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INVESTMENT ADVISER SETTLES SEC AND NEW YORK ENFORCEMENT ACTIONS RELATING TO MARKET TIMING, SELECTIVE DISCLOSURE

[17706] June 24, 2004 TO: BOARD OF GOVERNORS No. 46-04 COMPLIANCE ADVISORY COMMITTEE No. 64-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 63-04 SEC RULES MEMBERS No. 92-04 SMALL FUNDS MEMBERS No. 72-04 RE: INVESTMENT ADVISER SETTLES SEC AND NEW YORK ENFORCEMENT ACTIONS RELATING TO MARKET TIMING, SELECTIVE DISCLOSURE The Securities and Exchange Commission has issued an order making findings and imposing disgorgement, penalties, and compliance and mutual fund governance reforms in an enforcement proceeding against a registered investment adviser to a group of mutual funds ("Funds").1 The adviser consented to the entry of the SEC Order without admitting or denying the SEC's findings. In addition, the Attorney General of New York announced a settlement with the adviser of related state charges.2 Both actions involved allegations that the adviser (1) wrongfully permitted select investors to engage in extensive short-term trading in the Funds and (2) repeatedly disclosed to a brokerage firm the Funds' portfolio holdings, which at the time of disclosure were material nonpublic information. The settlements are summarized below.3 1 See In the Matter of Pilgrim Baxter & Assoc., Ltd., SEC Release Nos. IA-2251 and IC-26470, Admin. Proc. File No. 3- 11524 (June 21, 2004) ("SEC Order"). The SEC Order also censures the adviser and imposes a cease and desist order. Copies of the SEC Order and accompanying press release are available at http://www.sec.gov/litigation/admin/ia- 2251.htm and http://www.sec.gov/news/press/2004-84.htm, respectively. 2 See Pilgrim Baxter Settles Market Timing Case (press release issued by Office of NY State Attorney General Eliot Spitzer, June 21, 2004), available at http://www.oag.state.ny.us/press/2004/jun/jun21a_04.html. A copy of the settlement document (entitled an Assurance of Discontinuance) is available at http://www.oag.state.ny.us/press/2004/jun/jun21a_04_attach1.pdf. 3 According to the press releases issued by both regulators, litigation is continuing against Gary L. Pilgrim and Harold J. Baxter, the two founders of the adviser. 2 I. SEC Order A. Findings The SEC Order finds that from at least June 1998 through December 2001, the adviser permitted a select group of investors to trade rapidly in and out of certain Funds, contrary to disclosures in the Funds' prospectuses limiting investors' ability to exchange Fund shares. According to the SEC Order, the detrimental market timing was exacerbated by self-dealing by the two founders of the adviser, who formerly served as its President and as its Chairman and Chief Executive Officer ("former executives"). The SEC Order finds that the adviser permitted a hedge fund in which the former President had a substantial interest to engage in rapid

trading of a Fund that the President himself managed. It states that the former President sought and received the approval of the former Chairman and CEO for this trading arrangement, but that neither informed the Funds' board of trustees ("Board") of the arrangement. The SEC Order further finds that, from as early as 1998 and up to as recently as September 2003, the adviser, acting through the former Chairman and CEO, provided material, nonpublic information consisting of 30-day stale Fund portfolio holdings to a brokerage firm headed by a personal friend of the former Chairman and CEO. It states that customers of the brokerage firm used the information to facilitate market timing of the Funds and to exercise hedging strategies through other financial and brokerage institutions. Finally, the SEC Order finds that when the adviser decided in mid-2001 to limit market timing activity in the Funds, it terminated the trading privileges of all identified timers except for those of the hedge fund and the brokerage customers described above, whose privileges were not terminated until several months later. As a result of the conduct generally described above, the SEC Order finds that the adviser willfully violated: • the antifraud provisions of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, by failing to disclose to the Board that the former executives were: (1) engaging in potentially self-dealing, short-term securities trading; (2) permitting market timing in the Funds contrary to their prospectus disclosures; and (3) disclosing material nonpublic information to a broker whose customers were market timing the Funds; • Section 204A of the Advisers Act, by providing, through one of the former executives, nonpublic information regarding current portfolio holdings, valuations and transactions; and • Section 34(b) of the Investment Company Act of 1940, by making material misstatements and omissions in the Funds' prospectuses regarding limitations on exchanges into certain of the Funds. B. Remedial Efforts and Voluntary Undertakings In determining to accept the settlement offer, the SEC considered the cooperation that the adviser afforded the SEC staff and the efforts voluntary undertaken by the adviser and the Funds, which generally include the following: 3 Specific Actions and Internal Reviews • Upon the adviser's determination that the continued association of the former executives was not in the best interests of the adviser or the Funds, the two individuals resigned all positions with the adviser, its related entities, and the Funds. • The adviser separated the offices of Chairman and CEO and appointed new individuals to each post, with the new CEO being an individual previously unaffiliated with the adviser. The Board was restructured so that each current trustee is independent. • The Board retained special counsel to advise it and the Funds with respect to regulatory inquiries regarding market timing and late trading issues. • The adviser hired an additional attorney and additional compliance officer to assist in monitoring its compliance with the federal securities laws, including monitoring compliance and enforcement of the adviser's code of ethics. • The Board instructed its legal counsel to review and advise on the design and enactment of certain reforms proposed by the adviser, including: (1) policies to strengthen the adviser's capacity to prevent market timing of the Funds; (2) adoption of an enhanced code of ethics governing all of the adviser's employees; (3) a prohibition on employee investment in hedge funds or limited partnerships without certain certifications or information that will allow the adviser to assure itself that the employee does not have a conflict of interest; (4) enhanced reporting requirements for all employee accounts holding Fund shares; (5) certain fair value pricing procedures; and (6) a new policy on the disclosure of portfolio holdings. • The Board retained outside legal counsel to oversee an internal review of past trading practices in the Funds. Counsel reported the findings to the Board and made a presentation of the findings to the SEC staff. • The adviser retained an independent accounting firm to review its internal controls and procedures under SAS 70, with the findings to be provided to the Board. Fund Governance Policies and Procedures • At least 75% of the trustees of each Fund will be independent. • The chairman of the board of trustees of each Fund will be independent. • Any counsel to the independent trustees of

