, obtain disgorgement and civil penalties, and for other appropriate relief.

9. This court has jurisdiction over this action pursuant to Section 22(a) of the Securities Act, 15 U.S.C. § 77v(a), Section 27 of the Exchange Act, 15 U.S.C. § 78aa, and Section 214 of the Advisers Act, 15 U.S.C. 80b-14.

10. Certain of the acts, transactions, practices, and courses of business constituting the violations alleged herein occurred within the Western District of Pennsylvania and elsewhere, and were effected, directly or indirectly, by making use of the means and instruments of transportation and communication in interstate commerce, or the means and instrumentalities of interstate commerce, or the mails, or the facilities of a national securities exchange.

DEFENDANTS

11. **Mark D. Lay**, age 44, during the relevant time period resided in Aliquippa, Pennsylvania. During all times relevant to the facts alleged in this Complaint, Lay was the Chairman, CEO and Chief Investment Strategist of MDL Capital, owned approximately 35% of MDL Capital's shares, and was a member of MDL Capital's Board of Directors. Lay was also a director of the Fund. On October 30, 2007, after a trial, Lay was convicted in the Northern District of Ohio of criminal mail fraud, wire fraud and investment adviser fraud charges based on the same conduct alleged in this Complaint. He is currently incarcerated.

12. **MDL Capital Management, Inc.**, located in Pittsburgh, Pennsylvania, has been registered with the Commission as an investment adviser since September 2000. During the relevant time period, MDL Capital provided discretionary fixed income, equity and balanced portfolio management services to institutional clients, including pension and profit sharing plans, charitable organizations, corporations, state and municipal government entities, and Taft-Hartley plans.

RELATED ENTITY

13. **MDL Active Duration Fund, Ltd.** was an offshore investment vehicle known as an "exempted, open-ended mutual fund" created by MDL Capital and Lay. It was incorporated under the laws of Bermuda in May 2002. MDL Capital was the investment adviser to the Fund. The Fund ceased operations in November 2004 as a result of the events described in this Complaint.

FACTS

The Bureau's Pre-Existing Relationship with MDL Capital

14. At all times relevant to the facts alleged in this Complaint, defendant Lay acted by and through defendant MDL Capital.

15. The Bureau is an Ohio agency that provides workers' compensation insurance coverage for roughly two-thirds of Ohio's workforce. The Bureau is funded by Ohio employers. At the end of its 2004 Fiscal Year, the Bureau had approximately $21.3 billion in assets. These assets provide injured workers and their families with medical and compensation benefits to cover workplace injuries, diseases and death.

16. During the relevant time period, the Bureau used approximately 72 outside money managers to invest the Bureau's funds in securities. MDL Capital was one of those money managers.

17. On or about May 14, 1998, the Bureau and MDL Capital entered into an Investment Management Agreement ("Management Agreement"), signed by Lay on behalf of MDL Capital and by the Bureau. The Management Agreement established MDL Capital as an investment adviser to the Bureau.

18. In May 1998, the Bureau transferred $55 million to MDL Capital and directed it to manage this money under a "broad market" fixed income strategy in the Core Account, investing solely in fixed income government bonds, largely U.S. Treasuries.

19. The Bureau made two subsequent transfers of funds to the Core Account: $100 million in July 2002; and $200 million in June 2003. As of June 2003, the Bureau had invested a total of $355 million with MDL Capital in the Core Account.

20. Pursuant to the Management Agreement, the Bureau was to pay MDL Capital a quarterly management fee. Between February 2004, when the fraud described in this Complaint commenced, and the Bureau's termination of the Core Account in or about April 2005, MDL Capital received approximately $540,146 in management fees in connection with the Core Account.

The MDL Active Duration Fund

21. In May 2002, MDL Capital and Lay formed the Fund. The Fund was supposedly designed as an investment vehicle through which U.S. tax-exempt institutional investors and non-U.S. persons could invest in a portfolio consisting primarily of U.S.

Treasury notes and bonds, U.S. agency notes and bonds and corporate and mortgage-backed fixed income securities.

22. However, the Fund, which was the first hedge fund MDL Capital and Lay had ever managed, had only one investor during its entire existence -- the Bureau. In reality, Lay and MDL Capital formed the Fund in order to provide a new investment vehicle to the Bureau.

23. The Fund's by-laws provided that the Fund would be governed by a Board of Directors, and Lay was appointed a member of the Fund's Board.

24. In November 2002, MDL Capital entered into an Investment Advisory Agreement with the Fund which provided that MDL Capital would be the Fund's investment adviser.

25. Pursuant to the Investment Advisory Agreement, MDL Capital was to manage the investment of the Fund's assets and to administer the Fund's business operations. However, the Investment Advisory Agreement also specifically provided that MDL Capital's authority was subject to the guidelines in the Fund's Private Placement Memorandum, dated January 13, 2003 (the "PPM"), and the supervision of the Fund's Board of Directors.

