

**SUPREME COURT OF THE STATE OF NEW YORK  
COUNTY OF NEW YORK**

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**STATE OF NEW YORK,**

**Plaintiff,**

**-against-**

**CONSECO SERVICES, LLC, CONSECO EQUITY  
SALES, INC., CIHC, INC. (former Debtor-in-  
Possession), INVIVA, INC. and JEFFERSON  
NATIONAL LIFE INSURANCE CO.,**

**COMPLAINT**

**INDEX NO. \_\_\_\_\_**

**Defendants.**

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Plaintiff, by Eliot Spitzer, Attorney General of the State of New York, on behalf of the State of New York, complaining of the above-named defendants, alleges upon information and belief, that:

**INTRODUCTION**

1. Pursuant to the provisions of Article 23-A of the General Business Law, Eliot Spitzer, Attorney General of the State of New York, commenced an investigation of the mutual fund industry in July 2003. The investigation subsequently expanded to include variable annuity products sold by insurance companies. As part of that investigation the Attorney General uncovered evidence that Conseco, Inc.<sup>1</sup> and various of its subsidiaries including Conseco

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<sup>1</sup> Conseco, Inc. is a financial services holding company incorporated in Indiana with its principal place of business in Carmel, Indiana. In December 2002, Conseco, Inc. filed for protection under Chapter 11 of the U.S. Bankruptcy Code, reorganized around its insurance operations and emerged from bankruptcy in September, 2003. The reorganized Conseco, Inc. no longer is engaged in the business of issuing or selling variable annuities because in October 2002, Conseco, Inc. sold its variable annuity business to Inviva, Inc. Prior to the reorganization, as the parent company of the Conseco defendants, it profited from the illegal conduct described below and from the sale to Inviva.

Variable Insurance Company, Conseco Services, LLC, Conseco Equity Sales, Inc. and CIHC, Inc. (the former debtor-in-possession) (individually and collectively "Conseco"), along with the subsequent purchaser of its variable annuity business, Inviva, Inc. ("Inviva"), engaged in a fraudulent scheme in violation of Article 23-A of the General Business Law and other New York laws.

2. This case involves fraud and breach of fiduciary duty in the sale of variable annuities. Variable annuities are hybrid securities intended for retirement that combine elements of four different financial products: (1) mutual funds, (2) tax-deferred investments like Individual Retirement Accounts ("IRAs"), (3) life insurance policies, and (4) traditional annuities. Upon purchasing a variable annuity, a consumer can direct that his or her money be invested in one or more of the mutual fund "subaccounts" offered by the insurance company. These subaccounts, which mirror the mutual funds available to retail investors, are usually run by the retail fund manager. Gains in variable annuity subaccounts compound tax-free until withdrawal. In addition, variable annuities offer investors the chance to convert their investment, after a certain number of years, into a guaranteed stream of annuity payments for a period of years or for life. The typical variable annuity also has a death benefit guaranteeing the return of the investor's principal to heirs if death precedes the start of annuity payouts. Investors in these complex products pay both the costs of the underlying subaccounts, which can exceed 2% per year, as well as insurance charges of up to 2% per year.

3. While variable annuities are in some respects collaborative ventures between mutual funds and insurers, it is the insurance company that creates the portfolio of subaccounts, markets the product, provides prospectuses to potential buyers, implements the investment

decisions of purchasers, and monitors the trading activities of these investors to ensure they are not harming the subaccounts and other investors. In at least this last respect, the insurer bears a fiduciary duty to annuity investors. Under New York law, a fiduciary owes its clients not “honesty alone, but the punctilio of an honor the most sensitive.” A fiduciary may not put its own interest above its clients’ interests, and may not favor one client to the disadvantage of another.

4. Consecro and Inviva committed fraud and breached their fiduciary duties by secretly selling variable annuities to professional mutual fund timers. Mutual fund timers are arbitrageurs who exploit inefficiencies in mutual fund pricing through rapid trading. Their arbitrage gains come dollar-for-dollar out of the pockets of long-term investors. While fund timers’ primary targets have always been retail mutual funds, their search for new arbitrage opportunities eventually led them to variable annuity subaccounts. Consecro and Inviva welcomed them with open arms and allowed them to prey on the retirement money of their legitimate customers.<sup>2</sup>

5. Starting in late 2000, Consecro, Inc. began to sell variable annuities to hedge funds and other fund-timing entities through a subsidiary, Consecro Variable Insurance Company ("CVIC"). These were sham transactions. The hedge funds did not need life insurance. Nor were they interested in tax-deferred investing or annuity payments. However, they were willing to pay Consecro for these unwanted insurance features as an admission charge for rapid trading in the same subaccounts that were available to legitimate Consecro variable annuity owners.

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<sup>2</sup> The damage caused by the fund timers spread beyond Consecro's and Inviva's customers since the same subaccounts were often available as investment options to purchasers of variable annuities sold by other insurance companies.

