SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK
--X

STATE OF NEW YORK,

Plaintiff,

-against-

PILGRIM BAXTER & ASSOCIATES, LTD.,
GARY L. PILGRIM and HAROLD J. BAXTER,

Defendants.

--X

SUMMONS

Index No.:

Plaintiff Designates New York County as the Place of Trial.

TO THE ABOVE-NAMED DEFENDANTS:

YOU ARE HEREBY SUMMONED to answer in this action and serve a copy of your answer, or if the complaint is not served with the summons, to serve a notice of appearance on the Plaintiff's attorney within twenty (20) days after the service of this summons, exclusive of the day of service. If this summons is not personally served upon you, or if this summons is served upon you outside of the State of New York, then your answer or notice of appearance must be served within thirty (30) days. In case of your failure to appear or answer, judgment will be taken against you by default, for the relief demanded in the complaint.

Filed: November 20, 2003

Dated: New York, New York
November 20, 2003

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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK
--X

STATE OF NEW YORK, **COMPLAINT**

Plaintiff, **Index No.:**

-against-

PILGRIM BAXTER & ASSOCIATES, LTD.,
GARY L. PILGRIM and HAROLD J. BAXTER,

Defendants.

--X

The People of the State of New York ("Plaintiff") bring this action in the name of the State of New York by their attorney, Eliot Spitzer, Attorney General of the State of New York. Plaintiff, complaining of the defendants, Pilgrim Baxter & Associates, Ltd. ("PBHG"), Gary L. Pilgrim and Harold J. Baxter ("Defendants"), alleges the following upon information and belief:

PRELIMINARY STATEMENT

1. This action is brought in the name of the State of New York pursuant to Civil Practice Law and Rules § 1301, Article 23-A of the General Business Law ("The Martin Act"), section 349 of the General Business Law ("GBL"), and Executive Law § 63(12), for a judgment and order permanently enjoining Defendants from engaging in fraudulent activities and breaches of their fiduciary obligations in connection with the purchase and sale of securities and awarding Plaintiff damages, restitution, disgorgement of profits, disgorgement of management fees, fines, penalties and other just and proper relief.

2. This action is brought against: (i) PBHG which currently oversees, manages and administers a multi-billion dollar complex of mutual funds known as the PBHG funds; and (ii) the individual defendants who founded the PBHG funds in the 1980s and managed PBHG until they were forced to resign in November, 2003.

3. Defendants approved arrangements whereby a select group of favored investors – including a hedge fund in which defendant Gary Pilgrim had a substantial ownership interest – were permitted to “time” PBHG funds. “Timing” is an investment technique involving short-term, “in and out” trading of mutual fund shares. The technique is designed to exploit inefficiencies in the way mutual fund companies price their shares. Timing adversely affects mutual fund shareholders because it dilutes the value of their shares, disrupts orderly portfolio management and increases costs for shareholders.

4. In recognition of this detrimental effect, from 1998 to the present, the PBHG prospectus indicated that PBHG would not permit excessive “in and out” trading. The prospectus limits shareholder exchanges between the PBHG money market fund and the PBHG stock funds to four (4) per year.

5. But Defendants selectively enforced their anti-timing exchange limitation for their own gain. They exempted certain preferred investors (including hedge fund Appalachian Trails, L.P. (“Appalachian”) and clients of broker-dealer Wall Street Discount Corporation (“WSDC”)) from the four exchange per year limitation to enable market timing in PBHG funds.

6. Ordinary investors were not afforded the privileges given to entities such as Appalachian and WSDC. Many investors who exceeded the four exchange limitation but lacked the influence to merit a special market timing exemption from the founders of the PBHG funds had their exchange privileges revoked.

<u>Appalachian Trails, L.P.</u>

7. Appalachian Trails, L.P. is a hedge fund that was specially created for the purpose of engaging in mutual fund market timing. Defendant Gary Pilgrim, who managed the PBHG Growth Fund, was among the first Appalachian investors and maintained a substantial ownership interest in Appalachian.

