# Massachusetts and Vanguard Group reach interesting settlement that gives the $8-trillion manager a shot at avoiding 49 copycat suits , quick cash for the state and 65% of a loaf for hapless investors

The William Galvin-driven settlement covers the state's legal fees and sets up restitution fund and a state pay-out, but a pending Pennsylvania lawsuit is likely the first of many to follow.

**Author** **Oisin Breen** July 7, 2022 at 10:22 PM

**0 Comments**

William Galvin: Vanguard's deliberate decision [benefited] ultra-wealthy shareholders over main street investors.

> ***Brooke's Note: This week we learned Schwab will appease the SEC with $187 million. It took Vanguard all of $6.25 million. But you might just get what you pay for. Schwab is now well and truly out of the woods. Vanguard will have to wait and see what the SEC and/or the other 49 states not named Massachusetts choose to pursue. In both cases the payouts stem from strategic actions by the two firms competing hard and maybe in straight dollar terms the penalty chugs are worth it.***

The Vanguard Group just sealed a $6.25 million settlement with Massachusetts securities regulators over tax bills leveled at thousands of its unwitting target-date fund (TDF) investors.

Yet, the Malvern, Pa. manager of roughly $8 trillion may have also executed a masterwork of damage control by the way it crafted its deal with William Galvin, the aggressively litigious Massachusetts secretary of state.

"By acting as swiftly as it did, Vanguard has narrowed the potential outcomes should other states litigate, forcing them to accept a similar deal or look greedy, according to Bill Singer, attorney and writer of the Broke and Broker blog.

"In one fell swoop, Vanguard paid restitution to investors and settled the state investigation.

Bill Singer: Vanguard did not likely open a Pandora's Box.

"Given that damages are a key incentive for law firms on contingency, Vanguard did not likely open a Pandora's Box but may have implemented a fairly effective bit of damage control," he explains, via email.

The Massachusetts settlement also limits restitution to 65% of the tax liability any one person incurred as a result of Vanguard's failure to accurately ensure TDF investors understood potential tax events.

# Winning formula

Vanguard, which manages about $1 trillion of target of the industry's $3 trillion in target date funds, neither denied nor admitted wrongdoing.

Vanguard's failure to own up to its own mistakes will hurt it in the long run, says Daniel Wiener, via email, who publishes "The Independent Adviser for Vanguard Investors" newsletter. He is also chairman of RIA Adviser Investments in Newton, Mass.

"I found [its] response completely tone deaf. Vanguard should have admitted it was guilty of a bad move ... taken care of it, and come out looking like it was the good guy."

Maybe so, but Vanguard could just as easily have contested the issue, and it could very easily have won, counters Singer.

"Massachusetts' contention Vanguard 'surely had a duty to warn their investors' … may not stand up … [and it is unclear] whether the capital gains … was unforseeable [to investors]," he explains.

"I don't think it's unfair to say [they] were either cavalier or clueless," says the Massachusetts secretary of state.

Daniel Wiener: Cavalier or careless, it was ham-handed.

"Galvin's comments point to the fact that either Vanguard knew what the consequences of its actions would be, but didn't care enough to let investors know, or failed to realize them at all ... not a good look," adds Ari Sonneberg, a partner at the Wagner Law Group in Boston, via email.

## Doing penance

Vanguard itself signaled that settling with Massachusetts means the worst is behind it.

"We are glad to put this matter behind us and avoid the cost and distraction of a protracted process," its spokesman told RIABiz, via email.

Ron Surz: [Vanguard was] courting the giants and expecting the peons to accept.

It was the same line it issued to the Wall Street Journal, which broke the story yesterday (July 6).

The settlement follows a January-launched Massachusetts investigation into how a Vanguard fee rejig forced some higher fee TDFs to cover outflows by selling assets -- generating capital gains -- and how this hammered investors who unknowingly erred by placing TDFs in taxable accounts.

But Sonneberg says Vanguard is likely to do more penance at the hands of other states with capital gains taxes and perhaps the federal Securities and Exchange Commission (SEC) -- especially after all of Massachusetts' legwork to secure a settlement.

"[States] now know there is a winning formula," he says.

"It's hard to imagine, especially now that Massachusetts has written the playbook, that other states won't jump on the bandwagon," says Sonneberg, who estimates Vanguard could eventually face "hundreds of millions" of dollars in payouts over the issue.

# Big footing

But Singer disagrees.