6. Conseco went further and facilitated the trading of its timing clients in a number of ways. First, it negotiated and entered into timing capacity agreements with the Van Eck and Alger mutual fund families on the one hand and a group of professional fund timers on the other. Pursuant to these agreements, the timers would be allowed to trade agreed sums in the Van Eck subaccounts and unlimited amounts in the Alger subaccounts. Second, Conseco facilitated what is known as “under the radar” trading by its timers in the subaccounts whose managers had *not* agreed to be timed. Here, Conseco used its intimate knowledge of the innocent managers’ anti-timing policies to educate its favored timing customers about how to avoid detection. If a fund manager detected the activity and complained, Conseco would help the timer find another subaccount to target. Indeed, Conseco helped its fund timers by falsely telling subaccount managers that it did not tolerate timing activity when in fact it encouraged timers and did nothing at all to police them.

7. Conseco never revealed its timing program to its legitimate investors. Its prospectuses were misleading, stating that its variable annuities were not designed for timers and implying that Conseco would diligently monitor trading to prevent timing. Inviva continued these practices and deceptions after it purchased the Conseco variable annuity business in October of 2002.

8. In the end, the fund timers, Conseco and Inviva profited handsomely. The losers were the unsuspecting customers of Conseco and Inviva who actually bought variable annuity products for retirement purposes. They paid high fees and were rewarded by having their retirement investments become the targets of arbitrageurs. The damages from this fraud are the

fees that Conseco and Inviva collected from these unsuspecting long-term investors, plus the dilution and other costs of the timing activity.

9. By reason of defendants' fraudulent conduct, the State of New York seeks a judgment and order, *inter alia*, permanently restraining and enjoining defendants from further violating New York's securities law and requiring that all fees collected and profits obtained from the illegal activity be disgorged, that restitution and damages be awarded, and that costs and penalties be assessed and paid to the State of New York.

### **PARTIES**

10. This action by the Attorney General on behalf of the People of the State of New York is brought in the name of the State of New York pursuant to the Attorney General's authority under General Business Law Article 23-A and other State laws.

11. Defendant Conseco Services, LLC ("Conseco Services") is an Indiana-based wholly-owned subsidiary of Conseco, Inc. Conseco, Inc. formed Conseco Services to be the service provider for all of its affiliated companies. Conseco Services facilitated fund timing through its agreement with CVIC to provide back-office and other administrative and special services for CVIC in its day-to-day business operations, including payment of the employees who engaged in the illegal conduct described herein. After the sale of CVIC to Inviva, Conseco Services for six months provided the administrative and technical services for CVIC pursuant to a transition agreement. Conseco Services was not included in the Conseco, Inc. bankruptcy and it is not a releasee under the court's bankruptcy plan.

12. Defendant Conseco Equity Sales, Inc. ("CES") is a registered broker-dealer. CES served as the principal underwriter and distributor for Conseco's Monument and Advantage

Plus variable annuity products. CES did not participate in the Conseco, Inc. bankruptcy and it is not a releasee under the court's bankruptcy plan.

13. Defendant CIHC, Inc. (former debtor-in-possession) ("CIHC")<sup>3</sup> was an insurance holding company located in Carmel, Indiana. During the time of the conduct described in the Complaint, CIHC was a subsidiary of Conseco, Inc. that served as the holding company for Conseco Inc.'s various insurance businesses, including CVIC. CIHC filed for Chapter 11 bankruptcy protection in December 2002, and emerged in September 2003 under a court ordered plan of reorganization. Subsequent to its emergence from bankruptcy, CIHC went through several mergers with other Conseco, Inc. entities.

14. Defendant Inviva, Inc. ("Inviva") is a privately held Delaware insurance holding corporation. It is headquartered at 435 Hudson Street, New York, New York with administrative operations in Louisville, Kentucky. It owns two subsidiaries which are collectively licensed to sell variable annuity products nationwide including in the State of New York. On October 23, 2002, Inviva purchased all of the CVIC stock from CVIC's immediate parent, Conseco Life Insurance Company of Texas. However, pursuant to a transition agreement with defendant Conseco Services, Inviva did not take over full operation of the business until May 1, 2003.

15. Defendant Jefferson National Life Insurance Company ("JNL") sells variable annuities within or from the State of New York as the re-named successor to CVIC. It is an indirect wholly-owned subsidiary of Inviva with offices at 435 Hudson Street, New York, New York.

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<sup>3</sup> Only injunctive relief is being sought against CIHC because monetary relief is barred by the Order confirming the company's emergence from bankruptcy in September 2003. The other Conseco entities named as defendants did not participate in the bankruptcy.

## STATUTORY AND LEGAL FRAMEWORK

16. Article 23-A of the General Business Law (“GBL”) of the State of New York, (commonly referred to as the “Martin Act”), prohibits fraud in the offer and sale of securities to the public within or from the State of New York. Among the provisions relevant to this action are:

(a) GBL §352(1), which prohibits fraud and fraudulent practices and provides, *inter alia*, that a violation of any section of Article 23-A of the GBL is a fraudulent practice and authorizes the Attorney General to investigate such practices;

(b) GBL §352-c, which prohibits any person, partnership, or corporation from engaging in any fraud, deception, concealment or suppression; or making any false representation while knowing the truth or without making reasonable effort to know the truth or without knowledge concerning the representation; or engaging in any agreement, device or scheme to obtain money, profit or property by any means prohibited by this section; and

c) GBL §353, which authorizes the Attorney General to seek a permanent injunction enjoining any individual or entity who has taken part in, or has been concerned with, fraudulent practices from directly or indirectly engaging in the issue, sale, or offer of securities within or from the State of New York, and to seek restitution.

