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REPORT OF INVESTIGATION

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
OFFICE OF INSPECTOR GENERAL**

Case No. OIG-533

**Investigation of the Failure of the SEC's Los Angeles Regional
Office to Uncover Fraud in Westridge Capital Management
Notwithstanding Investment Adviser Examination Conducted
in 2005 and Inappropriate Conduct on the Part of Senior Los
Angeles Official**

October 26, 2010

REDACTION KEY

LE = Law Enforcement Privilege/Potentially
Harmful to Ongoing Litigation

EM = Examination Material

PII = Personal Identifying Information

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Introduction and Background

On March 15, 2010, the Securities and Exchange Commission ("SEC") Office of Inspector General ("OIG") received an anonymous complaint, detailing failures and inappropriate conduct concerning the investment adviser examination program at the SEC's Los Angeles Regional Office ("LARO"). The complaint alleged that [REDACTED] in the investment adviser examination program in the LARO, "instructed (and even bullied) examiners to not pursue certain red flags in an examination where the LARO exam staff uncovered a massive fraud." The complaint further stated [REDACTED] apparent motive for doing this seemed to be that he either performed or was materially involved in directing the most recent prior exam at the firm [that] did not uncover this giant fraud, although it may have existed at the time." The complaint identified the examination as involving "WG Trading Company/Westridge Capital Management" and the examiners as SEC Securities Compliance Examiners [REDACTED] and [REDACTED]. The anonymous complaint also alleged [REDACTED] lied to OIG investigators during testimony in a previous OIG investigation.

In addition, the complaint alleged that a hostile work environment existed at the LARO because LARO management did not aggressively discipline [REDACTED]

[REDACTED] The complaint also made wrongful employee termination claims.¹

The OIG found in its investigation that on February 25, 2009, the SEC filed an emergency action in the U.S. District Court for the Southern District of New York, obtaining an asset freeze and a temporary restraining order against Paul Greenwood ("Greenwood"), Stephen Walsh ("Walsh"), and their companies, WG Trading Company, L.P. ("WG Trading"), a registered broker-dealer, Westridge Capital Management, Inc.

¹ Because of their respective jurisdictions, the OIG and the SEC's office of Equal Employment Opportunity ("EEO") decided that the EEO office would have responsibility for investigating the hostile workplace and related-employment allegations in the anonymous complaint.

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("Westridge"), a registered investment advisor, and WG Trading Investors, L.P. ("WGTI"), an unregistered investment vehicle. According to the SEC Complaint, since at least 1996, Greenwood and Walsh solicited a number of institutional investors including educational institutions and public pension and retirement plans, by promising to invest their money in an enhanced equity index strategy. See SEC v. WG Trading Investors, L.P., *et. al.*, No. 09-1750 (SDNY filed Feb. 25, 2009) at Exhibit 1. However, instead of investing the money as promised, the complaint alleged that Greenwood and Walsh misappropriated as much as \$554 million in investor assets in the operation of a Ponzi scheme. *Id.*

The OIG investigated the allegations in the complaint, focusing on the failure of the LARO to detect the fraud at Westridge during its 2005 examination. We thoroughly analyzed the information that was uncovered by LARO examiners in 2005 and investigated whether additional work should have been undertaken to uncover the fraud, including why it was recommended that the 2005 investment advisor examination of Westridge be referred to the Boston Regional Office ("BRO") for an examination of the affiliated broker-dealer WG Trading, but no examination was conducted. The OIG also investigated the allegations against OCIE Supv. 4 to his interactions with examiners in connection with the 2009 examinations and his overall management style.

Scope of Investigation

The OIG obtained and reviewed the e-mail records of 11 former and current SEC employees, including all employees listed in the 2005 Westridge investment adviser ("IA") examination report and all employees listed in the 2009 Westridge IA examination report and WG Trading broker-dealer ("BD") examination report.

In all, the OIG searched over 68,000 e-mails. We obtained and reviewed e-mails for the period from January to May 2005 for all examiners who had any involvement with the 2005 Westridge IA examination. We also obtained and reviewed all e-mails for the period from February 2009 to August 2009 for examiners who worked on either the 2009 Westridge IA examination or the 2009 WG Trading BD examination.

In addition, on several different occasions, the OIG requested documents from the SEC's Office of Inspections Compliance and Examinations ("OCIE"). The documents requested and reviewed included the 2002, 2005, and 2009 IA examination reports for Westridge, the 2009 BD examination report for WG Trading, documents regarding OCIE's e-mail search for evidence of a referral to the BRO of the 2005 Westridge examination and the working file for the 2005 examination. The OIG carefully scrutinized and analyzed these documents, and consulted individuals within the OIG who have expertise in conducting OCIE examinations designed to uncover fraud.

The OIG also took the on-the-record testimony of the following 17 witnesses who had knowledge of the facts and circumstances surrounding the 2005 examination of

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Westridge, the 2009 examinations of Westridge and WG Trading, the possible examination referral to the BRO, and possible [OCIE Supv. 4] misconduct:

- (1) David Bergers, Regional Director, BRO, Securities and Exchange Commission; taken on May 10, 2010 ("Bergers Testimony Tr."). Excerpts of Testimony Transcript attached as Exhibit 2.
- (2) [OCIE Supv. 2] BRO Broker-Dealer Examination group, Securities and Exchange Commission; taken on May 10, 2010 [OCIE Supv. 3] Testimony Tr."). Excerpts of Testimony Transcript attached as Exhibit 3.
- (3) Lucile Corkery, Associate Regional Director, BRO Examination group, Securities and Exchange Commission; taken on May 10, 2010 ("Corkery Testimony Tr."). Excerpts of Testimony Transcript attached as Exhibit 4.
- (4) [SEC Empl. 2] BRO, Securities and Exchange Commission; taken on May 10, 2010 [SEC Empl. 2] Testimony Tr."). Excerpts of Testimony Transcript attached as Exhibit 5.
- (5) [Former SEC Supv. 1] BRO, Securities and Exchange Commission; taken on May 24, 2010 [Former SEC Supv. 1] Testimony Tr."). Excerpts of Testimony Transcript attached as Exhibit 6.
- (6) [OCIE Empl. 5] LARO Broker-Dealer Examination group, Securities and Exchange Commission; taken on June 17, 2010 [OCIE Empl. 5] Testimony Tr."). Excerpts of Testimony Transcript attached as Exhibit 7.
- (7) [OCIE Empl. 8] LARO Investment-Adviser Examination group, Securities and Exchange Commission; taken on June 17, 2010 [OCIE Empl. 8] Testimony Tr."). Excerpts of Testimony Transcript attached as Exhibit 8.
- (8) [OCIE Supv. 5] LARO Investment-Adviser Examination group, Securities and Exchange Commission; taken on June 17, 2010 [OCIE Supv. 5] Testimony Tr."). Excerpts of Testimony Transcript attached as Exhibit 9.
- (9) [OCIE Supv. 10] LARO Investment-Adviser Examination group, Securities and Exchange Commission; taken on June 17, 2010 ("[OCIE Supv. 10] Testimony Tr.") and June 25, 2010 ("[OCIE Supv. 10] Testimony Tr."). Excerpts of these Testimony Transcripts attached as Exhibits 10 and 11, respectively.
- (10) [OCIE Supv. 6] LARO Investment-Adviser Examination group, Securities and Exchange Commission; taken on June 18, 2010 ([OCIE Supv. 6] Testimony Tr."). Excerpts of Testimony Transcript attached as Exhibit 12.

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(11) [OCIE Empl. 4] LARO, Securities and Exchange Commission; taken on June 18, 2010 ([OCIE Empl. 4] Testimony Tr.). Excerpts of Testimony Transcript attached as Exhibit 13.

(12) [OCIE Supv. 11] Securities and Exchange Commission; taken on June 18, 2010 ([OCIE Supv. 11] Testimony Tr.). Excerpts of Testimony Transcript attached as Exhibit 14.

(13) Martin Murphy, Associate Regional Director of Regulation, LARO, Securities and Exchange Commission; taken on June 18, 2010 ("Murphy Testimony Tr."). Excerpts of Testimony Transcript attached as Exhibit 15.

(14) [OCIE Supv. 8] LARO Investment-Adviser Examination group, Securities and Exchange Commission; taken on June 21, 2010 ([OCIE Supv. 8] Testimony Tr.). Excerpts of Testimony Transcript attached as Exhibit 16.

(15) [Former OCIE Empl. 3] LARO Investment-Adviser Examination group, Securities and Exchange Commission; taken on June 21, 2010 ([Former OCIE Empl. 3] Testimony Tr.). Excerpts of Testimony Transcript attached as Exhibit 17.

(16) Rosalind Tyson, Regional Director, LARO, Securities and Exchange Commission; taken on June 25, 2010 ("Tyson Testimony Tr."). Excerpts of Testimony Transcript attached as Exhibit 18.

(17) [OCIE Supv. 4] LARO Investment-Adviser Examination group, Securities and Exchange Commission; taken on July 12, 2010 ([OCIE Supv. 4] Testimony Tr.). Excerpts of Testimony Transcript attached as Exhibit 19.

Relevant Statutes and Rules

The Commission's Conduct Regulation and Canons of Ethics

The Commission's Regulation Concerning Conduct of Members and Employees of the Commission (hereinafter "Conduct Regulation"), at 17 C.F.R. §§ 200.735-1 *et seq.*, sets forth the standards of ethical conduct required of Commission members and employees (hereinafter referred to collectively as employees). The Conduct Regulation states in part:

The Securities and Exchange Commission has been entrusted by Congress with the protection of the public interest in a highly significant area of our national economy. In view of the effect which Commission action

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frequently has on the general public, it is important that . . . employees . . . maintain unusually high standards of honesty, integrity, impartiality and conduct. . . [and] be constantly aware of the need to avoid situations which might result either in actual or apparent misconduct or conflicts of interest. . . .

17 C.F.R. § 200.735-2.

The Commission's staff has the obligation to continuously and diligently examine and investigate instances of securities fraud, as set forth in the Commission's Canons of Ethics. 17 CFR §§ 200.50, *et. seq.* The Canons of Ethics states that "[i]t is characteristic of the administrative process that the Members of the Commission and their place in public opinion are affected by the advice and conduct of the staff, particularly the professional and executive employees." 17 C.F.R. § 200.51. Hence, "it shall be the policy of the Commission to require that employees bear in mind the principles specified in the Canons." *Id.*

The Canons provide that "[i]n administering the law, members of this Commission should vigorously enforce compliance with the law by all persons affected thereby." 17 C.F.R. § 200.55. The Canons acknowledge that Members of the Commission "are entrusted by various enactments of the Congress with powers and duties of great social and economic significance to the American people," and that "[i]t is their task to regulate varied aspects of the American economy, within the limits prescribed by Congress, to insure that our private enterprise system serves the welfare of all citizens." 17 C.F.R. § 200.53. According to the Canons, "[t]heir success in this endeavor is a bulwark against possible abuses and injustice which, if left unchecked, might jeopardize the strength of our economic institutions. *Id.*

Executive Summary

On March 15, 2010, the OIG received an anonymous complaint, alleging that [REDACTED] in the investment adviser examination program in the LARO, "instructed (and even bullied) examiners to not pursue certain red flags in an examination [of Westridge Capital Management and WG Trading] where the LARO exam staff uncovered a massive fraud" and that his motive was related to his involvement in a previous examination of Westridge. The anonymous complaint also alleged that [REDACTED] lied to OIG investigators during testimony in a previous OIG investigation.

The OIG found in its investigation that on February 25, 2009, the SEC filed an emergency action in the U.S. District Court for the Southern District of New York, obtaining an asset freeze and a temporary restraining order against Paul Greenwood, Stephen Walsh, and their companies, WG Trading, a registered broker-dealer, Westridge a registered investment advisor, and WGTI, an unregistered investment vehicle.

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According to the SEC Complaint, since at least 1996, Greenwood and Walsh had been misappropriating as much as \$554 million in investor assets in the operation of a Ponzi scheme.

The OIG investigated the allegations in the complaint, focusing on the failure of the LARO to detect the fraud at Westridge during its 2005 examination. In conducting the investigation, the OIG searched over 68,000 e-mails and took the testimony of 17 witnesses who had knowledge of the facts and circumstances surrounding the matter.

The OIG investigation found that in 2005, the SEC's Los Angeles Regional Office missed a significant opportunity to uncover the Ponzi scheme and failed to conduct a competent and thorough examination of the investment adviser, Westridge, and did not take the necessary steps to ensure that a follow-up examination of the broker-dealer, WG Trading, was conducted. The OIG investigation also confirmed ^{OCIE Supv. 4} [redacted] was ^{PII} [redacted] on the 2005 examination of Westridge and that he also ^{PII} [redacted] the 2009 examinations of Westridge and WG Trading.

The OIG investigation further found that the 2005 Westridge examination was flawed in numerous respects. We found that significant portions of the field work and the writing of the examination report for the 2005 LARO examination of Westridge were conducted by a nearly brand-new examiner. We further found that while the LARO examination team became aware of obvious red flags about Westridge's operations that should have been scrutinized in the examination, the examination failed to follow-up on these matters and minimized the concerns they found.

The examiners who conducted the 2005 Westridge examination acknowledged that Westridge's investment structure in which Westridge clients became limited partners in the broker-dealer, was a red flag in and of itself, and its complex investment strategy combined with its goal of circumventing Regulation T and unusually high leverage were highly questionable. Moreover, the OIG investigation found that a brief, cursory review of Westridge conducted in 2009, which was based upon information available to the 2005 examiners, immediately determined that Westridge had numerous, significant red flags and risk factors that warranted immediate scrutiny and examination.

In addition, the LARO examination team reviewed the report of a previous examination of Westridge conducted in 2000 and identified specific concerns regarding Westridge's ability to access client assets held by WG Trading, and based upon that review, made a decision that "the examination will focus on custody issues." However, the actual examination did not conduct a custody analysis and made no effort to scrutinize Westridge's custody arrangement. In fact, although 80-85 percent of client assets were invested in the affiliated broker-dealer, WG Trading, the 2005 examination made no effort to examine these assets, even though the examination team admitted that they were "uncomfortable with the WG Trading activities."

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Yet, even when the LARO examination team made significant findings, they failed to appreciate or the significance of or follow up on what they found. For example, trade blotters, which were supposed to have been reviewed by Westridge to verify the investment strategy their investors were utilizing were discovered by the LARO examination team to be contained within ^{LE} [REDACTED]

^{LE} [REDACTED] however, no explanation was given to the examiners as to why they were not being reviewed.

The 2005 LARO examination team also identified numerous "red flags" during the course of the Westridge examination, which they noted in the report. One of the most significant concerns identified related to the poor compliance culture at Westridge. The examination staff concluded that Westridge had "ineffective compliance procedures and practices." They also concluded that Westridge "did not consider compliance with the federal securities laws to be a priority." Yet, even though they further documented that Westridge, a \$1.3 billion company, had hired a completely inexperienced compliance officer and purportedly could not afford compliance seminars, these concerns did not trigger further scrutiny or examination.

The LARO examination team also found "a myriad of inaccuracies" in Westridge's Form ADV. The report noted 15 incidents of inaccurate or incomplete information on the Form ADV, including failing to disclose that Westridge gave advice on interests in partnerships. However, these inaccuracies were attributed to Westridge's compliance culture, which was dismissed as merely "sloppy."

