

ORIGINAL



0000117104

BEFORE THE ARIZONA CORPORATION COMMISSION

1
2
3 MARC SPITZER
CHAIRMAN
4 JIM IRVIN
COMMISSIONER
5 WILLIAM A. MUNDELL
COMMISSIONER
6 JEFF HATCH-MILLER
COMMISSIONER
7 MIKE GLEASON
COMMISSIONER

Arizona Corporation Commission

DOCKETED

JUN - 2 2003

DOCKETED BY	<i>CKR</i>
-------------	------------

AZ CORP COMMISSION
DOCUMENT CONTROL

2003 JUN - 2 P 2:53

RECEIVED

9 In the matter of:

Docket No. S-03493A-03-0000

10 ROBERT C. FROST/ROBIN FROST,
11 husband and wife,
12 6062 E. Ludlow
13 Scottsdale, Arizona 85254

**RESPONSE TO NOTICE OF
OPPORTUNITY FOR HEARING**

14 Respondents.

15
16
17 Robert C. Frost, on behalf of himself and his wife, Robin Frost, for his Response to the
18 Notice of Opportunity for Hearing Regarding Proposed Order to Cease and Desist, for Restitution,
19 for Administrative Penalties, of Suspension or Revocation, and for other Affirmative Action
20 ("Notice of Opportunity for Hearing"), responds as follows:

- 21 1. Admits the allegations of paragraph 1.
22 2. Admits the allegations of paragraph 2.
23 3. Answering paragraph 3, admits the allegations of the first sentence of paragraph 3 and
24 accepts, as true, the allegations of the second sentence of paragraph 3.
25 4. Answering paragraph 4, admits that Robert Frost, in his capacity as an employee of
26 Morgan Stanley, has acted for the benefit of the marital community of Robert and Robin Frost,

1 denies that Robin Frost has taken any actions relevant to this Notice of Opportunity for Hearing, and
2 therefore denies the remaining allegations of paragraph 4.

3 5. Admits the allegations of paragraph 5.

4 6. Admits, on information and belief, the allegations of paragraph 6.

5 7. Admits that the Devenneys became customers of Morgan Stanley in late 1999 and
6 that Robert Frost acted as their financial advisor.

7 8. Denies the allegations of paragraph 8, and affirmatively states that the Devenneys
8 told Mr. Frost in late 1999 that they sought him out because they were dissatisfied with the returns
9 from their aggressive fixed income portfolio, their friends, who had recommended Mr. Frost to them,
10 were getting better returns by investing in growth securities and that they, too, wanted to invest in
11 growth securities.

12 9. Answering paragraph 9, denies knowledge or information sufficient to form a belief
13 as to the truth or falsity of the allegations of paragraph 9, except admits that the Devenneys had
14 investments with A. G. Edwards and Certificates of Deposit, admits that Carmen Devenney had an
15 IRA account, and affirmatively states that the Devenneys represented that they had liquid assets of.
16 \$240,000 and annual income of \$32,000.

17 10. Denies the allegations of Paragraph 10, and affirmatively states that based on the
18 limited records available to Mr. Frost, the Devenneys held the following securities at A.G. Edwards
19 as of October 29, 1999. In account no. 768-022836-057, with a stated investment objective of
20 "taxable income – aggressive," the Devenneys owned shares in two mutual funds that invested in
21 junk bonds. They owned 6,420.295 shares of MFS Series Trust III High Income Fund Class A with
22 a then-current value of \$4.93 per share, and a total value of \$31,652.05; and 3,044.911 shares of
23 Mainstay Funds High Yield Corporate Bond Fund Class B, with a then-current value of \$7.44 per
24 share, and a total value of \$22,654.14. The Devenneys also owned a Bankers Trust Subordinated
25 Note with a face value of \$25,000, and a then current market value of \$23,276.50 and 53 units of a
26 unit investment trust, UTS Corporate Income Fund #50 Intermediate Series, with a then-current unit