17. GBL §349 makes unlawful deceptive acts or practices in the conduct of any business, trade or commerce or in the furnishing of any service in the State of New York. The Attorney General is authorized to bring an action on behalf of the State of New York under this section to enjoin such acts and obtain restitution. Pursuant to GBL §350-d, civil penalties up to \$500 for each violation may be assessed against any individual or entity that violates GBL §349.

18. Section 63(12) of the Executive Law authorizes the Attorney General to seek an injunction barring repeated fraudulent and/or illegal conduct in the carrying on, conducting or transaction of business, and to seek restitution and damages.

19. In addition, as the State of New York's chief legal officer, the Attorney General brings this action pursuant to his *parens patriae* authority. Where, as here, the interests and well-being of the people of the State of New York are implicated, the Attorney General possesses *parens patriae* authority to commence legal actions for violations of state law. The State of New York has a quasi-sovereign interest in upholding the rule of law, in protecting the economic well-being of its residents and, with specific reference to the present action, in ensuring that the marketplace for the trading of securities functions fairly with respect to all persons who participate or consider participating therein.

## **TIMING VARIABLE ANNUITIES**

### **A. Background**

20. Variable annuities are securities, marketed and sold by insurance companies for retirement planning. A key feature is access to a portfolio of mutual fund subaccounts offering a variety of investment opportunities. The variable annuity contract owner<sup>4</sup> makes investment choices from these subaccounts. In addition to the advantages of mutual funds (such as diversification and professional management), variable annuities typically offer three features: (1) tax-deferred treatment of earnings; (2) a death benefit; and (3) annuity payout options that

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<sup>4</sup> The annuitant and the contract owner can be different parties. The annuitant has to be a natural person, while the owner can be an entity such as a hedge fund. When hedge funds bought variable annuities from Conseco, they put forward an employee to serve as the annuitant.

can provide guaranteed income for life. Unlike other tax-favored vehicles like IRAs, variable annuity contracts are not subject to annual contribution limits.

21. Variable annuity products come with an elaborate array of choices. The contracts may be purchased in a single payment or by means of a series of payments over time, during the so-called "accumulation phase." The accumulation phase continues until the date the annuitant chooses for payouts to begin. They can be immediate or deferred. In the case of an immediate annuity, payments begin right after the contract is purchased. A deferred annuity, on the other hand, matures until withdrawals are "annuitized" with regular payments taken either for a fixed period, for life, or on a discretionary basis. This payout or annuity phase can be structured in a variety of ways. In a tax-deferred annuity, withdrawals made after age 59½ are taxed as income; earlier withdrawals are subject to income tax and a 10% penalty. However, investors can avoid these tax penalties by giving up the tax-deferral benefits.

22. In addition to paying the managerial costs of the mutual fund subaccounts, investors in variable annuities pay various fees to the insurance company. These usually include mortality and expense risk, surrender charges for withdrawing funds before a given number of years, and annual contract or administrative fees which can be fixed or a percentage of account value. The "death benefit" typically guarantees that an account will maintain a certain value, usually the amount contributed, payable to heirs if the annuitant dies before the annuity payments are scheduled to begin. Special options like stepped-up death benefits and guaranteed minimum income benefits all carry additional costs.

23. Surrender charges penalize withdrawals in the first years of an annuity. For example, a seven percent surrender fee might be charged for a withdrawal during the first year of

ownership, with six percent the second year and so on, until the eighth year when no surrender charge is assessed.

24. Like mutual funds, variable annuity subaccounts set their prices once a day by dividing assets in the subaccount pool by the number of shares to come up with an Accumulation Unit Value or AUV, the annuity equivalent of a mutual fund's Net Asset Value or NAV. The AUV of a given subaccount is not always the exact equivalent of the NAV of the retail mutual fund it mirrors because there can be differences in the subaccount's underlying stocks or amount of cash on hand. The AUV also reflects deductions for mortality and expense costs (the insurance charge) and various administrative charges.

25. Annuity investors make transfers or trades among the subaccounts by sending directions to the insurance company. All transfers into and out of each subaccount are then aggregated by the company and forwarded to the mutual fund manager as "batch trades." As a result, the mutual fund manager generally cannot determine the identity of the shareholders whose trades are grouped together in a single batch -- only the insurer knows that. The combination of access to mutual funds and the anonymity offered by batch processing made variable annuities attractive vehicles for fund timers.

