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BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER
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JIM IRVIN
COMMISSIONER
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Arizona Corporation Commission

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In the matter of:

Docket No. S-03493A-03-0000

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

**AMENDED RESPONSE TO NOTICE OF
OPPORTUNITY FOR HEARING**

Respondents.

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

1. Admits the allegations of paragraph 1.
2. Admits the allegations of paragraph 2.
3. Answering paragraph 3, admits the allegations of the first sentence of paragraph 3 and accepts, as true, the allegations of the second sentence of paragraph 3.
4. Answering paragraph 4, admits that Robert Frost, in his capacity as an employee of 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, who directed him to keep the Devenneys' investments unchanged,
6 notwithstanding recent losses, and denies the remaining allegations of paragraph 25.

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

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

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

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

22 30. Answering paragraph 30, admits the allegations of the second sentence of paragraph
23 30, and denies the remaining allegations of paragraph 30.

24 31. Denies the allegations of paragraph 31.

1 to invest in growth securities. They also said that they wanted to withdraw approximately \$700 per
2 month from their joint account. To the best of Mr. Frost's recollection, the returns on their existing
3 portfolio did not allow them to make such withdrawals without invading their principal. He asked
4 for their existing brokerage statements and learned that the Devenneys had a joint investment
5 account at A.G. Edwards and a small IRA account. The joint account consisted of investments in a
6 bond, junk bond funds, and a unit investment trust in bonds. The Devenneys said they were
7 expecting some additional funds shortly after the first of the year.

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

19 43. The Devenneys said they would like to open an account at Morgan Stanley. They
20 reiterated that they were dissatisfied with their bond portfolio, and were changing their primary
21 investment objective to one of growth. Frost explained that he could not assist them in restructuring
22 their portfolio to meet their stated investment objectives until their existing investments were
23 transferred to Morgan Stanley. The Devenneys elected to transfer their joint account to Morgan
24 Stanley that same day, executing the ACATS transfer form, and Active Assets Account form
25 (including the form W-9), and providing him the information he needed to open the joint account.
26 Frost set up the joint account at Morgan Stanley to enable the Devenneys to systematically withdraw

1 the sum of \$700 per month for supplemental living expenses, as the Devenneys had requested. (The
2 paperwork for the IRA account was filled out a few days later, and the IRA account was opened on
3 November 29, 1999). Frost concluded the meeting by explaining to the Devenneys that he would
4 call them when the assets from their existing portfolio at A.G. Edwards were delivered to their new
5 account at Morgan Stanley to discuss with them at that time, the investments they wanted to make.

6 44. In December, 1999, assets from the Devenneys' previous securities account were
7 delivered to their newly-opened joint account at Morgan Stanley. The securities delivered were (i) a
8 Bankers' Trust Subordinated Note in the principal sum of \$25,000, with a then-current value of
9 \$23,062.50; (ii) 53 units of a Unit Investment Trust in intermediate corporate bonds with a par value
10 of \$51,530.84, and a then-current value of \$50,538.15; and (iii) two junk bond mutual funds with a
11 total then-current value of \$30,597.44.

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

20 46. The Devenneys met with Frost in the first week of January, 2000 to discuss the
21 requested reinvestment of their assets. Frost explained that over the long term historical returns from
22 a portfolio focussed on equities generally, and growth funds in particular, were favorable, but that
23 past performance was no guarantee of future results. Frost again stated that bonds were part of a
24 proper allocation, but Mr. Devenney again emphatically stated, "no bonds." Frost then
25 recommended that the Devenneys allocate their assets among four Morgan Stanley proprietary
26 mutual funds at that time: (i) American Opportunities, a large cap sector rotation fund; (ii) S & P

1 index fund, a large cap index fund; (iii) Mid-cap Equity Trust, a fund that sought to invest in middle
2 sized companies with excellent financial outlooks; and (iv) Information Fund, a growth fund that
3 focussed primarily on information and technology stocks. The Devenneys agreed to these
4 recommendations, the bond investments were liquidated, and the equity mutual funds were
5 purchased in accordance with the Devenneys' instructions within a few days thereafter.

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

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

25 49. During the January 2000 meeting, and in previous discussions with Frost, the
26 Devenneys had stated that they were expecting to receive a significant additional sum of money that

1 they wished to invest through Morgan Stanley. In March of 2000, the Devenneys had indeed
2 deposited more than \$100,000 in additional funds for investment. Consistent with their stated
3 investment objectives, the Devenneys invested a portion of these funds in the mutual funds they had
4 previously purchased, and also invested in two additional mutual funds: (i) the Van Kampen
5 Technology Fund; and (ii) the Small Cap Growth Fund, a fund that sought investments in small
6 companies of exceptional value. Importantly, because the Devenneys' continued to reject Frost's
7 advice to invest a portion of their assets in bond-related investments, he recommended that the
8 Devenneys keep more than \$31,000 in money market funds, which were then paying about 5.6% in
9 annual interest. Frost asked the Devenneys whether they would need this money for any significant
10 expenses, such as a house, car, vacation, loan to a child or medical expenses, and was assured by the
11 Devenneys that they would not need the money.

