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Citation: Clayton Smith (Re), 2018 ONSEC 33
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IN THE MATTER OF
CLAYTON SMITH

ORAL REASONS FOR APPROVAL OF SETTLEMENT
(Subsections 127(1) and 127.1(1) of the *Securities Act*, RSO 1990, c S.5)

Hearing: June 13, 2018

Decision: June 14, 2018

Panel:	Janet Leiper	Commissioner and Chair of the Panel
	Philip Anisman	Commissioner
	Frances Kordyback	Commissioner
Appearances:	Anna Huculak	For Staff of the Commission
	Clayton Smith	Appearing on his own behalf

ORAL REASONS FOR APPROVAL OF SETTLEMENT

The following reasons have been prepared for publication in the Ontario Securities Commission Bulletin, based on the reasons delivered orally at the hearing, and as edited, with footnotes, and approved by the Panel, to provide a public record.

[1] The Settlement Agreement dated May 28, 2018 (**Settlement Agreement**) between enforcement staff (**Staff**) of the Ontario Securities Commission (the **Commission**) and Clayton Smith (**Smith**), submitted for approval in this settlement hearing, provides an illustration of the potential for abuse when unchecked authority is conferred on a single individual.

I. SMITH'S CONDUCT

[2] The conduct admitted by Smith in the Settlement Agreement demonstrates a conscious disregard by Smith and Crystal Wealth Management System Limited (**Crystal Wealth**), under Smith's direction, of their fiduciary responsibilities to, and their obligations to act honestly, in good faith and in the best interests of, mutual funds they managed and clients who invested in those funds.

[3] Smith was the founder of Crystal Wealth and as its president, CEO, CFO, CCO, UDP, sole officer and director and indirect controlling shareholder, was its directing mind.[1] He controlled Crystal Wealth through a series of holding companies of which he was the only officer and director; he was the sole shareholder of CLJ Everest Ltd. (**CLJ Everest**), which owned all the voting shares of 1150752 Ontario Limited (**115 Limited**), which in turn owned a majority of Crystal Wealth's outstanding shares.[2]

[4] Crystal Wealth was the creator, promoter and trustee and the registered investment fund manager (**IFM**) and portfolio manager of fifteen mutual funds (the **Crystal Wealth Funds**) that distributed their securities on a prospectus-exempt basis.[3] Smith was registered as a portfolio manager and advising representative, was the lead portfolio manager for at least one of the Crystal Wealth Funds, Crystal Wealth Media Strategy (the **Media Fund**), and advised a number of Crystal Wealth's 1,250 clients who had discretionary managed accounts, many of whom were invested in various Crystal Wealth Funds.[4]

[5] Over a period of approximately five years, from April, 2012 to April, 2017 (the **Material Time**), Smith misappropriated significant amounts of money from two of the Crystal Wealth Funds, Crystal Wealth Mortgage Strategy (the **Mortgage Fund**) and the Media Fund, by causing payments to be made, directly and indirectly, to himself, his wholly-owned corporations and two other corporations that he owned equally with another shareholder and advising representative of Crystal Wealth in one case (**CWMI**) and with his former common law wife in the

[1] Settlement Agreement at paras 6 and 16. These reasons adopt the definitions used in the Settlement Agreement.
[2] Settlement Agreement at para 18.
[3] Settlement Agreement at paras 6 and 11-13.
[4] Settlement Agreement at paras 15, 17 and 35.

other (**Chrysalis**).[5] A brief description demonstrates the nature of this fraudulent conduct.

a. Mortgage Fund

[6] Smith caused the Mortgage Fund to make six payments totalling approximately $894,932 to 115 Limited. He subsequently told the Mortgage Fund's auditors that the Mortgage Fund held interests in mortgages corresponding to the amounts of these payments (the **Purported Mortgage Investments**) that were obtained through "MBS Partners", the registered name under which 115 Limited carried on business.[6] These Purported Mortgage Investments were contrary to the Mortgage Fund's offering memorandum, which represented that it would invest in mortgages with independent companies.[7] Moreover, when asked by Staff about MBS Partners on an examination under oath, he said he had no interest in MBS Partners and MBS Partners had no interest in Crystal Wealth; as MBS Partners was 115 Limited, Crystal Wealth's direct controlling shareholder, both statements were lies.[8]

[7] Smith subsequently misappropriated funds from the Media Fund by having it overpay for three film loans and directing the recipients, Media House and its related parties, to transfer the funds to a service provider to purchase the Purported Mortgage Investments from the Mortgage Fund.[9] He thus repaid the Mortgage Fund some or all of the amount he previously misappropriated from it with funds misappropriated from the Media Fund.