8. Pilgrim, with the knowledge and consent of Harold Baxter, permitted Appalachian to feverishly trade in and out of the PBHG Growth Fund and to trade in other funds. In spite of the four exchange rule that applied to other investors, Appalachian made nearly 100 exchanges into and out of the PBHG Growth Fund in 2000 and 2001. Pilgrim's reward was a substantial share of Appalachian's multi-million dollar profits from trading in the PBHG Growth Fund. During the same period of time, a buy-and-hold shareholder invested in the PBHG Growth Fund would have lost over 60% of his investment.

9. Pilgrim knew better than to allow timing in PBHG funds, as he later acknowledged in an e-mail to a fellow PBHG portfolio manager when he wrote:

> I think timers are a loser for our shareholders and probably not even in our business interests. So I would give them the boot period.

Unfortunately for PBHG's shareholders, Pilgrim's resolve to fight timers – including the special purpose Appalachian timing vehicle in which he was invested – came too late.

Wall Street Discount Corporation

10. WSDC was run by Alan Lederfeind, a close personal friend of defendant Harold Baxter. Baxter arranged to give Lederfeind's clients a special exemption from the four exchange per year limitation. Defendants also arranged to provide to WSDC the portfolio holdings of certain PBHG funds to facilitate timing activities.

11. In at least one instance, PBHG received "sticky assets" from a Wall Street Discount client. "Sticky assets" are an arrangement prevalent in the timing industry whereby a timer makes an investment of long-term capital in a fund other than the one being timed. Mutual fund managers earn advisory fees on both the timer's long term investment and the assets in the funds being timed. "Sticky assets" induce mutual fund managers to give, or reward them for having given, preferential treatment to the timer.

Other Timers

12. Appalachian and WSDC clients were not the only timers in the PBHG funds. Numerous other substantial market timers had invaded the funds as early as 1998. By 2000, Defendants estimated timing assets in PBHG funds (*i.e.*, the dollar volume of PBHG mutual funds that was subject to short-term trading) to be in excess of $500 million. In 2001, Defendants estimated timing assets in PBHG funds to be at least $573 million, a substantial portion of which were attributable to Appalachian and clients of Wall Street Discount Corporation. Even after these other market timers that were causing harm to the funds were identified, as with Appalachian and clients of Wall Street Discount, Defendants did little or nothing to stop them.

13. Although Defendants had drafted a policy in 1998 prohibiting timing and ejected certain timers from the PBHG funds, it was not until the latter part of 2001 that Defendants made a concerted effort to rid the funds of timers. But, even as they did, Defendants betrayed PBHG's long-term shareholders a second time. While all other timers were shut down in late 2001, Pilgrim and Baxter used their influence to "re-exempt" Appalachian and clients of Wall Street Discount Corporation from the four exchange rule and PBHG's anti-timing procedures.

14. All the while, PBHG's shareholders were kept in the dark. The PBHG prospectus was silent about these special dispensations given to favored investors and the inconsistent enforcement of the four exchange per year rule. To the contrary, the prospectus, which explicitly states the four exchange per year limitation, gave investors the misleading impression that timing was not being permitted.

Relief Sought

15. The State of New York seeks a judgment and order, inter alia, permanently restraining and enjoining the individual defendants from engaging in the offer and sale of securities within and from the State of New York, and directing that Defendants cease and desist from further violating New York's securities and other laws, that all profits from illegal activity be disgorged,

that all management fees earned by Defendants during the period market timing in PBHG funds occurred (estimated to be in excess of $250 million) be disgorged, that restitution and damages be awarded, and that costs and penalties be assessed and paid to the State of New York.

PARTIES

16. The People of the State of New York, plaintiff, are represented by Eliot Spitzer, Attorney General of the State of New York. Pursuant to General Business Law §§ 349 and 353 and Executive Law § 63(12), the Attorney General is authorized to commence legal action to enjoin fraudulent conduct and obtain restitution and damages.

17. Defendant PBHG is the investment adviser to the PBHG Funds and maintains offices at 1400 Liberty Ridge Drive, Wayne, Pennsylvania. PBHG is paid a monthly management fee based on the average daily net assets of the PBHG family of funds.

18. PBHG is an indirect, wholly-owned subsidiary of Old Mutual plc ("Old Mutual"), a South African based financial services group, with operations in life assurance, asset management, banking and general insurance. Old Mutual acquired PBHG in September, 2000. Prior to September, 2000, the sole shareholder of PBHG was United Asset Management Corporation ("UAM"), a New York Stock Exchange listed holding company principally engaged, through affiliates, in providing institutional investment management services and acquiring institutional investment management firms.