26. The PPM, which Lay helped to draft, set forth the Fund's investment objectives, investment strategies and guidelines. The PPM portrayed the Fund as a conservative investment vehicle, and stated that the Fund's investments would consist of U.S. Treasury notes and bonds, notes and bonds of U.S. government agencies, fixed income securities of U.S. corporations with a Standard & Poor's credit rating of B or better and mortgage-backed income securities.

27. The Fund's stated objectives were to outperform the Lehman Government Credit Bond Index when interest rates were generally declining and to protect Fund assets when interest rates were generally rising.

28. In order to meet its objectives, the Fund was to hedge against underlying interest rate trends by taking long and short positions. For example, if MDL Capital believed that interest rates were going to rise, it would use the Fund's assets to take a short position in a U.S. Treasury Bond ("T-Bond"); *i.e.*, it would borrow a T-Bond and sell it for cash. Eventually, MDL Capital would have to buy back the T-Bond to close out the short position. However, the assumption was that as interest rates rose, bond prices would fall, which meant that the adviser's liability would decrease and the adviser would be able to buy back the T-Bond at a lower price to close out the position, keeping the remainder as profit. Similarly, if MDL Capital believed that interest rates were going to fall, it would take a long position in the T-Bond; *i.e.,* purchase T-Bonds. Falling interest rates generally result in rising bond prices. Therefore, the adviser would be expecting to sell the T-Bond eventually at a higher price, thereby making a profit.

29. According to the PPM, the Fund expected to leverage its investment portfolio as a means to increase yield and enhance total return. Leverage was defined broadly in the PPM to include, but not be limited to, "short selling of securities, reverse repurchase agreements, certain options and futures transactions plus any borrowings to leverage the Fund's assets."

30. However, the PPM provided that only up to 150% of the Fund's assets could be leveraged (*i.e.*, the combined value of borrowings and short positions). Although the PPM stated that this leverage percentage was intended to be a guideline, it also required that any change had to be approved by the Fund's Board of Directors.

31. Moreover, the Bureau understood the PPM to mean that at no time would the leverage of the Fund exceed 150%, and the Bureau based its decision to invest some of its Core Account funds in the Fund on this conservative leverage guideline.

32. On or about August 20, 2003, the Bureau executed a Subscription Agreement with the Fund and, on September 12, 2003, the Bureau allocated $100 million from its existing Core Account with MDL Capital to purchase shares in the Fund.

33. The Bureau made two other investments in the Fund: On May 21, 2004 it allocated another $100 million into the Fund from the Core Account, and on September 25, 2004 it invested $25 million from other sources in order to meet a margin call.

34. The PPM provided that MDL Capital would receive a management fee equal to 1% per annum of the Fund's Net Asset Value at the end of each calendar quarter and that the Fund would pay MDL Capital a quarterly incentive fee equal to 20% of net profit.

35. Between the time the fraud described in this Complaint began in or about February 2004 and the Fund's termination in or about November 2004, MDL Capital received approximately $707,743 in management fees in connection with the Fund.

Lay and MDL Capital Improperly Exceeded the Leverage Guideline

36. From the inception of the Fund until its demise in November 2004, Lay directed all of the trading activity in the Fund's portfolio.

37. Lay knew the limitations established by the PPM, and the Bureau's reason for investing in the Fund. Nonetheless, in violation of his duties as an investment adviser and in contravention of the agreement with the Bureau, Lay fraudulently overleveraged the Fund's assets far in excess of the 150% leverage guideline, ultimately exposing the Bureau's funds to great risk.

38. During the first five months of operation, from late August 2003 through January 2004, Lay invested the Fund's assets in T-Bonds and U.S. Treasury Notes (both long and short), equity securities, corporate bonds, and mortgage-backed securities.

39. By February 2004, Lay had begun to concentrate the Fund's investment activity on T-Bond transactions. In late February 2004, Lay entered into a number of short T-Bond positions that resulted in month-end leverage of 234%, in excess of the leverage guideline.

40. On March 5, 2004, Lay increased portfolio duration across all of MDL Capital's accounts, including the Fund. According to a letter Lay sent to all of his clients, MDL Capital believed that interest rates would decline. Lay closed all of the short T-Bond positions in the Fund that he had opened in late February and immediately took long positions in T-Bonds.

41. On March 5, 2004, Lay used margin to purchase approximately $250 million in T-Bonds. Between March 5 and April 14, 2004, Lay engaged in a succession of T-Bond purchases and sales. Lay bought the T-Bonds as they rose in price and sold the T-Bonds as they fell in price. As a result, at the end of March 2004, the Fund had realized a loss of approximately $7 million, resulting in a negative 7.5% return in the Fund for March.

