

**ONTARIO
SUPERIOR COURT OF JUSTICE**

B E T W E E N:

ANTHONY WHITEHOUSE

Plaintiff

- and -

BDO CANADA LLP

Defendant

1. The Defendant BDO Canada LLP (“**BDO**”) admits the allegations in paragraphs 5 and 6 of the Statement of Claim.
2. BDO has no knowledge of the allegations in paragraphs 2, 3, 8, and 17 of the Statement of Claim except where expressly admitted below.
3. BDO denies the balance of the allegations contained in the Statement of Claim except where expressly admitted below. BDO specifically denies that the Plaintiff, Anthony Whitehouse, is entitled to the relief set out in paragraph 1 of the Statement of Claim or to any relief whatsoever.

Overview

4. The Plaintiff in this case is unjustifiably seeking to hold BDO responsible as an “insurer” for the entirety of losses sustained by Crystal Wealth’s unitholders.¹ Auditors are not insurers against fraud or other misconduct. They perform tests based on sampling but

¹ “Crystal Wealth” and other capitalized terms are defined below.

do not and cannot guarantee that an audit will detect all forms of financial misconduct. The manipulation of financial records by the management or directing mind of the client can be especially difficult to detect. In this case, any compensable unitholder losses were not caused by BDO but by the intentionally deceptive conduct of Crystal Wealth's founder and directing mind, Clayton Smith, and the fund manager CWMS.

5. BDO is itself a victim of the "scheme" alleged in the Statement of Claim, which was sophisticated and designed to evade detection by standard audit procedures. Smith employed a number of tactics, including forgery and outright lies, that were designed to mislead and did in fact mislead not only BDO but also Staff of both the Ontario Securities Commission ("**OSC**") and the B.C. Securities Commission.

6. BDO did not owe a duty of care to Mr. Whitehouse or other Crystal Wealth unitholders in regard to their personal investment decisions. BDO also denies that it was negligent in failing to detect Smith's carefully concealed misconduct or otherwise failing to protect the unitholders. Any compensable unitholder losses are wholly attributable to the misconduct of Smith and the fund manager CWMS.

7. Additionally, unitholders lack the legal capacity to pursue rights of action against BDO for negligent performance of a service; such rights of action, to the extent they exist, are the property of the Funds and are being pursued by Grant Thornton Limited in its capacity as Receiver to the Funds in another proceeding in the Ontario Superior Court of Justice. Accordingly, this action is duplicative of the Receiver's action and an abuse of process.

8. Further, and in any event, the damages claimed by the plaintiff are both premature and overstated. Amongst other factors: the claimed damages fail to account for the ongoing recoveries of Grant Thornton Limited as Receiver over the assets of CWMS and the Funds; the misconduct, to the extent it occurred, was confined to a limited timeframe near the end of BDO's relationship with Crystal Wealth; and inherent risks associated with many of the Funds' "direct" investments (as discussed below).

Background

Crystal Wealth

9. Crystal Wealth Management System Ltd. ("**CWMS**") was a Burlington, Ontario-based Investment Fund Manager, Portfolio Manager and Commodity Trading Manager whose founder, controlling shareholder, COO, and directing mind was Clayton Smith. CWMS operated and managed proprietary investment funds (the "**Funds**" and together with CWMS, "**Crystal Wealth**"), which were structured as open-ended mutual fund trusts distributed to investors, on an exempt basis, pursuant to Offering Memoranda.

