

# Compliance Building

*Doug Cornelius on compliance and business ethics*

## **Fund Manager Fraud for Exceeding Leverage Limits**

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It turns out that failing to adhere to your investment guidelines can not only get you sued by your investor, it can get you sent to jail.

Mark D. Lay ran a hedge fund whose sole investor was the Ohio Bureau of Worker's Compensation. The fund agreement had a non-binding 150% leverage guideline. Lay apparently relied on the non-binding nature of it and had 2/3 of the trades in excess of 150 leverage and over 20% of those trades involved leverage over 1000%. Lay ended up losing \$214 million of the \$225 million invested by the Bureau.



Apparently Lay not only greatly exceeded the leverage guidelines, he also lied about his excess.

Lay was convicted investment advisory fraud, conspiracy to commit mail and wire fraud, and two counts of mail fraud. Those convictions earned him a 12-year sentence at the Federal Correctional Institution in Fort Dix, N.J. and an order to repay nearly \$213 million from the loss and forfeit \$590,526 of the \$1.7 million in fees the bureau paid.

Lay lawyers tried get him out of the investment advisory fraud by claiming that the Bureau was not a client. They argued that the Bureau was merely an investor in the fund and that Lay advised the fund. It was this handling of deeming an investor in the fund as the "client" that caught my attention.

Lay's legal team used the [Goldstein v. SEC case](#) to argue that the SEC is precluded from treating fund investors as clients. The Sixth Circuit Court of Appeals did agree with that argument. The

found that the SEC could not treat *all* investors in a fund as clients, but they could treat *some* as clients under the Investment Advisers Act.

In this case, the Bureau was already a client under a different investment management agreement. So a client relationship was already established. Also, the Bureau was the only investor in the fund. This is an atypical fund relationship.

The case points out that investors in a fund may still be clients of the fund manager under the Investment Advisers Act.

*Sources:*

- [Sixth Circuit Opinion in US v Mark D. Lay \(July 14, 2010\)](#) 
- [Sixth Circuit Upholds Convictions of Hedge Fund Manger](#) by Thomas O. Gorman in *SEC Actions*
- [Key figure in Workers' Comp fraud loses appeal](#) by Mark Niquette for the *Columbus Dispatch*