



ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments



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Vanguard Faces Whistleblower Lawsuit

Toward the end of July, a lawsuit filed by a former Vanguard employee in May 2013 accusing the firm of avoiding \$1 billion in federal taxes and \$20 million in New York state taxes over the last decade was made public. Vanguard denies the validity of the complaint, but if the case does have merit, it could threaten the firm's "at-cost" operating structure, potentially resulting in higher fees on the company's mutual funds.

The thrust of the suit is that Vanguard has illegally benefited from paying below-market rates for services related to running its family of mutual funds, and that the purpose behind the at-cost structure is specifically to avoid paying taxes that other competing fund families face on fees collected from clients and assets managed.

As you may know, Vanguard has a unique structure in the mutual fund industry—it was set up in such a way that the mutual funds (and their shareholders) own the company (the SEC approved of this arrangement in an exemptive order). The driving purpose behind this mutual ownership organization is to allow the funds to charge lower fees than others in the industry by using profits to defray the cost of management fees. That focus on lower costs (and index funds) has helped turn Vanguard into the \$2.8 trillion giant of the mutual fund world it is today.

For what it's worth, the New York State Attorney General passed on the case, leaving it to the whistleblower and his attorney to file the suit with the New York Supreme Court themselves. The former Vanguard employee who filed the lawsuit, a corporate tax lawyer, would be eligible to receive up to 30% of any settlement or money recovered from the firm should his suit be successful.

While we do not have the expertise nor enough information to pass judgment on the legitimacy of the lawsuit, the charge could have serious repercussions for Vanguard and the mutual fund industry as a whole. As mentioned above, if it is found that the firm has somehow been abusing its SEC status and is subject to higher taxes and greater operating expenses as a result, those costs could be passed on to investors, and the firm might lose its

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edge as *the* low-cost fund provider. It would also deal the company's ethical credibility a significant blow as well.

We'll be keeping a careful eye on this developing story. However, even if Vanguard is found liable, we do not believe it will affect the quality of its funds, and would expect the firm to do its utmost to continue to set the industry standard for costs.

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