BDO's Retainers with Crystal Wealth

10. During the period that encompassed the fiscal years 2007 to 2015, BDO audited the annual financial statements of CWMS and, for differing lengths of time, the annual financial statements of various Funds (the "**BDO Audit Period**"). The number of Funds managed by CWMS, and in turn audited by BDO, increased over the course of the BDO Audit Period. Two Funds were under management in 2007 but by 2015 ten Funds were

under management. Of these, five were established in or after 2014. The following chart indicates the Funds that were audited by BDO and the relevant timeframes:

Fund	Fiscal Years Audited by BDO
Media Strategy	2011 – 2015
Mortgage Strategy	2007 – 2015
Enlightened Factoring (known as Enlightened Income until 2015)	2010 – 2015
Enlightened Resource	2009 – 2015
Medical Strategy	2010 – 2015
Enlightened Bullion	2015
High Yield Mortgage Strategy	2015
ACM Income	2014 – 2015
ACM Growth	2014 – 2015
Retirement One	2015

11. BDO’s audits of CWMS and the Funds were conducted pursuant to retainers negotiated and signed by Clayton Smith in his capacity as the principal of CWMS (the “**BDO Retainers**”). The BDO Retainers imposed certain explicit obligations on CWMS with respect to the disclosure of accurate and complete information to BDO. In particular, the BDO Retainers required CWMS to provide BDO with information relating to fraud or suspected fraud, effective corporate governance and related party transactions. During the BDO Audit Period, management representation letters were delivered to BDO

affirming that CWMS had discharged its responsibility to make the requisite disclosures to BDO.

BDO's Early Audits of the Funds

12. Prior to 2014, the Funds collectively held a small number of investments, comprised of both securities such as mutual funds, as well as "direct" investments such as mortgages and commercial loans. By their nature, the accounting treatment of the Funds' "direct" investments was inherently subject to a level of managerial discretion and judgment. Nonetheless, the "direct" investments often produced real returns which corroborated the value ascribed to them by CWMS and supported Smith's representations to BDO in the course of its audit work. During this period, BDO did not encounter any "red flags" which would cast doubt on Smith's integrity or the reliability of the Funds' accounting procedures or records.

Crystal Wealth's Expansion and Smith's Misconduct

13. Beginning in or around 2013, Crystal Wealth began to expand its investor base. During this period, the number of Funds increased, as did the number, variety and overall recorded value of the Funds' "direct" investments. It is now apparent that this expansion was driven in large part by false and exaggerated representations being made by Smith about certain of the Funds' "direct" investments offering "secure" and "guaranteed" returns (the "**Smith Inducements**").

14. The Smith Inducements were designed to induce both existing and new unitholders to invest in what were, in reality, inherently speculative and uncertain

ventures. BDO was not aware of the Smith Inducements at the time they were made. BDO is not responsible for the Smith Inducements, which were not made in the financial statements, nor for any losses arising from the Funds' performance failing to meet inflated expectations created amongst unitholders by the Smith Inducements.

15. In or around 2013, Smith embarked on a course of conduct involving the manipulation of the financial records of certain of the Funds. With the value of hindsight, it is now apparent that this conduct helped to create the appearance of stable or "guaranteed" performance by the Funds in order to meet false expectations created by the Smith Inducements and continue to attract new investment. Eventually this conduct also extended to the diversion of assets of certain Funds to Smith and parties related to Smith and measures to conceal this diversion.

16. As the directing mind of CWMS, Smith carefully concealed his misconduct from BDO, the unitholders, Canadian securities regulators and other third parties through various means, including manipulating and forging records, circumventing audit controls and coordinating with third parties to ensure consistency in his false responses to BDO's inquiries.

BDO Ceases to Act for Crystal Wealth

17. In the course of its audits for the fiscal year ending in 2016, BDO's relationship with Smith became increasingly strained. CWMS and Smith began to evade audit inquiries and failed to provide information and documents requested by BDO. As a result of CWMS and Smith's failures to provide the information requested by BDO, BDO was

only able to complete its audits for three of the Funds,² and Crystal Wealth failed to file or deliver audited financial statements for any of the Funds as required by March 31, 2017.

Crystal Wealth Receivership

18. In April 2017, OSC Staff obtained a Court Order appointing Grant Thornton Limited (“**GTL**” or the “**Receiver**”) as Receiver and manager of all assets, undertakings and properties of CWMS, the Funds, Smith and certain of his personal companies (the “**Appointment Order**”). The Appointment Order followed OSC Staff’s identification of suspected fraud through an expansive investigation involving, among other things, compelled witness examinations.