1 price of \$962.59 and a total value \$51,017.27. The Devenneys also had cash totaling \$36.83. In
2 account 768-0233131-057, an IRA Rollover Account, Carmen Devenney held 377.823 shares of
3 Federated Equity Income Fund Class B with a then-current price of \$20.67 per share, and a total
4 value \$7,809.60, and had a cash balance of <\$23.74.> Mr. Frost has no access to records reflecting
5 the Devenneys' Certificates of Deposit at this time. However, and based on the records that are
6 available to him, the allocation of assets in the securities accounts maintained by the Devenneys at
7 A.G Edwards at the time they sought out Mr. Frost to express their dissatisfaction to him with
8 respect to the disappointing returns they were getting on their "aggressive income" portfolio were
9 not as alleged in the Notice of Opportunity for Hearing, but were instead consistent with their then-
10 stated "aggressive" income investment objectives. They held: \$62,116 in junk bond funds and
11 equity mutual funds (about 44%) and \$74, 293.77 in a single subordinated corporate bond and
12 interests in a unit investment trust apparently invested in intermediate corporate bonds (about 56%).
13 On information and belief, had the Devenneys been content with their then-existing portfolio, and
14 their then-existing investment objectives, they would not have sought out Mr. Frost, and elected to
15 change their investment objectives to growth.

16 11. Denies the allegations of paragraph 11.

17 12. Denies that the Devenneys' junk bond funds represented only 13% of their entire
18 portfolio, and denies knowledge or information sufficient to form a belief as to the truth or falsity of
19 the allegations of the remaining allegations of paragraph 12.

20 13. Answering paragraph 13, admits that the Devenneys contacted Robert Frost in late
21 1999, admits that the Devenneys informed Mr. Frost that they contacted him at the recommendation
22 of one of Mr. Frost's clients, admits that the Devenneys met with Mr. Frost in November 1999 and
23 again in early January 2000, denies the allegations of the last two sentences of paragraph 13 and
24 denies knowledge or information sufficient to form a belief as to the truth or falsity of the remaining
25 allegations of paragraph 13.

26

1 14. Answering paragraph 14, denies the allegations of the first three sentences and the
2 last sentence of paragraph 14 and denies knowledge or information sufficient to form a belief as to
3 the truth or falsity of the remaining allegations of paragraph 14.

4 15. Answering paragraph 15, admits that in late December 1999, assets from the
5 Devenneys' securities account at A.G Edwards were delivered to their newly opened accounts at
6 Morgan Stanley, denies knowledge or information sufficient to form a belief as to the truth or falsity
7 of the remaining allegations of paragraph 15, and affirmatively states, on information and belief, that
8 the Devenneys' liquidated interests in mutual funds held at A.G. Edwards in the approximate sum of
9 \$25,000, and did not deliver the proceeds of that sale to Morgan Stanley.

10 16. Admits the allegations of the first sentence of paragraph 16, denies that the Notice of
11 Opportunity for Hearing accurately reflects the principal investment strategies of the American
12 Opportunities Fund, and refers to the prospectus for such fund to accurately state the principal
13 investment strategies of that Fund.

14 17. Admits that Robert Frost noted on a mutual fund switch letter that the Devenneys'
15 investment objectives had changed to growth, denies the remaining allegations of paragraph 17, and
16 affirmatively states that the Devenneys stated to Mr. Frost that their investment objectives had
17 changed to growth, on information and belief, it is this change in their investment objectives that
18 explains why the Devenneys sought out Mr. Frost in the first place, why they refused to invest in
19 bonds despite Mr. Frost's repeated recommendations that they purchase fixed income securities, and
20 why both Devenneys signed the mutual fund switch letter that stated, immediately above their
21 signature: "objective has changed to growth."

22 18. Denies the allegations of paragraph 18 except admits that the Devenneys purchased
23 the shares in four different mutual funds: Opportunities Fund, Information Fund, Mid-Cap Equity
24 Trust Fund and S & P 500 Index Fund, and that a portion of the assets in their newly opened account
25 at Morgan Stanley was used to purchase interests in Morgan Stanley's money market fund.
26

1 19. Answering paragraph 19, admits that the Devenneys informed Mr. Frost that they
2 owned approximately \$100,000 in certificates of deposit that would mature in early 2000, admits
3 that in late March 2000, the Devenneys delivered approximately \$108,000 to their custodial account
4 at Morgan Stanley, admits that the Devenneys utilized a portion of these proceeds to purchase shares
5 in five mutual funds: Van Kampen Technology, Small-Cap Growth, Opportunities, Information and
6 Mid-Cap Equity, admits that additional proceeds were retained in the Devenneys' money market
7 funds, denies the allegations of the first three sentences of paragraph 19 except to the extent admitted
8 herein, denies the allegations of the last sentence of paragraph 19, and denies knowledge or
9 information sufficient to form a belief as to the truth or falsity of the remaining allegations of
10 paragraph 19.

