

# Management's Discussion and Analysis

The financial statements present the results of the Ontario Securities Commission (OSC) for the year ended March 31, 2004 with 2003 comparatives and accompanying notes. Unless otherwise specified, references to years, for example 2003, refer to the fiscal years of the OSC ended March 31. The following comments analyse the factors which affected the OSC's operations during 2004 as well as the factors that reasonably may be expected to affect future operations and results.

The document should be read in conjunction with the financial statements. Certain statements included in this annual report are forward looking and are subject to important risks and uncertainties. The results or events predicted in these statements may differ materially from actual results or events. Factors which could cause results or events to differ from current expectations are described in the risks and uncertainties section. Readers should note that assumptions, although reasonable at the time of publication, are not guarantees of future performance.

## Overview

The Ontario Securities Commission is a corporation without share capital. The OSC functions as an independent regulatory agency and administrative tribunal responsible for overseeing the securities industry in Ontario. As a Crown corporation, the OSC is exempt from income taxes. The OSC's operations are funded through fees paid by securities market participants. Employee compensation and occupancy costs account for more than 80% of OSC expenditures.

The *Securities Act* requires the OSC to complete a Memorandum of Understanding with the Minister of Finance to outline the ongoing roles, responsibilities and accountability relationships between the two parties. The OSC and the Minister of Finance signed a Memorandum of Understanding in May 2003. This Memorandum of Understanding must be either affirmed or revised by the new Minister responsible for the OSC.

The OSC maintains accounting and internal control systems to provide reasonable assurance that its financial information is complete, reliable and accurate and that its assets are adequately protected. The Board of Directors, in conjunction with the Audit and Finance committee, has an oversight role to ensure the integrity of the reported information. The OSC Board has enhanced its capacity for independent oversight by creating a Lead Director position. Acting in consultation with the Chair and the Chairs of the Board Committees, the Lead Director is responsible for overseeing the operations of the OSC's Board of Directors to ensure that it carries out its responsibilities effectively.

## Analysis of Operating Results

### *Excess of Revenue over Expenditures*

Excess of revenue over expenditures for 2004 was \$21.6 million (2003 - \$14.6 million). The general operating surplus as at March 31, 2004 was \$28.7 million (2003 - \$7.0 million).

### *Actual Results Compared to Budget*

Our budget forecast was for an excess of revenue over expenditures of \$7.2 million in 2004. Our actual excess was \$21.6 million. The \$14.4 variance occurred because actual expenses were \$2.8

million lower than budget and revenues were \$11.6 million higher than forecast.

The key areas where actual expenditures were below budget were training (\$424K), Commission expenses (\$367K) and professional services (\$933K). The OSC also recovered \$685K more in enforcement costs than expected.

#### 2004 Actual versus Budget

	Actual	Budget	Variance	Variance
Revenues	76,612,642	65,011,000	11,601,642	17.8%
Expenses	<u>54,971,174</u>	<u>57,816,000</u>	<u>2,844,826</u>	4.9%
Excess of Revenue	21,641,468	7,195,000	14,446,468	200.8%
Capital	1,430,852	1,516,000	85,148	5.6%

#### *Revenue*

The OSC introduced a new, restructured fee schedule effective March 31, 2003. A primary objective of the new schedule was to ensure that the fees more accurately reflect the OSC's cost of providing services to market players. The fee schedule requires the payment of "participation fees" and "activity fees".

Participation fees generally are designed to represent the benefit derived by market participants from participating in Ontario's capital markets. Reporting issuers, registrant firms and unregistered investment fund managers are required to pay participation fees annually. The participation fee is based on a measure of the market participant's size, which is intended to serve as a proxy for the market participant's use of the Ontario capital markets. The amounts of the participation fees have been based on the cost of a broad range of regulatory services that cannot be practically or easily attributed to individual activities or entities. Participation fees replace most of the continuous disclosure filing fees and other activity fees charged to market participants under the previous fee regime.