19. PBHG contracted with PBHG Funds (formerly The PBHG Funds, Inc.) ("PBHG Trust") to serve as the investment adviser for the PBHG family of mutual funds. The PBHG Trust is a Delaware business trust registered under the Investment Company Act of 1940 as an open-end investment company. The PBHG Trust is made up of a series of portfolios each of which is given a separate name, such as the PBHG Emerging Growth Fund or the PBHG New Opportunities Fund.

20. PBHG Fund Distributors (the "PBHG Distributor") is a wholly-owned subsidiary of

PBHG and acts as the principal underwriter (a/k/a the distributor) of the PBHG family of mutual funds.

21. PBHG Fund Services (the "PBHG Administrator") is a Pennsylvania business trust and wholly-owned subsidiary of PBHG. In exchange for a monthly fee calculated as a percentage of the average daily net assets of the PBHG family of funds, the PBHG Administrator provides the PBHG funds with various administrative services such as office space, regulatory reporting services, equipment and personnel.

22. From at least 1997 until he was forced to resign on November 13, 2003, defendant Gary L. Pilgrim was: (i) the President of the PBHG Trust; (ii) a director of PBHG; (iii) a trustee of the PBHG Administrator; and (iv) the chief portfolio manager of the PBHG Growth Fund, PBHG Technology & Communications Fund and PBHG Core Growth Fund. From 1982 until 2003, Pilgrim was President of PBHG.

23. From at least 1997 until he was forced to resign on November 13, 2003, defendant Harold J. Baxter was: (i) a trustee of the PBHG Trust; (ii) the Chairman and Chief Executive Officer and a director of PBHG; and (iii) a trustee of the PBHG Administrator. From January 1998 until he was forced to resign on November 13, 2003, Baxter was a trustee of the PBHG Distributor.

BACKGROUND ON TIMING IN THE MUTUAL FUND INDUSTRY

24. Mutual funds are meant to be long-term investments. They are designed for buy-and-hold investors, and are therefore the favored homes for Americans' retirement and college savings accounts. Nevertheless, quick-turnaround traders routinely try to trade in and out of certain mutual funds in order to exploit inefficiencies in the way the funds price their shares (also known as calculating their net asset values ("NAVs")).

25. This strategy works only because some funds use "stale" prices to calculate the value of securities held in the fund's portfolio. These prices are "stale" because they do not necessarily

reflect the "fair value" of such securities as of the time the NAV is calculated. A typical example is a U.S. mutual fund that holds Japanese shares. Because of the time zone difference, the Japanese market may close at 2:00 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 at 4:00 p.m. in New York, he or she is relying on market information that is fourteen 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 them, and the fund's NAV will be artificially low. Put another way, the NAV does 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. This and similar strategies are known as "time zone arbitrage." Taking advantage of this kind of short-term arbitrage repeatedly in a single mutual fund is called "timing" the fund.

26. A similar type of timing is possible in mutual funds that contain illiquid securities such as high-yield bonds and 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 stale, and thus open it to being timed. This is sometimes known as "liquidity arbitrage."

The Effect on Long Term Shareholders

27. Effective timing captures an arbitrage profit. The arbitrage profit from timing 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 is reduced for those who are still in the fund.

28. Besides the pure wealth transfer of arbitrage (called "dilution"), timers also harm their target funds in a number of other ways. First, they impose their transaction costs such as commissions on the long-term investors. Second, trades necessitated by timer redemptions can lead to realization of taxable capital gains or losses at an undesirable time, increasing the tax bill for long-

term investors. Third, the timer's trades may result in the portfolio managers having to buy stock as it is going up in price or sell it into a falling market.

29. Fund managers often seek to minimize the disruptive impact of timers by keeping cash on hand to pay out the timers' profits without having to sell stock. This "strategy" does not eliminate the transfer of wealth out of the mutual fund caused by timing; it only reduces the administrative cost of those transfers and allows the long-term investors' money to be skimmed in a streamlined way. Such an approach can also reduce the overall performance of the fund by requiring the fund manager to keep a certain amount of the funds' assets in cash at all times, thus depriving the investors of the advantages of being fully invested in a rising market. Some fund managers even enter into special investments as an attempt to "hedge" against timing activity (instead of just refusing to allow it), thus deviating altogether from the ostensible investment strategy of their funds, and incurring further transaction costs.