11 20. Answering paragraph 20, admits that the securities in the Devenney Active Assets
12 Account declined in value from March 2000 through September 2001, and denies knowledge or
13 information sufficient to form a belief as to the truth or falsity of the remaining allegations of
14 paragraph 20.

15 21. Answering paragraph 21, admits that the Devenneys spoke with Mr. Frost on several
16 occasions during the period March 2000 through September 2001, admits that Mr. Frost was a
17 professional working for a reputable firm, and denies knowledge or information sufficient to form a
18 belief as to the truth or falsity of the remaining allegations of paragraph 21.

19 22. Denies knowledge or information sufficient to form a belief as to the truth or falsity
20 of the allegations of paragraph 22.

21 23. Denies the allegations of paragraph 23.

22 24. Answering paragraph 24, states that he does not now recall whether he met with the
23 Devenneys in October 2000, and therefore denies knowledge or information sufficient to form a
24 belief as to the truth or falsity of the remaining allegations of paragraph 24, but affirmatively states
25 that that on one or more occasions after November 1999, he told the Devenneys that he could not
26 predict how the market would perform, and states that he made recommendations to the Devenneys

1 on several occasions that they should invest a portion of their funds in fixed income investments,
2 only to be told that they did not want to purchase any bonds.

3 25. Answering paragraph 25, denies knowledge or information sufficient to form a belief
4 as to whether he met with the Devenneys in April 2001 but affirmatively states that he met with Mr.
5 Devenney in the Spring of 2001, and denies the remaining allegations of paragraph 25.

6 26. Answering paragraph 26, denies knowledge or information sufficient to form a belief
7 as to the truth or falsity of the allegations of paragraph 26, and affirmatively states that the correct
8 name of Mr. Frost's former branch manager is Carlos ("Charlie") Cajero.

9 27. Answering paragraph 27, denies knowledge or information sufficient to form a belief
10 as to the truth or falsity of the allegations of paragraph 27.

11 28. Denies the allegations of the first two sentences of paragraph 28. Admits that the
12 Devenneys' portfolio changed from an aggressive income-oriented portfolio to a growth-oriented
13 portfolio and affirmatively states that such change was made at their request, and denies knowledge
14 or information sufficient to form a belief as to the truth or falsity of the remaining allegations of
15 paragraph 28.

16 29. Answering paragraph 29, denies the allegations of the first and third sentences of
17 paragraph 29, admits the allegations of the fourth sentence of paragraph 29 and that portion of the
18 fifth sentence of paragraph 29 which states that Morgan Stanley did not require the customer to sign
19 the new account form, and denies knowledge or information sufficient to form a belief as to the truth
20 or falsity of the remaining allegations of paragraph 29.

21 30. Answering paragraph 30, admits the allegations of the second sentence of paragraph
22 30 and denies the remaining allegations of paragraph 30.

23 31. Denies the allegations of paragraph 31.

24 32. Answering paragraph 32, denies knowledge or information sufficient to form a belief
25 as to the truth or falsity of the allegations of the first two sentences of paragraph 32, and denies the
26 remaining allegations of paragraph 32.

1 for their existing brokerage statements and learned that the Devenneys had a joint investment
2 account at A.G. Edwards and a small IRA account. The joint account consisted of investments in a
3 bond, junk bond funds, and a unit investment trust in bonds. The Devenneys said they were
4 expecting some additional funds shortly after the first of the year.

5 42. Frost explained that a bond portfolio likely would not meet their growth objectives,
6 unless interest rates declined or they elected to reinvest the interest income generated by their
7 existing investments. He further explained that if interest rates rose, the value of their bond
8 investments could actually decline. He discussed with them the possibility of capital appreciation
9 (and capital loss) from investments in stocks. He explained how mutual funds are diversified and
10 how most are professionally managed. He discussed with the Devenneys the risks of owning mutual
11 funds including the risk of market loss. He suggested several mutual funds that he believed were
12 consistent with the Devenneys' stated objectives, and gave them prospectuses for several mutual
13 funds including, he believes, each of the mutual funds that the Devenneys elected to purchase several
14 weeks later, in January 2000. He also showed them how a systematic withdrawal program from a
15 broad based mutual fund portfolio could work by showing them several examples of such programs.