19. Since the Appointment Order, GTL has exercised its powers as Receiver to make interim distributions stemming from its ongoing realization of assets. GTL has signalled its intention to make further distributions in the future.

20. GTL’s success to date in recovering the Funds’ assets and distributing them to unitholders reflects the fact that Crystal Wealth was not an inherently fraudulent structure. Initially, and during the BDO Audit Period, the Funds had substantial assets which often realized real returns.

21. A typical pattern in financial frauds affecting otherwise viable enterprises is that they start with small, immaterial deceptions and then “snowball” over time as the fraudster must engage in riskier and more detectable manipulation of financial records in order to

² The Enlightened Resource Fund, Absolute Sustainable Dividend Fund and Conscious Capital Fund.

conceal the prior misconduct. It appears that Smith's misconduct was identified and halted relatively soon after it began, such that the Funds' investments retained material value at the time of the Appointment Order.

Smith Settles with OSC Staff

22. Smith reached a settlement with OSC Staff, which was approved by the OSC in May 2018. As part of his settlement, Smith admitted to fraud, including the direct misappropriation of investor funds, and to misleading both BDO and the OSC by providing false information to BDO during the course of its audits. Smith and the OSC agreed that Smith would be assessed a monetary penalty of \$250,000.

BDO Did Not Owe the Duty Alleged

23. BDO denies that it owed the plaintiff or any of the unitholders a duty of care in negligence *simpliciter* in respect of any use of the Funds' financial statements. The duty of care owed by an auditor conducting a statutory audit in negligence is well-defined and restricted in Canadian law. The duty is owed to the client (in BDO's case, CWMS and the Funds). The duty does not extend to individual investors making use of financial statements for their personal investment decisions.

24. BDO also denies that it knew or ought to have known the identities and contact information of, and exact amounts held in each Fund by, each unitholder. BDO engaged directly with CWMS and its management (i.e., Smith) in conducting its audits, and had no direct interactions with the unitholders, many of whose investments were spread across multiple investment accounts at Smith's discretion. In any event, what BDO knew or did

not know about the unitholders is irrelevant given that BDO's duty was owed to CWMS and the Funds and not the unitholders.

25. Further, BDO specifically denies that it owed a duty of care to the plaintiff, Mr. Whitehouse, who first invested in the Funds beginning in April 2016, i.e., *after* the end of the BDO Audit Period. Even if BDO owed a duty to those unitholders who were invested in the Funds at the time it performed audits, which is not admitted but is specifically denied, BDO cannot possibly owe a duty to Mr. Whitehouse because it did not and could not have known about him at the time it performed its mandates. Auditors clearly do not owe a duty "at large" in negligence to members of the general public who may be considering investing in their client. Such would give rise to indeterminate liability.

Individual Unitholders Lack the Capacity to Pursue Negligence Claims

26. As is expressly provided in the Declaration of Master Trust - which governed each of the Funds and was incorporated by reference within the Funds' Offering Memoranda - CWMS is the trustee for the unitholders and stands possessed of, and holds sole legal title to, all of the property and assets of the Fund. The Declaration of Master Trust further provides that no unitholder "shall have or be deemed to have individual ownership of any property or asset of a Fund and the interest of a [u]nitholder shall consist only of the right to receive payment from the Trustee of his interest in a Fund . . ." Accordingly, to the extent there is any right of action against BDO, it is held and may be enforced by CWMS alone.

27. Indeed, GTL in its capacity as Receiver of the assets of CWMS and the Funds is pursuing this right of action in a separate proceeding in the Superior Court of Justice (Commercial List), having Court File # CV-18-595063-00CL (the “**Receiver Action**”). The Receiver Action is brought by GTL for the benefits of all stakeholders in Crystal Wealth, including the unitholders.

28. Mr. Whitehouse is or should be fully aware of the Receiver Action, because counsel of record in the Receiver Action is the same counsel of record in the present action. Accordingly, this action is not only duplicative and redundant; it is an abuse of the process of the court.