a Fund will be an “independent legal counsel,” as defined under the Investment Company Act. • No action by a Fund board will be taken without the approval of a majority of the independent trustees. Any action opposed by a vote of one or more of the independent 4 trustees, together with the reason for the opposing vote(s), will be disclosed in Fund shareholder reports. • Commencing in 2005, each Fund will hold a shareholder meeting to elect its board of trustees at least once every five years. • Effective August 1, 2004, the Funds will comply with Rule 38a-1 under the Investment Company Act. Ongoing Cooperation • The adviser will cooperate fully with the SEC in any investigations, litigations or other proceedings relating to or arising from matters described in the SEC Order and/or set forth in the SEC’s complaint. • In connection with such cooperation, the adviser has agreed, among other things, to waive, upon written request from the SEC staff, any evidentiary privileges or protections from discovery in connection with (1) the matters described in the SEC Order and/or set forth in the SEC’s complaint or (2) any internal investigation of such matters. C. Required Undertakings The SEC Order also sets forth the following required undertakings: General Compliance • The adviser will maintain a Code of Ethics Oversight Committee responsible for all matters relating to issues under the adviser’s code of ethics. The adviser will report to the Chief Compliance Officer (“CCO”) of the Funds at least quarterly on issues arising under the code of ethics, including all violations of the code. Any material violations of the code will be reported promptly to the CCO. • The adviser will establish an Internal Compliance Controls Committee. The Funds’ CCO will be invited to participate in all meetings of the committee. The committee will report to the Audit Committee of the Board at least quarterly on internal compliance matters. • The adviser will provide to its Audit Committee the same reports of the Code of Ethics Oversight Committee and the Internal Compliance Controls Committee that it provides to the Audit Committee of the Board. • The responsibilities of the adviser’s CCO will include matters related to conflicts of interest. 5 • The adviser’s CCO will report to the independent trustees at least quarterly any breach of fiduciary duty or the federal securities laws of which the CCO becomes aware. Any material breach will be reported promptly. • The adviser will establish a corporate ombudsman to whom its employees may convey concerns about ethics matters or questionable practices. The adviser must review any matters brought to the ombudsman’s attention, along with any resolution of such matters, with the independent trustees with such frequency as the independent trustees may instruct. • Effective August 1, 2004, the adviser will comply with Rule 206(4)-7 under the Advisers Act. Disgorgement, Civil Penalties, and Other Sanctions • The adviser will pay $40 million in disgorgement and a civil money penalty of $50 million. • Independent Distribution Consultant – Within 30 days of the SEC Order, the adviser must retain an Independent Distribution Consultant acceptable to the SEC staff and to the majority of the independent trustees. The consultant will develop a plan to distribute the total disgorgement and penalties ordered to compensate the funds’ shareholders for losses attributable to market timing activity during the relevant period. The Independent Distribution Consultant must submit the distribution plan to the adviser and the SEC staff within 100 days of the SEC Order. Following the issuance of an SEC order approving a final plan of disgorgement, the Independent Distribution Consultant and the adviser must take all necessary and appropriate steps to administer the final plan. • Independent Compliance Consultant – Within 30 days of the SEC Order, the adviser must retain an Independent Compliance Consultant acceptable to the SEC staff and to the majority of the independent trustees to conduct a comprehensive review of its supervisory, compliance, and other policies and procedures designed to prevent and detect breaches of fiduciary duty, breaches of the code of ethics, and federal securities law violations by the adviser and its employees. The review must include, but not be limited to: (1) the adviser’s market timing controls across all areas of its business; (2) pricing practices that may make the Funds