"There could be a pile-on effect, but it would be depicted as such, and the publicity value that drives many state regulators would be lessened," he adds.



The SEC could pursue a federal action to gain an omnibus settlement, Sonneberg says. The regulator declined to comment.

"States [may also be] obligated to pursue this issue," he says.

At least one Federal District Court, for the Eastern District of Pennsylvania, has already launched its own investigation.

Ari Sonneberg: [States] now know there is a winning formula.

"Vanguard hurt its smaller, taxable investors, so that it could favor its larger retirement plans," says Jonas Jacobson, partner and counsel for the law firm of Dovel & Luner, in a March statement on behalf of the Pennsylvania investors.

The big-footing narrative was also part of Galvin's comments to to the WSJ.

"Firms should be putting retail investors first when making management decisions, and Vanguard failed to do that in this case," Galvin said.

"These extraordinary capital gains were caused by Vanguard’s conscious decision to benefit ultra-wealthy shareholders over main street investors," Galvin said.

# Payouts

The $6.25 million settlement money isn't chicken feed.

"[It] was a real windfall for Massachusetts. First, it retain[s] the taxes collected as a result of Vanguard's [TDF] actions; second it recover[s] the cost of pursuing action ... and finally it gets to look like a hero," Sonneberg says.

In Massachusetts, alone, more than 5,500 taxable accounts received distributions from Vanguard TDF’s, the WSJ reported.

Paid through Vanguard subsidiary Vanguard Marketing Corp., the settlement also includes a $500,000 payout to the state of Massachusetts and a $250,000 payment to support the new fund's administration.

## Fund arcana

The issue traces back to Dec. 2020, when Vanguard reduced the minimum investment in its institutional TDFs to $5 million from $100 million, a move that ultimately led to the Massachusetts and Pennsylvania investigations.

As a result, major corporate retirement plans swiftly moved their assets out of Vanguard's bread-and-butter TDFs and into the cheaper institutional TDFs.

Tailored for tax-deferred accounts, TDFs bundle together stocks, bonds and cash, then reduce their equity exposure as investors near retirement.

Jonas Jacobson: Vanguard hurt its smaller, taxable investors.

Vanguard's 2035 and 2040 TDFs then posted collective outflows of $15 billion, falling to $38 billion and $29 billion in managed assets (AUM), respectively, by year end 2021.

"[It was a] gimmick Vanguard used … to lure investors out of competing products, without providing any notice about possible tax consequences [for retail] investors," Sonneberg explains.

"[Vanguard was] courting the giants and expecting the peons to accept," says Ronald Surz, president of Target Date Solutions, a research boutique in San Clemente, Calif.

## Failure to communicate

The fall in AUM across a number of Vanguard TDFs forced it to sell some of each fund's holdings -- up to 15% in one case.

The sales then triggered "higher than usual long- and short-term capital gains," which Vanguard distributed to the funds' remaining shareholders, according to a memorandum of understanding reviewed by the WSJ.

Vanguard has undergone a personality shift since the late Jack Bogle (pictured) stepped down in 1999.

Yet, thousands of Vanguard TDF investors failed to understand it built the set-and-forget funds specifically for tax-deferred retirement accounts. Nor did Vanguard go out of its way to ensure they understood.

Prior to the settlement, Vanguard's main TDF webpages did not state that the funds were unsuitable for taxable accounts. Its TDF prospectus only notes on page 10 that "distributions may be taxable".

Investors incurred tax bills as high as $150,000, the WSJ reported.

The three named plaintiffs in the Pennsylvania class action against Vanguard faced tax liabilities of $9,000, $12,000, and $36,000, as a result of the company's TDF rejig, InvestmentNews reports.

## Personality shift

Vanguard's "personality" is shifting toward a garden variety Wall Street amorality, according to at least one industry observer.

Examples of the change include its partnership with American Express, a growing active management business, at times rising fees, increased bonuses based on asset gathering and a lawsuit against a breakaway rep. See: Vanguard upshifts to more Wall Street-style exec-comp.

"Since Bogle stepped down and was forced off the board [in 1999], Vanguard has had expansion-minded leaders who ... have been getting into all manner of businesses ... forgetting that the core business and reputation around it is key," says Wiener.

McKinsey, the storied Boston.consultancy, has also played its part in pushing Vanguard to diversify its product lines and pursue higher margin businesses -- often in very unVanguardian places, like private equity. See: Vanguard Group's private equity retail push gets real.