[8] Although the Mortgage Fund's offering memorandum stated that it would invest primarily in residential mortgages, Smith caused it to purchase two film loans, which were subsequently sold to the Media Fund. The money paid for one of these loans was substantially returned to Smith amounting to a further misappropriation of approximately $1,575,000.[10]

[9] Smith also caused Crystal Wealth to enter into a financing agreement with MCS to provide financing for energy projects. The same day, he had CLJ Everest enter into an arrangement with MCS under which a monthly consulting fee of 15 per cent of the net free cash flow from all such energy projects would be paid to CLJ Everest for unspecified assistance with "any aspect of MCS's business operations". Smith subsequently had the Mortgage Fund pay $2,000,000 to an MCS affiliate, which was recorded as a loan in the Mortgage Fund's financial statements, $1,750,000 of which was advanced by the MCS affiliate to CLJ Everest and used by it to purchase shares of Crystal Wealth from the other shareholder of CWMI.[11] Smith thus used funds obtained from the Mortgage Fund to increase his indirect share ownership of Crystal Wealth. Smith admits this and the other Mortgage Fund transactions were fraudulent.[12]

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[5] Settlement Agreement at paras 19, 20, 28 and 37.
[6] Settlement Agreement at paras 18 and 22-23.
[7] Settlement Agreement at para 21.
[8] Settlement Agreement at paras 18, 23 and 45.
[9] Settlement Agreement at para 28(b)(ii).
[10] Settlement Agreement at paras 27 and 29.
[11] Settlement Agreement at paras 31-33.
[12] Settlement Agreement at para 34.

b. Media Fund

[10] Although the Media Fund's offering memorandum said that funds would be invested in film loans to independent producers, six such loans were provided to Media House for films produced by corporations controlled by Media House's majority shareholder and sole director.[13] At Smith's direction, approximately $6,990,000 of these loans were transferred to Smith and his corporations[14] and to the Mortgage Fund's service provider to purchase from the Mortgage Fund the Purported Mortgage Investments[15] and other mortgages that were in arrears.[16] This course of conduct, too, was fraudulent.

[11] Smith also arranged for payments that were, in effect, a kickback in connection with the purchase by the Media Fund of certain other film loans from Media House. The contract with Media House provided that Media House was to receive a loan facilitation fee of up to 10 per cent of the face value of these loans. For several of the loans, Media House paid 30 per cent of its loan facilitation fee to CWMI, amounting to approximately $622,780, substantially all of which was paid to Smith and CWMI's other shareholder.[17]

[12] The Settlement Agreement treats this payment separately as a conflict of interest, which Crystal Wealth failed to disclose to investors in the Media Fund contrary to Ontario securities law.[18] In fact, although the Settlement Agreement does not say this, all of the misappropriations described in the Settlement Agreement raised conflicts of interest, disclosure of which would have prevented their accomplishment.[19]

c. Duty to Clients

[13] Finally, during the Material Time, Smith caused clients of Crystal Wealth, whose discretionary accounts he managed, "to be invested in the Mortgage and Media Funds". He admits that in doing so he failed to deal fairly, honestly and in good faith with them, contrary to Ontario securities law.[20]

II. APPROPRIATE SANCTIONS

a. Market Prohibitions

[14] Smith's egregious, admittedly fraudulent conduct in directing and managing the investment funds of clients invested in the Mortgage and Media Funds warrants serious sanctions. The sanctions agreed to in the Settlement Agreement would permanently exclude him from participation in the securities market by prohibiting him from trading in securities or derivatives, from becoming or acting