Tools to Combat Market Timing

30. Mutual fund managers are aware of the damaging effect that timers have on their funds. And while the effects on individual shareholders may be small once they are spread out over all the investors in a fund, their aggregate impact is not: for example, one recent study estimates that U.S. mutual fund shareholders lose $4 billion each year to timers. Eric Zitzewitz, Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds (October 2002) 35, at http://faculty-gsb.stanford.edu/zitzewitz/Research/arbitrage1002.pdf. While it is virtually impossible for fund managers to identify every timing trade, large movements in and out of funds -- like those made by select investors that were permitted to time PBHG funds -- are easy for managers to spot. And mutual fund managers have tools to fight back against timers.

31. Fund managers typically have the power simply to reject timers' purchases. Many funds have also instituted short-term trading fees ("early redemption fees") that effectively wipe out the arbitrage that timers exploit. Generally, these fees go directly into the affected fund to reimburse

it for the costs of short term trading. In addition, fund managers are required to update NAVs at the end of the day in New York when there have been market moves that might render the NAV stale. This is called giving the fund a "fair value." It eliminates the timer's arbitrage. As fiduciaries for their investors, mutual fund managers are obliged to do their best to use these weapons to protect their customers from the dilution that timing causes.

Incentives for Allowing Market Timing

32. Given the harm that timing causes, and the tools available to put a stop to it, why would a mutual fund manager allow his fund to be timed? The answer lies in the way that mutual funds are organized. Typically a single management company sets up a number of mutual funds to form a family. While each mutual fund is in fact its own portfolio, as a practical matter the management company runs all of them. The portfolio managers who make the investment decisions for the funds and the executives to whom they report are all typically employees of the management company, not the mutual funds themselves. Still, the management company owes fiduciary duties to each fund and each investor.

33. The management company makes its profit from fees it charges the funds for financial advice and other services. These fees are typically a percentage of the assets in the fund, so the more assets in the family of funds, the more money the manager makes. The timer understands this perfectly, and frequently offers the manager more assets in exchange for the right to time. Fund managers have succumbed to temptation and allowed investors in the target funds to be hurt in exchange for additional money in their own pockets in the form of additional management fees.

MARKET TIMING AT PBHG

34. From at least 1998 until at least December, 2001, numerous investors market timed PBHG funds with the knowledge of and, in some cases, outright permission from, Defendants. An internal PBHG "Timer Activity Summary" reflects that as of April 20, 2001, investments by entities

engaged in market timing activities reached:

(i) in excess of $385 million in the PBHG Growth Fund comprising nearly 11% of the assets of the fund;

(ii) in excess of $91 million in the PBHG Technology & Communications Fund comprising nearly 7.5% of the fund's assets; and

(iii) $53 million in the PBHG Emerging Growth Fund comprising nearly 8% of the fund's assets.

By July 12, 2001, timer assets in the PBHG Growth Fund had ballooned to more than $466 million or nearly 14% of fund assets.

35. Despite recognizing (as early as 1998) the harmful effects of market timing activities and adopting policies to restrict them, Defendants did little to put an end to market timing. While some market timers were ejected from the PBHG funds during the period from 1998 to 2001, Defendants expressly permitted timing for their "friends" and for their own gain.

36. Defendants' first apparent recognition of the harmful effects of market timing is reflected in an anti-market timing policy drafted in 1998. In mid-1998, PBHG portfolio managers had complained to PBHG senior management about the disruptive effect of market timing activities. Consequently, the PBHG family of funds announced a "timer policy." The policy and the PBHG prospectus limited shareholders to four (4) exchanges annually from any of the PBHG funds to the PBHG Cash Reserves Fund (a money market fund). In addition, the PBHG family of funds established a team, referred to herein as the "timing police," whose members were directed to research market timing activities, run reports to identify market timers and issue instructions to PBHG's transfer agent to put an end to the market timing activity.