BDO Met the Requisite Standard of Care

29. To the extent that BDO owed unitholders a duty of care, which is denied, and individual unitholders have the capacity to pursue this action, which is also denied, BDO met the requisite standard of care in auditing the financial statements of CWMS and the Funds. BDO conducted each of its audits in accordance with Generally Accepted Auditing Standards (“**GAAS**”) and met its obligations thereunder to obtain reasonable assurance that the Funds’ financial statements were free of material misstatement.

30. Auditors are not required to assume fraud in the absence of specific reasons for suspicion. A properly conducted audit may still fail to detect a material fraud, particularly one that is perpetrated by management. Under GAAS, an auditor’s duty to detect fraud does not extend to the authentication of audit evidence, and is limited by factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the relative

size of the amounts manipulated, and the seniority of the individuals involved. All of these factors are relevant in this case. Smith's misconduct, to the extent it occurred, was undetectable to BDO before it ceased to act for the following reasons:

- (a) Smith disguised the Funds' true finances, circumvented controls and skilfully and intentionally manipulated records;
- (b) As above, such misconduct occurred late in the BDO Audit Period, after a number of audit years in which no red flags were apparent;
- (c) Such misconduct extended only to a portion of the Funds' total assets under management;
- (d) As above, such misconduct was only detected through an expansive investigation conducted by OSC Staff involving compelled witness examinations and other measures. In contrast, OSC Staff did not uncover the misconduct during their prior compliance reviews of Crystal Wealth, wherein they were provided with and reviewed the same records provided to BDO;
- (e) Smith provided a variety of forged documents and false responses to BDO in response to its audit inquiries and coordinated with third parties to ensure consistency in his misrepresentations to BDO.

31. As noted above, the Funds' investments had real value and some of those investments increased in value both during and after the BDO Audit Period. In addition, certain of the Funds made investments near the end of the BDO Audit Period that have

been deemed impaired by GTL only on account of events that occurred or were discoverable after the BDO Audit Period.

The Damages Claimed are Overstated and Premature

32. BDO denies that it caused any of the damage or losses alleged by Mr. Whitehouse or by the proposed class and puts the plaintiff to the strict proof thereof.

33. In the alternative, the damages or losses alleged are excessive for the following, amongst other, reasons:

- (a) Many or all of the Funds' investments were inherently speculative and uncertain in nature, and some or all of the losses sustained by the unitholders were merely ordinary course business losses that would have been sustained irrespective of the alleged fraud and other misconduct;
- (b) Many of the losses at issue related to transactions that occurred after the BDO Audit Period;
- (c) The damages claimed by the plaintiff fail to account for, and must be reduced by, GTL's past and future monetization of the Funds' assets;
- (d) The damages claimed are premature and fail to account for positive conclusions reached by GTL regarding the future recoverability of the Funds' investments and anticipated future distributions to unitholders;
- (e) The plaintiff and proposed class have failed to mitigate their damages because they have failed to follow avenues of recovery against Crystal

Wealth, Smith and other third parties who condoned, participated in or benefitted from Smith's misconduct;

- (f) The plaintiff and proposed class profited from the sale of assets at values that were inflated as a result of Smith's misconduct, which amounts must be set off against any alleged losses; and
- (g) The damages claimed are duplicative of those being claimed in the Receiver Action.

Relief Sought

34. BDO denies that the plaintiff is entitled to the relief claimed and requests that this action against it be dismissed with costs payable to BDO on a substantial indemnity scale.

35. In the alternative, BDO requests that this action be permanently stayed in favour of the Receiver Action pursuant to Section 106 of the *Courts of Justice Act*, R.S.O. 1990, c. C.43, with costs payable to BDO on a substantial indemnity scale.

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Court File No. CV-17-579357-00CP

**ONTARIO
SUPERIOR COURT OF JUSTICE**

**IN THE MATTER OF Proceedings under the
Class Proceedings Act, 1992**

Proceeding commenced at Toronto

STATEMENT OF DEFENCE OF BDO CANADA LLP

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