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[13] Settlement Agreement at paras 24-27.
[14] Settlement Agreement at para 28(a).
[15] See paragraph 7, above.
[16] Settlement Agreement at para 28(b).
[17] Settlement Agreement at paras 35-37.
[18] Settlement Agreement at para 38; National Instrument 31-103 - *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, ss 13.4(2) and (3) (**NI 31-103**). The Settlement Agreement does not state that this was fraudulent.
[19] See LD Brandeis, *Other People's Money and How the Bankers Use It* (1914, Harper Torchbook Edition, 1967) at62 ("Sunlight is said to be the best of disinfectants; electric light the most efficient policeman").
[20] Settlement Agreement at paras 15, 39 and 47(b); OSC Rule 31-505 - *Conditions of Registration*, s 2.1.

as a registrant or promoter and from acting in any managerial position with an issuer or registrant (including an investment fund manager).[21] These sanctions are clearly appropriate.

b. Disgorgement

[15] In most circumstances, other sanctions would be as well. The Settlement Agreement describes misappropriations from the Mortgage Fund and Media Fund over an extended period totalling approximately $11,832,712.[22] All of these funds were misappropriated through Smith's portfolio management activities on behalf of Crystal Wealth and, as admitted in the Settlement Agreement, were contrary to section 126.1 of the Act or the conflict of interest provisions of NI 31-103.[23] As a result, an order requiring Smith to disgorge all of the funds obtained as a result of these contraventions of Ontario securities law would usually be appropriate. The Settlement Agreement does not provide for one.

[16] The Settlement Agreement states, however, that a receiver and manager has been appointed under section 129 of the Act over the assets of Crystal Wealth, the Crystal Wealth Funds, CLJ Everest, 115 Limited, Chrysalis' bank account and Smith's personal assets for the benefit of investors in the Crystal Wealth Funds and other creditors of Crystal Wealth.[24]

[17] The implication is that Smith has no remaining assets. The effect of the receiver's appointment is thus equivalent to a disgorgement order applicable to all of Smith's assets with a more direct benefit to Crystal Wealth's investors, whether or not these assets are equal to the misappropriated amounts that would be subject to a disgorgement order (which is not disclosed in the Settlement Agreement). In these circumstances, a disgorgement order, if enforced as a claim by Staff in the receivership, would reduce proportionately the amount that investors may receive. As a result, the fact that the Settlement Agreement does not require disgorgement of the funds obtained by Smith does not take it beyond a reasonable range of appropriate sanctions.[25]

c. Monetary Administrative Penalty

[18] The agreed sanctions also include a monetary administrative penalty in the amount of $250,000. In the context of Smith's conduct, this amount is arguably insignificant. When the receiver and manager was appointed, the AUM of the Crystal Wealth Funds were $193,198,912, and the Media Fund alone had AUM of

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[21] Investment fund managers are registrants; see *Dhanani (Re)* (2017), 40 OSCB 4457, 2017 ONSEC 15 at para 14.

[22] Paragraphs 6 and 8-11, above.

[23] NI 31-103, s 13.4. Smith is also responsible for these contraventions as the authorizing director and officer of Crystal Wealth, as he admitted; see Act, s 129.2; Settlement Agreement at paras 34, 38 and 47(a) and (e).

[24] Settlement Agreement at paras 48-50. As of May 1, 2018, approximately $30,817,199 had been returned to investors by the receiver. This is significantly less than Crystal Wealth's $193,198,912 assets under management (**AUM**) and the $54,466,843 AUM of the Media Fund as of April 20, 2017, one week before the receiver was appointed; Settlement Agreement at paras 14, 24 and 48.

[25] This is so, even though a settlement that required disgorgement of funds obtained from investors where a receiver had been appointed has been approved by the Commission; see *Pogachar (Re)* (2011), 34 OSCB 1048 (order) and 1055 (settlement agreement). The settlement in this case was with the corporate respondents, was agreed to by their receiver acting for them and required allocation of the disgorged funds to specified classes of investors and the distribution of these funds by the receiver.

approximately $54,466,843. The amounts misappropriated by Smith totalled almost $12,000,000. In light of these amounts and Smith's multiple contraventions, an administrative penalty of $250,000 is inadequate and would not be an appropriate sanction.