The 2005 examination also disclosed that Westridge's marketing materials contained significant omissions and failed to clearly describe its investment strategy, yet the examiners did not attach significance to these findings. The LARO examination team also uncovered that Westridge's stated policy was to delete all e-mails after a hardcopy was printed and although, as a result, they were unable to review e-mail documentation as part of their examination, they did not ascribe improper motives to this finding, concluding that Westridge officials were simply, "not technology savvy."

The OIG investigation further found that after conducting the examination, the 2005 LARO examination team actually not only failed to follow-up on obvious red flags but, inexplicably, decided to lower Westridge's risk rating to "risk group 2 – medium risk" as a result of their examination. The 2005 Westridge examination report justified the decision to downgrade Westridge's risk rating as follows: ^{LE, EM} [REDACTED]

^{LE, EM} [REDACTED] do not appear to involve a high degree of risk." However, the report did not elaborate on this determination and on the very same page of the report stated that "there are significant risks associated with the operations of WG Trading."

While the LARO examination team dismissed the red flags relating to the investment adviser, Westridge, they did have enough concerns about the operations at WG Trading that they decided to recommend that the Boston Regional Office ("BRO")

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conduct a broker-dealer examination of WG Trading. Several times in the 2005 Westridge Examination report, the LARO examination team noted its intention to refer its report to the BRO for an examination of WG Trading; the OIG investigation found that all members of the 2005 examination staff generally believed that a broker-dealer examination was warranted.

However, the OIG found that the referral never happened. The OIG investigation determined that none of the members of the 2005 LARO examination team could recall actually referring the matter to the BRO and no one in the BRO ever received a referral. In addition, numerous e-mail searches were conducted, including by the OIG, and the results showed no e-mails between the LARO and the BRO regarding Westridge and no internal LARO e-mails discussing a referral to BRO amongst the LARO staff. In addition to finding no written evidence of a referral, the OIG investigation also found the consensus among the examination staff was that even if a referral was made orally, rather than through an e-mail or written document, there would be some documentation somewhere referencing the referral, and likely some documentary record of the report being provided together with the referral.

The OIG investigation further found that in the timeframe of the 2005 Westridge examination in the LARO, there were no policies or protocols that governed the referral of examination findings and no instructions on how a referral was to be made. In addition, there was no procedure for following up on a referral and in fact, although the 2005 Westridge examination report specifically referenced that the findings were being referred to the BRO, no one on the LARO examination team made any effort to confirm that a referral had been made, or inquired as to whether the BRO received the referral, conducted an examination or found any fraud. Thus, no examination was conducted of WG Trading, allowing the fraud to continue.

The OIG further found that in 2009, when an experienced examination team conducted a joint investigation of Westridge and WG Trading, following up partially on a referral from the National Futures Association ("NFA"), which found several suspicious documents in an audit, and the LARO's own assessment of high risk firms, the fraud was easily uncovered. The examiners acknowledged that Westridge and WG Trading were both operating in the "exact same fashion" in 2009 as they were in 2005, and the OIG investigation found that when the 2009 examination team followed up on the same "red flags" identified in 2005 the 2009 team immediately discovered the fraud.

The 2009 LARO examination team found that ^E [REDACTED]

^E

^E

^E [REDACTED] The OIG investigation found that the 2005 LARO examination staff had access to similar records during their examination ^E [REDACTED] trading blotters could have been used as evidence of the same violation. The ^{PII} [REDACTED] on the 2009 examination

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actually confirmed that the fraud was uncovered with very simple methods in 2009, noting, "in retrospect that fraud was not that hard to uncover." He explained, "all you really had to do was look at the amount of net assets that were on Westridge's books, compare that with the amount of money that WG Trading was representing that they were managing, and those amounts just didn't tie out." Yet, this simple analysis was not done in 2005.

The 2009 LARO examination team also found that Westridge provided inaccurate and misleading marketing materials to its clients, as had the 2005 examination team. However, unlike the 2005 examination team, who dismissed these inaccuracies as Westridge being "sloppy," the 2009 team specifically referenced the omissions in Westridge's Form ADV about the existence and purpose of promissory notes in their report and found these omissions to be material.

Perhaps most significantly, the 2009 examination team conducted a custody analysis, something that the 2005 team had planned to conduct, but never did. The 2009 LARO examination team determined that because the two senior officials were "owners, and thus supervised persons of [Westridge], and had access to all client funds that were invested in or passed through WG Trading and Westridge, [they] had custody of the applicable client's assets." As a result, the 2009 LARO examination team determined that Westridge was not in compliance with the custody rule with respect to the invested assets because Westridge's clients did not receive statements reflecting the appropriate holdings and transactions, as required by the rule. The OIG investigation found that the 2009 LARO examination team made this custody determination based on the same facts that existed in 2005.

The 2009 LARO examination team also obtained the records of WGTI, the unregistered investment advisor that was being used as a "pass-through" between Westridge and WG Trading, and in those records uncovered evidence of the fraud. The 2005 LARO examination team did not even request WGTI records during their examination and seemed confused about whether the SEC had any authority to obtain documents from unregistered entities even where they suspected fraud.

The OIG investigation found a major difference between the manner in which the two examinations were conducted related to the fact that the 2009 examinations were conducted after the "Madoff" scandal. The OIG found that after Bernard Madoff confessed to operating a \$50 billion Ponzi scheme and the OIG issued a report of investigation regarding the failure of the SEC to uncover Bernard Madoff's Ponzi scheme, SEC examiners focused more acutely on custody of assets, conducted more joint examinations and were more aggressive in seeking records from unregistered firms. Unfortunately, the OIG investigation found that the 2005 Westridge examination was conducted under "pre-Madoff" procedures by examiners, who were aware of and had in their hands evidence of potential fraud, but did not take the basic steps necessary to investigate the matter further and, as with Madoff, a significant fraud was not uncovered at that time.

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The OIG investigation also concluded that had the LARO referred their findings to the BRO and had a broker-dealer examination of WG Trading been conducted in 2005, the fraud would have likely been discovered. This finding was confirmed by both BRO broker-dealer examiners and the 2009 LARO examination team.

The OIG also specifically investigated the allegation in the anonymous complaint that [OCIE Supv. 4] "instructed (and even bullied) examiners to not pursue certain red flags" in the 2009 examinations in an attempt to hide his failures in the 2005 examination. While the OIG investigation did not find evidence substantiating the claim [OCIE Supv. 4] instructed or bullied examiners to ignore "red flags" in the 2009 examinations of Westridge and WG Trading that would have identified issues or areas that he himself failed to uncover in the 2005 Westridge examination or [OCIE Supv. 4] directed substantive changes to the report's findings, the OIG did find that examiners were uncomfortable with [OCIE Supv. 4] in the 2009 examinations and that this created an appearance of impropriety, which could have been avoided if [OCIE Supv. 4] recused from the 2009 examinations. In the course of its investigation, the OIG also found evidence that many LARO employees had significant concerns [OCIE Supv. 4] management style in general. Yet, the OIG also found that there was little, if any, evidence that any action was taken by management to resolve or even address these concerns. We found that many LARO employees were fearful to complain because of possible retaliation. The OIG did not substantiate the allegation [OCIE Supv. 4] lied in previous testimony.

We are recommending that the Chairman, Director of OCIE and the LARO Regional Director carefully review this ROI and share with LARO management the portions of this ROI that relate to the performance failures by those employees who still work at the SEC, so that appropriate action (which may include appropriate performance-based action) is taken, on an employee-by-employee basis, as appropriate. We are also specifically recommending that [OCIE Supv. 4] not be placed back in a supervisory role in the LARO.

We are further recommending that the LARO establish a staff recusal policy for examinations and that the LARO include, in its examination referral policy and procedures, a mechanism for tracking the outcome of an examination referral.

Finally, we are recommending that the Chairman, the Director of OCIE and the LARO Regional Director take the necessary actions to establish appropriate mechanisms in the LARO to ensure that employee feedback about supervisors is appropriately and sufficiently addressed so that LARO employees feel comfortable conveying feedback about their superiors without fear of retaliation.

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Results of the Investigation

I. In 2005, the LARO Examination Team Failed to Conduct a Thorough and Satisfactory Examination of Westridge Capital Management and Failed to Follow up on Numerous Red Flags

A. An Inexperienced Staffer was Assigned to Lead the 2005 Examination of Westridge Capital Management

The OIG investigation found that significant portions of the field work and the writing of the examination report for the 2005 LARO examination of Westridge were conducted by a nearly brand-new examiner. Former OCIE Empl. 3 was hired as a securities compliance examiner for the SEC's LARO right after PII was hired as a securities compliance examiner for the SEC's LARO right after PII. PII Former OCIE Empl. 3 Testimony Tr. at 6. She was assigned as the examiner for the 2005 Westridge examination PII after starting at the SEC. *Id.* at 9. During testimony with the OIG, Former OCIE Empl. 3 described her role on the Westridge examination as the "junior examiner," but noted that she was "responsible for writing the report and doing basic reviews and fact checking while on the exam." *Id.* at 10.

OCIE Supv. 5 was Former OCIE Empl. 3 Branch Chief and the first level supervisor on the examination. *Id.* at 10. Former OCIE Empl. 3 described OCIE Supv. 5's role as being responsible for "[i]dentifying the proper risk areas, probing into things that perhaps as a junior and senior examiners, that we may have overlooked, making sure that the exam is conducted properly and training me as a junior examiner." *Id.* Although Former OCIE Empl. 3 remembered OCIE Supv. 5 as participating in all the field work, OCIE Supv. 5 specifically recalled that he participated only in "portions of the field work, not [the] entire field work." *Id.* at 10-11; OCIE Supv. 5 Testimony Tr. at 11.

OCIE Supv. 4 an accountant at that time, also played a role in the Westridge examination. Former OCIE Empl. 3 understood OCIE Supv. 4 was to be the PII and that he was "responsible for looking at the more complex aspects of the exam." Former OCIE Empl. 3 Testimony Tr. at 10. OCIE Supv. 4 testified OCIE Supv. 4 was brought on to "act as a lead examiner" because they "needed someone senior, some examiner with a lot more experience." OCIE Supv. 5 Testimony Tr. at 13. However, in his testimony with the OIG, OCIE Supv. 4 his role on the examination as relatively minor. OCIE Supv. 4 said that "[t]echnically, Former OCIE Empl. 3 was the lead" and that he was "assigned on a temporary basis" because he had "a week of down time" between examinations. *Id.* at 13. He said he was involved in the "pre-exam prep" work and five days of the field work, but that he left the examination before the end of the field work and did not have a role in writing or reviewing the report. *Id.* at 13-14.

Kevin Goodman ("Goodman") was the Assistant Regional Director on the examination. See cover page of Westridge Capital Management Investment Adviser Examination Report dated April 29, 2005 (2005 Westridge Examination Report) at Exhibit 20. Former OCIE Empl. 3 said Goodman was not on site at Westridge, but that OCIE Supv. 5 would

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typically confer with him by telephone. Former OCIE Empl. 3 Testimony Tr. at 11. Former OCIE Empl. 3 said she did not confer with Goodman until after the examination, when she was writing the report. *Id.*

Although there were several examiners assigned to the Westridge examination, the OIG investigation found that most of the responsibility and work fell to Former OCIE Empl. 3 PII out of law school. Despite being the most junior member of the team, Former OCIE Empl. 3 was the lead examiner and wrote the examination report. Her inexperience may have played a role in the team's failure to detect the ongoing fraud at Westridge and the team's failure to refer the examination for a follow-up broker-dealer examination.

B. In Preparing for the 2005 Examination of Westridge, the LARO Examination Team Identified Red Flags in Westridge's Investment Strategy and Structure

The OIG Investigation found that in the process of engaging in preparation activities for the 2005 Westridge examination, there were obvious red flags about Westridge's operations that should have been scrutinized in the examination, particularly with regard to Westridge's complicated investment strategy. Westridge's investment strategy consisted of two components, the first component being related to investing in short-term government securities and indexed futures contracts, for which 10-15 percent of client assets were invested. 2005 Westridge Examination Report at 3. The second component was an index arbitrage strategy that was accomplished by investing the remaining 80-85 percent in Westridge's affiliated broker-dealer, WG Trading.² *Id.*

According to the 2005 Westridge Examination Report, Westridge clients became limited partners in WG Trading by purchasing limited partnership interests. *Id.* at 4. Because they were limited partners rather than customers, they were not subject to the margin requirements of Regulation T.³ *Id.* at 4. This allowed WG Trading to leverage up to 20 times the market value of each trade. *Id.*

The examiners who conducted the 2005 Westridge examination acknowledged to the OIG that Westridge's investment structure was a red flag in and of itself, and "unusual." Former OCIE Empl. 3 referred to Westridge's arrangement as "highly questionable"

² WG Trading was operated as a pooled investment vehicle that used arbitrage transactions to "exploit the inefficiencies that might exist between the prices of index futures and the prices of the underlying securities." 2005 Westridge Examination Report at 3-4.

³ Federal Reserve Board's Regulation T, Credit by Brokers and Dealers, 12 C.F.R. §220, governs extension of credit by securities brokers and dealers, including all members of national securities exchanges. According to Regulation T, a customer may borrow only up to 50 percent of the purchase price of securities that can be purchased on margin. 12 C.F.R. §220.12(a).

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and admitted that neither she nor the other examiners had ever seen something like it before, stating:

I remember that the investment structure of Westridge Capital had to do with placing their clients as limited partners in the general partnership, which was WG Trading. And that was highly questionable and something that I certainly had never seen. And I don't believe OCIE Supv. 5 and OCIE Supv. 4 either had.

Former OCIE Empl. 3 Testimony Tr. at 12-13.

OCIE Supv. 4 described the novelty of Westridge's structure and the complexity of its trading strategy in the following exchange:

Q: Was there anything unusual or of concern about the structure of the way the operations were set up in connection with that exam?

A: the fact that it was an affiliated fund and it was not operated out of the same location was a little, probably different than normal. The strategy I would say would be the most interesting, you know, aspect or unusual aspect. It was the first time I had ever come across index arbitrage, and I had been there with the Commission for probably PII

OCIE Supv. 4 Testimony Tr. at 17-18.

In addition to the investment structure, which the LARO examiners acknowledged was "questionable," the complex investment strategy combined with its goal of circumventing Regulation T, its unusually high leverage in which such a large percentage of investor assets were invested in an affiliated broker-dealer, should have been viewed as red flags as well. Furthermore, with so much money flowing to an affiliate, the examiners should have been alerted that there could be custody issues and that a custody analysis would be prudent.⁴

⁴ As discussed in further detail in Section III of this report, as further indication that the 2005 LARO examination team should have been alerted to obvious red flags very early on in their examination process, the OIG investigation found that a brief, cursory review of Westridge conducted in 2009 based upon information available to the 2005 examiners, determined that Westridge had numerous, significant red flags and risk factors that warranted immediate scrutiny and examination.

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C. In Planning the Examination in 2005, the LARO Examination Team Reviewed a 2000 Examination Report, Which Contained a Custody Analysis and Initially Intended to Focus on Custody Issues

In preparation for the 2005 Westridge examination, the LARO examination team reviewed the examination report of the previous examination of Westridge conducted by LARO staff in 2000.⁵ OCIE Supv. 5 Testimony Tr. at 14. The 2000 examination report revealed that the LARO examination team determined that Westridge had weak internal controls and found performance disclosure issues, as well as other deficiencies. Westridge Capital Management Investment Adviser Examination Report dated February 25, 2000 (2000 Westridge Examination Report) at 1, at Exhibit 21.