#### **B. Fund Timing in Variable Annuities**

26. Like retail mutual funds, variable annuities can fall victim to fund timers -- quick-turnaround traders who siphon value out of funds through rapid trading. This trading strategy exploits inefficiencies in the way funds set their prices for both retail products and variable annuity subaccounts. It works because some funds use stale prices to calculate the value of securities held in their portfolios. A typical example is a U.S. mutual fund that holds Japanese

shares. Because of the time zone difference, the Japanese market may, for example, close at 1:00 a.m. New York time. If the U.S. mutual fund manager uses the closing prices of the Japanese shares in his or her fund to arrive at an NAV (or the AUV for a variable annuity subaccount) at 4:00 p.m. in New York, he or she is relying on market information that is fifteen hours old. If there have been positive market moves during the New York trading day that will cause the Japanese market to rise when it later opens, the stale Japanese prices will not reflect such value and the fund's NAV/AUV will be artificially low. Put another way, the NAV/AUV would not reflect the true current market value of the stocks the fund holds. On such a day, a trader who buys the Japanese fund at the stale price is virtually assured of a profit that can be realized the next day by selling after the increased fund value is reflected in its price. This and similar strategies are known as "time zone arbitrage."

27. A similar type of timing is possible in mutual funds or subaccounts that contain illiquid securities such as high-yield bonds or small capitalization stocks. Here, the fact that some of the fund's securities may not have traded for hours before the New York closing time can render the fund's NAV/AUV stale, and thus open it to being timed. This is sometimes known as "liquidity arbitrage."

28. Another type of arbitrage is available to the timers who engage in "late trading"—buying or selling shares after 4:00 p.m. EST on a given day while receiving that day's NAV/AUV. Late trading allows timers to capitalize illegally on post-market closing events. In essence, all NAVs and AUVs are "stale" after 4:00 p.m. EST so the ability to trade late creates arbitrage opportunities in *any* kind of mutual fund.

### **C. The Effect of Fund Timing on Long-Term Investors**

29. Effective mutual fund timing captures an arbitrage profit that comes dollar-for-dollar out of the pockets of the long-term investors: the timer steps in at the last moment and takes part of the buy-and-hold investors' upside when the market goes up, so the next day's NAV/AUV is reduced for those who are still in the fund. When the market is falling, the timer's profit increases losses for regular investors.

30. Fund timing is not entirely risk free, however. The timer has to keep his or her money in the target fund for at least a day. As a result, he or she may enjoy additional gains – or incur losses – depending on the market. But such gains and losses are distinct from the timer's arbitrage profit which capitalizes on price inefficiencies.

31. Besides the pure wealth transfer resulting from successful arbitrage (called “dilution”), timers also harm long-term investors in their target funds in a number of other ways. First, they impose their transaction costs, such as additional trading commissions, on the long-term investors. Second, the timers' trades may force the portfolio manager to buy stock as it goes up in price or sell it in a falling market. Third, portfolio managers may be compelled to hold additional cash in order to accommodate timer transactions.

### **FUND TIMING AT CONSECO AND INVIVA**

32. Consecos, and later Inviva, sold various annuity "products" having distinct features. The two products at issue here are the Monument and Advantage Plus products. Consecos created these annuities in the late 1990s for a target market of 50-71 year olds with approximately fifty thousand dollars to invest. Both Monument and Advantage Plus offered essentially the same portfolio of approximately sixty subaccounts including Van Eck and Alger

funds. Monument had no early surrender fee; Advantage Plus had one that was partially offset by deposits or "bonuses" to the account made by the insurer. These products were largely marketed to the public by broker-dealers.

33. Neither Consecro nor Inviva disclosed the extensive timing arrangements in Monument and Advantage Plus to the investing public. Instead, each company created the illusion that they either did not permit fund timing or were protecting against timers. Indeed, their prospectuses falsely stated that timing was discouraged and that they monitored it to protect their investors.

**A. Misleading Prospectus Language**

34. An investor buying a variable annuity contract receives a prospectus, fills out an application and then is issued a contract. As part of the process, each applicant must be provided with both a prospectus for the particular variable annuity product and for every subaccount option. Each prospectus contains, among other information, detailed descriptions of investment policies and guidelines, schedules of fees charged for management and insurance benefits, and examples of performance tables. A consumer is expected to read thoroughly each prospectus before buying in order to make an informed decision.

35. Prospectuses for both Monument and Advantage Plus stressed long-term goals, stating that “[this] contract is to be used to accumulate money for retirement or other long-term tax-deferred investment purposes,” and “annuity contracts are a means of setting aside money for future needs, usually retirement.” This language is misleading to long-term investors because, as Consecro and Inviva were well aware, their fund timing clients were exclusively using these products for short-term trading.

36. The prospectuses also created the misleading impression that timing would be discouraged and monitored. For example, from 2000 to 2003, the prospectuses warned “[t]his product is not designed for professional market timing organizations.” In fact, as much as 95% of the assets in the Monument product ultimately belonged to “professional market timing organizations.”<sup>5</sup> In addition, the prospectuses stated that transfers between subaccounts that exceeded one every thirty days were subject to a \$25 fee and the company expressly reserved the right to modify or even terminate an investor's transfer privileges. Although similar language was also contained in each variable annuity contract, the defendants never charged anyone such a fee.

37. In 2002, a section entitled “Excessive Trading Limits” was added to the Monument prospectus suggesting even more vigilance by Conseco to prevent the harmful effects of timing:

We reserve the right to limit transfers in any Contract year, or to refuse any transfer request for a contract owner . . . if:

- we believe, in our sole discretion, that excessive trading by the Contract owner . . . may have a detrimental effect on the accumulation unit values of any subaccount or the share prices of any portfolio or would be detrimental to other Contract owners; or
- we are informed by one or more portfolios that they intend to restrict the purchase of portfolio shares because of excessive trading or because they believe that a specific transfer or a specific group of transfers would have a detrimental effect on the price of the portfolio shares.