[19] Moreover, the Settlement Agreement suggests that the administrative penalty may not be collectible. Like similar settlement agreements, the Settlement Agreement provides that a failure by Smith to comply with the agreed order will entitle Staff to bring proceedings against him based on both the misconduct described in the Settlement Agreement and the breach of the order. Under the Settlement Agreement, however, this provision does not apply to the administrative penalty and costs.[26] As a result, if Smith does not pay the administrative penalty and costs to which he has agreed, the settlement will continue to be binding on Staff, so long as he complies with the market prohibitions in the order. The effect of this exclusion is emphasized by Smith's acknowledgement that a failure to pay will result in his name being added to the list of delinquent respondents that is published by the Commission.[27]

[20] The potential for a proceeding based on the facts admitted in a settlement agreement for a breach of the agreed order encourages compliance with the order, including monetary sanctions, and enhances the deterrent effect of the settlement.[28] The carveout in the Settlement Agreement thus reduces any incentive to comply with the monetary and costs orders and the specific deterrence that it may otherwise accomplish.

[21] The relatively small administrative penalty, when combined with Staff's inability to take proceedings if it is not paid and Smith's acknowledgement, may also diminish the general deterrence of the agreed sanctions and could bring into question the reasonableness of these sanctions.[29] If payment is not expected, it may be preferable not to include an administrative penalty and costs in a settlement agreement.[30] A monetary sanction that is merely symbolic may have a perverse effect and diminish confidence in the Commission's enforcement process. In this case, however, for the following reasons, the sanctions remain within a reasonable range of appropriateness.

d. Public Interest

[22] The fact that a receiver has been appointed over Smith's personal assets does not mean he will never have assets. Smith is capable and enterprising, as is demonstrated by the fact that under his direction, in less than 20 years, Crystal Wealth acquired AUM of almost $200 million and by the complexity of the fraudulent misappropriations described in the Settlement Agreement. It is possible that Smith will acquire funds following the receivership, the conclusion

[26] Settlement Agreement at para 56. A carveout like this one is contained in only one prior settlement agreement; see *Kotton (Re)* (2017), 40 OSCB 4855, 2017 LNONOSC 291 at para 100.
[27] Settlement Agreement at para 53. Although this provision is common in settlement agreements, its deterrent effect is questionable, and in a case like this one, likely negligible.
[28] See, e.g., *Wing (Re)* (2018), 41 OSCB 4365, 2018 ONSEC 25 at para 17 (***Wing***).
[29] The fact that one prior settlement agreement contains similar provisions does not, in our view, support the reasonableness of this one.
[30] See, e.g., *Sbaraglia (Re)* (2013), 36 OSCB 2572 (order) and 2609 (settlement agreement) at paras 29-30 (settlement of proceeding based on similar conduct; no monetary sanction or costs because receiver appointed over respondent's assets); see also *Marlow (Re)* (2006), 29 OSCB 5217 at paras 5-7.

of which will not release him from liability for his debts. Staff will be entitled to register the agreed order in the Superior Court of Justice, after which it will be enforceable as an order of the Court.[31] As such, its enforcement will not be subject to a limitation period.[32] Thus, despite the carveout in the Settlement Agreement, the monetary penalty and costs may be collectible in the long term, if Staff seeks to enforce the order.

[23] In addition, the complexity of the transactions described in the Settlement Agreement indicates that a lengthy hearing will be necessary if the Settlement Agreement is rejected. A hearing would require full proof of the facts agreed to in the Settlement Agreement and, possibly, evidence relating to other transactions not included in it. The Settlement Agreement will thus remove the need to conduct a lengthy hearing and by saving substantial Staff time, will enable Staff to address other enforcement needs.

[24] More significantly, it is not clear that any result obtained after a hearing on the merits would fulfill the Commission's mandate to a substantially greater degree than the agreed order. The market prohibitions will accomplish the direct protective purposes of sanctions under the Act by precluding any activities by Smith relating to the securities market and investors. A failure to comply with them will entitle Staff to bring a proceeding based on all of Smith's admitted conduct. In view of the receivership, it is far from clear that any disgorgement order and administrative penalty that might be imposed after a lengthy hearing would accomplish enough to make this Settlement Agreement unreasonable. As a result, the Settlement Agreement embodies adequate specific and general deterrence to bring the agreed sanctions within a reasonable range of appropriateness.[33] For these reasons, approval of the Settlement Agreement is in the public interest and we shall make an order substantially in the form agreed to by Staff and Smith in this hearing.