16 43. The Devenneys said they would like to open an account at Morgan Stanley. They
17 reiterated that they were dissatisfied with their bond portfolio, and were changing their primary
18 investment objective to one of growth. Frost explained that he could not assist them in restructuring
19 their portfolio to meet their stated investment objectives until their existing investments were
20 transferred to Morgan Stanley. The Devenneys elected to transfer their joint account to Morgan
21 Stanley that same day, executing the ACATS transfer form, and Active Assets Account form
22 (including the form W-9), and providing him the information he needed to open the joint account.
23 Frost set up the joint account at Morgan Stanley to enable the Devenneys to systematically withdraw
24 the sum of \$700 per month for supplemental living expenses, as the Devenneys had requested. (The
25 paperwork for the IRA account was filled out a few days later, and the IRA account was opened on
26 November 29, 1999). Frost concluded the meeting by explaining to the Devenneys that he would

1 call them when the assets from their existing portfolio at A.G. Edwards were delivered to their new
2 account at Morgan Stanley to discuss with them at that time, the investments they wanted to make.

3 44. In December, 1999, assets from the Devenneys' previous securities account were
4 delivered to their newly-opened joint account at Morgan Stanley. The securities delivered were (i) a
5 Bankers' Trust Subordinated Note in the principal sum of \$25,000, with a then-current value of
6 \$23,062.50; (ii) 53 units of a Unit Investment Trust in intermediate corporate bonds with a par value
7 of \$51,530.84, and a then-current value of \$50,538.15; and (iii) two junk bond mutual funds with a
8 total then-current value of \$30,597.44.

9 45. In late December 1999, Frost telephoned the Devenneys to inform them that the
10 assets they had elected to transfer to Morgan Stanley had been received. The Devenneys agreed to
11 meet with Frost shortly after January 1 to discuss the reinvestment of those assets. During this late-
12 December telephone conversation, the Devenneys asked Frost to recommend appropriate mutual
13 funds that were consistent with their growth objectives. They specifically stated that they did not
14 want to invest any of their assets in bonds or bond funds. Indeed, when Frost stated that a proper
15 allocation of assets would include a portion of the portfolio being invested in the bond class, the
16 Devenneys reiterated that they did not want any bonds.

17 46. The Devenneys met with Frost in the first week of January, 2000 to discuss the
18 requested reinvestment of their assets. Frost explained that over the long term historical returns from
19 a portfolio focussed on equities generally, and growth funds in particular, were favorable, but that
20 past performance was no guarantee of future results. Frost again stated that bonds were part of a
21 proper allocation, but Mr. Devenney again emphatically stated, "no bonds." Frost then
22 recommended that the Devenneys allocate their assets among four Morgan Stanley proprietary
23 mutual funds at that time: (i) American Opportunities, a large cap sector rotation fund; (ii) S & P
24 index fund, a large cap index fund; (iii) Mid-cap Equity Trust, a fund that sought to invest in middle
25 sized companies with excellent financial outlooks; and (iv) Information Fund, a growth fund that
26 focussed primarily on information and technology stocks. The Devenneys agreed to these

1 recommendations, the bond investments were liquidated, and the equity mutual funds were
2 purchased in accordance with the Devenneys' instructions within a few days thereafter.

3 47. There are several contemporaneously prepared documents reflecting the Devenneys'
4 election to change their primary investment objective from income to growth. Frost's daytimer
5 entries with respect to the sale and purchase of the Devenneys' mutual funds reflect the Devenneys'
6 desire to invest primarily in growth securities, as do two mutual fund switch letters signed by the
7 Devenneys on January 3, 2000. The prospectuses for the mutual funds also clearly articulate the
8 principal investment strategies of the fund managers as well as the risk to principal invested in those
9 funds.

