

**UNITED STATES OF AMERICA**  
**before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**INVESTMENT ADVISERS ACT OF 1940**  
**Release No. 2961 / December 14, 2009**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-13713**

<b>In the Matter of</b>	:	<b>ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940</b>
<b>Stephen Jay Mermelstein,</b>	:	
<b>Respondent.</b>	:	
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**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 (“Advisers Act”) against Stephen Jay Mermelstein (“Mermelstein” or “Respondent”).

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (“Offer”), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings, Making Findings, and Imposing Remedial Sanctions Pursuant to Section 203(f) of the Investment Advisers Act of 1940 (“Order”), as set forth below.

### III.

On the basis of this Order and Respondent's Offer, the Commission finds<sup>1</sup> that:

#### **RESPONDENT**

1. **Stephen Jay Mermelstein**, age 58, resides in Warren, New Jersey. Mermelstein was a founder of Ark Asset Management Co., Inc. ("Ark") and, during the Relevant Period, was the Chief Operating Officer. Mermelstein oversaw the legal, compliance and operational aspects of Ark's advisory business.

#### **RELEVANT ENTITIES**

2. **Ark Asset Management Co., Inc.**, a New York corporation headquartered in New York, New York, was registered with the Commission as an investment adviser from August 21, 1989 through March 2, 2009, when it withdrew its registration. It was the wholly-owned, operating subsidiary of Ark Asset Holdings, Inc. ("Ark Holdings"). Ark was originally the investment management arm of Shearson Lehman Brothers Inc. Ark ceased operations on February 27, 2009 and sold substantially all of its assets. On or about March 30, 2009, Ark Holdings consented to an involuntary bankruptcy proceeding under Chapter 7 of the Bankruptcy Code.

3. **NorthStar Funds** ("Proprietary" accounts or funds) was a set of hedge funds created by Ark in 2000. In December 2003, the portfolio manager responsible for trading both NorthStar and Specialty Growth, left Ark and created a separate entity, NorthStar Capital Funds, LLC, which took over the management of the NorthStar Funds.

4. **Specialty Growth** ("Client" accounts) was a set of advisory accounts created by Ark in 1986 and managed using a growth strategy. Specialty Growth clients included large institutional investors, such as retirement plans, pension funds and charitable organizations.

#### **SUMMARY**

5. This matter involves Respondent's failure reasonably to supervise a now-deceased portfolio manager ("Portfolio Manager") who engaged in fraudulent trade allocation – "cherry-picking" – at Ark, which was a registered investment adviser. The Portfolio Manager (who died in 2005) favored the Proprietary accounts over the Client accounts in the allocation of securities between August 2000 and December 2003 ("Relevant Period"). The Portfolio Manager placed orders for securities, but changed or delayed making allocations of the purchases and sales until after the order had been filled and the price of the security had been obtained, which allowed the Portfolio Manager to allocate more favorable trades to the Proprietary accounts. As a result of this fraudulent

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<sup>1</sup> The findings herein are made pursuant to the Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

conduct, Ark realized at least \$19 million of ill-gotten gains in the form of performance fees from the Proprietary accounts. Respondent was Ark's Chief Operating Officer during the Relevant Period. Respondent failed reasonably to supervise because he failed to detect and prevent the Portfolio Manager's fraud in spite of red flags indicating that the Portfolio Manager's allocation practices were questionable.

## **FACTS**

### **A. Background**

6. In August 2000, Ark launched a set of hedge funds, the NorthStar Funds, in which numerous Ark employees, traders, and board members invested. The Portfolio Manager made all investment decisions with respect to, and had sole trading authority over, both the Proprietary and Client accounts and was also invested in the Proprietary accounts. Both the Proprietary accounts and the Client accounts engaged in day-trading. In fact, the Proprietary funds realized most of their profits from day-trading stocks. The Portfolio Manager often traded the same securities for the Proprietary and Client accounts.

