

96 CIV 2515

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

EDWARD E. BAO,

Defendant.

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: 96 Civ.
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: COMPLAINT
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Plaintiff Securities and Exchange Commission alleges:

SUMMARY

1. For at least ten years ending in 1994, defendant Edward E. Bao, then an executive officer of Gruntal & Co., Incorporated (Gruntal), a full-service brokerage firm, engaged in a fraudulent scheme whereby stale and outstanding customer and vendor checks, balances and securities from customer accounts, and unclaimed dividends were diverted to Gruntal profit and loss accounts and used to fund off-books payments of Gruntal expenses. As a result, Gruntal's income was inflated from at least 1985 through 1994. To conceal the scheme, Bao had others at Gruntal create fictitious customer accounts and falsify the books and records of Gruntal and its immediate corporate parent, Gruntal Financial Corp. (Gruntal Financial); he and others also intentionally circumvented the internal accounting controls of Gruntal Financial.

2. As a result of this scheme, from 1985 through mid-1987, Gruntal Financial filed with the Commission and disseminated to

the public certain materially false and misleading annual and quarterly reports and a materially false and misleading registration statement that overstated Gruntal Financial's income and failed to disclose the involvement of certain members of senior management in the diversions.

3. In 1987, Gruntal Financial was acquired by The Home Group, Inc. In connection with that acquisition, and while in possession of material non-public information about the fraudulent scheme described in this complaint, Bao contracted with the Home Group to sell a total of 618,000 shares of Gruntal Financial common stock, thereby avoiding substantial losses. He also falsely represented that Gruntal Financial's SEC filings contained no material misstatements and that Gruntal was conducting its business in compliance with applicable laws.

4. As described more fully below, Bao violated the federal securities laws by engaging in the fraudulent diversion scheme and by selling Gruntal Financial securities without disclosing the scheme, and unless enjoined is likely to commit such violations in the future.

JURISDICTION

5. This Court has jurisdiction over this action pursuant to Sections 20(b) and 22(a) of the Securities Act of 1933 [15 U.S.C. §§ 77t(b) and 77v(a)] and Sections 21(d), 21(e), and 27 of the Securities Exchange Act of 1934 [15 U.S.C. §§ 78u(d), 78u(e), and 78aa].

6. Bao, directly or indirectly, used the means and instrumentalities of interstate commerce, of the mails, or of the facilities of a national securities exchange in connection with the transactions, acts, practices, and courses of business alleged herein.

THE DEFENDANT

7. From December 1983 to December 1994, Bao was a director and Executive Vice President for Operations and Administration of both Gruntal and Gruntal Financial. He is no longer employed by Gruntal or Gruntal Financial.

THE ISSUER

8. At all times relevant, Gruntal Financial was a Delaware corporation with its principal place of business in New York City engaged in the operation of a full-service brokerage business through its wholly-owned subsidiary, Gruntal. Until it was acquired by the Home Group in August 1987, Gruntal Financial's securities were registered with the Commission pursuant to Section 12(b) of the Exchange Act [15 U.S.C. § 78l(b)] and traded on the New York Stock Exchange.

9. At all times relevant, Gruntal has been a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act [15 U.S.C. § 78o(b)].

FACTS

THE FRAUDULENT DIVERSION SCHEME

Diverting Checks, Dividends, and Other Assets

10. Beginning in at least 1984, Bao directed certain managers and employees at Gruntal to divert stale customer and vendor checks, balances and securities from dormant customer accounts, and unclaimed dividends for the purpose of inflating Gruntal's income and reducing its expenses. As part of the scheme, Bao established, or directed the establishment of, fictitious customer accounts at Gruntal and directed that the diverted assets be transferred to the fictitious accounts. Bao was assisted in the diversions by Gruntal's Director of Operations, its Manager of Internal Audit, and its Executive Cashier, each of whom acted at Bao's direction.

11. At Bao's direction, diverted assets totaling approximately \$5 million were transferred out of the fictitious customer accounts and into Gruntal profit and loss accounts or used to fund off-books cash payments of certain Gruntal expenses.

Altering and Falsifying Books and Records

12. At Bao's direction, various Gruntal books and records were altered or falsified to conceal the diversions. In furtherance of the diversion scheme, Bao, or others acting at his direction, created false dividend claim forms, debit and credit advices, debit and credit memos, and bookkeeping journal entries. Bao and those acting at his direction created these false records to conceal the fraudulent nature of the transactions.