42. Lay then changed his strategy. However, the strategy was a radical departure from the one disclosed in the PPM and agreed to by the Bureau. Lay never disclosed this change of strategy and its attendant risks to the Bureau nor did he receive prior approval from the Fund's Board.

43. Instead of declining, interest rates rose in the Spring of 2004. On April 14, Lay closed all of the long T-Bond positions in the Fund, realizing losses of approximately $39 million, or roughly 38% of what was at that time a $102 million account. At the same time, without consulting the Fund's Board or notifying the Bureau, Lay began to employ an

extremely aggressive strategy of exclusively shorting the T-Bond in a highly risky attempt to recoup the Fund's losses, completely abandoning the conservative leverage guideline in the PPM.

44. On April 14, as a result of this strategy, Lay had leveraged the Fund's assets to approximately 1,012%.

45. Because the Bureau was unaware that Lay was engaging in unauthorized and excessive leverage, in May 2004 the Bureau allocated another $100 million from the Core Account to the Fund as it had intended to do at the time of the initial investment.

46. Because interest rates generally had risen in May 2004, the Fund managed a positive return of 1.27% for the month, although the Fund's assets were leveraged 274% by month's end. However, Lay continued to aggressively sell short the T-Bond in June and July 2004. Because interest rates peaked in June and fell again in July, the Fund experienced monthly returns of negative 3.46% and 11.19%, respectively. During these months, Lay aggressively traded in the direction of the market by continuing to sell short the T-Bond. Lay had increased the Fund's leverage to 474% by the end of June 2004 and 907% by the end of July 2004.

47. In August 2004, Lay continued to engage in aggressive short selling of the T-Bond, resulting in excessive losses as interest rates continued to decline. Specifically, the Fund experienced returns of negative 37.03% in August and finished the month with 234% leverage. At its highest point in August 2004, the Fund was leveraged almost 2,700%.

48. In September 2004, however, Lay engaged in some of his most aggressive short T-Bond trading. At the beginning of the month, only $88 million of the original $200 million in capital contributions, all of which had been transferred from the Bureau's Core Account,

remained in the Fund. By the end of September 2004, Lay and MDL Capital had leveraged the Fund's assets 13,501% with a return of negative 83% for the month.

49. By the end of September 2004, Lay's risky, undisclosed and unauthorized trading had caused the Fund's net assets to dwindle to a mere $30 million.

50. On September 29, 2004, after becoming aware of Lay's improper trading and in an effort to limits its already overwhelming losses, the Bureau submitted a request to redeem its investment in the Fund and requested that the remaining balance be liquidated and returned to the Bureau by the end of the year.

51. Despite the Bureau's request and its clear efforts to prevent further losses, Lay continued to aggressively sell short T-Bonds at a time when interest rates continued to fall. In October 2004, Lay's trading in the Fund was the most aggressive to date, and he leveraged the Fund's assets as high as 21,797%.

52. As of November 4, 2004, the value of the Fund was $8.7 million in net assets and the Fund had generated a return of negative 71% for the 35-day period beginning October 1 and ending November 4, 2004.

53. When the Fund was finally closed in November 2004, the Fund had lost approximately $160 million as a result of short sales that greatly exceeded the 150% leverage guideline. As a result, the conservative hedge to which the Bureau had agreed became, without the Bureau's knowledge or consent, an exceedingly risky investment.

Lay and MDL Capital Sent False and Misleading Reports to the Bureau

54. Lay controlled the flow of information that the Bureau received regarding the Fund, and he either knew or was reckless in not knowing that the Bureau was unaware of the risks to which he had exposed its assets. MDL Capital and Lay never obtained authorization

from the Bureau, or the Fund's Board of Directors, to expose the Fund to such significant risks associated with the excessive overleveraging. Instead, MDL Capital and Lay deceived their client, the Bureau, by failing adequately to disclose that they were leveraging the Fund far beyond the guideline set forth in the PPM and the understanding of the Bureau. The defendants sent false and misleading information to the Bureau in connection with the operation and performance of its investment in the Fund.

55. Lay and MDL Capital provided the Bureau with monthly and other intermittent reports regarding the Fund. However, none of these reports disclosed the leverage being exercised in the Fund with the Bureau's assets or explained the true reasons for the losses.

56. MDL Capital did not create or send a separate monthly report to the Bureau regarding the Fund. Instead, beginning in September 2003, MDL Capital selectively incorporated a limited amount of information about the Fund into monthly reports about the Core Account (the "Core Reports"). Significantly, the Core Reports did not identify the amount of leverage being used in the Fund.

57. When the Bureau asked for more information regarding the Fund, Lay made misrepresentations to, stalled, or misled the Bureau by, among other things, preparing and sending to the Bureau several "*ad hoc*", or non-periodic, reports, none of which specifically listed the amount of leverage that was being utilized in the account. Further, the information contained in these reports was insufficient to reveal the significant risks MDL Capital and Lay were taking in the Fund with the Bureau's assets.