37. A June 16, 1998 document entitled "MARKET TIMER POLICY" articulated some of the harm that market timers can cause long-term shareholders:

> Effective immediately, The PBHG Funds, Inc. (the "Fund") will institute a policy with respect to market timers. Exchange orders will not be accepted from any

> shareholder that is identified as a market timer. Market timers are shareholders that process more than four exchanges in and out of the Cash Reserves Money Market, or are exchanging from one fund to another. Market timers can have a significant impact on a portfolio manager's ability to effectively manage the assets of their funds. Portfolio activity generated by these cash flows can create capital gains and/or losses which result from the buying and selling of stock to cover the cash flows and generate additional transaction costs that are passed along to all of the underlying shareholders. These transactions also generate additional transaction cost [sic], which are passed along to all of the underlying shareholders. Therefore, the Fund implemented this procedure to protect the best interest of its long-term shareholders.

38. In June, 1998, Defendants started to combat market timing and revoked the exchange privileges of approximately 100 shareholders who had exceeded the four exchange per year limitation. But Defendants expressly exempted WSDC, a New York based broker dealer managed by Alan Lederfeind, from the four exchange per year limitation. Lederfeind was a close personal friend of defendant Baxter and had hedge funds and others engaged in market timing as clients.

39. After June, 1998, PBHG made some attempts to discourage market timers other than WSDC's clients. In 2000, Defendants began to allow the Appalachian Trails hedge fund -- in which defendant Pilgrim was an investor -- to time the PBHG funds.

40. In late Summer or early Fall of 2001, Defendants had begun a renewed campaign to shut down timing activity in PBHG funds. As a member of the timing police force phrased it, PBHG was engaged in a "war on financial terrorists (a.k.a., Timers)." While the timing police waged war on all other timers and shut them out of PBHG funds, the special relationship between WSDC and Appalachian and PBHG prevailed again. Appalachian and clients of WSDC were again exempted from the four exchange rule.

41. All timing activity in PBHG funds, whether expressly authorized, tacitly permitted or otherwise resulted in dilution or other harm to PBHG's long term shareholders.

Appalachian Trails

42. Appalachian is a Delaware limited partnership with its principal address in Avon, Connecticut. Appalachian was originally formed in March 1995 by Michael Christiani, defendant Gary Pilgrim and his wife and a fourth individual. At the time of Appalachian's formation, Pilgrim

and his wife owned more than two thirds of the partnership. Christiani, a hedge fund manager, managed Appalachian and through an entity he controlled served as Appalachian's general partner.

A. Appalachian's Market Timing Strategy

43. The express purpose of Appalachian's formation was to engage in market timing of mutual funds using a variety of sophisticated computer models and other methodologies. Appalachian's organizational documents state that its assets will be moved:

> from a fully-invested position in selected stock mutual funds to a fully-invested position in selected fixed-income funds, when the General Partner interprets by its indicators that current risk is greater than return. When the potential return exceeds indicated risk, the General Partner will move the Fund's assets from a fully protected [position in] fixed income funds to a fully invested position in selected stock mutual funds to participate in anticipated market advances.

44. The organizational documents further state that between 10 and 50 exchanges per year between fixed income funds and stock mutual funds were anticipated to execute Appalachian's investment strategy. The purpose of so many exchanges was to reduce stock market risk without eliminating Appalachian's ability to participate in upward movements by the stock funds. The organizational documents explain the all-important ability to make numerous exchanges as follows:

> In any given year the assets of the Fund have been invested in stock specific mutual funds slightly less than 50% of the time...[and] thus invested in fixed income mutual funds slightly greater than 50% of the time.... The reduced exposure to the stock mutual funds and the increased exposure to fixed-income mutual funds has resulted in a dramatic reduction of overall stock market risk with little or no loss in upside exposure because of the overall accuracy of our approach. The added advantage to this approach has been that during a rising interest rate environment, we benefitted from those higher rates during the time we were invested in fixed-income mutual funds....

45. To secure the ability to exchange frequently between money market and equity funds at PBHG, Appalachian ultimately went to Gary Pilgrim.

B. Appalachian Gets A Special Exemption to Market Time PBHG Funds

46. In 2000, defendant Pilgrim, with the knowledge and consent of defendant Baxter, granted Appalachian a special dispensation from the rules that applied to PBHG's shareholders

generally to market time at least the PBHG Growth Fund and the PBHG Technology & Communications Fund.