13. Bao, or others acting at his direction, also opened accounts in the names of fictitious companies and created false account opening documents, account statements, and account statement entries.

14. As a consequence of Bao's diverting assets in this fashion to Gruntal profit and loss accounts or using them to make off-books payments of Gruntal expenses, Gruntal overstated its revenues, understated its expenses, and, consequently, overstated its income.

15. Because Gruntal Financial is a holding company that conducts its business through Gruntal, Bao's falsifying Gruntal's books, records, and accounts also resulted in falsification of Gruntal Financial's books, records, and accounts. And because Bao succeeded in inflating Gruntal's income, he also thereby inflated Gruntal Financial's income.

THE FALSE FILINGS

16. From 1985 through the third quarter of fiscal 1987, as a result of Bao's scheme, Gruntal Financial filed with the Commission certain false and misleading periodic reports and a false and misleading registration statement. These filings, including the financial statements contained therein, were materially misstated because they failed to reflect or disclose the amounts and uses of the diverted assets. As a result, the filings overstated Gruntal Financial's income.

17. In June 1986, Gruntal Financial filed a registration statement on Form S-1 (and Amendment No. 1 thereto) with the

Commission to register a public offering of convertible subordinated debentures and the underlying common stock. The financial statements included in those filings overstated Gruntal Financial's fiscal 1985 pre-tax income by 15 percent. The financial statements included in Gruntal Financial's Form 10-K for fiscal 1985 likewise overstated pre-tax income by 15 percent. The financial statements in Gruntal Financial's Form 10-Q for the third quarter of fiscal 1987 overstated pre-tax income by 8 percent. In each instance, the overstatement of income was materially false and misleading. Moreover, none of the reports disclosed the involvement of certain members of senior management in the diversion of assets.

BAO'S ILLEGAL TRADING

18. On June 24, 1987, while Bao was a director of Gruntal Financial, the Board of Directors of Gruntal Financial unanimously approved resolutions approving a merger agreement with the Home Group pursuant to which Gruntal Financial and an acquisition subsidiary of the Home Group would be merged and each share of outstanding Gruntal Financial common stock would be converted into the right to receive \$9.50 in cash.

19. As part of the merger agreement, Gruntal Financial represented and warranted that none of the reports, schedules, registration statements, or definitive proxy statements filed by Gruntal Financial with the Commission since January 1, 1986, "contained any untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary

in order to make the statements therein, in light of the circumstances under which they were made, not misleading," that those filings "complied in all material respects with the requirements" of the Securities Act, the Exchange Act, and the Commission's rules and regulations thereunder, and that the financial statements included in those filings had "been prepared in accordance with generally accepted accounting principles." Gruntal Financial further represented and warranted that, except as had been disclosed, the businesses of Gruntal Financial and its subsidiaries "are not being conducted in violation of any law, ordinance or regulation of any Governmental Entity."

20. On June 24, 1987, Bao and certain other Gruntal Financial insiders entered into a stock purchase agreement with the Home Group pursuant to which Bao sold a total of 618,000 shares of Gruntal Financial common stock (582,000 shares for his own account and another 36,000 shares as trustee for certain trusts). All 618,000 shares were sold at \$9.50 per share, resulting in total proceeds of \$5,871,000.

21. As part of the stock purchase agreement, Bao represented and warranted that the representations and warranties of Gruntal Financial set forth in the merger agreement were true and correct.

FIRST CLAIM

Violations of Section 17(a) of the Securities Act,
Section 10(b) of the Exchange Act,
and Rule 10b-5 thereunder
in connection with the fraudulent diversion scheme

22. The Commission realleges and incorporates by reference Paragraphs 1 through 17 above.

23. At Bao's direction, and in furtherance of the fraudulent diversion scheme, certain Gruntal managers removed balances and securities from customers' securities accounts, purchased securities with the stolen balances, sold customers' securities, took customer checks representing proceeds of securities transactions, and misappropriated dividends payable to contra-brokers, institutional investors, and Gruntal's customers.

24. By reason of the foregoing, Bao violated Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)], Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)], and Rule 10b-5 [17 C.F.R. § 240.10b-5] promulgated thereunder.