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<sup>5</sup> As noted above, the subaccounts available to Monument and Advantage Plus investors were also available to investors in other Conseco variable annuity products, as well as to investors in variable annuities sold by other insurance companies.

We may apply the restrictions in any manner reasonably designed to prevent transfers that we consider disadvantageous to other Contract owners.

38. Inviva was particularly aware of the detrimental effects of market timers as evidenced by the 2003 prospectus for its own product called Direct Annuity. The Limitations on Transfers section read in part:

Because excessive transfers among Subaccounts can disrupt the management of the Underlying Funds and increase the Underlying Funds' costs for all owners of Contracts, we reserve the right to limit the number of transfers you may make in any Contract year or to refuse any transfer request if: (1) we determine, in our sole discretion, that your transfer patterns among the Subaccounts reflect a market timing strategy. . .

39. Moreover, in Monument's May 1, 2003 prospectus, Inviva amended the Excessive Trading Limits section by expanding its discretionary role to protect the investments of all its contract holders if:

[a] transfer request would result in a redemption of a 'substantive' amount from an investment portfolio that had been allocated to that portfolio for less than 30 days; 'substantive' means a dollar amount that Jefferson National determines, in its sole discretion, could adversely affect the management of the investment portfolio.

We may apply the restrictions in any manner reasonably designed to prevent transfers that we consider disadvantageous to other contract owners.

In addition, accumulation period transfers were subject to further modification if, in JNL's "sole opinion," the transfer by one or more owners "is, or would be, to the disadvantage of other owners."<sup>6</sup>

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<sup>6</sup> Inviva subsequently eased the restriction on trades during both the accumulation and annuity phases from one trade per 30 days to 12 trades over the course of the contract year.

40. In Advantage Plus, the product that carried an eight percent surrender charge, the prospectuses included the same \$25 fee if more than one transfer was made every thirty days. It also contained the following qualification:

. . . (5) Your right to make transfers is subject to modification if we determine, in our sole opinion, that the exercise of the right by one or more owners is, or would be, to the disadvantage of other owners. Restrictions may be applied in any manner reasonably designed to prevent any use of the transfer right which is considered by us to be to the disadvantage of other owners ... .

In addition, rights were reserved to modify the transfer provisions as to frequency and dollar amount and even to completely terminate the transfer privilege. The same “Excessive Trading” provision found in the Monument prospectus was added to Advantage Plus in 2002.

41. Taken together, these anti-timing provisions reassured investors that Conseco and Inviva were monitoring trading in the subaccounts and would take action if it became harmful. Since individual investors were in no position to police the overall trading in the Conseco and Inviva annuities, the insurance companies’ undertakings to police and to exercise discretion on behalf of legitimate investors created a fiduciary relationship.

42. In comparison, the disclosure language for Advisor, Conseco’s special product for individuals interested in rapid trading, shows that Conseco knew how to disclose a pro-timing policy when it chose to do so. This prospectus made clear that Advisor was developed for timers and stated that it was "sold only to individuals who wish[ed] to accumulate assets by engaging in strategic or tactical asset allocation investing with the assistance of a professional money manager.” The anti-timing provisions in Conseco's other products as discussed above were absent in the Advisor prospectus.

## **B. Fund Timing at Conseco**

### **1. Negotiated Timing Capacity**

43. In the Fall of 2000, Conseco was approached by an officer of the Van Eck mutual fund family and a representative of a hedge fund named Prairie Masters Fund LLC, (“Prairie Masters”) with a proposal: Prairie Masters would buy a \$9.5 million annuity contract in Monument if Conseco would allow it to trade frequently in the Van Eck subaccounts. Van Eck encouraged the arrangement even though the prospectus sent to each investor in the Van Eck subaccounts stated that they were “designed for long-term investing.” Conseco signed on despite its own cautionary prospectus language.

44. This was by far the largest contract Conseco had ever sold. After receiving special approval from Conseco’s actuaries and making special arrangements which included breaking the investment into two contracts under \$5 million each, the annuities were funded in January of 2001. Prairie Masters waived tax deferral for its investments. Prairie Masters purchased a third Monument contract in March 2002 for \$687,286. By the time the contracts were redeemed in early June 2002, Prairie Masters had traded over 100 times, primarily in Van Eck funds but also “under the radar” in other Conseco subaccounts, and had earned over \$800,000.

45. Prairie Masters was the first of Conseco's many negotiated timing-capacity arrangements. Conseco embraced the fund timing business and institutionalized new practices and procedures that afforded preferential treatment for timers. Ultimately, Van Eck allocated more than \$80 million of capacity in four international subaccounts<sup>7</sup> to timers. In addition, Alger

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<sup>7</sup> Worldwide Bond, Worldwide Emerging Markets, Worldwide Hard Assets and Worldwide Real Estate.