McKinsey declined to answer if it influenced Vanguard over the TDF-fund fee changes.

"This was just a dumb mistake ... sloppy oversight ... [and] it wasn't that more people suddenly bought TDFs ... [but] Vanguard could have limited their sale to just IRA and 401(k) accounts and plans," says Wiener.

Vanguard used to prevent investors from putting municipal bond funds in IRAs, although the company has yet to answer if it still does, or why it did not prevent the inclusion of TDFs in taxable accounts.

In Sept. 2021, Vanguard rendered the problematic fee rejig meaningless by merging institutional and investor class TDFs. See: Vanguard promises to move a minor mountain next February to make its TDF prices more competitive.

"Had they just done that this whole thing would never have happened," says Wiener.

Vanguard has yet to answer whether it intends to advise current TDF clients to ensure they hold the funds in tax-deferred accounts. It has also yet to reveal when and how it plans to improve its disclosures over capital gains taxation linked to its TDFs.

# Rival silence

As part of its investigation into Vanguard, Massachusetts regulators contacted the top five TDF vendors, namely Vanguard, Fidelity Investments, Capital Group's American Funds, BlackRock, and T.Rowe Price.

Only Fidelity, T. Rowe and American Funds has responded to the request. Fidelity did not comment. American Funds says 99% of its TDF assets are in tax-deferred accounts.

T. Rowe says that it has disclosures and systems in place to avoid harming target-date fund investors

"With respect to client communications, our Personal Investing website notifies investors that share price, principal value, yield, and return will vary, and that investors may have a gain or loss when they sell shares.

"Our fund prospectuses also include detailed information regarding the impact the fund’s dividend or capital gain distributions can have on a taxable account. Also note that a significant portion of T. Rowe Price’s target date assets under management are held in target date trusts, and these are all in tax-advantaged accounts. As always, we continue to look for opportunities to further improve our communications with our shareholders."

T. Rowe's declined to say what percentage TDF assets are in retail or taxable accounts other tyhan to day it is "very small."

The Massachusetts regulator has yet to clarify whether the other four 'top five' TDF vendors, excluding Vanguard, remain under investigation. Nor has the regulator answered its peers in other states have asked for its playbook.

"It would be wise for [TDF vendors] to ensure that they are providing adequate disclosures to investors," says Sonneberg.

## Different priorities

Galvin and Sonneberg say the Vanguard TDF imbroglio is the result of either negligence or ignorance.

"Cavalier or careless, it was ham-handed. Vanguard should have owned up and fixed it," says Wiener.

This settlement will only add to Galvin's legend -- despite a potential recent setback against Robinhood.

"While Galvin may have been a bit red-faced when his case against Robinhood got tossed, I don't think he has much to prove to voters in Massachusetts – he's handily won every Secretary of the Commonwealth election he's ran in the last couple of decades." Sonneberg says.

"He also had a recent win in a case against MassMutual that was widely publicized.  Most elected officials operate with the notion that they are playing to an audience – Galvin is no different.

"His suit against Vanguard is very much in line with his general MO and likely appeals to the Massachusetts electorate which tends to be on the liberal side of things."

Dublin-native and Edinburgh-based Oisín Breen has spent seven years writing about finance, including five whirlwind years diving into the advisor world for RIABiz. A widely published and well regarded poet with two full collections under his belt, Breen is also an academic in English Literature with a deep fondness for his Scottish rabbit, Hessell. @Breen

RIA Compliance

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## Karin Risi, who built $170-billion Vanguard Personal Advisor Services, takes new role and Matt Benchener is taking her spot as head of US retail for the $6.3 trillion manager

Risi now heads planning and still directly reports to CEO Tim Buckley and her 34 year-old understudy, Benchener gets her job at year's end.

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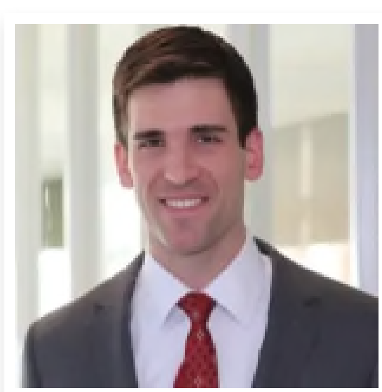
# Vanguard Group's private equity retail push gets real as it launches buyer-beware products this summer to its brokerage accounts as prelude to selection for 'suitability' through its RIA

The $7.1 trillion Malvern, Pa., manager will first sell HarbourVest private shares with stern warnings before making alts part of Vanguard Personal Advisor Services portfolios

**Author** **Brooke Southall** May 25, 2021 at 10:42 PM

2 Comments



Matt Benchener: Investors who can access high-quality, broadly diversified strategies with top private equity managers can potentially realize significant financial benefits.