In addition, the 2000 Westridge Examination Report identified specific concerns regarding Westridge's ability to access client assets held by WG Trading. *Id.* at 4. Based upon these concerns, the examiners performed a custody analysis in 2000, although they concluded that Westridge did not have custody of client assets invested in WG Trading. *Id.*

In the examination proposal for the 2005 Westridge examination, Former OCIE Empl. 3 stated, "In light of the fact that client assets may be held in custody by Registrant's affiliate, the examination will focus on custody issues which arise as a result of this arrangement." Memorandum from Former OCIE Empl. 3 to IA/IC Supervisory Staff dated February 10, 2005, at Exhibit 22. However, as described in further detail below, custody was not a focus of the 2005 Westridge examination. In the 2005 examination report, the short section that described custody appears to only refer to the 10-15 percent of client assets invested in the index futures contracts and the unaffiliated brokerage firms that held those assets. 2005 Westridge Examination Report at 6. There was no discussion in the report of any custody analysis related to the 80-85 percent of investor assets invested in WG Trading. 2005 Westridge Examination Report.

When asked why the examination did not focus on the custody issues identified in the examination proposal, Former OCIE Empl. 3 did not recall why the examiners changed course, although she acknowledged that custody was one of the issues that the examination team was not able to "fully vet out." Former OCIE Empl. 3 Testimony Tr. at 36. OCIE Supv. 4 unable to explain why the custody issue was not pursued in the 2005 examination, noting that it "was not common" for an examination proposal to be issued and the examination not to focus on the items in the proposal. OCIE Supv. 4 Testimony Tr. at 22.

⁵ Kevin Goodman was the only overlapping member of both examination teams; he was the "Senior Special Counsel" for the 2000 examination and the "Assistant Regional Director" on the 2005 examination.

⁶ As discussed further in Section III below, when an examination team returned to Westridge in 2009, that team did review custody issues and determined that because Greenwood and Walsh were owners and "supervised persons" of Westridge and "had access to all client funds that were invested in or passed through WG Trading and WGTI," they were considered to have had had custody of client assets.

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D. Despite the Red Flags, a Satisfactory and Thorough Examination of Westridge was Not Conducted

The OIG investigation found the LARO examination team failed to follow their own examination proposal, and failed to follow up on the obvious red flags in Westridge's structure, investment strategy and operations and instead narrowed the focus of their examination, while failing to uncover the ongoing fraud.

1. The 2005 LARO Examination Team Ignored the Overwhelming Majority of Client Assets Invested by Westridge

Although the 2005 Westridge examination proposal specifically stated that the 2005 Westridge examination would focus on custody issues, the 2005 LARO examination team did not even conduct a perfunctory custody analysis. In addition and perhaps even more importantly, the 2005 Westridge examination team failed entirely to conduct any analysis of the overwhelming majority of investors' assets (80-85 percent), which were invested through the broker-dealer, WG Trading.

As discussed above, Westridge had a complicated, two-part investment strategy with the first part involving the purchase and sale of future contracts in which 10-15 percent of client assets were invested. 2005 Westridge Examination Report at 3. The second portion was an index arbitrage strategy that was accomplished by investing the remaining 80-85 percent in Westridge's affiliated broker-dealer, WG Trading. *Id.*

OCIE Supv. 5 [REDACTED] acknowledged to the OIG that the LARO examination team focused their examination on only the 10-15 percent of investor assets invested in futures contracts and disregarded completely the 80-85 percent invested in WG Trading. OCIE Supv. 5 [REDACTED] Testimony Tr. at 33-34.

OCIE Supv. 5 [REDACTED] elaborated on this point in the following exchange:

- Q: So in terms of understanding the strategy, wouldn't one really need to look at WG Trading since there was such a high percentage of -- in WG Trading and such a low percentage everywhere else?
- A: Well, we did not -- as I said earlier, we considered the -- just the 10 to 15 percent managed by the Westridge. Those are the assets managed -- assets under management for Westridge.

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Id. at 34-35.

When questioned as to why the examination decided not to examine any matters relating to the 80-85 percent of investments made through the broker-dealer, WG Trading, even after finding that the investment advisor, Westridge, played a relatively small role in the overall investment strategy, ^{OCIE Supv. 5} responded simply that it was his "responsibility to conduct an investment advisor examination" of Westridge, not WG Trading.⁷ *Id.* at 35-37.

^{Former OCIE Empl. 3} also confirmed that the examination team limited their focus to the 10-15 percent of client assets invested by Westridge and made no effort to examine the 80-85 percent of assets invested through WG Trading, in the following exchange:

Q: Was it your understanding either because of your work or what your supervisors told you that, say, the issue of the 15 Percent versus 85 Percent, that it was your focus in the Westridge Capital exam to look at the 15 Percent, not necessarily the 85 Percent since you were looking at Westridge and not WG Trading?

A: I think that is a correct statement, yes.

^{Former OCIE Empl. 3} Testimony Tr. at 36-37.

Moreover, ^{Former OCIE Empl. 3} acknowledged that during the examination, the examination team was "uncomfortable with the WG Trading activities" and even interviewed one of the principals of WG Trading in an attempt to "gain more comfort with what was going on" with WG Trading. *Id.* at 37. She further acknowledged that the interview was not helpful and did not provide the comfort they were seeking. *Id.*

Yet, instead of following up with more requests for information or further examining the matter, the OIG investigation found that the LARO examination team simply ignored the concerns about WG Trading and focused solely on the narrow issues relating to the 10-15 percent of invested assets.⁸

⁷ Although ^{OCIE Supv. 5} testified he considered only the 10-15 percent to be assets managed by Westridge, Westridge clearly included the additional 80-85 percent that was invested in WG Trading when calculating its advertised assets under management and Westridge was paid an advisory fee on the full amount. The 2005 Westridge Examination Report states the following: "The standard advisory fee is 0.25% per annum, based on assets under management.... Registrant includes the amount of client assets invested in WG Trading in its calculation of advisory fees." 2005 Westridge Examination Report at 5.

⁸ In testimony with the OIG, ^{Former OCIE Empl. 3} indicated that there was increasing pressure at the LARO to get examinations completed in a timely manner, stating, "There were -- there was definitely an awareness of the numbers of exams that had to be completed, had been completed, still needed to be completed. Sort of over the time that I worked at the SEC, the length of exams came under greater scrutiny." ^{Former OCIE Empl. 3}

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2. The Examination Team Took No Action to Verify that Funds Were Invested in WG Trading, Notwithstanding Their Discovery of a Lack of Due Diligence on the Part of Westridge

The OIG investigation found that although the LARO examination team identified significant risks involving WG Trading, it made no effort to verify that funds were actually invested with WG Trading as promised by Westridge. Moreover, the record is devoid of evidence that any analysis was conducted to confirm Westridge's trading strategy, as it related to WG Trading.

The only evidence of any analysis of Westridge's trading strategy is OCIE Supv. 5 testimony that the LARO examination team looked at a copy of a trade blotter, but only for the limited purpose of seeing if the stocks listed made up the S&P 500 index. OCIE Supv. 5 Testimony Tr. at 27-28. OCIE Supv. 5 told the OIG that the trade blotter was a "very thick, very long document" and because of that they could not "do much analysis other than just confirming those are actually the securities that make up the index." *Id.* at 28.

OCIE Supv. 5 also told the OIG that when the team requested the trade blotter(s) from Westridge's OCIE Supv. 5 the team discovered that Westridge did not verify WG Trading's investments because the OCIE Supv. 5 *Id.* OCIE Supv. 5 acknowledged opening OCIE Supv. 5 but could not articulate any further action taken to follow up on this alarming discovery. *Id.*

The OIG investigation found no evidence that the 2005 examination team even considered the possibility that the OCIE Supv. 5 could have been used as evidence that Westridge failed to fulfill its fiduciary responsibility with regard to client assets, in violation of Section 206 of the Investment Advisers Act.⁹ The 2009 Westridge Examination Report concluded that Westridge violated Section 206 of the Investment Advisers Act, specifically noting as evidence of the violation that none of the financial or trading data was being reviewed by Westridge. 2009 Westridge Examination Report at 26-28. We found that the 2005 staff also knew that Westridge did not review financial or trading data and could have referred this information to Enforcement for a potential Section 206 case against Westridge in 2005.¹⁰

Testimony Tr. at 36. This fact may have motivated the 2005 examination staff to so narrowly focus their examination.

⁹ Section 206 of the Investment Advisers Act of 1940 establishes a fiduciary standard of conduct for investment advisers. 15 U.S.C. § 80b-6 rule 206 [17 CFR 275.206] under the Investment Advisers Act of 1940.

¹⁰ The OIG made a similar finding in its Stanford investigation report. See *Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme* (OIG-526), issued March 31, 2010 (available on our web site at: <http://www.sec.gov/news/studies/2010/oig-526.pdf>). In that report, the OIG concluded that Enforcement could have potentially shut down the alleged fraudulent certificate of deposit sales had they filed a Section 206 case for failure to conduct any due diligence. *Id.* at 115.

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OCIE Supv. 4 admitted that in 2005, the LARO examination team took no action to determine if the investors' funds that were allegedly being funneled to WG Trading were actually invested in WG Trading as Westridge represented to its customers. OCIE Supv. 4 Testimony Tr. at 69. He further noted that if in 2005, they had "conducted what we do now in terms of our 2009 asset verification procedures, it would clearly require confirmation with the individual investors, as well, which would have allowed us to necessarily see a discrepancy between what was being represented to the investors and what was actually available in liquidating equity," thus potentially uncovering the fraud. *Id.* at 72.

3. The Examination Staff Identified Numerous Other Red Flags During the 2005 Westridge Examination, but Failed to Follow-Up Appropriately

a. Ineffective Compliance Officer

The 2005 LARO examination team identified numerous "red flags" during the course of the Westridge examination, which they noted in the report. One of the most significant concerns identified related to the poor compliance culture at Westridge. The examination staff concluded that Westridge had an "ineffective" compliance program. 2005 Westridge Examination Report at 8. They also concluded that Westridge "did not consider compliance with the federal securities laws to be a priority." *Id.* at 2.

One noteworthy example was Westridge's appointment of WGTC CCO as its Chief Compliance Officer ("CCO"). The LARO examination team stated in the report that WGTC CCO had "no experience ensuring compliance with the Adviser's Act" and had "not attended any compliance seminars in order to prepare [herself] for her role as chief compliance officer." *Id.* at 9. The LARO examination team elaborated on their concerns about WGTC CCO in a document they prepared entitled E, EM

E, EM

WGTC CCO "We doubt competency of CCO, she does not have 40 Act experience... [C]ertainly does not have sufficient authority within the firm." *Id.* at 0908. They further noted, "CCO is also administrative assistant- does not have adequate stature in firm. CCO was not allowed to go to compliance seminars b/c too costly for firm." *Id.* at 0906.

Internal examination documents reflect the significant concerns on the part of the examiners with respect to WGTC CCO ability to effectively act as CCO for Westridge. In testimony, the examiners further emphasized these concerns. Former OCIE Empl. 3 explained to the OIG, "So seeing WGTC CCO as CCO was shocking. I mean, she was basically the office manager and had, it appeared, been dubbed with the CCO title." Former OCIE Empl. 3 Testimony Tr. at 16. OCIE Supv. 4 expressed a similar assessment of WGTC CCO in his testimony with the OIG, noting that the examiners "were asking a lot of questions about WGTC CCO

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qualifications,” and stating, “I do not believe she had any prior experience [in compliance.]^{OCIE Supv. 4} Testimony Tr. at 25.

The issues involving ^{WGTC CCO} lack of experience, training and stature and the “ineffective” compliance program should have been significant red flags for the examination staff. Although the examiners documented their concerns; noting that Westridge, a \$1.3 billion company, had hired a completely inexperienced compliance officer and purportedly could not afford compliance seminars, these concerns did not trigger further scrutiny or examination.

b. ADV Inaccuracies

The LARO examination team also stated in the 2005 examination report that they found “a myriad of inaccuracies” in Westridge’s Form ADV.¹¹ 2005 Westridge Examination Report at 9. The report noted 15 examples of inaccurate or incomplete information on the Form ADV; including failing to disclose that Westridge gave advice on interests in partnerships. *Id.* at 13. This lack of disclosure seems particularly egregious considering Westridge recommended that clients invest 80-85 percent of their funds in WG Trading as limited partners.

However, although noted in the examination report, these inaccuracies did not provoke any further scrutiny.^{OCIE Supv. 5} stated that he was not concerned about this finding in the following exchange:

Q: All right. So what about that? Failure to disclose that registrant offers advice on interests and partnerships? Is that an item that is of concern --

A: It was -- did not raise too much of a concern because it was one of the check-the-box response, I believe. Just did not check one of the box.

^{OCIE Supv. 5} Testimony Tr. at 42.

When the OIG asked ^{Former OCIE Empl. 3} what she remembered about the Form ADV inaccuracies, she admitted that there were some substantive areas of concern with the ADV.^{Former OCIE Empl. 3} Testimony Tr. at 19. However, she attributed it to Westridge’s compliance culture, which she dismissed as merely “sloppy.” *Id.*

¹¹ Form ADV enables the SEC to register investment advisers. Every applicant for registration with the SEC as an adviser must file this form. See 17 C.F.R. § 275.203-1.

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c. Advertising

The 2005 examination also disclosed that Westridge's marketing materials contained significant omissions and failed to clearly describe its investment strategy, yet did not attach significance to these findings. The 2005 examination report stated, "Registrant routinely failed to incorporate the requisite disclosures when presenting materials to prospective and/or existing clients in one-on-one presentations." 2005 Westridge Examination Report at 10. This finding was also noted in the prior two examinations conducted in 1993 and 2000.¹² *Id.* However, the examiners dismissed this concern, finding in their report that the inadequacy of disclosures was an issue of "carelessness rather than serious recidivism." *Id.* at 7.

The LARO examination team also found that Westridge's "marketing materials frequently include[d] a description of its strategy which has the potential to leave even the most sophisticated investor confused regarding registrant's relationship with its affiliates, WG Trading." *Id.* at 14. The LARO examination team became aware that this concern was shared by others when Westridge produced to them correspondence from a client that withdrew its money from Westridge. The LARO examination team found that Sun Life Financial ("Sun Life") was a Westridge client and in 2002 began to question the trading strategy employed by Westridge. *See* Sun Life E-mail From Genesis Marketing Group to [REDACTED] dated March 22, 2002, at Exhibit 25. Correspondence produced to the 2005 examination team indicated that Sun Life did not understand the strategy and was unclear as to whether the product was making money. *Id.* Ultimately, Sun Life withdrew its investment. *See* Letter to Sun Life Financial from Paul Greenwood dated April 29, 2003, at Exhibit 26, confirming verbal receipt of Sun Life's request to withdraw.