American Funds granted unlimited timing capacity in its small cap subaccount despite the advice in its prospectus that "based on the portfolio's investment style and objective, an investment in [the fund] may be better suited to investors who seek long-term capital growth and can tolerate fluctuation in their investment's values."

46. By September 2001, \$75 million in timing money had been committed for investment in Monument with another \$25 million projected for the year. Even more money followed. Fund timers eventually took over the Monument product. A few weeks before the sale to Inviva closed in October 2002, timers accounted for 60% of Monument's assets and one-third of Advantage Plus assets. During the six month transition period ending May 1, 2003, during which Conseco Services continued to administer the variable annuity business, timer assets grew to \$120 million, accounting for all but \$5 million of Monument assets.

47. An email exchange from September 2001 shows how clearly Conseco officers on all levels understood the agenda of their fund-timing clients, especially the vice president and assistant vice president in charge of CVIC's sales and distribution of variable annuities (respectively, "Sales VP" and "Sales AVP"). In this exchange, the Sales AVP discussed how to capture a potential \$4 million timing account. At issue was the split between Conseco's profits and the commission to be paid to the broker who had introduced the potential client. Writing to a group that included the Sales VP, in-house counsel, a pricing actuary and the head of product development, the Sales AVP said:

The tax deferral is a moot point to [the fund timers]. ... They only wish to time the market. Annuities are often the only places that will allow you to do it these days. They need a money market that can handle it and a fund that is willing to take it, which they have found. However, we will need to make sure Van Eck has a 'heads

up' about the case, as this is a sizeable sum of money. It will probably make them drool anyway.

48. Ultimately Conseco entered into approximately 100 arrangements granting timing capacity in the Van Eck and Alger funds, all of which were nurtured and monitored by the Sales VP and Sales AVP. Conseco representatives traveled to New York to negotiate these agreements, entered into such agreements with New York entities, and harmed innocent New York variable annuity investors as a result.

49. For example, a November 2001 email from the Sales AVP courting the business of CVIC's "New York client," Canary Capital, read in part:

I understand you were interested in actively managing assets inside some of the Van Eck funds. We are very interested in meeting your investment needs. [The Sales VP] mentioned you were interested in the total assets inside of our products, and I have attached a spreadsheet of all of our funds. Please keep in mind, if you are interested in heavy trading, Van Eck ... and Alger have all expressed an interest in receiving the assets. Please feel free to contact either [the Sales VP] or myself if you have any questions or concerns. We look forward to doing business.

50. Hedge funds made major investments and received special treatment. The Sales AVP personally serviced all big-money actively traded accounts. She maintained spreadsheets and files on what she designated as "market timers" and interacted with the timers to keep them as satisfied customers, she sent instructions to timers requiring them to notify her of all transfers into and out of the Alger and Van Eck subaccounts so she could track and allocate capacity, and she worked closely with the brokers who earned hefty commissions by bringing timing accounts to Conseco.

## 2. Timing Under the Radar

51. Going beyond this negotiated capacity for timing, the Sales AVP helped the fund timers as they engaged in "under the radar" timing in Monument subaccounts where they did *not* have capacity, thus enabling them to escape detection by the fund managers. For instance, on July 17, 2001, she wrote to a broker confirming Consecos "proposal" for unlimited trading in Monument subaccounts by the broker's timer-client unless, in the future, "our money managers approach us." These trades, limited to \$500,000 each, were approved in all Alger American portfolios and nine other fund families which had *not* negotiated timing capacity. The \$500,000 limit was the Sales AVP's effort to hide the timing from these unsuspecting subaccount managers.

52. Many timers disregarded their capacity arrangements with Alger and Van Eck by sneaking into other subaccounts, particularly international funds that were supposed to be off limits. As set forth below, despite Consecos awareness of these deceptions, it took no steps to control the furtive trades unless a fund manager detected excessive trading. Managers were at a disadvantage in doing so since timer trades were masked by being bundled into batch orders with the trades of Consecos legitimate customers. If, and only if, a fund manager raised an issue about a particular transaction would Consecos reveal what it already knew: that the trade in question had been made by a timer. If the fund then complained, Consecos would issue verbal warnings to the timer involved and occasionally block a trade. Absent a complaint from the fund, no action would be taken. Indeed, Consecos made no effort at all to police the fund timers.

53. As early as August 2001, American Century Variable Portfolio, Inc. ("American Century") complained to Conseco about market timing in its International Fund, a Conseco subaccount, clearly stating why it had no tolerance for timers:

If I can be of assistance creating a message as to why timing will not be permitting [sic] I am happy to help...! the basis is that it drives trading costs up for remaining shareholders, it is extremely time consuming and difficult for the PM's to manage the huge swings in cash positions .. [sic] possibly violates Conseco transaction rules... (Do you happen to know what your rules are?)

Nonetheless, timing continued and American Century made additional complaints throughout that year and into 2002 when, in February, the fund threatened to reject the next purchase due to a series of rapid trades of several million dollars within a week. Recognizing that Conseco knew who was making the large trades while the fund only saw bundled purchases, and that an outright rejection of a trade by the fund might harm an "innocent client" of Conseco's, American Century asked the Sales VP whether Conseco was "making any progress with this issue that I can point to? ... help me with alternatives." Another email in the series stated:

I can not [sic] emphasize enough the serious nature of this issue. ... I would encourage you and your distribution people to take all steps necessary to eliminate the market timers executing these trades. If it continues we will be forced to reject transactions. If you need any further documentation from us, or if you need me to speak to someone else at CONSECO [sic], please do not hesitate to give me a call. We want to do everything we can to help you put an end to this problem.

