Ontario Securities Commission | Commission des valeurs mobilières de l'Ontario | 22nd Floor, 20 Queen Street West, Toronto ON M5H 3S8 | 22e étage, 20, rue Queen Ouest, Toronto ON M5H 3S8

Citation: First Class Crypto Inc (Re), 2020 ONSEC 14
Date: 2020-05-28
File No. 2020-9

IN THE MATTER OF
FIRST CLASS CRYPTO INC., JOHNATHAN HARRIS, MITCHELL CARNIE AND NEILL KLOSS

REASONS AND DECISION FOR APPROVAL OF SETTLEMENT
(Sections 127 and 127.1 of the *Securities Act*, RSO 1990, c S.5)

Hearing:	In writing	
Decision:	May 28, 2020	
Panel:	M. Cecilia Williams	Commissioner and Chair of the Panel
	Craig Hayman	Commissioner
	Frances Kordyback	Commissioner
Appearances:	Charlie Pettypiece	For Staff of the Commission
	Christi Hunter	For Neill Kloss
	Mitchell Carnie	For himself and First Class Crypto Inc.
	Johnathan Harris	For himself and First Class Crypto Inc.

REASONS AND DECISION FOR APPROVAL OF SETTLEMENT

[1] Staff of the Ontario Securities Commission (**Staff**), First Class Crypto Inc. (**FCCI**), Johnathan Harris (**Harris**), Mitchell Carnie (**Carnie**) and Neill Kloss (**Kloss**) (FCCI, Harris, Carnie and Kloss collectively the **Respondents**) have jointly submitted that it would be in the public interest to approve a settlement between the parties dated May 26, 2020 (the **Settlement Agreement**).[1] We agree.

[2] We have reviewed this settlement in detail and have had the benefit of a confidential settlement conference, held by teleconference, with all parties, and where represented, their counsel. We asked questions of the parties and heard their submissions. Following the confidential settlement conference, the parties responded in writing to further questions of the Panel. The parties also confirmed that they all consented to proceed by way of a written hearing for the public approval of the settlement. These are our reasons for approving the Settlement Agreement.

[3] The facts, which are set out in detail in the Settlement Agreement include:

a. FCCI is an Ontario company that purported to be in the business of crypto asset mining. Harris and Carnie are founding shareholders, directors, officers and directing minds of FCCI. Kloss became a shareholder and *de facto* director or officer of FCCI and represented himself as the Chief Financial Officer and a Vice-President of FCCI.

b. From December 2017 to May 2018, the Respondents raised $364,082 from 43 Ontario investors by entering in two forms of investment contracts (**FCCI Investment Contracts**):

   i. the Lending Mining Contract (**LMC**), which promised investors compounded monthly returns without exposure to the volatility of the crypto asset market through the purchase of mining rigs; and

   ii. the Crypto Security Plan (**CSP**), which promised investors annual returns on investor funds held in the crypto asset market.

c. The Respondents promoted FCCI Investment Contracts to the public through a variety of means including, marketing materials, holding investment seminars and by encouraging individuals to become "recruiters" in exchange for promised referral fees. The Respondents held training seminars and created training materials for recruiters.

d. Most investors entered into the LMC investment contract. Investors were promised earnings between 3% and 6% compounded monthly for LMCs and 12% annually for CSPs. Investors either paid in Canadian dollars, which were exchanged for crypto assets or transferred crypto assets directly to FCCI. All crypto assets were held in blockchain wallets controlled by the Respondents.

e. The FCCI Investment Contracts are "investment contracts" and therefore "securities" under the *Securities Act* (the **Act**)[2] because:

[1] The Settlement Agreement is marked as Exhibit 1 in this written hearing.
[2] RSO 1990, c S.5

i. investors invested with an intention or expectation of profit;

ii. the investment was made into a common enterprise where the success of the investment and the ability to deliver the promised returns depended on the significant efforts of the Respondents; and

iii. the Respondents' efforts, including sourcing, establishing and maintaining mining rigs for LMC investors and making and managing investments in the crypto asset market for CSP investors, were essential managerial efforts that affected the failure or success of the FCCI enterprise.

f. In person, in marketing materials and in the FCCI Investment Contracts, the Respondents made numerous false or misleading statements that induced investors into signing the FCCI Investment Contracts. Statements made to investors also omitted facts that FCCI investors would consider relevant. The false and misleading statements made included:

i. the Respondents had mining rig facilities and enough mining rigs to meet obligations to investors;

ii. LMC investment funds would be used to purchase mining rigs;

iii. LMC investment funds were guaranteed and not subject to the fluctuation of the crypto asset markets;

iv. FCCI had insurance that could protect LMC investment funds;

v. FCCI's crypto asset holdings and mining rigs were protected by physical and technological security; and

vi. FCCI would pay compounded monthly returns to investors in LMC and annual returns to investors in CSP.