[REDACTED] Former OCIE Empl. 3 recalled the Sun Life correspondence and noted that Westridge's "trading strategy was quite complex" and "difficult for [her] to understand." [REDACTED] Former OCIE Empl. 3 Testimony Tr. at 23. She recalled that "it was something that [they] were trying to get a hold on" and they "were questioning the understanding of the investors," noting that "finding communication like [the Sun Life e-mail] sort of affirmed our concern." *Id.* at 23-24. However, there was no follow-up on this concern in the examination.

d. E-mail Retention

The 2005 examination report also uncovered an extremely lax e-mail policy at Westridge. 2005 Westridge Examination Report at 14. The LARO examination team found that Westridge's stated policy was to delete all e-mails after a hardcopy was

¹² In 1993, an LARO Investment Advisor examination team conducted an examination of Westridge finding the following violations: 1) misleading performance advertising, 2) failure to maintain books and records, 3) inadequate policy regarding use of insider information, 4) inadequate disclosures regarding conflicts of interest, 5) late filing of Form 13F, 6) failure to make annual offer of Form ADV to clients, 7) having custody and possession of client assets without complying with custody rules, and 8) inadequate controls regarding client fees. 2000 Westridge Examination Report at 4.

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printed. *Id.* As a result, the examiners were unable to review e-mail documentation as part of their examination, which is often critical in examining a firm, particularly where there is the possibility of fraud.

However, OCIE
Supv. 5 in his testimony with the OIG, did not attach much significance to this finding, in the following exchange:

- Q: Is that a concern that perhaps e-mails are being deleted?
- A: Investment adviser books and record rule does not specifically require e-mail to be -- e-mail is not required -- not necessarily part of the books and record. If e-mail contains certain information concerning client correspondence and certain recommendation is made by the adviser, it could be so --
- Q: So -- so if you have an entity which clearly doesn't seem to have compliance as a priority, hires a chief compliance officer who is also an administrative assistant and they don't even want to pay for her to go to compliance conferences, and at the same time there are potentially e-mails that are deleted, you have kind of a Byzantine structure that's difficult to understand, it turns out the entity you are looking at really had played a very small role in the operations, wouldn't these all add up to a significant concern?
- A: No, because we were looking at the Westridge operations, and we understood Westridge's role. And we under- -- we understood their role was playing trading in futures and cash management. E-mails -- we didn't -- our examiners -- examination staff did not begin to -- it was relatively recent, not long ago, just one or two years before this exam, we started to request e-mails; and that was -- I don't think we requested e-mails prior to that. It was during the market timing scandal -- I don't know if you recall that -- that's the first time we actually started requesting e-mails. And there were -- a lot of advisers were -- there was no specific whether e-mails are supposed to be kept by the advisers or not. So keeping -- so somebody -- you know, and there's no clear guidance on what -- on the adviser rule what e-

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mails should be kept and that cannot be kept. So it is not – it's not – it's not clear as to whether these e-mails are required record. So -- and Mr. Carter appears to be an older gentleman, and he did not appear sophisticated with the computer, and so when we requested certain documents, they didn't know how to burn a CD. So we -- the impression we received is perhaps they don't – they're just not technology savvy.

OCIE Supv. 5

Testimony Tr. at 46-47.

Former OCIE Empl. 3 also was not disturbed by the lack of electronic e-mail and said it was not uncommon to find registrants with only printed copies of e-mail. Former OCIE Empl. 3 Testimony Tr. at 20. However, she did acknowledge there was no way of confirming that they were reviewing all the e-mails or that all e-mails were maintained as stated in the Westridge policy. *Id.*

4. Upon Review of the Westridge Report, Senior BRO Examiners Concluded that There Were Numerous Red Flags Uncovered During the 2005 Westridge Examination That Required Follow-Up

Two senior members of the Boston Regional Office ("BRO") examination staff, Associate Regional Director Lucile Corkery ("Corkery") and OCIE Supv. 2 reviewed the 2005 Westridge report in the course of the OIG investigation and concluded that there were significant red flags identified in the examination that required follow-up.¹³

Corkery, the BRO's Associate Regional Director who oversees the examination program for the BRO, was asked specifically about the issues identified by the 2005 LARO examination team in the Westridge examination in the following exchange:

Q: Okay. All right. Let me ask you a couple of questions just generally based on your knowledge of investment advisor exams or by virtue of your position at least in the last several years. If one were to do an examination and find that the registrant did not consider compliance with the federal security

¹³ The OIG questioned members of the BRO staff about whether they received a referral concerning Westridge or WG Trading and whether they would have conducted an examination of WG Trading if they had received a referral. During the course of that testimony, members of the BRO staff made observations about the findings in the 2005 Westridge Examination Report.

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laws to be a priority, would that be a red flag or a cause for concern?

A: Yes, it would.

Q: What about where they found in a review of a registrant's form ADV a myriad of inaccuracies, would that be a cause or red flag for concern?

A: Yes.

Q: Particularly that it doesn't disclose that the registrant offers advice on interests and partnerships that inaccurately discloses that the registrant used short sales in its investment strategies, when, in fact, the broker-dealer conducts short sales, and gives inaccurate information for index arbitrage? Would you consider that to be significant inaccuracies or more technical inaccuracies?

A: I'd consider the combination significant.

Q: What about if you found that electronic e-mail was deleted and you were uncertain whether you would get all the electronic e-mails? Would that be a cause of concern or a red flag in an exam?

A: Yes.

Corkery Testimony Tr. at 15-16.

OCIE Supv. 2 [REDACTED] for the BRO broker-dealer examination program, concurred in the following exchange:

Q: Is it fair to say that in the [2005 Westridge] IA exam the IA examiners identified red flags, areas of concern in their examination?

A: Yes, yes, I think that there were areas of legitimate concern.

Q: So, for example, one of the things they identified was the registrant did not consider compliance with the federal security laws to be a priority. Would that be something that is a red flag or a concern?

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A: That's a concern.

* * *

Q: Here's a sentence from the 2005 exam: "During the staff's review of registrants form ADV, a myriad of inaccuracies were noted." What about inaccuracies in ADV? Is that something that's a cause for concern?

A: Well --

Q: Particularly if there's numerous inaccuracies?

A: I think if it's pervasive enough and if they're material I think it would be a cause for concern, you know, depending on the nature. You know, if it's a wrong address number or something, if it's more substantive.

Q: In this case there was a failure to disclose that registrant offers advice on interests and partnership; inaccurately disclosed that investors use short sales in their investor strategies. There was a failure to disclose about the utilization of index arbitrage. Would you consider those types of inaccuracies to be substantive and material?

A: I would.

* * *

Q: What about the fact that they identified in the 2005 exam that electronic e-mail could be deleted after a hard copy is printed, so they didn't know necessarily that they got the entirety of the electronic e-mails. Is that also a cause for concern?

A: Yes.

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5. Despite the Numerous and Obvious Red Flags Identified During the 2005 Examination, the 2005 LARO Examination Team Actually Lowered Westridge's Risk Rating After the Examination

The 2005 Westridge examination report stated that the underlying reason for conducting the examination was that Westridge was deemed to be a "high risk advisor." 2005 Westridge Examination Report at 1. The OIG investigation found that after conducting the examination, the 2005 LARO examination team actually lowered Westridge's risk rating to "risk group 2 – medium risk" despite the red flags it encountered.

The 2005 Westridge examination report justified the decision to downgrade Westridge's risk rating as follows: [REDACTED] LE, EM

[REDACTED] LE, EM do not appear to involve a high degree of risk." *Id.* at 2. However, the report did not elaborate on this determination and on the very same page of the report stated that, "there are significant risks associated with the operations of WG Trading" in which Westridge's clients' funds were being primarily invested. *Id.*

The lowering of Westridge's risk rating is particularly curious since, as discussed below in Section III, experienced LARO examiner [REDACTED] OCIE Supv. 10 [REDACTED] OCIE Supv. 10 determined based upon only a brief and cursory review that Westridge was a high risk firm. [REDACTED] OCIE Supv. 10 explained as follows in her testimony:

The report basically placed this registrant, Westridge, into a risk group two which basically means medium risk. What was odd to me is that the report indicated that "the investment strategy and implementation do not involve a high degree of risk." That's a quote from the report...

I didn't agree with a few of the sentences in the examination report, sentences that indicated that it was a low-risk strategy, sentences that indicated, you know, that - like the investment strategy did not involve a high degree of risk, and I couldn't figure out where that was coming from because the investment strategy as I was reading it, as it was laid out in the report, didn't make any sense to me. So, I didn't see how that could be a conclusion.

[REDACTED] OCIE Supv. 10 Testimony Tr. at 24, 30-31.

When questioned about the decision to lower Westridge's risk rating [REDACTED] OCIE Supv. 4 stated he did not know why the risk rating was lowered. [REDACTED] OCIE Supv. 4 Testimony Tr. at 27-28. He also acknowledged that in his view, there were significant risks associated with the operations of WG Trading. *Id.* at 29.

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II. Although the 2005 LARO Examination Team Made a Decision to Refer Their Findings to the BRO for an Examination of WG Trading, the Referral Was Never Made and No Examination was Conducted

A. Decision to Make a Referral

The 2005 LARO examination team, upon concluding their examination, had enough concerns about the operations at WG Trading that they decided to recommend that the BRO conduct a broker-dealer examination of WG Trading. 2005 Westridge Examination Report at 2, 3, 14. The examination team decided to refer the examination to Boston, rather than conduct the WG Trading examination themselves, because of geographical proximity, as WG Trading was located in Connecticut, which is in the Boston region. OCIE Empl. 4 Testimony Tr. at 10-13. According to OCIE Supv. that time frame it would have been highly unusual for examiners from another regional office to go conduct exams of a firm that was covered by another regional office... [T]he standard protocol would be to ask [Boston] to conduct the examination of that particular entity." OCIE Supv. 4 Testimony Tr. at 47.

Several places in the 2005 Westridge Examination report, the LARO examination team noted its intention to refer its report to the BRO for an examination of WG Trading. Under the heading "Actions Taken" the examination team indicated that it had "referred the matter concerning Registrant's clients investing in WG Trading as a pooled investment vehicle to the Boston District Office." 2005 Westridge Examination Report at 14. In addition, on page three of the report, the staff noted that WG Trading had not been examined since 1995 and stated, "[T]he staff recommends that the Commission's Boston District Office conduct an examination of WG Trading." *Id.* at 3.

The OIG investigation found that all members of the 2005 examination staff generally believed that a broker-dealer examination was warranted. Examiner Former OCIE Empl. 3 called the operations at WG Trading "completely questionable" and said "that is why the referral was made." Former OCIE Empl. 3 Testimony Tr. at 24-25. She also noted, "what we were able to see of the relationship between Westridge and WG Trading was not ordinary and not something that we were able to confirm from the records at Westridge." *Id.* at 14.

OCIE Supv. 5 also testified that because the Westridge examination team "couldn't do a lot of analysis" to verify that WG Trading was actually implementing the strategy it was representing and because Westridge was not verifying the strategy either, "perhaps WG Trading should be examined." OCIE Supv. 5 Testimony Tr. at 28. OCIE Supv. 4 also thought a broker-dealer examination of WG Trading was needed, stating that "given the strategy that they were operating and the way they were operating and the fact that it was a broker-dealer that was also a hedge fund, I would have thought an examination was appropriate." OCIE Supv. 4 Testimony Tr. at 31.

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Prior to making the referral decision, Former OCIE Empl. 3 met with OCIE Empl. 4. OCIE Empl. 4 LARO's PII OCIE Empl. 4 Testimony Tr. at 10. OCIE Empl. 4 said he concurred with Former OCIE Empl. 3 and was, "convinced that this should go to Boston." *Id.* at 13-14. He said he concluded that because WG Trading had not been examined in ten years and because they were doing a "sophisticated business and a very large one," they should be examined. *Id.*

OCIE Empl. 4 had a different recollection of the 2005 examination staff's opinions on whether a referral was appropriate. OCIE Empl. 4 testified that he believed that Former OCIE Empl. 3 supervisors did not have the same level of concern about WG Trading as Former OCIE Empl. 3. *Id.* at 21-22. In an e-mail to LARO Regional Director Rosalind Tyson in February 2009, OCIE Empl. 4 also stated, "I'm not totally shocked that there is no evidence that the referral was made to Boston. I think the IA supervisors wanted to placate Former OCIE Empl. 3 but they weren't so eager to carry out a recommendation from a BD staff member." E-mail to Rosalind Tyson from OCIE Empl. 4 dated February 27, 2009 at Exhibit 27. In testimony, OCIE Empl. 4 elaborated on this e-mail, stating, that he "could sense that Former OCIE Empl. 3 was -- Former OCIE Empl. 3 had some concerns, but the IA -- her IA supervisors either totally relied on her or -- or didn't have the same level of concern that she had." OCIE Empl. 4 Testimony Tr. at 21. OCIE Empl. 4 also noted that "between the BD and IA staff, there [was] not always complete teamwork. There's a level of competition between the two groups." *Id.* at 25. OCIE Empl. 4 said he thought that lack of teamwork may have been the reason Former OCIE Empl. 3 supervisors were not "too eager" to refer the examination. *Id.* at 24.

Whether because of "lack of teamwork," or a faulty referral process, as discussed below, the OIG investigation found the referral never occurred.

B. Although the 2005 Examination Report Stated that the 2005 LARO Examination Team Made a Referral, There is No Evidence a Referral Occurred

1. No Recollection of Actually Sending the Referral

The OIG investigation found that none of the members of the 2005 LARO examination team could recall actually referring the matter to the BRO. Former OCIE Empl. 3 stated she had some memory of making a telephone call to another office for a referral, but did not remember if the referral involved Westridge. E-mail dated February 25, 2009 from Former OCIE Empl. 3 to OCIE Supv. 5 at Exhibit 28. She did, however, have a specific recollection of contacting LARO Enforcement staff attorney Enf. Empl. 1 about Westridge because one of the investors in Westridge was involved with an Enforcement action on which Enf. Empl. 1 was working. *Id.*

Former OCIE Empl. 3 further elaborated on her recollections during testimony in the following exchange:

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Q: What do you think happened?

A: My sort of operating technique would be to speak with [Assistant Regional Director] Kevin [Goodman]. This obviously then went through [OCIE Empl. 4] If I wrote in the report and signed off on it that I made the referral, I would expect that I had talked to either [OCIE Empl. 4] or Kevin to get a contact name. And it would have been somebody not my -- it wouldn't be an examiner. It would be a branch chief or an [Associate Regional Director] or someone in the Boston office who I would call. And the calls were usually "Okay. Great. Send me the report," or "I'll mark that in the file. Next time we go out there, we'll take a look at things."

Q: But you don't have any recollection of sending a copy of the report --

A: No.

Q: the IA 2005 Westridge report to Boston.

A: No.

Q: And you don't have a specific recollection of having a phone call about Westridge --

A: No.

Q: -- with anybody at Boston.

A: Not specifically. I do -- I definitely remember making a referral for an exam-- it would have been earlier on in my time at the SEC as opposed to closer to the time I departed -- and making the phone call. And it's likely that it's Westridge but --

Q: But you don't know for sure.

A: No.

Former OCIE Empl. 3

Testimony Tr. at 30-31.

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OCIE Supv. 4 testified that no one remembered making the referral, stating, "my recollection is that OCIE Supv. 5 did not have a recollection of making the referral. Kevin Goodman did not have a recollection of making the referral; and Former OCIE Empl. 3 had indicated she remembers making a referral but cannot remember whether or not it was a referral related to this particular examination." OCIE Supv. 4 Testimony Tr. at 32.