54. When Conseco gave American Century a "heads up" in October 2002 that a large trade had been made but that the trade had not been made by a timer, the fund was lulled into believing that "Conseco has gotten our message - they are monitoring and actively policing our trades for us ... ." In fact, no such policing was ever undertaken and similar complaints from

American Century continued for over a year. In March 2003, the Sales AVP wrote to her Inviva counterpart that she had advised American Century "that we do not tolerate timers." That statement, of course, was totally false. It was designed to lull American Century into lowering its guard against timers. In fact, the timing activity continued at least until the end of the transition period.

55. Other subaccount managers had similar communication with Conseco when they spotted high volume rapid trading. One fund company wrote in a May 2002 email: "[the company] stands upon a zero tolerance for timing policy and we look to the insurance companies to help us keep these individuals out of our funds and protect the other shareowners." The fund company sent at least five additional emails to Conseco reiterating its "no-timing" policy. Although recognizing that the fund company was "ready to take the gloves off," Conseco failed to take any action against the timers. More than a year later, in September 2003, the same admonition regarding a \$4.7 million trade was repeated to Inviva:

To date we have not seen any action taken to rid the funds of the activity that is occurring. ... It is imperative that we get this money out of our fund. It is obviously timing activity and [the company] stands upon zero tolerance of this activity. We look to our insurance Partners to assist us in keeping this type of money out of our funds.

In spite of these appeals being made for more than a year, the timing was not stopped.

56. Inviva also lulled mutual fund companies into believing that they would be protected from timers. One such company approved its subaccounts for use by Inviva "based on [the] 'zero tolerance policy' and procedures [Inviva] communicated to [the company] with respect to kicking out timers from the products where [the company] portfolios are available."

### 3. Sham Annuity Contracts

57. In order to take advantage of both negotiated and under the radar timing opportunities at Conseco, hedge funds purchased sham annuities from Conseco, entering into multiple contracts, naming principals and employees as annuitants to satisfy the natural person requirement, waiving all insurance and tax-benefit features, and making hundreds of round trips within months of purchase.

58. For example, Principia Investment Partners, LP ("Principia"), a timing hedge fund based in Palm Beach, Florida, bought six separate Monument variable annuity contracts totaling over \$33 million from Conseco and Inviva. The owner of each policy was either Principia or a related entity. The annuitants, who had to be natural persons, were variously a Principia accountant, an operations manager, and its general partner. The general partner, who was thirty-two years old at the time he bought the annuity, chose to receive annuity payments starting in the year 2075, when he would have been 105 years old. All told, the Principia entities made approximately 180 round trips trading mostly in Van Eck funds but also under the radar with other fund families, making roughly \$700,000 by doing so.

59. Another timing hedge fund, Beacon Rock, used six different entities, none bearing the Beacon Rock name, to purchase nine Monument contracts totaling approximately \$30 million. The two fund managers each served as annuitant for two of the contracts, its head trader for two after that, and its office manager for the last three. The office manager, who was thirty years old when her first contract with Conseco was signed, chose to receive annuity payments starting in the year 2078, when she would have been 106.

### **C. Fund Timing at Inviva**

60. Inviva first learned about Conseco's fund timing operation while it was contemplating the purchase of CVIC in May 2002. Inviva requested information on “jumbo” sales and received from Conseco a report showing its “large actively managed tickets” and the percentage of Conseco’s sales that these represented. In anticipation of the purchase, a fund manager even warned Inviva about the timing problems at Conseco and asked that they be addressed upon the completion of the sale. However, before the purchase was completed in October 2002, the situation had worsened to such an extent that that fund suspended its sales in CVIC’s variable annuity products. An email to the Sales VP (forwarded to Inviva) explained that the “substantial size and frequency” of the trades by the fund timers “negatively impacted both the ability to manage the portfolio as well as the existing shareholders.”

61. Inviva’s Chief Financial Officer was explicitly told by a Conseco salesperson in February, 2003, that the large accounts were for timing purposes. In addition, Inviva’s Board of Directors was aware of the big-ticket fund timing program. In February 2003, the Board was informed that Inviva was successful in “continuing to attract market timers” and that their “special fund allocations with Van Eck and Alger . . . allow timers to trade frequently with certain of these funds.” Periodic updates about fund timing were provided to the Board.

62. Conseco Services continued to administer the business under a transition agreement which extended until April 30, 2003. Early in that period, both the Sales VP and Sales AVP told Inviva employees about Conseco’s “big-ticket traders,” their frequent trading, the preferential treatment they received and the procedures that needed to be followed to continue the fund timing. In fact, the Sales VP and Sales AVP were heavily engaged in

managing the Conseco market timers throughout the transition period. As Inviva phased in a new manager to take over the Sales AVP's duties, the Sales AVP continued to set up the accounts, monitor trading activity, allocate the capacity in the Van Eck subaccounts and send nightly notification to Van Eck of the net amount of trades. She also continued as the point person for questions and complaints about timing activity from the subaccount managers. The Sales VP continued to interact with the wholesalers and independent broker-dealers and pursue more timing funds.