7. At the time the Proprietary funds were created and throughout the Relevant Period, Respondent, in his role as Chief Operating Officer, was directly responsible for overseeing operations and compliance at Ark, including oversight of the Portfolio Manager's trading desk.

### **B. The Cherry-Picking Scheme**

8. At or soon after the launch of the Proprietary funds, the Portfolio Manager began to execute a cherry-picking scheme that favored the Proprietary accounts in the allocation of securities. The Portfolio Manager often changed initial allocation decisions or made allocation decisions after execution and sometimes at the end of the trading day.

9. When placing trades, neither the Portfolio Manager nor the traders who worked for him documented how the trade would ultimately be allocated between the two sets of accounts. While each set of accounts had different order tickets, orders were routinely written on an order ticket for one of the two sets of accounts. Where the order was written, however, did not reflect how the Portfolio Manager would ultimately decide to allocate the securities. Instead, after an order was filled, the Portfolio Manager would sometimes decide to keep the entire allocation with one set of accounts (i.e., the Proprietary or Client accounts), would sometimes move part of the allocation to the other set of accounts, or would sometimes decide to allocate the entire trade to the other set of accounts.

10. Profitable trades were more likely to be allocated to the Proprietary accounts than to the Specialty Growth accounts, with a difference in profitability of approximately 68% to approximately 37% respectively. Additionally, approximately 75% of the Proprietary funds' long day-trades were profitable while only approximately 37% of the Client accounts' long day-trades were profitable. Consequently, there was a significant overall

performance differential between the Proprietary accounts and the Client accounts for most of the Relevant Period.

11. Respondent knew that there was a disparity in performance between the Proprietary accounts and the Client accounts. Directors and officers, including Respondent, were informed at board meetings throughout the Relevant Period about the performance of the Client accounts. In addition, Respondent was also invested in the Proprietary funds and thus knew about the performance of the Proprietary accounts.

**C. Failure to Supervise**

12. Because Ark's Chairman delegated to Respondent oversight of the trading function at Ark, which included the trading activities of the Portfolio Manager and the employees who worked on the trading desk, Respondent was a supervisor of the Portfolio Manager for purposes of the Advisers Act.

13. Although Respondent understood the conflict created by the fact that the Portfolio Manager was trading for both the Proprietary and Client accounts at the same time, Respondent failed to monitor trading patterns or order tickets in order to detect any fraudulent allocations or improper trading. Respondent relied on the Portfolio Manager and his traders to self-report any improper conduct without sufficient independent verification.

14. Respondent received at least three red flags of possible wrongdoing in the allocation of securities: first, in or around 2000, the Portfolio Manager's head trader informed Respondent that the Portfolio Manager did not make allocation decisions at the time he placed orders; second, in or around 2001, the Portfolio Manager requested, and was granted, approval from the Respondent to make allocation determinations within a certain amount of time after trading orders had been placed or executed; finally, in late 2002, Respondent received and reviewed an SEC examination staff's deficiency letter concerning, among other things, possible improper allocation practices at Ark relating to initial public offerings.

15. Specifically, sometime in or around 2000, after the Portfolio Manager was already trading for both the Proprietary and Client accounts, the head trader informed Respondent that the Portfolio Manager was not making allocation determinations contemporaneously with orders.

16. In early 2001, the Portfolio Manager approached Respondent and asked for compliance approval to make allocation determinations after he placed his trading orders. Respondent's response to this red flag was to permit the Portfolio Manager to make allocation decisions within a certain amount of time after he had placed or executed his orders.

17. Finally, Respondent reviewed a Commission examination staff's letter from December 12, 2002 regarding IPO allocations. The letter suggested that the Proprietary

funds may have been favored in the allocation of IPO shares and thus was a red flag of irregularities. Ark affirmed in response to the examination staff's letter that it made changes to its compliance procedures. However, Respondent did not thereafter conduct any substantive reviews of trades, did not review order tickets or conduct any specific review with respect to allocation practices between the Proprietary accounts and the Client accounts. No new procedures were implemented after the examination concerning allocation practices.