10 48. Although the Devenneys complain from time to time that they were unaware they
11 would be assessed deferred sales charges if they liquidated their investments in the mutual funds,
12 that assertion cannot be credited. The mutual fund switch letters signed by the Devenneys also
13 include an acknowledgment that each of the Devenneys' "understand that the [new mutual fund]
14 being purchased with the proceeds from [the] sale [of the old fund], may be assessed a contingent
15 deferred sales charge upon liquidation if sold prior to the required holding period as described in the
16 prospectus, which I received and read thoroughly." Frost believes that he provided prospectuses to
17 the Devenneys in November 1999 which discussed the deferred sales charges. The Devenneys were
18 again provided prospectuses when they actually purchased interests in the mutual funds. The order
19 confirmations issued following the Devenneys' purchase of the various mutual funds stated that "ON
20 SELLING YOUR SHARES, YOU MAY PAY A SALES CHARGE. FOR THE CHARGE AND
21 OTHER FEES, SEE THE PROSPECTUS."

22 49. During the January 2000 meeting, and in previous discussions with Frost, the
23 Devenneys had stated that they were expecting to receive a significant additional sum of money that
24 they wished to invest through Morgan Stanley. In March of 2000, the Devenneys had indeed
25 deposited more than \$100,000 in additional funds for investment. Consistent with their stated
26 investment objectives, the Devenneys invested a portion of these funds in the mutual funds they had

1 affirmative representations, both orally and in writing, that they had changed their investment
2 objective from aggressive income to growth.

3 2. Frost's listing of "speculation" as a secondary investment objective for the
4 Devenneys is not fraudulent, and does not violate Arizona law, even if it inaccurately states the
5 Devenneys' secondary investment objectives, because, among other things, it is immaterial in that
6 none of the investments Frost recommended to the Devenneys were speculative, and because no one
7 including the Devenneys was misled by information on the new account form.

8 3. The State, and the Devenneys are estopped from claiming after-the-fact, that the
9 investment objectives the Devenneys' directed Frost to implement were not their real investment
10 objectives after all, and are estopped from claiming that the Devenneys really wanted income
11 oriented investments.

12 4. The Devenneys are charged with knowledge of the risks to their investment portfolio
13 set forth in writing in the prospectuses provided to the Devenneys contemporaneously with their
14 purchases of shares in those mutual funds. Thus, even if it were true that Frost did not orally
15 disclose to the Devenneys that the mutual funds he recommended increased the risk of loss to the
16 Devenneys principal, a factual assertion Mr. Frost denies, the transactions do not violate A.R.S.
17 Section 44-1991 unless the prospectus disclosures of such enhanced risk are materially misleading
18 and no such allegation has been made here.

19 5. Frost denies that he assured the Devenneys that the market would recover but, even if
20 such a prediction had been made by anyone to the Devenneys, it could not possibly constitute
21 actionable fraud because such a prediction of future performance is not a misrepresentation of fact,
22 and because the Devenneys' would have had no right to rely on such a prediction.

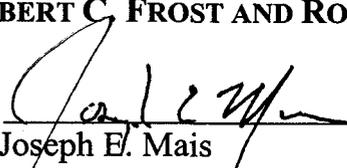
23 WHEREFORE, having fully answered the Notice of Opportunity for Hearing, Robert Frost
24 (and Robin Frost, named solely in her capacity as the spouse of Robert Frost) request that the
25 proposed Order to Cease and Desist be denied, the Request for Restitution be denied, the Request for
26 Administrative Penalties be denied, the Request for Suspension or Revocation be denied, the

1 Request for Other Affirmative Action be denied and that this Commission enter its order exonerating
2 Mr. Frost of all charges brought by the Securities Division in this matter.

3 Dated: June 2, 2003.

4 Respectfully submitted,

5 **ROBERT C. FROST AND ROBIN FROST**

6
7 By 

8 Joseph E. Mais

9 Brian C. Lake

10 BROWN & BAIN, P.A.

11 2901 North Central Avenue

12 Post Office Box 400

13 Phoenix, Arizona 85001-0400

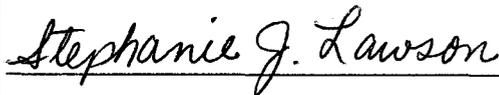
14 Attorneys for Respondents Robert C. Frost
15 and Robin Frost

16 Original and thirteen copies filed
17 June 2, 2003, with:

18 Docket Control Center
19 Arizona Corporation Commission
20 1200 West Washington
21 Phoenix, Arizona 85007-2996

22 Copy of the foregoing hand-delivered June 2, 2003, to:

23 Phillip A. Hofling, Esq.
24 Securities Division
25 Arizona Corporation Commission
26 1300 West Washington, Third Floor
Phoenix, Arizona 85007-2996



231466_1