2. No Record of a Referral

In February 2009, when NYRO enforcement staff sought approval for the emergency action against Westridge and WG Trading, SEC Commissioner Elisse Walter asked questions about whether there were previous examinations of Westridge and WG Trading and expressed concerns about what those examinations may have revealed. E-mail from James Clarkson to David Bergers *et. al.*, dated February 26, 2009 at Exhibit 29. In response, efforts were made to locate and review examination reports concerning Westridge and WG Trading and it was discovered that WG Trading had not been examined, despite the recommendation in the 2005 Westridge Examination Report, and that neither the LARO nor the BRO could confirm the recommendation was conveyed to the BRO. *Id.*

The OIG found that the BRO conducted a thorough search of staff e-mails, using their own information technology staff and the OIT staff at SEC headquarters and found no e-mails referencing Westridge or WG Trading.¹⁴ The BRO also conducted interviews of all relevant staff members and searched paper files and found no one who received or became aware of a referral from the LARO regarding WG Trading at that time. David Bergers ("Bergers"), Regional Director for the BRO, described the BRO's exhaustive search for evidence of a referral:

What I recall is that we wanted to make sure that we were searching the name of anyone that seemed to be a possible recipient of a referral. And so -- and we also wanted to make sure the search was as broad as possible. So we came up with a number of different words for searching both the entity -- and you can see here that we asked them to search for Westridge, WG Trading, with periods, without period, Former OCIE Empl. 3 might have been a name associated.

Maybe that was the name of a person out in LA...

...And so I think there had been some contact with LA and that the LA office said that they believed someone had talked to either a branch chief or an assistant at the time. And so what we did is we tried to make sure that we had

¹⁴ SEC Empl. 2 for the BRO conducted the e-mail searches for the BRO. SEC Empl. 2 Testimony Tr. at 4, 6. SEC Empl. 2 said he was confident in the mechanism he used for the search and, "nothing turned up." *Id.* at 8.

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the name of every broker-dealer branch chief at the time, and that would have been [redacted] OCIE Supv. 3

[redacted] OCIE Supv. 7, OCIE Supv. 2

[redacted] and [Associate Regional Director] Lucy Corkery, who was the assistant at the time. And we also added some other names.

[redacted] Former SEC Supv. 1

[redacted] was an assistant for the investment advisor program, but in the past he had responsibilities for the broker-dealer program as well. Her name is not here, but I believe we also ended up including [redacted] SEC Supv. 2 as another assistant who was not really involved with the broker-dealer program, but we tried to -- we also included my name which was initially spelled incorrectly, and then [former Boston Regional Director] Walter [Ricciardi]'s name on the chance that this could have come in to anyone who had some kind of authority.

... We went to Washington for some e-mails, restored some e-mails, and even then there were periods missing but we got all the e-mails that we could to try to find any reference to a referral.

Bergers Testimony Tr. at 15-16.¹⁵

The OIG conducted its own e-mail search as part of this investigation and found no evidence of a referral. This search uncovered no e-mails between the LARO and the BRO regarding Westridge and no internal LARO e-mails discussing a referral to BRO amongst the LARO staff. The only e-mail indicating any passing of substantive information about Westridge outside the LARO examination unit was a May 3, 2005 e-mail chain between [redacted] Former OCIE Empl. 3 and [redacted] Enf. Empl. 1 an Enforcement staff attorney in the LARO. See E-mail dated May 3, 2005 from [redacted] Former OCIE Empl. 3 to [redacted] Enf. Empl. 1 attached as Exhibit 32. In her initial e-mail to [redacted] Enf. Empl. 1 [redacted] Former OCIE Empl. 3 attached the 2005 Westridge examination report and wrote that she was sending [redacted] Enf. Empl. 1 a copy of the examination report "with an abundance of caution" to let [redacted] Enf. Empl. 1 know that San Diego County was one of Westridge's clients. *Id.* In a follow-up e-mail, [redacted] Former OCIE Empl. 3 wrote:

¹⁵ An additional search was conducted by LARO management who had the SEC's Office of Information Technology ("OIT") perform a search of LARO staff e-mails. See e-mail dated February 26, 2009 from [redacted] SEC Empl. 1 to Rosalind Tyson at Exhibit 30. OIT's search of LARO e-mails found no indication that a message was sent to Boston in 2005 regarding Westridge or WG Trading. *Id.* OCIE headquarters also searched its records for any mention of a referral and found nothing. See e-mail dated February 27, 2009 from OCIE Associate Director/Chief Counsel John Walsh to LARO Regional Director Rosalind Tyson at Exhibit 31.

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"There is no referral to Enforcement, nor any serious findings. We just wanted to make you aware of the investment of San Diego County in case it correlated with your Enforcement case regarding the City of San Diego." *Id.* There was no reference to a referral to Boston in the e-mail to Bowers.

The OIG also interviewed [OCIE Supv. 2] who was [PII] in the BRO in 2005, and who testified that he did not receive a referral and did not recall ever speaking to [Former OCIE Empl. 3] about a referral. [OCIE Supv. 2] Testimony Tr. at 18. [OCIE Supv. 2] further testified that he spoke with his supervisor, Associate Regional Director Corkery, the other [OCIE Supv. 7 and OCIE Supv. 3] as well as [SEC Supv. 2], and no one had any recollection of a referral from LARO about WG Trading. *Id.* at 19. Corkery also testified that she did not recall anyone contacting her about Westridge or WG Trading in 2005. *Id.*

Finally, the OIG interviewed former BRO [Former SEC Supv. 1] because there were incomplete e-mail records for [Former SEC Supv. 1] for the relevant time periods. [Former SEC Supv. 1] stated that he did not recall receiving a referral about Westridge or WG Trading and had not heard of either entity [Former SEC Supv. 1] Testimony Tr. at 11. He also said he did not remember getting a call from [Former OCIE Empl. 3] and said her name was not familiar to him. *Id.* at 17.

In addition to finding no written evidence of a referral, the OIG investigation also found the consensus among the examination staff was that even if a referral was made orally, rather than through an e-mail or written document, there would be some documentation somewhere referencing the referral, and likely a documentary record of the report being provided together with the referral.

[OCIE Supv. 4] testified that a copy of the report would have been sent with a telephone referral: "I believe the standard protocol or most likely that the report would have been provided as a follow-up to any call. [OCIE Supv. 4] Testimony Tr. at 32. [OCIE Supv. 4] also said that in his experience the Assistant Director would make the referral, not the examiner. *Id.* at 33. [Former OCIE Empl. 3] immediate supervisor, [OCIE Supv. 5] stated that if he were to make a referral, he would send a copy of the report: "to help the broker-dealer folks to understand the operations and concerns that we made." [OCIE Supv. 5] Testimony Tr. at 31.

[OCIE Empl. 4] who consulted with [Former OCIE Empl. 3] on the Westridge referral, also thought, "it would be natural" to send a copy of the report with a referral. [OCIE Empl. 4] Testimony Tr. at 18. He further stated he could not "envision a scenario" where someone would refer an examination and not send the report. *Id.* at 19. He noted that on the receiving end, he would "at a minimum" ask for a copy of the report. *Id.*

Regional Director Bergers concurred that even if a referral was made by telephone, there would be some follow-up where the report was forwarded to the appropriate office. Bergers Testimony Tr. at 18. He noted that in order to conduct the examination, the receiving office would, of course, require a copy of the report. *Id.*

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OCIE Supv. 2 [REDACTED] concluded, "I believe it's unlikely [that there actually was a referral] because I think that if there had been a phone call it would be likely that it would be referred to somewhere in the e-mail somewhere. And someone would -- could have made a phone call, and I suppose it could have ended at that, but I think it's highly unlikely I think there would be some reference somewhere." *Id.* at 24.

Former OCIE Empl. 3 [REDACTED] noted in her testimony that there was an electronic database maintained by OCIE where examination reports were posted after an examination, although she admitted that she did not know exactly who had access to the database, and there was no indication that Former OCIE Empl. 3 [REDACTED] referred anyone in the BRO to the fact that she was placing the 2005 Westridge examination report in the database. Former OCIE Empl. 3 [REDACTED] Testimony Tr. at 43.

Thus, the OIG investigation concludes based upon the lack of written evidence or record of a referral of the 2005 Westridge examination report from the LARO to the BRO, and no e-mail or other documentation referencing such a referral either in the LARO or the BRO, and no record of the examination report being sent to the BRO, that the 2005 LARO examination team never actually referred the findings in the 2005 Westridge report to the BRO.

3. The Lack of Protocols for Referrals or Follow-up

The OIG investigation further found that in the timeframe of the 2005 Westridge examination in the LARO, there were no policies or protocols that governed the referral of examination findings and no instructions on how a referral was to be made.

Associate Regional Director for Regulation in the LARO Martin Murphy acknowledged the lack of referral policies at the LARO at that time. Murphy Testimony Tr. at 33. Likewise, LARO Regional Director Rosalind Tyson admitted that "[a]t that time, our referral protocol was very informal." Tyson Testimony Tr. at 21.

In addition to there being no referral policy at the LARO, there was no procedure for following up on a referral and in fact, although the 2005 Westridge examination report referenced that the findings were being referred to the BRO, no one on the LARO examination team followed-up to confirm that a referral had been made, as explained by OCIE Supv. 4 [REDACTED] in the following exchange:

Q: All right. But in the 2005 time frame, when a referral would be made by the L.A. Office to another office, would there be normally follow-up by the L.A. Office to find out whether the exam occurred, what happened in the exam?

A: Typically, no.

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Q: How come?

A: From a supervisory standpoint, I don't quite know. From the examiner's standpoint and my experience, if we referred something, we provided a memo or referral along with any supporting documentation to the other office and it would be up to the other office to determine what they wanted to do in regard to that particular referral or recommendation. That's should be the --

Q: But wouldn't you want to know what they did --

A: That would have been their independent decision. They have their own supervisory structure, their own assessment procedures, and they would have made that determination on their own.

Q: But would you want to know what they did, what they found? I mean, you were referring it for a reason, because there was a concern.

A: Like I said, I couldn't speak to, as a supervisor on this exam. I could not speak to that. As an examiner on the exam, I was doing approximately ten to 16 exams a year. You know, you're going from one exam to the next. You have three or four open exams. If it's disposed of, you've made the recommendation to the other office, to the proper person, you know, that would pretty much have closed that action.

OCIE Supv. 4

Testimony Tr. at 41-42.

Former OCIE Empl. 3

confirmed that she too would not have followed-up on a referral as follows:

Q: When you work on an exam and you look at the investment advisory side and you find issues that in this case, you decided it was necessary to have a referral to have the WG Trading broker-dealer side looked at, would you follow up normally to see what happened with that referral?

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A: No, that would not have been my practice. Since I was contacting somebody senior in another office, in the Boston office in this example, it wouldn't -- I wouldn't have felt that it was my place to call up some other supervisor and say, "Have you followed up on that?"

Q: So you never knew whether the broker-dealer exam had occurred or what happened.

A: No.

Former OCIE Empl. 3

Testimony Tr. at 38.

Thus, even though the entire 2005 LARO examination team decided that it was appropriate to refer their findings relating to Westridge for an examination of WG Trading, the OIG investigation found no evidence that the LARO had actually referred the matter or that anyone in the LARO followed-up or inquired as to whether the BRO received the referral, conducted an examination or found any fraud.¹⁶

III. If a Satisfactory and Thorough Examination of Westridge had Been Conducted, the Fraud May Have Been Uncovered in 2005

A. An Experienced Examiner and Branch Chief, After Just a Couple of Days of Researching Westridge, Determined in 2009 that Westridge was a High Risk Firm that Should be Placed at the Top of an Inspection List

The OIG investigation found that in 2009, a brief, cursory review of Westridge based upon information available to the 2005 examination team, determined that Westridge had numerous, significant red flags and risk factors that warranted immediate scrutiny and examination.

In February 2009,

LE, EM

LE, EM

LE, EM

OCIE Supv. 10

Testimony Tr. at 22. Since there were six branch chiefs in the IA examination group at the LARO at that time, each branch chief reviewed one advisor. *Id.* at 23.

OCIE Supv. 10

an experienced examiner and

PII

PII

conducted the review of Westridge. *Id.*

OCIE Supv. 10

what she termed a

"pre-exam type review" that included filling out a

LE, EM

¹⁶ In March 2009, the LARO created a formal referral policy. See Memorandum Dated March 5, 2009 from Martin Murphy to All Supervisory Exam Staff at Exhibit 33. The policy states that

LE, EM

LE, EM

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reading the 2005 Westridge examination report, and checking different databases. *Id.* With just a couple of days' worth of research, [OCIE Supv. 10] concluded that Westridge was a high risk firm with many issues that needed follow-up. *Id.* at 25, 34.

[OCIE Supv. 10] provided the OIG with the [E, EM] she filled out during her review of Westridge. In her [E, EM] [OCIE Supv. 10] concluded that Westridge was a "high risk" firm. [E, EM] [E, EM] at 3, at Exhibit 34. She described Westridge's arrangement with WG Trading, as "one of the oddest arrangements" she had ever seen. *Id.* She referred to its use of 20 times leverage, as "nuts." *Id.* [OCIE Supv. 10] also identified several additional specific factors that caused her concern, including that Westridge had "access to client funds" and "the means to produce false statements or confirmations." *Id.* She also wrote about her concern that Westridge had a large value of assets with large account sizes and yet had a limited number of employees performing advisory duties. *Id.*

In her testimony, [OCIE Supv. 10] described her findings in her [E, EM] [E, EM] as follows:

. . . . It's a high-risk firm; and my reasons for that were that there were a lot of affiliations. I'm writing this very colloquially. The registrant has clients invest directly in an affiliated broker-dealer as limited partners which is one of the oddest arrangements I've ever seen. They do this to avoid Reg. T, also very odd. It is unclear whether the affiliated broker dealer is actually using 20-times leverage or just has the ability to do so. I wrote: "Twenty-times leverage sounds nuts." This is the way I talk. Also, one of the owners of registrant and the affiliated broker-dealer, Stephen Walsh, is an owner-manager of another investment advisor located in New York. Based on this little write-up, there were custody concerns. There was a possible hedge fund. The assets were very large. The employees are very small. And I determined that because it had so many risk factors, this is a high-risk firm and the investment strategy didn't make sense. Someone needs to go figure this out.

[OCIE Supv. 10] Testimony Tr. at 25-26.

[OCIE Supv. 10] also concluded that Westridge's investment strategy "didn't make economic sense" and seemed "overly complicated." *Id.* at 24. She also expressed significant concerns about her finding that Westridge "came up with its investment strategy," at least in part out of its desire to "avoid the margin requirements of Reg T." *Id.* at 24-25.

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OCIE Supv. 10 explained that her rationale for concluding that Westridge needed to be examined further was based on:

the activities of the advisor and their relationship with an affiliate broker-dealer, the relationship where the advisor was engaging a strategy which I didn't understand, where they would recommend that advisory clients basically invest in the affiliated broker-dealer which sounds -- the most bizarre thing I've ever heard.

Id. at 33.

OCIE Supv. 10 confirmed in her testimony that she arrived at all these conclusions and findings "upon a review of the Westridge Capital 2005 examination report and a couple of days of research." *Id.* at 26.