<u>Lay Made Other Misrepresentations to the Bureau Regarding the Fund's Losses</u>

58. When the Bureau began to question what MDL Capital and Lay had done with the Bureau's investment in the Fund, Lay continued to deceive the Bureau and compounded

the fraud by greatly understating the degree of risk to which he and MDL Capital had exposed the Fund.

59. On at least two occasions when Bureau personnel confronted Lay about the losses in the Fund, Lay misled the Bureau about the reasons for and amount of the losses as well as the leverage percentage being used.

60. On or about April 23, 2004, after the Fund had lost approximately $7 million, the chief investment officer of the Bureau met with Lay to discuss the Fund's losses. During this meeting, Lay did not disclose that he had exercised leverage in the Fund that had exceeded the 150% limitation. Instead, he falsely claimed that the losses were due to market conditions and did not mention the role the excessive leverage played in these losses.

61. In mid-May 2004, the Bureau received the April 2004 month-end Core Report and learned for the first time that the Fund had lost approximately $39 million, a fact that Lay had concealed during the mid-April meeting with the Bureau. At the time of that meeting, Lay already knew that the Fund had lost an additional $39 million because the Fund had realized these losses on April 14 when he closed all of the long T-Bond positions.

62. On or about May 18, 2004, concerned about the losses being incurred by the Fund and the use of leverage, two of the directors called a special meeting of the Fund's Board of Directors. During the meeting, Lay misled and lied to the Board. For example, although he admitted he was aware of the 150% leverage guideline, he falsely claimed that the Bureau was fully aware of the extent of leverage being used in the Fund.

63. On or about September 16, 2004, at the Bureau's insistence, Lay met with Bureau officials to address questions regarding the Fund's poor performance. He admitted that the Fund was being excessively leveraged. However, he continued to deceive the Bureau

by greatly understating the degree of risk to which he had exposed the Fund. Although Lay admitted at that time that he had overleveraged the Fund, he claimed the Fund had been leveraged only 17 times the Fund's assets when he knew or was reckless in not knowing that the Fund was leveraged between 55 and 60 times its assets.

FIRST CLAIM FOR RELIEF

Violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder

64. Paragraphs 1 through 63 are realleged and incorporated herein by reference.

65. From approximately February 2004 through November 2004, as a result of the conduct alleged herein, defendants Lay and MDL Capital, in the offer or sale or in connection with the purchase or sale of securities, directly or indirectly, by the use of the means and instruments of transportation and communication in interstate commerce, or the means and instrumentalities of interstate commerce, or the mails, or the facilities of a national securities exchange: (a) employed devices, schemes and artifices to defraud; (b) obtained money or property by means of, and made, untrue statements of material fact, and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; and (c) engaged in acts, transactions, practices and courses of business which operated as a fraud or deceit upon offerees, purchasers and prospective purchasers of securities.

66. By reason of the foregoing, defendants Lay and MDL Capital have directly or indirectly violated Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a), Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, thereunder.

SECOND CLAIM FOR RELIEF

Violations of Sections 206(1) and 206(2) of the Advisers Act

67. Paragraphs 1 through 66 are realleged and incorporated herein by reference.

68. During the period set forth above, defendants Lay and MDL Capital, directly and indirectly, by use of the mails and the means and instrumentalities of interstate commerce and while acting as investment advisers: (a) employed devices, schemes and artifices to defraud advisory clients and prospective clients; and (b) engaged in transactions, practices and courses of business which operated as a fraud and deceit upon such clients and prospective clients.

69. By reason of the foregoing, defendants Lay and MDL Capital violated Sections 206(1) and 206(2) of the Advisers Act, 15 U.S.C. §§ 80b-6(1) and 80b-6(2).

WHEREFORE, the Commission respectfully requests that this Court:

I.

Issue an injunction permanently restraining and enjoining defendants Lay and MDL Capital from violating Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a), Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, thereunder, and Sections 206(1) and 206(2) of the Advisers Act, 15 U.S.C. §§ 80b-6(1) and 80b-6(2).

II.

Order defendants Lay and MDL Capital, jointly and severally, to disgorge all ill-gotten gains that they derived from the activities set forth in this Complaint, together with prejudgment interest.

III.

Order defendants Lay and MDL Capital to pay civil penalties, pursuant to Section 20(d) of the Securities Act, 15 U.S.C. § 77t(d), Section 21d(3) of the Exchange Act, 15 U.S.C. § 78u(d) and/or Section 209(e) of the Advisers Act, 15 U.S.C. § 80b-9(e), as a result of the violations set forth herein.

IV.

Order such other and further relief as this Court may deem just and appropriate.

Respectfully submitted,

s/ David W. Snyder

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