vulnerable to market timing; (3) utilization by the Funds of short-term trading fees and other controls for deterring excessive short term trading; (4) the adviser's policies and procedures concerning conflicts of interest, including conflicts arising from advisory services to multiple clients; and (5) the adviser's controls with respect to preventing misuse of material nonpublic information. The Independent Compliance Consultant must complete its review and provide its recommendations in a report to the adviser, the Board, and the SEC staff no more than 120 days after the entry of the SEC Order. 6 • Periodic Compliance Review – At least once every three years, commencing in 2006, the adviser must undergo a compliance review by a third party that is not an interested person of the adviser. The third party must issue a report of its findings and recommendations to the Internal Compliance Controls Committee and the Funds' CCO. • Certification – No later than 24 months after the entry of the SEC Order, the adviser's CEO must certify to the SEC in writing that the adviser has fully adopted and complied in all material respects with the required undertakings and the recommendations of the Independent Compliance Consultant, or must describe any material non-adoption or non-compliance. • Recordkeeping – Any record of the adviser's compliance with the required undertakings must be preserved for at least six years from the end of the fiscal year last used, the first two years in an easily accessible place. II. Settlement of State Charges The complaint by the Attorney General of New York, which contained factual allegations that generally mirror those in the SEC Order, charged the adviser and the former executives with fraudulent conduct and breaches of fiduciary duty in violation of New York's Martin Act and other statutes. The adviser, without admitting or denying the allegations of the complaint, agreed to the entry of an Assurance of Discontinuance to resolve the charges against it. The Assurance of Discontinuance imposes a cease and desist order on the adviser and generally requires the following: • Disgorgement and Penalties – The adviser will pay disgorgement and penalties in the amounts and manner set forth in the SEC Order. • Reduction in Advisory Fees – The adviser will reduce the advisory fees charged to the Funds (except any money market fund) by at least $2 million per year for five years. According to the Attorney General's press release, this will constitute a 3.16% reduction. • Restrictions on the Adviser's Management of the Funds – On or after October 1, 2004, the adviser generally may manage or advise a Fund only if, among other things: o The Board has at least 75% independent trustees and an independent chair. o The Board hires and retains a full-time senior officer, reporting exclusively to the Board, to monitor compliance and establish a process to ensure that the proposed management fees to be charged to the Fund are reasonable, negotiated at arm's length, and consistent with the Assurance of Discontinuance. The senior officer may also function as the Fund's CCO, provided that he or she is not otherwise an employee of the adviser. 7 o The reasonableness of fees is determined by the Board through either competitive bidding (which must include at least three sealed bids) or an annual independent evaluation that considers factors including: (1) the level of fees charged to institutional investors for like services; (2) the level of fees charged by other mutual funds for like services; (3) the costs of providing services; and (4) the profit margins of the adviser and its affiliates. o The Fund and the adviser publicly disclose a reasonable summary of any independent evaluation conducted in connection with the renewal of the Fund's advisory contract within 15 days of the Board's determination of management fees. The summary must contain data regarding the factors considered in the evaluation and sufficient specifics so that a reasonable investor can make an informed decision regarding the reasonableness of the fees, but the summary does not have to include confidential, competitively sensitive data. Public disclosure must include at least: (1) continuous, prominent posting on the adviser's website of the two most recent summaries; (2) inclusion of the most recent summary in the Fund's prospectus; and (3) prominent notice in shareholder account statements of the summary's availability. • Actual Cost Disclosures – In an easy-to-

understand format, the adviser must disclose: o in periodic account statements, the fees and costs in actual dollar amounts charged to each investor based upon (1) the investor's most recent quarterly closing balance and (2) a hypothetical $10,000 investment held for 10 years, assuming an annual return of 5% and continuation of the reduced management fee rates required by the Assurance of Discontinuance, and showing the impact of such fees and costs on fund returns for each year and cumulatively. o in the Fund's prospectus and on the adviser's website, the fees and costs associated with the hypothetical example described above. o on the adviser's website, a calculator that will enable an investor to calculate the fees and costs, in actual dollars and on a Fund by Fund basis, charged to the investor based on the investor's most recent quarterly closing balance. • Other Compliance Matters – The adviser will comply with the undertakings in the SEC Order relating to (1) maintenance of a Code of Ethics Oversight Committee, (2) establishment of a corporate ombudsman, and (3) periodic compliance reviews. • Cooperation – The adviser will cooperate fully and promptly with the Attorney General in any pending or subsequently initiated investigation, litigation (including the continuing action against the former executives) or other proceeding relating to market timing and/or the subject matter of the complaint. Among other things, such cooperation will include waiving, upon request by the Attorney General: (1) all privileges, including attorney-client and attorney work product privileges, with respect to all matters in the complaint through the date of its filing; and (2) all privileges relating 8 to any internal investigations concerning matters in the complaint, including production of all interview notes taken in connection with such investigations. Such cooperation also will include making outside counsel reasonably available to provide comprehensive presentations concerning any internal investigation relating to all matters in the complaint and to answer questions. Rachel H. Graham Assistant Counsel

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