47. During the period from March, 2000 through December, 2001, Appalachian traded feverishly in and out of the PBHG Growth Fund, which was managed by defendant Pilgrim. During that period, Appalachian made in excess of 40 exchanges into the PBHG Growth Fund and then back out to the PBHG Cash Reserves Fund. A given exchange sometimes exceeded $30,000,000. The aggregate volume of trading during this period amounted to approximately $1.2 billion.

48. During 2001, Appalachian made in excess of 50 exchanges into the PBHG Growth Fund and then back out to the PBHG Cash Reserves Fund. A given exchange during this period sometimes exceeded $50,000,000. The aggregate volume of trading during this period amounted to approximately $2.2 billion.

49. Appalachian earned millions by trading the PBHG Growth Fund during 2000 and 2001. Appalachian's trading activity in PBHG Growth Fund diluted the fund's long term shareholders and resulted in other harm including increased transaction costs.

50. On the other hand, a shareholder who "maintained a long term investment perspective" – as investors were encouraged to do in the PBHG prospectus – and held the PBHG Growth Fund during the time frame of Appalachian's trading in 2000 and 2001 would have lost over 60% of his investment in 2000 and over 26% in 2001.

51. Appalachian also market timed the PBHG Technology & Communications Fund in 2001.

52. During the period from February 2001 to April 2001, Appalachian made 8 exchanges between the PBHG Technology & Communications Fund and the PBHG Cash Reserves Fund. A given exchange during this period was as large as $20 million. The aggregate volume of trading during this period amounted to approximately $127 million.

53. A shareholder who held the PBHG Technology & Communications Fund during the time frame of Appalachian's trading in 2001 would have lost over 19% of his investment.

54. Appalachian's trading activity diluted and caused other harm to the long term shareholders of the PBHG funds. Defendant Pilgrim, on the other hand, was a winner. His and his wife's share of Appalachian's profits from trading in the PBHG Growth Fund and PBHG Technology & Communications Fund from 2000 to 2001 was substantial.

Wall Street Discount Corporation

55. The special market timing permission given by Defendants to WSDC is expressly set forth in a June 22, 1998 PBHG memorandum that memorialized the discussions of PBHG's senior management. Among others, the memo was addressed to defendant Harold Baxter, a trustee of the PBHG Trust and CEO of PBHG.

56. The memorandum states:

> Pursuant to our recent discussions and increased complaints from the portfolio managers, we have developed and are prepared to implement PBHG's Timer Policy. Shareholders that are found to be exchanging between funds or buying and selling shares (in the same dollar amount) more than four times in a twelve month period will have their exchange and/or telephone purchase privileges revoked....Currently we have identified about 100 timers with approximately $55,000,000 in assets across all funds. Approximately $35,000,000 of theses [sic] assets are attributable to accounts managed by Alan Lederfeind. **We have exempted Mr. Lederfeind's accounts from the policy with the understanding that he can only trade in the Growth, Emerging Growth and Technology & Communications Funds....**

(emphasis added).

57. Lederfeind introduced at least one of his market timing clients to defendant Baxter and suggested that the timer make a "sticky asset" investment in a new PBHG fund that was being launched. WSDC also transmitted the portfolio holdings of certain PBHG funds that it had received from PBHG to at least one of its timing clients. The portfolio holdings were used by the timer to facilitate its market timing strategy.

58. In May, 2000, a PBHG employee complained about the disruptive effect timing activity was having:

> Have you talked to Mr. Baxter about Alan's timer yet? I'm not sure if this $100 MM is from Wall Street Discount but it is really a disruptive amount of money. I wouldn't keep hounding you about it if the size was not close to 10% of the total assets. Is there anything we can do to slow it down or make it smaller?

Nevertheless, the express permission of Lederfeind's clients to market time the PBHG funds through WSDC was not rescinded.

<u>Other Market Timers</u>

59. In addition to Appalachian and clients of WSDC, there were numerous other entities that market timed PBHG funds with the express permission of or tacit approval of Defendants. In a December 8, 2000 e-mail, after receiving a report related to suspected timing activity, a member of the PBHG timing police wrote:

> What I am trying to get here is a picture of the timers using our funds. I estimate that there is about $500-$600 million of money that moves between the Cash and Equity Funds frequently. It can be tied to only a few accounts.

As of April 20, 2001, an internal PBHG document reflects that timing assets in all PBHG funds amounted to more than $573 million.