> ***Brooke's Note: Virtually every asset manager and RIA owner has had some form of Vanguard envy in the past dozen years. The $7-trillion firm gets respect, love and success by keeping things simple, cheap and honest -- and still outperforming with beta returns in a bull market. But apparently Vanguard sees greener grass in the Wall Street pasture and would like to graze its herd there part of the time in search of alpha. The question is whether Vanguard can use its culture, competency and scale to make private equity fulfill its long-sought destiny with mainstream high-net-worth investors. Or, will Wall Street create a backflow of its patented effluent and taint Vanguard's relatively pristine brand among RIAs and investors alike? Details are few but resolve is now evident. Vanguard is soon to purvey many private shares, with carefully chosen words about how it'll work out.***

Vanguard Group is set to private-label the private-equity funds of a $79-billion Boston alternative assets manager and peddle them to thousands of high-middlebrow private investors -- by way of its commission brokerage, for now, but soon to clients of its $231-billion RIA.

The strategy will initially be available this summer to eligible, non-advised Vanguard clients and is expected to be made available to eligible advised clients of Vanguard Personal Advisor Services (VPAS) in the near future, its release states.

It defines private equity as "any type of equity not sold on a public stock exchange." It says the market includes 7,200 companies with shares worth $3 trillion, or 6% of share value in global markets.

The $7.1 trillion Malvern, Pa., investing giant -- arguably both the nation's largest asset manager to RIAs and the largest RIA-style wealth manager -- is known largely for its branded piety.  Though it manages trillions in active assets, its Jack Bogle legacy relates mostly to selling ultra-cheap, ultra-liquid, ultra-diversified, ultra proprietary and ultra-transparent indexed portfolios.

Now its pitch is shifting toward Main Street hoi polloi as it touts "access" to HarbourVest funds for accredited clients of its $231-billion RIA.

“Over time we will expand access to this asset class, which has traditionally been reserved for the wealthiest investors, to the many qualified investors at Vanguard,” said Vanguard CEO, Tim Buckley in a release.

John Toomey: 'HarbourVest has long supported democratizing private markets.'

## Hands off

Vanguard is more than sanguine about private equity, according to Matt Benchener, managing director of Vanguard Retail Investor Group.

“Our extensive private equity research suggests that investors who can access high-quality, broadly diversified strategies with top private equity managers can potentially realize significant financial benefits over long time horizons.”

Josh Charlson: 'The notion of 'hedge funds for the masses' is hardly new.'

Yet, private equity can be perilous in high doses, Morningstar's Josh Charlson writes in a Morningstar column: The (Limited) Case for Investing in Alternatives

"Unlike the 30%-plus allocations to alternatives seen with many endowments, or the 15% to 20% allocations typical of pension funds, individuals would be better off restricting allocations to the 3% to 10% range--enough to have some impact on the portfolio but not so high as to potentially imperil the portfolio."

That said, it's buyer beware, for now.

"The decision to invest in the HarbourVest funds will be the sole responsibility of such self-directed clients, and no Vanguard entity will determine the suitability of investments in any HarbourVest fund or otherwise make investment recommendations to Vanguard’s self-directed clients," the company warns.

When VPAS uses discretion to place private equity into accounts, multiple internal entities will participate in the process.

"Advised clients of Vanguard’s Personal Advisor Services will be able to access HarbourVest funds through Vanguard National Trust Company," its release states. "Vanguard National Trust Company will assess the suitability of any recommendations to PAS clients to invest in the HarbourVest funds."

# Democratizing markets



Vanguard follows Fidelity and Schwab in providing upmarket access to private equity through iCapital. See: No sooner does Lawrence Calcano raise $146 million than he buys rival Artivest -- then Wells Fargo alts service -- capping iCapital's 500%-plus run on alternatives 'platform' to $58 billion -- with almost every wolf on Wall Street chipping in

In the same Vanguard release, John Toomey, managing director of HarbourVest Partners, also touts the importance of providing downmarket investors with "access" to upmarket products.