12 50. Had the Devenneys left their money market funds alone, they would have had
13 sufficient cash reserves to withdraw, from their money market funds alone, the \$700 per month they
14 said they needed for supplemental living expenses without ever touching their mutual fund portfolio
15 for about five years. Thus, Frost believes and contends that notwithstanding the worst bear market
16 in a generation, the Devenneys' portfolio was structured to meet their stated needs for income for an
17 extended period of time. However, in July 2000, less than four months after approving an allocation
18 strategy that would have met their stated cash needs for another five years, the Devenneys withdrew
19 \$25,000 from their money market account. When Frost learned of this withdrawal and complained
20 that it had jeopardized the asset allocation strategy they had agreed to (after the Devenneys persisted
21 in their refusal to consider bonds), the Devenneys told Frost that they had decided to buy a new car.
22 Moreover, when Frost again recommended that they move some of their remaining assets to bonds,
23 the Devenneys again refused. Instead, the Devenneys maintained their existing portfolio until they
24 issued a panic order to sell all of their mutual funds while the market was closed in the wake of the
25 September 11 tragedy.

26

1 Affirmative Defenses

2 1. Frost had reasonable grounds to believe that the recommendations he made to the
3 Devenneys' were suitable for them based on the information they provided to him, including their
4 affirmative representations, both orally and in writing, that they had changed their investment
5 objective from aggressive income to growth.

6 2. Frost's listing of "speculation" as a secondary investment objective for the
7 Devenneys is not inaccurate, is not fraudulent, and does not violate Arizona law. It is not inaccurate
8 because the Devenneys approached Frost to liquidate their fixed income portfolio, changed their
9 investment objectives to growth, and refused thereafter to invest in bonds, notwithstanding Frost's
10 repeated recommendations that they invest in bonds. Given the four choices on the new account
11 form, it was both accurate and appropriate to list "speculation" as a secondary objective in light of
12 these facts. Moreover, even if "speculation" was not the Devenneys' secondary investment
13 objective, the listing of such an objective was not fraudulent because, among other things, it is
14 immaterial in that none of the investments Frost recommended to the Devenneys were speculative,
15 because there is absolutely no evidence, much less clear and convincing evidence that Frost intended
16 to deceive anyone by listing speculation as a secondary objective, and because there is no evidence
17 that anyone, including the Devenneys, was misled by information on the new account form.

18 3. The State, and the Devenneys are estopped from claiming after the fact, that the
19 investment objectives the Devenneys' directed Frost to implement were not their real investment
20 objectives after all, and are estopped from claiming that the Devenneys really wanted income
21 oriented investments.

22 4. The Devenneys are charged with knowledge of the risks to their investment portfolio
23 set forth in writing in the prospectuses provided to the Devenneys contemporaneously with their
24 purchases of shares in those mutual funds under the "bespeaks caution" doctrine and otherwise.
25 Thus, even if it were true that Frost did not orally disclose to the Devenneys that the mutual funds he
26 recommended increased the risk of loss to the Devenneys principal, a factual assertion Mr. Frost

1 denies, the transactions do not violate A.R.S. Section 44-1991, and cannot constitute a dishonest or
2 unethical practice, unless the prospectus disclosures of such enhanced risk are materially misleading.
3 The Division has not alleged that the risk disclosures in the relevant prospectuses were misleading,
4 no such allegation could be made, and no enforcement action against Frost would lie in the event the
5 prospectuses were misleading absent proof that he knew the prospectus disclosures were misleading.

6 5. Frost denies that he assured the Devenneys that the market would recover but, even if
7 such a prediction had been made by him or by anyone else to the Devenneys, it could not possibly
8 constitute actionable fraud because such a prediction of future performance is not a
9 misrepresentation of fact, and because the Devenneys' would have had no right to rely on such a
10 prediction.

11 6. The Arizona Constitution bars the Commission's purported exercise of jurisdiction
12 over Robin Frost in that such purported exercise of jurisdiction exceeds the Commission's authority
13 to regulate securities.

14 7. A.R.S. Section 2031.C., which purports to give the Division authority to recover from
15 the assets of the Frost community for actions which by the Division's own acknowledgement
16 occurred in or before September 2001, was not enacted until after the alleged misconduct at issue,
17 and may not be applied retroactively to the conduct alleged in the Notice of Opportunity for Hearing.

18 8. The Notice of Opportunity for Hearing fails to state a claim for securities fraud with
19 reasonable particularity as required by Rule 9(b) of the Arizona Rules of Civil Procedure.

20 9. The Devenneys approved, authorized, directed and/or ratified all conduct that the
21 division now claims to have been wrongful, therefore barring the Division's efforts to now claim that
22 the conduct alleged, all of which relates to the Devenneys, was wrongful.

23 10. Mr. Frost was singled out for prosecution by the Commission while other individuals
24 similarly situated were not prosecuted, and on information and belief, the decision to prosecute Mr.
25 Frost but not others similarly situated was based on an impermissible motive or lacked a rational
26 basis for the difference in treatment.

1 Copy of the foregoing hand-delivered June 30, 2003, to:

2 Phillip A. Hofling, Esq.
3 Securities Division
4 Arizona Corporation Commission
5 1300 West Washington, Third Floor
6 Phoenix, Arizona 85007-2996

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6 Stephanie J. Lawson

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