[25] Approval in this case should not, however, be treated as acceptance of the reasonableness of the carveout in paragraph 56 of the Settlement Agreement[34] or as a precedent for consideration of the parameters of reasonableness in future settlement hearings. Rather, this decision should be limited to its facts, recognizing that a carveout of this nature is inconsistent with the specific and general deterrence that is essential to the prevention sought in Commission sanction orders.[35]

III. ADDITIONAL COMMENTS

a. Reprimand

[26] The Settlement Agreement invites two further comments. First, the agreed order includes a reprimand. Authority to reprimand was granted in 1994 to enable the Commission to sanction registrants and other market participants where another

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[31] Act, s 151.
[32] *Limitations Act, 2002,* SO 2002, c 24, Schedule B, s 16(1)(b); see, e.g., *Independence Plaza 1 Associates, LLC v Figliolini*, 2017 ONCA 44 at para 32.
[33] See, e.g*., Electrovaya (Re)* (2017), 40 OSCB 5795, 2017 ONSEC 25 at paras 5-8; *Wing* at paras 4, 5 and 11.
[34] See paragraph 19, above.
[35] See *Wing* at para 1.

sanction would be too severe.[36] An agreement to be reprimanded may also recognize a respondent's acceptance of responsibility and commitment to future compliance with Ontario securities law.[37] In a case like this one, it may also serve as an attempt to emphasize and bring home to a respondent direct responsibility for his or her abusive conduct.

[27] A reprimand, like other sanctions, must be based on the facts of each case, which determine its utility.[38] In view of the conscious nature and repetition of the wrongdoing described in the Settlement Agreement, a reprimand would appear to add little, if anything, to the prohibitions in the agreed order. If it is perceived as a token sanction, merely a slap on the wrist, it may undermine the effect of reprimands generally. While including it here does not make the settlement unreasonable, it is important to consider in future cases based on similar egregious conduct whether a reprimand serves a useful purpose with respect to an individual respondent.

b. Regulatory Framework

[28] Finally, the conduct described in the Settlement Agreement is indicative of the potential for conflicts of interest in the management of mutual funds. Transactions involving conflicts of interest by mutual funds that are reporting issuers are subject to review by an independent review committee (**IRC**).[39] Although not mentioned by the parties, Smith's management of Crystal Wealth and the Crystal Wealth Funds demonstrates a need for such protection with respect to mutual funds that distribute securities in the exempt market and are not reporting issuers. Had the transactions in this case been subject to IRC review, they might not have occurred.[40] An IRC would at a minimum have made it more difficult for Smith to manage Crystal Wealth and the Crystal Wealth Funds in the manner he did. In view of the amounts of assets under management by mutual funds that are not reporting issuers, the limitation of NI 81-107 to reporting issuers should be reconsidered.

IV. REPRIMAND

[29] Mr. Smith, we acknowledge and recognize your cooperation in settling these matters. As part of the settlement agreement, a reprimand is imposed on you. The Panel notes that this settlement arose from your failure toward your community – a breach of trust that appears to be the product of your willingness to be deceitful and to prefer your own interests over those of others, unlawfully, over a lengthy period of time. You have accepted formal responsibility. There are questions to take away with you, to which only you know the answers. Why did you allow this to happen? Will you serve your community with integrity in the future? Will you resolve to do better? That is yet to be known.

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[36] See *Credit Unions and Caisses Populaires Act*, 1994, SO 1994, c 11, s 375; *Proposals to Amend the Enforcement Provisions of the Securities Act* (1991), 14 OSCB 1907 at 1908 (where other sanctions "too great an intrusion"); Borden Ladner Gervais, *Securities Law and Practice* (2013), vol 3, p 22-71, s 22.7.3(b.6).

[37] See, e.g., *Sentry (Re)* (2017), 40 OSCB 3435, 2017 ONSEC 7 at paras 14-18; *Wing* at para 18.

[38] See *Global RESP Corporation (Re)* (2018), 41 OSCB 4369, 2018 ONSEC 26 at paras 13-15.

[39] See National Instrument 81-107 – *Independent Review Committee for Investment Funds* (**NI 81-107**).

[40] See note 19, above and accompanying text.

Dated at Toronto this 14th day of June, 2018.

"Janet Leiper"
Janet Leiper

"Philip Anisman"
Philip Anisman

"Frances Kordyback"
Frances Kordyback