After OCIE Supv. 10 finished her review of Westridge, she met with the other branch chiefs to present her findings and circulated her ^{LE, EM} to the other branch chiefs at the meeting. *Id.* at 23, 27. After the meeting, all of the branch chiefs concluded that Westridge had the highest risk of all the investment advisers reviewed and deserved to "rise to the first position on the list." *Id.* at 26-27.

OCIE Supv. 10 noted that both OCIE Supv. 5 and OCIE Supv. 4 were at the meeting to discuss the investment advisers, although she did not recall if they commented on Westridge specifically. *Id.* at 30. OCIE Supv. 10 noted that she felt "embarrassed" to be "calling them out" during her presentation. *Id.*

OCIE Supv. 10 conclusion that further examination work was required, after a brief and cursory review of Westridge's operations, illustrates the obviousness of the red flags, as well as their severity. OCIE Supv. 10 easily concluded, in a couple of days, and using information that was available to the 2005 examiners, that Westridge was a high-risk advisor with a questionable strategy and practices. Her concerns about access to client funds and custody issues should have been concerns shared by the 2005 examiners, as should have been her concerns about Westridge's confusing investment strategy and the large amount of assets managed by very few employees.

Based upon OCIE Supv. 10, Witness 1's Atty recommendation, in late January or early February 2009, the LARO selected Westridge and WG Trading for a joint examination. OCIE Supv. 10 Testimony Tr. at 22-23. OCIE Supv. 4 Testimony Tr. at 43.

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B. The NFA Forwarded Information About Potential Fraud to the SEC and an Experienced Examination Team Was Assigned to Conduct Simultaneous Examinations of Westridge and WG Trading

On February 5, 2009, the National Futures Association ("NFA") conducted an audit of Walsh and Greenwood, who were commodity pool operators and therefore members of the NFA. 2009 Westridge Examination Report at 1. During the audit, the NFA found several suspicious documents, including \$554 million in promissory notes dating back to 1996, payable to WGTI from Walsh and Greenwood. *Id.* The NFA contacted Walsh and Greenwood and asked them about the promissory notes and to explain whether they had the ability to pay the \$554 million back to WGTI. *Id.* Walsh and Greenwood refused to cooperate and on February 12, 2009, the NFA suspended Walsh and Greenwood from membership and prohibited them from accepting investor funds. *Id.* On February 13, 2009, the NFA forwarded this information to the SEC. *Id.*

While the LARO was preparing to examine Westridge and WG Trading based upon the recommendation from [OCIE Supv. 10] the LARO was informed of the referral from the NFA regarding Greenwood and Walsh. [OCIE Supv. 10] Testimony Tr. at 22-23; [OCIE Supv. 4] Testimony Tr. at 48. The LARO then quickly assembled a team of examiners to simultaneously examine both Westridge and WG Trading. *Id.* at 51-52. According to [OCIE Supv. 4] unlike in 2005, in 2009, the LARO decided to have the same team from the LARO do an examination of both Westridge and WG Trading because, "two separate exam teams would be a liability from the standpoint of not being able to understand the full operations and interplay between the two entities [OCIE Supv. 4] Testimony Tr. at 46. When asked why this approach was not used in 2005 [OCIE Supv. 4] said "changes [were] implemented as a result of the Office of Inspector General's report, the Madoff examination." *Id.* at 47.¹⁷ [OCIE Supv. 4] further explained that in 2005 it would have been highly unlikely for examiners from another regional office to conduct an examination of a firm in another region; however, in 2009, they could "no longer afford to take risks" and "needed to have full control and understanding of the operations of both firms." *Id.*

[OCIE Empl. 5] [OCIE Empl. 8] [OCIE Empl. 1] and [OCIE Empl. 5] were assigned as the examiners on the 2009 joint examinations of Westridge and WG Trading. [OCIE Empl. 5] had been examining broker-dealers for the SEC for [PII] years and had significant knowledge and experience with hedge funds and commodity pools. [OCIE Empl. 5] Testimony Tr. at 9, 13. [OCIE Empl. 8] who had been examining investment advisers for the SEC for four years, and [OCIE Empl. 1] who had been an investment adviser examiner with the SEC since 2004, were assigned as the investment adviser examiners. [OCIE Empl. 8] Testimony Tr. at 7. [OCIE Supv. 8] and [OCIE Supv. 11] were assigned [PII] on the examinations [OCIE Supv. 4] Testimony Tr. at 52. [OCIE Supv. 8] an attorney, came to the SEC in 2004, after several years in private

¹⁷ See OIG's Report No. OIG 509, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*, available on our web site at: <http://www.sec.gov/news/studies/2009/oig-509.pdf>.

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practice doing investment management work. [redacted] OCIE Supv. 8 Testimony Tr. at 7-8. [redacted] OCIE Supv. 11 who had been with the SEC for ten years, had served as both an investment adviser examiner and more recently as a broker-dealer examiner. [redacted] OCIE Supv. 11 Testimony Tr. at 6-8. [redacted] was assigned to supervise the entire examination, having recently been promoted to [redacted] OCIE Supv. 4 Testimony Tr. at 10, 51. Despite being a member of the 2005 examination team, [redacted] OCIE Supv. never sought to recuse himself from supervising the 2009 examination. *Id.* at 52-53.¹⁸

On February 17, 2009, the LARO examination staff began on-site work at Westridge and at WG Trading. 2009 Westridge Examination Report at 1. According to the 2009 IA examination report, the examinations focused on "verification of client assets, disclosures made to clients regarding the use of client funds, and the use of promissory notes and feeder entities for investment into WG Trading." *Id.* at 5.

The 2009 LARO examination team found that Walsh and Greenwood misappropriated and misused Westridge's client assets invested in promissory notes issued by WGTI. *Id.* at 18. They found that Westridge's clients were told that 100 percent of the money they invested by purchasing WGTI promissory notes would be invested in WG Trading. *Id.* However, the 2009 LARO examination team found that only a small portion of the money invested in WGTI actually went to WG Trading. *Id.*

C. Several of the Major Findings in the 2009 Examination Could Have Been Found, or Were Found, in the 2005 Westridge Examination

As discussed above, the 2005 LARO examination team failed to follow-up on red flags they uncovered in their 2005 examination. [redacted] OCIE Empl. 4 confirmed that Westridge and WG Trading were both operating in the "exact same fashion" in 2009 as they were in 2005. [redacted] OCIE Supv. 4 Testimony Tr. at 69-70. The record shows that when the 2009 examination team followed up on the same "red flags" identified in 2005, the fraud was easily discovered.

1. Due Diligence and Asset Verification

The 2009 LARO examination team found that [redacted] LE

[redacted] LE
[redacted] LE The examination team further concluded that [redacted] LE

The 2009 Westridge examination specifically found that [redacted] LE

[redacted] LE *Id.* at 27. The examination found

¹⁸ Issues surrounding [redacted] OCIE Supv. 4 management of the 2009 examinations and his lack of recusal are discussed in Section V of this report.

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that ^E [REDACTED] received annual audited financial statements for WG Trading, he did ^E [REDACTED] *Id.* The 2009 LARO examination team concluded that ^E [REDACTED]

During the 2009 examination, the examination team performed such an analysis and compared WG Trading's 2007 audited financial statements with Westridge's client investment records and found a \$600 million shortfall. *Id.* WG Trading's audited financials reflected net assets of approximately \$1.5 billion as of December 31, 2007, while Westridge's records showed client investment in WG Trading to be \$2.1 billion. *Id.* at 27-28.

The 2005 LARO examination staff had access to similar records during their examination. In fact, the OIG investigation found that the 2005 LARO examination staff's work papers included WG Trading's audited financial statements from 2002 and 2003. The OIG reviewed these financial statements as part of this investigation, and using documents obtained from the 2005 LARO examination team's work papers, the OIG conducted a comparison of WG Trading's 2003 audited financial statements with Westridge's 2003 Form ADV.¹⁹ The OIG found WG Trading's 2003 audited financial statements showed \$1.126 billion in partner contributions, representing the funds that Westridge's investors had purportedly invested in WG Trading while Westridge's 2003 Form ADV claimed Westridge had \$2.9 billion in assets under management. As 80 percent of the \$2.9 billion in Westridge's funds were purportedly invested in WG Trading, or \$2.32 billion, the comparison yielded a shortfall of \$1.2 billion.²⁰

^E [REDACTED] OCIE Supv. 4 ^E [REDACTED] admitted that conducting this type of analysis in 2005 could have found a discrepancy that could have alerted them to the fraud, in the following exchange:

Q: Well, first, the audited financial statements of WG Trading. Were those at Westridge when you did an exam in 2005? Do you remember seeing those?

A: They were.

Q: Did you look at those?

¹⁹ Part 1A Item 5 of the Form ADV includes information on assets under management. See 17 C.F.R. §275.203-1.

²⁰ We note that the date of WG Trading's 2003 audited financial statements is as of December 31, 2003, while the section of Westridge's 2003 Form ADV that identified assets under management is dated May 2003. See Excerpts from Independent Auditors' Report for WG Trading Company LP at 0481-0482 at Exhibit 35. See also Form ADV for Westridge Capital Management, Inc., at 1355 at Exhibit 36.

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A: My recollection is that I did.

Q: Were there also documents that would have shown the net amount of assets that Westridge's clients had invested?

A: We would have had a client list. I believe there's a client list that represents 100 percent of the assets, not just the 85 percent, or nothing broken out between 85 and 15, if that makes sense.

Q: Did you compare those two in 2005?

A: I do not have a recollection of comparing those two in 2005.

Q: Does the statement that we've talked about on page 27 of the 2009 report indicate that maybe a comparison of the two could have determined that there was discrepancy?

A: Correct.

Q: So, if that had occurred in 2005, the discrepancy could have been determined back then?

A: Potentially.

OCIE Supv. 4

Testimony Tr. at 78-79.

OCIE Supv. 11 on the 2009 examination, confirmed that the fraud was uncovered with simple methods in 2009, noting, "in retrospect that fraud was not that hard to uncover." OCIE Supv. 11 Testimony Tr. at 19. He explained, "we even pointed out in the report all you really had to do was look at the amount of net assets that were on Westridge's books, compare that with the amount of money that WG Trading was representing that they were managing, and those amounts just didn't tie out." *Id.*

E

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As discussed in Section I above, the 2005 LARO examination team was also aware that [REDACTED] OCIE Supv. 5 stated that they found [REDACTED] and concluded that [REDACTED] OCIE Supv. 5 Testimony Tr. at 28. They also were aware of and in fact, concluded that Westridge had an ineffective compliance program. 2005 Westridge Examination Report at 8. Thus, there was evidence uncovered in 2005 that [REDACTED] [REDACTED] Yet, in 2005, the examination teams failed to attach any significance to this evidence and did not follow-up adequately.

2. Marketing Omissions and Misrepresentations

The 2009 LARO examination team found that Westridge provided inaccurate and misleading marketing materials to its clients. 2009 Westridge Examination Report at 3. The 2009 team specifically referenced the omissions in Westridge's Form ADV about the existence and purpose of promissory notes. *Id.* at 29. The 2009 examination team found these omissions to be material, stating: "The lack of disclosure about the existence, purpose, and nature of feeder entities and promissory notes, particularly in key disclosure documents such as Registrant's Form ADV and WG Trading's limited partnership agreements and subscription agreements amount to a material omission." *Id.*

Yet, as discussed in Section I above, the 2005 LARO examination team was aware of these same concerns, noting specifically in the 2005 examination report, that, there were "a myriad of inaccuracies" in Westridge's form ADV. 2005 Westridge Examination Report at 9. The 2005 report also stated that Westridge, "routinely failed to incorporate the requisite disclosures when presenting materials to prospective and/or existing clients." *Id.* at 10.

However, instead of viewing these misstatements and omissions as material, the 2005 examination team concluded that they were examples of "carelessness rather than serious recidivism." *Id.* at 7.

3. Custody Issues

Rule 206(4)-2 of the Investment Advisers Act of 1940 defines "custody" as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." 2009 Westridge Examination Report at 41; *see also*, 15 U.S.C. § 80b-6 rule 206(4)-2 [17 CFR 275.206(4)-2] under the Investment Advisers Act of 1940. The rule further defines custody as any capacity, such as general partner of a limited partnership, that gives the investment adviser or a supervised person legal ownership of or access to client funds or securities. *Id.* at 40.

The 2009 LARO examination team determined that because Walsh and Greenwood were "owners, and thus supervised persons of [Westridge], and had access to all client funds that were invested in or passed through WG Trading and WGTI,

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[Westridge] had custody of the applicable client's assets." 2009 Westridge Examination Report at 40. The 2009 examination staff further concluded that Westridge's supervised persons, Walsh and Greenwood, were general partners of WGTI and as such had access to client assets invested in WGTI giving Westridge custody of those assets. *Id.* at 41.

Rule 206(4)-2 imposes certain requirements on investment advisers that have custody of client securities or funds. *Id.* The 2009 LARO examination team determined that Westridge was not in compliance with the custody rule with respect to the assets invested in WGTI because Westridge's clients did not receive statements from WGTI's custodian or from Westridge reflecting WGTI's holdings and transactions as required by the rule. *Id.* at 41-42. The 2009 examination team also concluded that WGTI was not audited and consequently audited financial statements were not distributed to Westridge's clients that invested in WGTI, as was required by the rule. *Id.* at 42.

The 2009 LARO examination team made this custody determination based on the same facts that existed in 2005. The 2005 LARO examination team was aware that Walsh and Greenwood were the general partners of WG Trading and WGTI and, thus, had access to Westridge's client assets that were invested in and through those entities. 2005 Westridge Examination Report at 2, 5. The 2005 examination team also knew Walsh and Greenwood were the majority owners of Westridge. *Id.* at 2. As described in greater detail in Section I above, even though planning documents for the 2005 Westridge examination clearly indicated an intention to focus on custody issues, the 2005 examination report did not contain a custody analysis of the assets invested in WG Trading and WGTI.²¹ Had the LARO examination team done so, they should have come to the same conclusion as the 2009 examination team did, which was that Westridge did have custody of those client assets. Such a determination would have triggered a requirement that WGTI distribute independently audited financial statements each year to all its limited partners. 2009 Westridge Examination Report at 41 (*See also* Rule 206(4)-2(b) (4)). Given all the fraud evidence the 2009 team found in WGTI's records (as discussed in the following section), an independent audit of WGTI in 2005 likely would have detected the fraud.

4. Review of Records from WGTI

The 2009 LARO examination team uncovered evidence of fraud in the records of WGTI, the unregistered investment vehicle that was being used as a "pass-through" between Westridge and WG Trading. For example, WGTI's balance sheet showed \$667 million in promissory notes were issued to WGTI Investors with only \$94 million actually going to WG Trading. 2009 Westridge Examination Report at 18. In addition, WGTI's records included evidence of payments from WGTI to entities affiliated with

²¹ As also discussed in Section I, although the 2000 examination team conducted a custody analysis, they concluded Westridge did not have custody of client assets invested in WG Trading.

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Walsh and Greenwood, including a \$19 million payment to Walsh's ex-wife and an \$18.6 million payment to the horse farm operated by Greenwood's wife. *Id.* at 19.

The 2009 LARO examination team easily obtained access to WGTI's records once on site at WG Trading ^{OCIE Supv. 4} Testimony Tr. at 65-66. The 2005 LARO examination team did not even request WGTI's records during their examination. *Id.* at 70. In fact, ^{OCIE Supv. 5} [REDACTED] seemed confused about whether the SEC had any authority to obtain documents from unregistered entities even where they suspected fraud, as evidenced by the following exchange:

Q: So you're saying it's not possible for the SEC to get documents from an unregistered entity?