63. After the purchase, Inviva continued the Conseco product line, sales practices, and timing arrangements and actively sought additional fund timing money. Indeed, Inviva marketed to brokers their “relationship with Van Eck” and that they were “able to offer select clients the opportunity to actively trade in select Van Eck funds.” Starting on May 1, 2003, Inviva and JNL began issuing CVIC's products under the JNL name and continued actively managing timing assets.

64. In May 2003, Van Eck added a "parking" requirement for timers, a variant on the “sticky money” some firms required from mutual fund timers. This consisted of a new Van Eck short-term income fund where timers were required to deposit their funds when they were not invested in the Van Eck subaccounts targeted for arbitrage. These parked assets ensured that Van Eck would continue to collect its fees on timing money until another arbitrage opportunity arose. As an incentive to Inviva to add the new subaccount and direct its timers to use it, Van Eck promised to provide \$30 to \$40 million more capacity for the fund timers.

65. When Van Eck reduced fund capacity because of the damage timing was causing, Inviva helped its timers find alternative international funds to time. Despite the fact that several

such funds had expressed zero tolerance for timing, Inviva merely cautioned the timers in general terms that some funds were "more sensitive" than others with respect to frequency and number of trades permitted. By mid-June, the total "active" or fund timing money was \$152.7 million.

66. Like Conseco, Inviva waited for the funds to flag large or frequent trades which were detrimental to other investors. Only then would Inviva issue a verbal warning and occasionally block a trade. Otherwise no action was taken. Inviva never alerted the affected funds that unpermitted trading might be occurring. Ultimately, Inviva was deluged with requests from the subaccounts to track down the fund timers who were disrupting the funds.

67. In September, 2003, after the announcement of a complaint by the New York Attorney General against, among others, Canary Capital Partners, a hedge fund, and the subsequent investigations into market timing and late trading, Inviva's fund timing business collapsed. Following a two-month period of rapid-fire redemptions by Monument's fund timers, Monument's assets plummeted from approximately \$135 million to \$10 million.

### **CONCLUSION**

68. Defendants have, through their acts, misrepresentations, concealments and deceptions, committed and/or profited from both statutory and common law frauds.

69. Defendants either knowingly or intentionally participated in conduct designed to mislead the purchasing public who, having relied upon the material representations made to them, were harmed. In addition, defendants breached their confidential and/or fiduciary relationships with the purchasing public.

70. Plaintiff State of New York on behalf of the People of the State of New York has been irreparably harmed and has no other remedy at law.

### **FIRST CAUSE OF ACTION**

71. The acts and practices of the defendants relating to fund timing violated section 352-c(1)(a) of the General Business Law, in that they involved the use or employment of a fraud, deception, concealment, suppression, or false pretense, engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of securities.

### **SECOND CAUSE OF ACTION**

72. The acts and practices of the defendants relating to fund timing violated section 352-c(1)(c) of the General Business Law, in that they involved the use or employment of a representation or statement which was false, where the person who made such representation or statement: (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation made, and where such acts or practices were engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of securities.

### **THIRD CAUSE OF ACTION**

73. The acts and practices of the defendants relating to fund timing violated section 352-c(2) of the General Business Law, in that defendants engaged in an artifice, agreement, device or scheme to obtain money, profit or property by a means prohibited by section 352-c of the General Business Law.

#### **FOURTH CAUSE OF ACTION**

74. The acts and practices of defendants relating to fund timing were fraudulent and deceptive in violation of General Business Law § 349.

#### **FIFTH CAUSE OF ACTION**

75. The acts and practices of the defendants relating to fund timing violated section 63(12) of the Executive Law, in that defendants engaged in repeated fraudulent or illegal acts or otherwise demonstrated persistent fraud or illegality in the carrying on, conducting or transaction of a business.

#### **SIXTH CAUSE OF ACTION**

76. The acts and practices of defendants alleged herein constitute fraud under the common law of the State of New York.

#### **SEVENTH CAUSE OF ACTION**

77. The acts and practices of defendants alleged herein constitute a constructive fraud under the common law of the State of New York.

**WHEREFORE**, plaintiff demands judgment against the defendants as follows:

A. That all defendants be permanently restrained and enjoined from engaging in any fraudulent practices in violation of Article 23-A of the General Business Law, Section 349 of the General Business Law and section 63(12) of the Executive Law;

B. That all defendants, with the exception of defendant CIHC, pursuant to GBL § 353 (3), GBL §349 and Executive Law § 63(12), disgorge all profits obtained, including fees

collected and pay all restitution and damages caused, directly or indirectly by the fraudulent acts complained of herein;

C. That all defendants, with the exception of defendant CIHC, pay penalties pursuant to GBL § 350-d;

D. That all defendants, with the exception of defendant CIHC, pay plaintiff's costs; and

E. That the Court award such other and further relief to plaintiff as the Court may deem just and proper in the circumstances.

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Dated: New York, New York  
August 9, 2004