60. The trading activity of market timers other than Appalachian and clients of WSDC diluted and caused other harm to the long term shareholders of the PBHG funds.

<u>PBHG's Renewed Efforts to Shut Down Timers</u>

61. Even after PBHG started a renewed effort in late 2001 to rid timers from its funds, Defendants exempted Appalachian and the clients of WSDC from the timing policy and four exchange per year limitation.

62. A PBHG Project Status Report dated September 30, 2001 reflects this continuing exception:

> PBHG Fund Services and PBHG Shareholder Services, with the help of DST Systems, participated in creating and began enforcing a new PBHG Funds Timer Policy. The new policy eliminated the majority of timing activity previously experienced by the Funds but allows controlled timing initiated by two institutions.

Those two institutions were Appalachian Trails and WSDC.

63. An August 16, 2001 e-mail confirms the exception for the clients of WSDC:

> PBHG Funds had made a decision to not allow market timers to trade in the PBHG Family of Funds. PBHG constitutes market timing to be more than 3 trades in and out of an equity fund within a calendar year. PBHG has identified that the below Investec Ernst and Company accounts to have shown [sic] a recent history of market timing....These accounts have been suspended from trading with PBHG. PBHG is asking Investec Ernst and Company to stop all market timing activity. The only exception to this request is Wall Street Discount, they may continue to trade freely....

64. Defendants also granted continuing permission to time PBHG funds to Appalachian, Christiani individually and to several other entities to which Christiani was linked. In an e-mail on August 15, 2001, one PBHG employee queried:

> Mr. Chirstiani is also linked to [other entities]. I assume they should be left alone. Please advise....

Another employee responded:

> Yes, for now. I need to look at the total value of all his accounts, as I was unaware of the connection. Can you tell me how much money he has in total and the amount he is trading in each fund?

65. At the same time as Defendants granted exceptions to WSDC and Christiani, PBHG actively shut down other timers. For example, an October 31, 2001 e-mail to a broker dealer states:

> The PBHG Funds has recently reaffirmed their commitment to prevent market timing activity in their family of funds. They consider more than three trades in and out of an equity fund within a calendar year to be detrimental and excessive market timing. The accounts/representatives listed below have been identified as market timers and will no longer be permitted to purchase PBHG fund shares. Please also be advised that any future attempts at market timing by these individuals, or any other representative of your firm, may result in suspensions of entire branch and dealership relationships.

Nevertheless, Appalachian Trails, Christiani and the clients of WSDC were expressly permitted to market time PBHG funds until December 2001.

66. Internal PBHG documents reflect that all timers who had negotiated capacity to time PBHG funds, including Appalachian and WSDC, were eliminated by January, 2002.

FIRST CAUSE OF ACTION

67. The acts and practices of the Defendants alleged herein violated Article 23-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 or commodities.

SECOND CAUSE OF ACTION

68. The acts and practices of the Defendants alleged herein violated Article 23-A 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 or commodities.

THIRD CAUSE OF ACTION

69. The acts and practices of the Defendants alleged herein violated Article 23-A 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

70. The acts and practices of Defendants alleged herein were fraudulent and deceptive in violation of General Business Law § 349.

FIFTH CAUSE OF ACTION

71. The acts and practices of the Defendants alleged herein constitute conduct proscribed by 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.

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

WHEREFORE, Plaintiff demands judgment against 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 and Section 349 of the General Business Law or proscribed by section 63(12) of the Executive Law;

B. That the individual defendants be permanently restrained and enjoined from directly or indirectly engaging in the sale, offer to sell, purchase, offer to purchase, promotion, negotiation or distribution of any securities;

C. That Defendants and any of their agents or others acting on their behalf be restrained and enjoined permanently from allowing market timing in any PBHG mutual funds or any other funds managed by Defendants;

D. That Defendants, pursuant to GBL § 353(3), GBL § 349 and Executive Law § 63(12), disgorge all fees earned during the period of time illegal activity was permitted, disgorge all profits obtained from their illegal activities, and pay all restitution and damages caused, directly or indirectly, by the fraudulent acts complained of herein;

E. That Defendants pay penalties pursuant to GBL § 350-d;

F. That Defendants pay costs; and

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

Dated: New York, New York
November 20, 2003

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