A: I'm not saying it is not possible. I was saying, if we were not able to obtain records -- often when we do an investment or other investigations, we often encounter unregistered entity -- affiliated entities of the adviser or investment company.

Q: So if a company wants to conduct fraud and they do it through an unregistered entity --

A: Can I finish my --

Q: Well, I have a question. If a company wants to conduct fraud --

A: Uh-huh.

Q: -- and they do it through an unregistered entity --

A: Uh-huh.

Q: -- you can't uncover it. The SEC just can't uncover it cause it's unregistered. Is that --

A: I'm not going to answer that hypothetical cause I don't know. I mean, I don't know whether that's -- you know, can or cannot.

Q: So you don't know if the SEC is able to uncover fraud where there's an unregistered entity involved?

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A: I'm not saying that. I'm just saying that it is -- when it's an unregistered entity, we don't have a right to obtain documents from that -- about that entity --

Q: Does the enforcement division have the right to obtain documents --

A: I don't know what they have or they don't have cause I never worked for the enforcement division.

Q: But you can -- has -- has the investment adviser staff ever made a referral to enforcement?

A: I don't know whether, you know -- I don't -- I don't recall. I mean, I don't know whether --

Q: You've never --

A: -- it's possible --

Q: -- you've never heard of a case where an investment adviser exam made a referral to the enforcement division?

A: Mr. Kotz, I was told never say "never," and I would not --

Q: So in your experience, you've -- you've -- you haven't had a situation where you're even aware of the investment adviser group making a referral to enforcement?

A: I don't know. Maybe. I'm just -- can't recall any specific instance; and, therefore, I do not want to answer that question.

Q: Okay.

A: But many times in an examination, we encounter unregistered affiliates, and we often request documents voluntarily. Many times we -- sometimes we get records. They get corporations. Other times we don't. And there -- I personally have some experience that, when we push for the record and they registrant refuse to provide the record, stating that we

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don't have jurisdiction, and we brought that up to the office, and at the end, we never receive the record.

OCIE Supv. 5

Testimony Tr. at 59-61

OCIE Empl. 8

an examiner assigned to the 2009 examinations discussed the failure of the 2005 LARO examination team to seek and review documents from WGTI in the following exchange:

Q: Okay. So in your examination on-site at Westridge Capital, you were able to view documents that related to WGTI?

A: Correct.

Q: Even though WGTI was unregistered?

A: Correct.

Q: Okay. Now, were you aware of whether in 2005 the IA examiners had knowledge of WGTI or that there was some pass-through vehicle?

A: My understanding is they had knowledge of WGTI.

Q: Do you know if they reviewed any WGTI documents in 2005?

A: My understanding is they did not review any documents of WGTI.

Q: Do you know why not?

A: My understanding of why they did not is because WGTI was unregistered, and there was either some – a difficulty in obtaining the document or decision not to request any documents pertaining to WGTI. I don't know which of the case is true.

Q: Okay. Now, as a general matter, if the SEC is doing an examination and it suspects fraud or potential fraud, if you have an entity like WGTI that is unregistered, would that preclude the SEC from reviewing those documents, whether through the context of the examination or if they wanted to get

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enforcement involved? I mean, is the fact that some entity's unregistered, does that mean the SEC can never look at those documents if they're suspecting fraud?

A: I'm not sure what our abilities are to obtain documents of unregistered entities. I know that pre-Madoff there were plenty of instances where people felt shy about requesting documents from a firm that's unregistered. I know that post-Madoff, people feel much more capable and not shy about requesting those documents from unregistered firms.

OCIE Empl. 8

Testimony Tr. at 24-25.

The OIG investigation found a major difference between the manner in which the two examinations were conducted related to the fact that the 2009 examinations were conducted after the "Madoff" scandal.²²

OCIE Supv. 8

said that custody of assets was a focus of the 2009 examination because of Madoff:

This was right after the Madoff -- problems that arose after Madoff. And so it was a focus on, you know, looking at custody arrangements, in particular, custody arrangements where the broker-dealer or affiliated broker-dealer may have custody of advisers, clients' assets.

OCIE Supv. 8

Testimony Tr. at 40.

OCIE Supv. 4

also said that after Madoff, and specifically after the OIG's Madoff report, protocol changed allowing for joint investment adviser and broker-dealer examinations, which OCIE Supv. 4 said was critical to understanding risk:

A: We -- in my -- the Madoff filings from the Office of Inspector General. We made a determination in our office that having two separate offices and two separate exam teams would be a liability from the standpoint of not being able to understand the full

²² The OIG found that the SEC received numerous complaints that Bernard Madoff was potentially operating a Ponzi scheme, but failed to conduct competent examinations and investigations of Madoff and his firms. Specifically, the OIG found that two broker-dealer examinations conducted of Madoff's firms failed to follow-up on custody-related issues that would have uncovered the fraud. See Report No. OIG 509, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*, issued August 31, 2009 available at <http://www.sec.gov/news/studies/2009/oig-509.pdf>.

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operations and interplay between the two entities, the movement of money and how the two firms worked together; and the determination was made that we would need the joint exam team -- the same examiners was the original intention who would go to Westridge first to conduct their exam from the idea that the money was coming into Westridge, and then ultimately hitting WG, and that same exam team would then go to WG Trading Company to conduct the broker-dealer exam....

Q: So, what was the difference between the protocol in 2005 and the protocol in 2009?

A: Changes implemented as a result of the Office of Inspector General's report, the Madoff examination. We determined that that particular protocol was something we could no longer afford to take risks with, that we needed to have full control and understanding of the operations of both firms to really understand the risks of what was going on. So, that was why that particular decision was made.

OCIE Supv. 4

Testimony Tr. at 46-47.

OCIE Supv. 4

also hypothesized about the failures in the 2005 examination and testified that if they had conducted third-party asset verifications in 2005, as they do now after Madoff, they would have found the fraud:

Q: Looking back now, do you think that more should or could have been done in 2005 with respect to the investment adviser exam of Westridge Capital?

A: Hindsight is 20/20. If we conducted third-party asset verifications pursuant to recommendations and the Office of Inspector General's Madoff report in 2005, at that time in 2005, it would have required us to get third-party confirmation of the assets with a custodian, most likely J.P. Morgan or Merrill Lynch, I believe, or with the current custodians for WG Trading and confirmation with the individual investors as to amount invested. That was one of the particular items....

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--if we'd conducted what we do now in terms of our 2009 asset verification procedures, it would clearly require confirmation with the individual investors, as well, which would have allowed us to necessarily see a discrepancy between what was being represented to the investors and what was actually available in liquidating equity.

Q: And that's an area you believe that fraud would have been uncovered?

A: I do.

Id. at 71-72.

OCIE Empl. 8 also explained that after Madoff there was a "renewed focus on ensuring that we review the existence of client assets at all firms." OCIE Empl. 8 Testimony Tr. at 26.

OCIE Empl. 8 further explained that the 2009 Westridge and WG Trading examinations were different because after the Madoff case, verification of assets became a key concern:

Q: You stated several times about differences in how things were done pre- and post-Madoff.

A: Yes.

Q: So do you think that part of the reason why the exams were conducted differently in 2005 and 2009 -- or just generally how the exam was conducted in 2005 -- has to do with that pre- and post-Madoff? In other words, if this Westridge Capital IA exam had been conducted post-Madoff, it might have been done very differently than it was done 2005?

A: I believe so.

Q: Why do you think that?

A: Because one of the key concerns post is the verification of assets, and I believe the exam team in 2005 identified that there was this other fund, unregistered fund, WGTI; and post-Madoff, we would not conclude the examination without making every reasonable attempt to get a hold of the information about the financials of WGTI.

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Id. at 38-39.

However, the OIG investigation found that the 2005 Westridge examination was conducted under "pre-Madoff" procedures by examiners who were not focused sufficiently on verifying client assets and at least one of whom was confused about whether the SEC could obtain documents from unregistered entities even if fraud was suspected. Thus, although the 2005 examination team was aware of and had in its hands evidence of potential fraud, they did not take the basic steps necessary to investigate the matter further and, as in Madoff, a significant fraud was not uncovered at that time.

IV. If the LARO had Referred their Findings in the Westridge IA Examination and a Broker-Dealer Examination of WG Trading had been Conducted, the Fraud Would Also Likely Have Been Discovered

The OIG investigation found that prior to the 2009 cause examination of WG Trading, WG Trading had not been examined by the broker-dealer examiners at the SEC since 1995. 2005 Westridge Examination report at 3. According to BRO Associate Regional Director Corkery, it was not unusual to go to go 15-20 years between broker-dealer examinations due to resource limitations. Corkery Testimony Tr. at 11. BRO OCIE Supv. 2 testified that there are 450 registered broker-dealers in the BRO's territory and he said there was no particularly prescribed time period between broker-dealer examinations, as they were simply based on a risk analysis. OCIE Supv. 2 Testimony Tr. at 10, 12.

OCIE Supv. 2 stated that WG Trading did come up as a potential candidate for an oversight examination in 2006. *Id.* at 16. However, another broker-dealer was deemed a better choice because that firm had been examined by both the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) within the year and there was an Enforcement link to one of the firm's principals. *Id.* at 14-16.

Moreover, the OIG investigation found evidence that had the LARO actually referred the Westridge examination findings, the BRO would have conducted a broker-dealer examination of WG Trading in 2005. BRO Regional Director Bergers said, "The sense that I got from the staff here is that if they had read the report that they would have gone out on site." Bergers Testimony Tr. at 25. OCIE Supv. 2 thought it "would be pretty automatic" for the BRO to do an examination if they had gotten a referral from the LARO. OCIE Supv. 2 Testimony Tr. at 17.

Corkery testified that given the numerous red flags in the 2005 Westridge examination report, the BRO would have been concerned and looked for fraud in an examination of WG Trading in the following exchange:

Q: Do you think if you had these kinds of red flags where you had these consistent returns, lack of

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disclosure, inaccuracies in the ADV, compliance program that didn't seem to be a priority, given that the compliance person had little experience and wasn't being trained, documentation that you weren't getting, e-mails that were deleted, would those be at least potential concerns that there might be some kind of fraud?

A: Certainly it would be a concern. Potential fraud, the lack of disclosures would concern me greatly, and as to why there was a lack of disclosure and the affiliations.

Q: So if the broker-dealer unit got such a referral, would one of the things they'd be looking for is at least a potential of fraud?

A: Yes. And just acts of conflict of interest that are inherent in these relationships.

Corkery Testimony Tr. at 18-19.

OCIE Supv. 2 stated he believed that the BRO would have uncovered the fraud if they had done the WG Trading examination in 2005, as evidenced in the following exchange:

Q: Do you think it's possible or even likely that had the Boston office conducted a broker-dealer examination of WG Trading in 2005, given what the development advisors found in their Westridge IA report in 2005 and given what we now know the Los Angeles folks both on the IA and BD side found in 2009, that they would have uncovered that there was at least a potential fraud here?

A: That certainly is possible, and I would hope it would be likely.

Q: Because the SEC broker-dealer unit's job is – is able to uncover these type of frauds by doing examinations, right?

A: Yes.

Q: And so where you have situations like in this case there are red flags, there are concerns, there are

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documents that can be reviewed, the broker-dealer folks are able to either uncover the fraud themselves or raise enough issues that they bring enforcement in to help uncover the fraud?

A: Yes.

Q: So it may very well be that if the referral had actually happened in 2005, this fraud would have been uncovered many years before it finally was in 2009?

A: That is possible, yes.

Q: And do you think it's likely?

A: Likely, as I said, I hope it would be likely, but I think there is a reasonable possibility or a good possibility, you know.

OCIE Supv. 2 Testimony Tr. at 35-36.

OCIE Supv. 2 also stated that based upon the red flags in the 2005 Westridge examination report, the broker-dealer examination of WG Trading would have focused on "Ponzi scheme type payments" and would have made efforts to "figure out where the money is and how much is there," determining if there was actual trading if they're claiming to be doing trading" and "looking to try to see if any money was going out in an appropriate fashion." *Id.* at 33.

Members of the 2009 LARO examination team also concurred that a 2005 examination of WG Trading could have uncovered the fraud. OCIE Supv. 11 testified directly that if a broker-dealer examination was conducted in 2005 in a manner similar to the examination in 2009, the fraud would have been detected. OCIE Supv. 11 Testimony Tr. at 18. Examiner OCIE Empl. 5 also concurred, identifying numerous red flags and discrepancies that could have been detected had an examination been conducted of WG Trading in 2005. OCIE Empl. 5 Testimony Tr. at 22-23.

Thus, had either the 2005 LARO Westridge examination team conducted a competent and thorough examination of Westridge in 2005, or actually referred their findings about WG Trading to the BRO, the fraud would likely have been discovered several years earlier.

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V. Allegation ^{OCIE Supv. 4} Attempted to Cover up Mistakes he Made in the 2005 Examination During his Supervision of the 2009 Examinations

The OIG also investigated the allegation in the anonymous complaint that ^{OCIE Supv. 4} "instructed (and even bullied) examiners to not pursue certain red flags in an examination where the LARO exam staff uncovered a massive fraud. ^{OCIE Supv. 4} motive for doing this seemed to be that he either performed, or was materially involved in directing, the most recent prior exam at the firm."

The OIG investigation found that notwithstanding ^{OCIE Supv. 4} involvement with the 2005 Westridge examination and notwithstanding significant questions about how the 2005 LARO examination team, which included ^{OCIE Supv. 4} failed to uncover an ongoing fraud at Westridge ^{OCIE Supv. 4} never considered recusing himself from the 2009 LARO examinations of Westridge and WG Trading and his superiors did not recommend that he be recused either.

In testimony ^{OCIE Supv. 4} stated he did not have any concerns about supervising the 2009 examination in the following exchange:

Q: And so, did you consider in your mind whether it was a good idea to be so heavily involved in this 2009 exam given that you were involved in the 2005 exam?

A: No, I did not. It was not -- it is not atypical for examiners to examine the same firm twice; not atypical for supervisors to supervise an examination, another examination of the same registrant twice. And then oftentimes, it is sometimes considered helpful to have one or more of the prior exam team on that exam because they have a better basis for understanding the firm.

Q: What about a case like this where you had been involved in an exam of that entity and then later on there was credible evidence of a fraud and there might be concern that you potentially might have missed the fraud in connection with your 2005 exam?

COUNSEL FOR ^{OCIE Supv. 4} concern?

BY MR. KOTZ:

Q: Wouldn't that be your concern that here you are now working on a 2009 exam of a matter where you potentially could have missed the same thing in 2005?

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A: I had absolutely no concerns. It never even hit my mind. To be honest with you, I had the exact opposite feeling, that if there was something that was missed in the previous exam, I wanted to make absolutely sure that this exam was run exactly by the book and everything that we needed to find out we found out and we brought to light.

OCIE Supv. 4 Testimony Tr. at 53-54.