SECOND CLAIM

Violations of Section 17(a) of the Securities Act,
Section 10(b) of the Exchange Act,
and Rule 10b-5 thereunder in connection with
false and misleading filings with the Commission

25. The Commission realleges and incorporates by reference Paragraphs 1 through 21 above.

26. Bao was responsible for Gruntal Financial filing with the Commission, from 1985 to mid-1987, a Form S-1 registration statement and amendment thereto and certain annual and quarterly

reports that contained materially false and misleading financial statements and omitted disclosure of the diversions.

27. Bao, as a director, signed Gruntal Financial's Form S-1 registration statement and amendment thereto and its annual reports on Form 10-K for fiscal 1985 and 1986 when he knew, or was reckless in not knowing, that they contained materially false and misleading financial statements and omitted disclosure of the diversions.

28. By reason of the foregoing, Bao violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

THIRD CLAIM

Violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder in connection with Bao's sale of stock while in possession of material non-public information

29. The Commission realleges and incorporates by reference Paragraphs 1 through 21 and 26 through 27 above.

30. Bao sold 618,000 shares of Gruntal Financial common stock while in possession of material non-public information. He did not disclose that information prior to selling his shares; in fact, he made specific representations and warranties that were directly contrary to what he knew.

31. By selling Gruntal Financial common stock pursuant to specific misrepresentations and without disclosing material non-public information in his possession, Bao avoided substantial losses.

32. By reason of the foregoing, Bao violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

FOURTH CLAIM

Violations of Section 13(b)(5) of the Exchange Act
and Rule 13b2-1 thereunder in connection with
falsified books and records and intentional
circumvention of internal controls

33. The Commission realleges and incorporates by reference Paragraphs 1 through 17 above.

34. By falsifying the books and records of Gruntal, Bao knowingly falsified, or caused to be falsified, the books and records of Gruntal Financial, ensuring that those books and records did not fairly and accurately reflect the transactions or dispositions of the assets of Gruntal Financial. He also knowingly circumvented Gruntal Financial's internal controls.

35. By reason of the foregoing acts and practices, Bao violated Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)] and Rule 13b2-1 [17 C.F.R. § 240.13b2-1] promulgated thereunder.

FIFTH CLAIM

Violations of Rule 13b2-2
under the Exchange Act in connection
with misstatements and omissions to
Gruntal Financial's independent auditors

36. The Commission realleges and incorporates by reference Paragraphs 1 through 17 above.

37. From 1985 through July 1987, Bao, or certain managers and employees acting at Bao's direction, provided or made

available to the independent auditors, in connection with their audits of Gruntal Financial's financial statements, falsified documents and records, including bookkeeping journals, debit and credit memos, and other falsified records and documents, as more fully described above.

38. By creating, and directing the creation of, false or fictitious books, records, and accounts, Bao caused false and misleading statements and documents to be given to the independent auditors of Gruntal Financial. Bao failed to disclose the diversions to the independent auditors.

39. By reason of the foregoing, Bao violated Rule 13b2-2 [17 C.F.R. § 240.13b2-2] promulgated under the Exchange Act.

PRAYER

WHEREFORE, the Commission respectfully requests that this Court:

I.

Permanently enjoin Bao from violating Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)], Sections 10(b) and 13(b)(5) of the Exchange Act [15 U.S.C. §§ 78j(b) and 78m(b)(5)], and Exchange Act Rules 10b-5, 13b2-1, and 13b2-2 [17 C.F.R. §§ 240.10b-5, 240.13b2-1, and 240.13b2-2].

II.

Enter an Order, pursuant to Section 20(e) of the Securities Act [15 U.S.C. § 77t(e)] and Section 21(d)(2) of the Exchange Act [15 U.S.C. § 78u(d)(2)], permanently barring Bao from acting as an officer or director of any issuer that has a class of

securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] or that is required to file reports pursuant to Section 15(d) of the Exchange Act [15 U.S.C. § 78o(d)].

III.

Order Bao to disgorge all illegal profits and losses avoided as a result of his 1987 sale of Gruntal Financial common stock, together with prejudgment interest thereon; and

IV.

Grant such other relief as this Court may deem just and appropriate.

Respectfully submitted,

Dated: _____

April 9, 1996

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