g. In reality:

i. FCCI had no established mining facilities;

ii. from December 2017 to May 2018, the Respondents could not purchase mining rigs to meet FCCI's obligations under the LMCs;

iii. during that period while the Respondents attempted to source mining rigs, LMC investment funds were held in volatile crypto assets that were decreasing in value; and

iv. FCCI had no insurance on mining rigs and no insurance that would purportedly protect principal investments of LMC investors.

h. By the time the Respondents shut down FCCI's business in June 2018 a substantial amount of the investors' funds had been lost. The Respondents asked investors to sign documents purporting to cancel the FCCI Investment Contracts and acknowledge that investors had been paid in full. For some investors, the Respondents also issued promissory notes promising to repay investor losses.

i. Not only did the Respondents fail to repay the principal amounts originally invested in FCCI, the Respondents also failed to pay investors the monthly and annual returns promised.

[4] The Respondents admit that they have breached Ontario securities law and acted contrary to the public interest:

a. by engaging in unregistered trading of FCCI Investment Contracts, contrary to s. 25(1) of the Act;

b. by distributing FCCI Investment Contracts, contrary to s. 53(1) of the Act;

c. where no registration or trading exemptions were available to the Respondents;

d. by making prohibited representations, contrary to s. 44(2) of the Act; and

e. Harris, Carnie and Kloss, as directors, officers or *de facto* directors or officers of FCCI, authorized, permitted or acquiesced in FCCI's breaches of ss. 25(1), 53(1) and 44(2) and are deemed to also have not complied with Ontario securities law pursuant to s. 129.2 of the Act.

[5] The Respondents acknowledge that they acted contrary to the public interest as they failed to operate the business in a manner that protected FCCI investors and investor funds by, among other things: lacking the proficiency, integrity and solvency necessary to protect investors; failing to adequately maintain basic documentation regarding FCCI's operations; and, on the wind down of FCCI, cancelling access to corporate email accounts, liquidating crypto asset balances and deleting records, including all records of blockchain addresses. The Respondents had a responsibility to ensure FCCI kept accurate and complete books and records.

[6] The registration and prospectus requirements are cornerstones of Ontario's securities regulatory regime. It is important that companies and individuals that engage in the business of trading in securities, or that hold themselves out as doing so:

a. be properly registered or be entitled to rely on available exemptions; and

b. do so either under a prospectus or be entitled to rely on available prospectus exemptions.

[7] We have however, taken into account mitigating circumstances. Specifically, the Respondents:

a. sought an early resolution to this matter, in advance of enforcement proceedings commencing;

b. proactively facilitated the partial return of funds to certain investors upon shutting down FCCI in June 2018 and continue to make some additional repayments to certain investors after FCCI's shut down; and

c. provided information to Staff that suggests that $215,453 of the principal amount originally raised from investors has been repaid.

[8] The details of the terms under which the parties have agreed to settle are contained in the Settlement Agreement and need not be repeated here. To summarize:

a. the individual Respondents shall pay administrative penalties of:

i. $41,125 by Harris;

ii. $31,125 by Carnie; and

iii. $17,750 by Kloss;

b. disgorgement shall be made to the Commission of:

i. $120,000 by FCCI, Harris and Carnie on a joint and several basis; and

ii. $28,629 by Kloss;

c. costs shall be paid to the Commission as follows:

i. $20,250 by FCCI, Harris and Carnie, on a joint and several basis; and

ii. $4,750 by Kloss;

d. prior to this settlement approval hearing, Harris paid $5,000, Carnie paid $3,000 and Kloss paid $51,129 to the Commission with respect to the financial sanctions and costs.

e. Harris and Carnie shall each pay installments of $10,000 to the Commission every six months, starting on the date that is six months from the date on which the Settlement Hearing Agreement is approved until the amounts ordered against them are paid in full.

f. FCCI is permanently prohibited from trading securities and derivatives and acquiring securities and accessing exemptions in Ontario securities law;

g. subject to a limited carve out for trading securities and derivatives and acquiring securities in registered accounts of the individual Respondents, each of Harris, Carnie and Kloss is subject to restrictions on trading in any securities or derivatives, acquiring any securities, accessing exemptions contained in Ontario securities law, and becoming or acting as a registrant or promoter for the following periods:

i. Harris – the later of 12 years from the date of the Order and such time as all financial sanctions and costs are paid in full;

ii. Carnie – the later of 7 years from the date of the Order and such time as all financial sanctions and costs are paid in full; and

iii. Kloss – 5 years;

h. subject to a limited carve out for personal companies of Harris and Carnie, each of the individual Respondents:

i. shall resign any positions they may hold as a director or officer of any issuer or registrant; and

ii. is prohibited from becoming or acting as a director or officer of any issuer or registrant for the following periods:

(a) Harris – the later of 12 years from the date of the Order and such time as all financial sanctions and costs are paid in full;

(b) Carnie – the later of 7 years from the date of the Order and such time as all financial sanctions and costs are paid in full; and

(c) Kloss – 5 years;

i. The respondents are prohibited from acting as a registrant or promoter for the following time periods:

   i. Permanently for FCCI;

   ii. Harris – the later of 12 years from the date of the Order and such time as all financial sanctions and costs are paid in full;

   iii. 7 Carnie – the later of 7 years from the date of the Order and such time as all financial sanctions and costs are paid in full; and

   iv. Kloss – 5 years; and

j. the Respondents are reprimanded.

[9] The Commission's role at a settlement hearing is to determine whether the negotiated result falls within a range of reasonable outcomes, and whether it would be in the public interest to make the order requested.

[10] We recognize that the Settlement Agreement is the product of negotiations between Staff and the Respondents. When considering settlements for approval, the Commission respects the negotiation process and accords significant deference to the resolution reached by the parties.

[11] Approval of this settlement would resolve a proceeding promptly, efficiently and with certainty. A settlement avoids the expenditure of significant resources that would be associated with a lengthy, contested merits hearing. The payment of costs helps to reduce the burden on market participants to pay for investigations and enforcement proceedings.

[12] An order of disgorgement is appropriate in this instance. The Respondents admit that the sale of FCCI Investment Contracts to the public was an illegal distribution of securities and it is appropriate that amounts obtained be disgorged. The Respondents have agreed to disgorge the amount that remains unpaid to investors.

[13] Harris and Carnie continue to make repayments to FCCI investors. To the extent that further payments are made to FCCI investors, any Respondent may apply to the Commission pursuant to s. 144 of the Act to vary the terms of the settlement order. The Settlement Agreement provides for a means of establishing that payments have, in fact, been made to investors in support of any such application.

[14] The Commission has, in other instances, agreed to payment plans for financial sanctions. In this circumstance, the payment plan for Harris and Carnie is supported by several factors:

a. Staff confirmed that each of Harris and Carnie has paid a portion of the financial sanctions at the time of the settlement approval written hearing;

b. the financial situation of Harris and Carnie; and

c. the Commission's ability in the event of any breach of the Settlement Agreement, including failure of Harris or Carnie to make any of the periodic payments, to bring any proceedings necessary to recover the full amounts owing.

[15] The parties submit and we agree that the proposed financial sanctions and bans reflect the misconduct of the individual Respondents and their roles and responsibilities at FCCI and they are proportionate in the circumstances.

[16] This misconduct was serious. In particular, the failure to keep accurate and complete books and records is of significant concern to the protection of investor interests. This concern is heightened when operating in the crypto asset sector.

[17] This failure combined with the fact that the crypto assets acquired with investor funds were held in blockchain wallets controlled by the Respondents raises uncertainty about the status of those assets and any future access by the Respondents. The Panel took comfort on these issues from the Respondents' representations in the Settlement Agreement that the crypto assets were liquidated and all records of the addresses for those wallets were deleted.

[18] The Panel took additional comfort from the fact that the Settlement Agreement does not contain a full and final release for future proceedings relating to this matter. As a result, Staff may bring further proceedings against the Respondents, despite the Settlement Agreement, if Staff discovers that materially more funds were raised, materially more investors were involved or materially more investors or funds remain unpaid.

[19] The registration and prospectus requirements, as well as the prohibitions against making false and misleading statements, are core to the investor protection objectives of the Act. In this instance, the misconduct occurred over a short six-month period, involved a limited monetary amount and did not recur.

[20] The Panel also took note of the fact that the Respondents:

a. have never been registered with the Commission;

b. are unsophisticated and inexperienced individuals;

c. have limited involvement in Ontario's capital markets; and

d. have demonstrated some recognition of the seriousness of their misconduct by their admission, through their agreement to be reprimanded and as a result of the steps taken to make repayments to investors and wind down the FCCI business.

[21] In our view, the terms of the settlement fall within a range of reasonable outcomes in the circumstances. The settlement also properly reflects the principles applicable to sanctions, including recognition of the seriousness of the misconduct and the importance of fostering investor protection and confidence in the capital markets.

[22] For these reasons, we conclude that it is in the public interest to approve the settlement. We will therefore issue an order substantially in the form attached to the Settlement Agreement.

[23] The Respondents have agreed to a reprimand. That permits us to reinforce the importance of compliance with Ontario securities law. They are hereby reprimanded.

Dated at Toronto this 28th day of May, 2020.

"M. Cecilia Williams"
M. Cecilia Williams

"Craig Hayman"
Craig Hayman

"Frances Kordyback"
Frances Kordyback