OCIE Supv. 4 supervisor, Martin Murphy, similarly testified that the staffing of the 2009 LARO Westridge and WG Trading examinations was based on availability and competency and no consideration was given to the fact OCIE Supv. 4 had been involved with the 2005 Westridge examination. Murphy Testimony Tr. at 19. Likewise, LARO Regional Director Rosalind Tyson testified that there was no policy for recusing staffers where someone had done an earlier examination that did not detect an ongoing fraud, and she did not see that there was a problem in OCIE Supv. 4 supervise the examinations. Tyson Testimony Tr. at 11-12. She also said she was not aware that any staffers felt OCIE Supv. 4 supervision of the 2009 examination was inappropriate. *Id.* at 14.

However, the OIG found that the examiners who worked on the 2009 LARO examinations of Westridge and WG Trading did have significant concerns about OCIE Supv. 4 involvement. Examiner OCIE Empl. 5 testified he believed OCIE should have been recused from the 2009 examinations so "that the examiners on the team [would] feel that it is an open exam, just less stressful than having someone who possibly could be subconsciously defensive." OCIE Empl. 5 Testimony Tr. at 35-36. Examiner OCIE Empl. 8 also testified that he "had concerns about OCIE Supv. 4 involvement with the 2009 examination" because OCIE Supv. 4 had been involved with the 2005 examination in which the "substantial fraud" had not been uncovered. OCIE Empl. 3 Testimony Tr. at 14-15.

In addition to general concerns, OCIE Empl. 5 testified that he had several significant disagreements with OCIE Supv. 4 during the 2009 Westridge and WG Trading examinations regarding the scope of the examinations, and that he was concerned that there were "particular areas" of the examinations OCIE Supv. 4 felt shouldn't be looked at." OCIE Empl. 5 Testimony Tr. at 25. OCIE Empl. 5 stated OCIE Supv. 4 questioned the necessity of determining the capital balances, which OCIE Empl. 5 felt was "part of the story of the fraud" and eventually was allowed to perform. *Id.* at 26-27. OCIE Empl. 5 testified that it crossed his mind that the disagreement OCIE Supv. 4 was related to the 2005 examination and that it added to the "stress level" of the examination. *Id.* at 36-37. He also noted that he did not recall ever having another examination in his time at the SEC where there were so many disagreements. *Id.* at 31. However, OCIE Empl. 5 said that at the end of the examinations, he "was fairly satisfied with the write-up on the capital balances" and OCIE Supv. 4 "did not substantially alter[] anything [in the examinations reports] that [he] would have taken exception to." *Id.* at 38-39.

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In addition, the examiners assigned to the 2009 examinations of Westridge and WG Trading reported that the level of OCIE Supv. 4 involvement in the 2009 examinations was "unusual" for such a senior official. OCIE Empl. 5 testified OCIE Supv. 4 "reviewed and edited" the 2009 report and had "regular telephone calls" with the staff during field work. OCIE Empl. 5 Testimony Tr. at 14-15. He stated that he and OCIE Empl. 8 had lengthy telephone conversations OCIE Supv. 4 sometimes lasting two hours, on 11 of the 15 days of field work. *Id.* at 15. OCIE Empl. 5 considered the level of involvement "unusual" and noted, "I don't believe I have had PII be that involved" in an examination before. *Id.* at 49, 51. Similarly, OCIE Empl. 8 testified OCIE Supv. 4 had daily, long telephone conversations with the staff during the field work and had weekly meetings with them thereafter. OCIE Empl. 8 Testimony Tr. at 18. OCIE Empl. 8 also thought that it was unusual to have so many long telephone conversations with PII while in the field. *Id.* at 19. However, OCIE Empl. 8 did not indicate that he had any "substantive disagreements" OCIE Empl. 8 with respect to the 2009 examinations. *Id.* at 17.

OCIE Supv. 4 denied any impropriety in connection with his work on the 2009 examinations of Westridge and WG Trading. OCIE Supv. 4 Testimony Tr. at 56. He stated, "That is not true" when confronted with the allegation that he instructed examiners not to look into certain areas so it would not appear he missed them in 2005. OCIE Supv. 4 also had a very different account of the disagreements with OCIE Empl. 5. He testified the disagreements he had with OCIE Empl. 5 had more to do with time constraints than the substance of OCIE Empl. 5 work, explaining as follows:

...Capital balances, as I said, was always one of the priority items. I believe approximately -- well, somewhere several months down the line, there were issues with OCIE Empl. 5 because his capital balances analysis had not been completed yet; and considering the fact that we were working in conjunction with Enforcement which had already issued, filed their claim in federal court, there were -- time was of the essence to provide a completion to our exams as quick as possible with as much relevant information as possible so that Enforcement would have that information available to them when they were taking proffers from different individuals and also in deciding who to charge because they had only charged Walsh and Greenwood in the beginning. So, I know there was discussion about whether or not other examiners on the team -- whether it was OCIE Empl. 1 or OCIE Empl. 8 -- could assist or take over portions of that capital balance analysis in order to speed up the process because they already had completed their tasks....

Id. at 58.

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Thus, while the OIG investigation did not find specific evidence that [OCIE Supv. 4] instructed or bullied examiners to ignore "red flags" in the 2009 examinations of Westridge and WG Trading that would have identified issues or areas that he himself failed to uncover in the 2005 Westridge examination or [OCIE Supv. 4] directed substantive changes to the report's findings, the OIG did find that examiners were uncomfortable with [OCIE Supv. 4] involvement in the 2009 examinations and that this created an appearance of impropriety that could have been avoided if [OCIE Supv. 4] had been initially recused from the 2009 examinations.

VI. Numerous Complaints About [OCIE Supv. 4] Management Style Were Not Addressed by His Superiors

In the course of its investigation, the OIG found evidence that many LARO employees had significant concerns [OCIE Supv. 4] management style in general. Yet, the OIG also found that there was little, if any, evidence that any action was taken by management to resolve or even address these concerns and that employees feared retaliation if they complained to LARO management.

Examiner [OCIE Empl. 5] described how uncomfortable he felt [OCIE Supv. 4] and testified that on one occasion, [OCIE Supv. 4] "aggressively passed me in the hallway and I had to move out of his way." [OCIE Empl. 5] Testimony Tr. at 48. [OCIE Empl. 5] said he told his supervisor, [OCIE Supv. 11] about his problems [OCIE Supv. 4] at 49. [OCIE Empl. 5] testified that [OCIE Supv. 11] responded to him, "Don't worry about it," or "Keep working." *Id.*

[OCIE Empl. 5] also testified that many other examiners had difficulties working with [OCIE Supv. 4] in the following exchange:

A: Since I've worked on the assignment – these assignments that we've been speaking about in 2009 - I have heard of quite a few examiners that have had difficulties in working with [OCIE Supv. 4]

Q: Okay. Which examiners?

A: Well, two of them are no longer here. They are females that I think technically they may have been permitted to resign, but one of them was a [Former OCIE Empl. 6] and another was [Former OCIE Empl. 7] and they had a difficult time working with him.

Id. at 53-54.

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Examiner [OCIE Empl. 8] also stated he "heard from many examiners [that] they don't enjoy working with [OCIE Supv. 4] because [OCIE Supv. 4] management style and how he talks to or communicates with people." [OCIE Empl. 8] Testimony Tr. at 34-35.

[OCIE Supv. 10] also testified that she knew of employees who had issues [OCIE Supv. 4] management and communication style. [OCIE Supv. 10] Testimony Tr. at 9-10. [OCIE Supv. 10] testified that she was actually asked to mentor [OCIE Supv. 4] he was first promoted to branch chief. *Id.* at 10. [OCIE Supv. 10] said [OCIE Supv. 4] subordinates let her know that they had problems with [OCIE Supv. 4]. In fact, [OCIE Supv. 10] decided she no longer wanted to mentor [OCIE Supv. 4] because she felt he was "too reactive" and that she was doing too much "damage control" for him. *Id.* at 12-13.

[OCIE Supv. 8], who reported directly [OCIE Supv. 4] expressed concerns with his managerial approach. [OCIE Supv. 8] testified that in [OCIE Supv. 4] unexpectedly called her on her vacation to tell her he was firing examiner [Former OCIE Empl. 6] [OCIE Supv. 8] Testimony Tr. at 25. [OCIE Supv. 8] said she "personally did not agree" with the decision and had "no warning" it was coming. *Id.* at 26, 29. She said it was "alarming" to her and she expressed her concerns to [OCIE Supv. 10] [OCIE Supv. 9 and OCIE Supv. 1] *Id.* at 29-30. [OCIE Supv. 8] also testified she felt she was treated unfairly in her mid-year review [OCIE Supv. 4] at 34. [OCIE Supv. 8] further testified that Examiner [OCIE Empl. 9] who previously worked [OCIE Supv. 4] expressed concerns [OCIE Supv. 4] *Id.* at 36-37.

The OIG investigation also found that some employees who had concerns about [OCIE Supv. 4] were afraid of retaliation if they raised them too aggressively with management. Examiner [OCIE Empl. 8] also said he heard about [OCIE Supv. 4] from Examiner [Former OCIE Empl. 7] [OCIE Supv. 8] and Examiner [OCIE Empl. 5] and that all three "expressed concerns over retaliation if they were to go up the chain of command and express their concerns about [OCIE Supv. 4] [OCIE Empl. 3] Testimony Tr. at 35. [OCIE Supv. 8] admitted that she had concerns about "a negative impact" and not being "looked at like as a team player" if she were to complain up the supervisory chain about [OCIE Supv. 4, OCIE Supv. 8] Testimony Tr. at 31. She also said she had the impression that Associate Regional Director of Regulation and [OCIE Supv. 4] [PII] supervisor, Martin Murphy, would not have been receptive to her concerns about [OCIE Supv. 4] *Id.*

[PII]

[PII]

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OCIE Supv. 8 [redacted] said the decision to take OCIE Supv. 4 [redacted] supervisory duties was welcomed by the staff. OCIE Supv. 8 [redacted] Testimony Tr. at 36. She said, "people would come in and were happy . . ." to learn he was no longer a supervisor. *Id.* However, this was PII [redacted] taken as a result of the strong reaction from OCIE Supv. 4 [redacted] staff relating to the distribution of information concerning his PII [redacted] use. The OIG found no evidence that, notwithstanding the concerns expressed by numerous employees about OCIE Supv. 4 [redacted] style, any action was taken by LARO management to address these larger issues.

VII. Allegation OCIE Supv. 4 [redacted] **Made Misstatements** PII [redacted]

The OIG also investigated the allegation in the anonymous complaint that OCIE Supv. 4 [redacted] "appears to have made possible misstatements, omissions or lacked candor" in his testimony before the OIG in connection with the PII [redacted]



The OIG did not find evidence to substantiate this allegation. In its investigation,



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In his testimony before the OIG [redacted]

[redacted]

[redacted] Accordingly, the OIG did not find evidence that [redacted] testimony was false or inaccurate as [redacted]

[redacted]

[redacted] We did not find evidence [redacted] was specifically aware that anyone else at the SEC [redacted]

[redacted] or that [redacted] ever became aware of such knowledge on the part of any SEC employee.

The anonymous complaint also claimed [redacted] had engaged in a misstatement [redacted] that he had not been the subject of any disciplinary action or performance improvement plan. The anonymous complaint indicated that [redacted] had mentored him because of his "poor people skills." The OIG investigated this allegation and found no evidence [redacted] was the subject of any disciplinary action or ever placed on a performance improvement plan, and [redacted] specifically testified that her efforts to mentor [redacted] were not part of any disciplinary action against him or any finding that his performance was deficient. [redacted] Testimony Tr. at 11.²⁴

Conclusion

The OIG investigation found that in 2005, the SEC's LARO missed a significant opportunity to uncover a Ponzi scheme and failed to conduct a competent and thorough examination of the investment adviser, Westridge Capital Management, and did not take the necessary steps to ensure that a follow-up examination of the broker-dealer, WG Trading was conducted. The OIG further found that in 2009, when an examination team conducted a joint examination of Westridge and WG Trading, which it acknowledged were both operating in the "exact same fashion" in 2009 as in 2005, and the 2009 examination team followed up on the same "red flags" identified in 2005, the fraud was quickly and easily discovered. The OIG investigation also concluded that had the LARO referred their findings to the BRO and had a broker-dealer examination of WG Trading been conducted in 2005, the fraud would have likely been discovered.

[redacted]

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The OIG investigation found a major difference between the manner in which the two examinations were conducted related to the fact that the 2009 examinations were conducted after the "Madoff" scandal. The OIG found that after Bernard Madoff confessed to operating a \$50 billion Ponzi scheme and the OIG issued a report of investigation regarding the failure of the SEC to uncover Bernard Madoff's Ponzi scheme, SEC examiners focused more acutely on custody of assets, conducted more joint examinations and were more aggressive in seeking records from unregistered firms. Unfortunately, the OIG investigation found that the 2005 Westridge examination was conducted under "pre-Madoff" procedures by examiners, who were aware of and had in their hands evidence of potential fraud, but did not take the basic steps necessary to investigate the matter further and, as in Madoff, a significant fraud was not uncovered at that time.

The OIG also specifically investigated the allegation in the anonymous complaint that [OCIE Supv. 4] "instructed (and even bullied) examiners to not pursue certain red flags" in the 2009 examinations in an attempt to hide his failures in the 2005 examination. While the OIG investigation did not find evidence substantiating the claim [OCIE Supv. 4] instructed or bullied examiners to ignore "red flags" in the 2009 examinations of Westridge and WG Trading that would have identified issues or areas that he himself failed to uncover in the 2005 Westridge examination or [OCIE Supv. 4] directed substantive changes to the report's findings, the OIG did find that examiners were uncomfortable with [OCIE Supv. 4] involvement in the 2009 examinations and that this created an appearance of impropriety, which could have been avoided [OCIE Supv. 4] had been initially recused from the 2009 examinations. In the course of its investigation, the OIG also found evidence that many LARO employees had significant concerns about [OCIE Supv. 4] management style in general. Yet, the OIG also found that there was little, if any, evidence that any action was taken by management to resolve or even address these concerns.

Accordingly, the OIG recommends that the Chairman, Director of OCIE and the LARO Regional Director carefully review this ROI and share with LARO management the portions of this ROI that relate to the performance failures by those employees who still work at the SEC, so that appropriate action (which may include appropriate performance-based action) is taken, on an employee-by-employee basis, as appropriate.

The OIG also specifically recommends that [OCIE Supv. 4] not be placed back in a supervisory role in the LARO.

The OIG is also recommending that the Chairman, the Director of OCIE and the LARO Regional Director take the necessary actions to establish appropriate mechanisms in the LARO to ensure that employee feedback about supervisors is appropriately and sufficiently addressed so that LARO employees feel comfortable conveying feedback about their superiors without fear of retaliation.

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The OIG recommends that the LARO establish a recusal policy whereby an individual who previously worked on an examination that did not uncover an existing fraud is recused from working on a subsequent "cause" examination of that entity looking for evidence of the fraud. The OIG also recommends that the LARO include, in its examination referral policy and procedures, a mechanism for tracking the outcome of an examination referral, particularly where a follow-up examination is recommended.

This report is being provided to the Regional Director of the Los Angeles Regional Office, the Deputy Chief of Staff, Office of the Chairman, Commissioner Walter, Director of the Office of Compliance Inspections and Examinations, the General Counsel, the Ethics Counsel, the Associate Executive Director for the Office of Human Resources, and the Director of the Office of Equal Employment Opportunity.

Submitted



Date: 10-26-10

Concur:

Date: 10/26/10

Approved:

H. David Kotz

Date: 10.26.10