“HarbourVest has long supported democratizing private markets, and we are pleased to enter into this next phase with Vanguard by broadening access to qualified individual investors,” he said.

HarbourVest bringing access to alternative investments is not totally the same as Thomas Jefferson bringing individual liberties to American colonists. See: Fidelity dumps two liquid alts managers after they fail to deliver the vaunted 'hedge effect' in stormy markets

"The notion of 'hedge funds for the masses' is hardly new," wrote Charlson in his column.

"The boom in liquid, alternative mutual funds after the 2008 financial crisis was supposed to provide individual investors with a tantalizing opportunity to access the same types of strategies typically reserved for institutions and the ultra-wealthy, all at a fraction of the cost and with increased transparency and liquidity."

# Dodging land mines

A Vanguard spokesman declined to be interviewed for this article and said the release contained all the information Vanguard will supply, for now.

Vanguard also declined to comment on the fee expense of its private equity investments -- even a range -- citing the way private placement fees vary.

"Given the nature of private placements, specific fee details cannot be legally disclosed," Vanguard spokesman Charles Kurtz says.

Vanguard's research report on private equity says the cost may be 600 basis points annually when all factors are considered. The HarbourVest ADV2 shows it charges up to 125 basis points and as low as zero.

William F. Sharpe developed the Sharpe ratio to measure return versus risk.

Buckley is careful not to promise better returns -- at least not anytime soon.

“Private equity has the potential to improve long-term investment outcomes of a broadly diversified portfolio,” he noted.

That said, Vanguard will only give investors better "outcomes" by dodging landmines private equity is notorious for, including higher expenses, lower liquidity and limited transparency -- and leaning heavily on a third-party subadvisor.

Vanguard's release disputes the notion that collaborating with a subadvisor is a drawback.

"Vanguard has a long and successful history of partnering with the world’s premier external advisory firms to help fulfill its mission of giving investors their best chance for investment success," it says.

"This tradition continues through the firm’s strategic relationship with HarbourVest, one of the industry’s most experienced and successful private equity providers."

## Uninspiring data

Indeed, if history is any guide, Vanguard faces headwinds in using private equity for better outcomes, wrote Charlson in a Morningstar column that followed Vanguard's first announced use of alts for institutional client portfolios.

"The story told by the available data is, at best, uninspiring," he writes.

That said, alternative investments advocates say that achieving absolute higher returns is not necessary for "better outcomes." Because alts are not part of the public securities markets, they trade to the beat of their own drummer.

But Morningstar data finds scant evidence that alternative investments are even that effective as low-correlation portfolio insurance.

"The only category to beat that benchmark's Sharpe [ratio] (admittedly, a strong period for stocks and core bonds) was the nontraditional bond category," he writes.

"Several of the alternative categories produced negligible or even negative Sharpe ratios, disappointingly including lower-correlation areas such as managed-futures and market-neutral."

Fran Kinniry writes the case is strong for private equity.

The Sharpe ratio was developed by Nobel laureate William F. Sharpe to help investors understand an investment's return compared to its risk. The ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk.

Volatility is a measure of the price fluctuations of an asset or portfolio, according to financial references.

## Balancing act

This past February, Vanguard published a white paper titled The Case for Private Equity. It "suggests" buying private equity can achieve "benefits."

"Vanguard believes the investment case for private equity is strong," authors Fran Kinniry, Ted Dinucci, Alex Green and Liz Foo write in the executive summary.

"Private equity represents a distinct and growing segment of world equity markets that, because of its significant illiquidity and other market dynamics, offers suitable investors the opportunity to earn long-term excess returns while increasing portfolio diversification."

Brooke lives on a houseboat, works in an office and juggles calls across the five time zones and four countries his small team works. He's out to prove an economic major can make a living as a journalist and that articles need not be a loss leader if they are written well and geared to an intelligent readership. @RIABiz

The Vanguard Group

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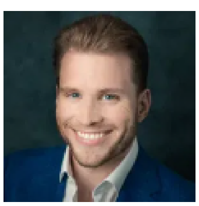

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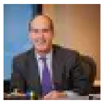

### Jamie McLaugthlin

May 26, 2021 — 10:26 AM

Sad, actually. Even the estimable Vanguard Group, can't find enough earwax to muffle the siren calls of the manufacturing and distribution complex.

### Jarshman

May 26, 2021 — 2:58 PM

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