18. Had Respondent responded reasonably to the red flags, he could have detected and prevented the fraudulent cherry-picking scheme.

## **VIOLATIONS**

21. Section 203(e)(6) of the Advisers Act authorizes the Commission to impose sanctions against an adviser for failing reasonably to supervise, with a view to preventing violations of the provisions of the federal securities laws and rules thereunder, another person who commits such a violation, if that person is subject to the adviser's or associated person's supervision. Section 203(f) of the Advisers Act provides for sanctions against associated persons for the same conduct.

22. Liability for failure to supervise may be imposed when a supervisor fails "to learn of improprieties when diligent application of supervisory procedures would have uncovered them." *Blinder, Robinson & Co.*, Exchange Act Rel. No. 19057, 26 SEC Docket 238, 240 (Sept. 17, 1982) (supervisors who failed to supervise because they failed properly to review order tickets, which would have alerted them to possible violations). *See also Rhumblin Advisers*, Advisers Act Rel. No. 1765, 68 SEC Docket 276 (Sept. 29, 1998) (settled order) (investment adviser and principal both "failed reasonably to supervise [the trader], who was subject to their supervision within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing his violations" of the federal securities laws).

23. Respondent failed reasonably to supervise the Portfolio Manager's trading practices even though he was made aware of at least three red flags of irregularities.

24. Instead of responding to those red flags by conducting regular and vigorous reviews of order tickets, allocation spreadsheets and the timing of allocations, Respondent improperly permitted the Portfolio Manager to make allocation decisions within a certain amount of time after orders had been placed or executed. Respondent also, in spite of the red flags, relied on the Portfolio Manager and the traders to self-report without adequate independent verification. Respondent thus failed to detect the improper cherry-picking that would have been revealed by a reasonable review and monitoring of the Portfolio Manager's trading activity.

25. Accordingly, Respondent failed reasonably to supervise the Portfolio Manager, who was subject to his supervision within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing the Portfolio Manager's violations of Section

10(b) of the Exchange Act and Rule 10b-5 thereunder and the Portfolio Manager's aiding and abetting violations of Sections 206(1) and (2) of the Advisers Act.

### **UNDERTAKING**

Respondent has undertaken to cooperate fully with the Commission in any and all investigations, litigations or proceedings relating to or arising from the matters described in the Order. In connection with such cooperation, Respondent undertakes:

- a. To produce, without service of a notice or subpoena, any and all documents and other information reasonably requested by the Commission's staff;
- b. To be interviewed by the Commission's staff at such times as the staff may reasonably request and to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and
- c. That in connection with any testimony of Respondent to be conducted at deposition, hearing or trial pursuant to any notice or subpoena, Respondent:
  - i. Agrees that any such notice or subpoena for his appearance and testimony may be served by regular mail on his counsel, Ronald G. Blum, Manatt, Phelps & Phillips, LLP, 7 Times Square, New York, New York 10036; and
  - ii. Agrees that any such notice or subpoena for his appearance and testimony in an action pending in a United States District Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure or the Commission's Rules of Practice.

### **IV.**

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Mermelstein's Offer.

Accordingly, pursuant to Section 203(f) of the Advisers Act:

**A. IT IS HEREBY ORDERED** that Respondent be, and hereby is, suspended from association in a supervisory capacity with any investment adviser for a period of six months, effective on the second Monday following entry of this Order.

**B. IT IS FURTHER ORDERED** that Respondent shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of \$50,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, Virginia 22312; and (D) submitted under cover letter that identifies Stephen Jay Mermelstein as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Andrew M. Calamari, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, New York, New York, 10281. Such civil money penalty may be distributed. Regardless of whether any such distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that he shall not, after offset or reduction in any Related Investor Action based on Respondent's payment of disgorgement in this action, argue that he is entitled to, nor shall he further benefit by offset or reduction of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that he shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Elizabeth M. Murphy  
Secretary