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FAIR GAME

Hedge Fund Kept U.S. Inquiry Quiet

By **Gretchen Morgenson**

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In the volatile world of high finance, hedge funds come and hedge funds go. So there was little fanfare last week, apart from a few upset investors, when Vertical Capital, with \$1.4 billion under management, suddenly announced it was unwinding its \$400 million hedge fund operation.

Behind the scenes, however, is a troubling Wall Street story, redeemed, in part, by a whistle-blower who was not willing to go along with what she viewed as dubious business practices.

In a letter to investors sent during the evening of Dec. 2, Vertical said it was negotiating with the Securities and Exchange Commission to settle a civil securities fraud case against its founder, Brett Graham, and its related brokerage firm, VCAP Securities. The commission concluded that VCAP, overseen by Mr. Graham, violated securities laws when it liquidated five collateralized debt obligations in 2012, the letter said. The broker made improper bids during the liquidations because it was “in the possession of confidential information” that gave it “an unfair advantage over other bidders,” the letter said.

The letter said it expected the S.E.C. settlement to require VCAP to close and Mr. Graham to pay a fine and be barred from the industry for a period of time. The S.E.C. cited no violations by Vertical Capital.

Jonathan Gasthalter, a spokesman for Vertical, declined to elaborate on the S.E.C. investigation and did not make any of the firm’s executives available for comment. Vertical, based in Midtown Manhattan, was founded in 2002 by Mr. Graham, a longtime Bear Stearns executive. Until 2006, Bank of America was a minority investor in Vertical.

In addition to its hedge fund, Vertical is a manager of collateralized debt obligations that contain bundles of mortgage loans. As a manager, Vertical decides which loans are bundled into the securities.

Not surprisingly, some of Vertical's C.D.O.s didn't do so well in the mortgage mess. One featured in the fraud case filed last year by the Justice Department against Standard & Poor's, the credit rating agency. Vertical was the collateral manager overseeing a \$1.5 billion deal in early 2007, the lawsuit said. Citibank invested \$15 million in a piece of the security that was rated AAA by S.&P.; six months later, the C.D.O. collapsed and Citibank lost its entire investment, the Justice Department said.

Vertical is registered with the S.E.C. as an investment adviser and counts mostly institutional investors as clients, regulatory filings show. According to a recent Vertical pitch book, its hedge fund operation has performed well. The composite net return for various funds was 377 percent for the period beginning in October 2009 and ending in August. (Vertical prepared the returns, a footnote stated, and they were not independently verified.)

But the hedge fund world is a crowded place, and hoping to drum up new investors, Vertical hired Miriam Freier as director of marketing and investor relations in June 2013. In an interview last week, Ms. Freier said she traveled extensively introducing investors to Vertical's funds; within a year, she had brought in \$50 million. Another investor was preparing to invest \$25 million.

But in September, Ms. Freier said, she received disturbing information from a prospective Vertical investor. As part of his due diligence, the investor filed a Freedom of Information Act request with the S.E.C. about the firm. The commission responded with a letter declining to provide the requested information because Vertical was under investigation.

This was news to Ms. Freier, whose job it was to keep Vertical's clients up on firm developments.

"I emailed the partners of the firm and said, 'What is going on?' " she said in the interview. "They started slowly disclosing things to me but not to any other employees."

Brett Graham is the founder of Vertical Capital.
Sam Bolton/PatrickMcMullan.com, via AP Images



She offered to speak with the S.E.C. and with investors to fulfill what she believed were the firm's disclosure duties. But her superiors warned her not to tell anyone about the investigation until the firm's negotiations with the S.E.C. were completed.

Weeks passed. Ms. Freier said she felt angry about having to live a lie in her job. By November, she was out of patience. "I didn't want to be there anymore," she said.

The company asked her to stay on until mid-February to help advise investors about the hedge fund's wind-down. Around Thanksgiving, Vertical offered her a separation agreement outlining pay terms and obligations.

The terms were unacceptable to both Ms. Freier and to Jonathan Sack, her employment lawyer at Sack & Sack. He asked the firm for additional pay for Ms. Freier and indemnification against any fines or judgments that might be awarded against her related to the regulatory problems.

Vertical refused and fired Ms. Freier on Dec. 3. She had already begun calling investors to tell them what she had experienced at the firm. Ms. Freier is also offering to give information about the firm to the S.E.C. as a whistle-blower.

Vertical is now treating Ms. Freier as a traitor. Of her requests for additional pay and indemnification, Mr. Gasthalter said: "After reaching a mutual agreement on an amicable separation, this disgruntled, now former employee sought to extort the company."

Lewis D. Lowenfels, a securities law expert in New York, said the situation at Vertical highlighted the importance of prompt disclosures by money managers today.

“At a time when whistle-blowing is widespread and encouraged by the S.E.C., investment advisers must be particularly careful to make timely and accurate disclosures of information that would be material to investors,” he said.

On the matter of timing, Mr. Gasthalter said, “Vertical Capital informed investors the day after receiving the initial draft of a proposed settlement from the S.E.C.”

Late last week, Mr. Sack sued Vertical on Ms. Freier’s behalf. “Thankfully, the whistle-blower protections of Dodd-Frank offer a remedy for victims of retaliation,” he said. “While I’m always surprised to see the ruthlessness of people in the workplace, in this instance, the acts of desperation and greed at the expense of my client’s career and reputation reach new lows.”

For her part, Ms. Freier said she was still absorbing what went on at Vertical. “Investors have a right to know when a firm is under an S.E.C. investigation that could result in the wind-down of a fund,” she said. “They also have the right to know if a key person making investment decisions on their portfolios could be at risk of being removed from the industry as a result of a settlement with the S.E.C.”

She added: “Investors are putting their trust in money managers not only to oversee their assets but also to communicate and be transparent about any issue which could potentially impact their investment.”

Vertical’s hedge fund investors, waiting to get their capital back, might agree.

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