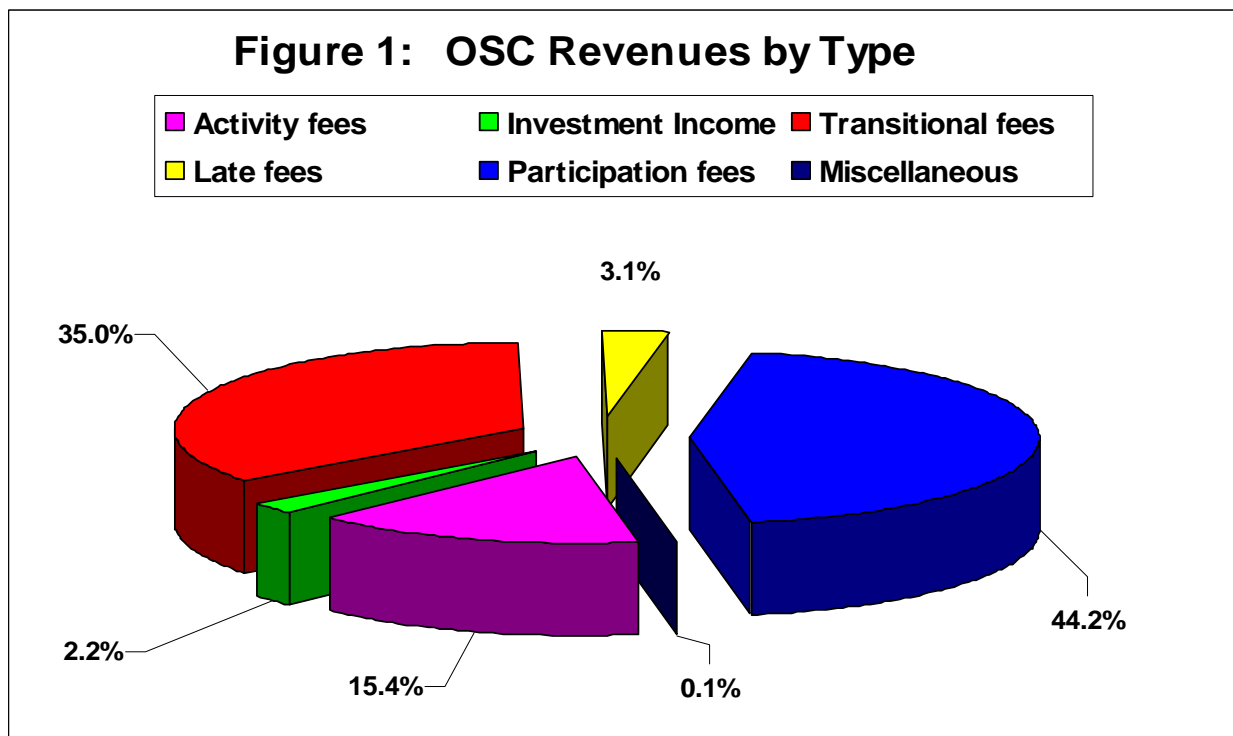
Activity fees are designed to represent the direct cost of OSC staff resources used in undertaking certain activities requested of staff by market participants; for example, the review of prospectuses and applications for discretionary relief or the processing of registration documents. Activity fees are charged only for tasks undertaken by staff at the request of the market participant. Activity fees are charged for a limited number of activities only and are flat rates based on the average cost to the OSC of providing the service.

The *Securities Act* states that, when ordered to do so by the Minister of Finance, the OSC shall pay into the Consolidated Revenue Fund such of its surplus funds as determined by the Minister. In 2004, the OSC remitted \$14.5 million owing from 2003. Under the new fee model, the OSC plans to set fee levels every three years. The Minister has confirmed that the OSC is no longer required to remit its surpluses. Any surpluses retained are subject to appropriate terms and conditions which are yet to be finalized. Any deficits will be funded either through surpluses previously generated or generated in the future, or from the OSC's reserve.

In 2004, fees collected under the *Securities Act* and the *Commodity Futures Act* increased by \$6.1 million or 8.7% to \$76.6 million. The OSC recognizes revenue when earned, which is usually upon receipt. Since the introduction of the revised fee structure, the OSC has collected more fees than projected. As the previous fee structure was solely activity-based, fees received under the new fee model cannot be compared on a line by line basis.

	% of Total Revenue	2004	2003	Change	% Change
<b>Participation fees</b>	44.2	\$33,880,566	\$0	\$33,880,566	100.0
<b>Transitional fees</b>	35.0	26,826,132	0	26,826,132	100.0
<b>Activity fees</b>					
Activity fees	15.1	11,570,364	0	11,570,364	100.0
Prospectus filings	0.2	123,847	35,853,829	(35,729,982)	-99.7
Registration	0.1	44,332	26,724,635	(26,680,303)	-99.8
Disclosure filings	0.0	13,416	5,105,622	(5,092,206)	-99.7
Applications for exemptive relief	0.0	13,867	1,311,277	(1,297,410)	-98.9
	15.4	11,765,826	68,995,363	-57,229,537	-82.9
<b>Late fees</b>	3.1	2,382,418	0	2,382,418	100.0
<b>Investment income</b>	2.2	1,672,727	1,375,337	297,390	21.6
<b>Miscellaneous</b>	0.1	84,973	102,208	(17,235)	-16.9
<b>Total revenues</b>	94.6	76,612,642	70,472,908	6,139,734	8.7

Figure 1 shows the five primary sources of OSC revenue:



**Participation fees** are the largest revenue source accounting for 44.2% of revenues. Actual fees collected exceeded forecast by \$7.5 million. Some issuers filed their participation fees earlier than expected, accounting for \$5.4 million of the variance. The newness of the fee structure and incomplete baseline data for certain fee revenues explains the remaining \$2.1 million variance from our original forecast.

**Transitional fees** accounted for 35% of total revenues and exceeded forecast by \$5.1 million due to inaccurate forecasting. Transitional fees are outstanding fees pertaining to the previous fee schedule. For example, under the previous fee schedule, prospectus fees for mutual funds were paid at the end of the prospectus period based on sales.

**Activity fees** accounted for 15.4% of total revenues. These fees reflect the cost of providing various services (registration, applications for exemption, prospectus review etc.) to market participants. The fees have been set to recover the average cost incurred by the OSC to provide each service. Activity fee volumes are the most variable component of our revenues. Transaction volumes have been, and are expected to remain, below the levels projected when the new fee schedule was established.

**Late fees** accounted for 3.1% of revenues. Actual fees collected exceeded forecast by \$1.4 million because it was difficult to forecast the level of late filings. These fees were established to encourage timely regulatory filings (e.g. insider reports) and are expected to decline over time. Approximately half of the late fees collected related to SEDI insider filings.

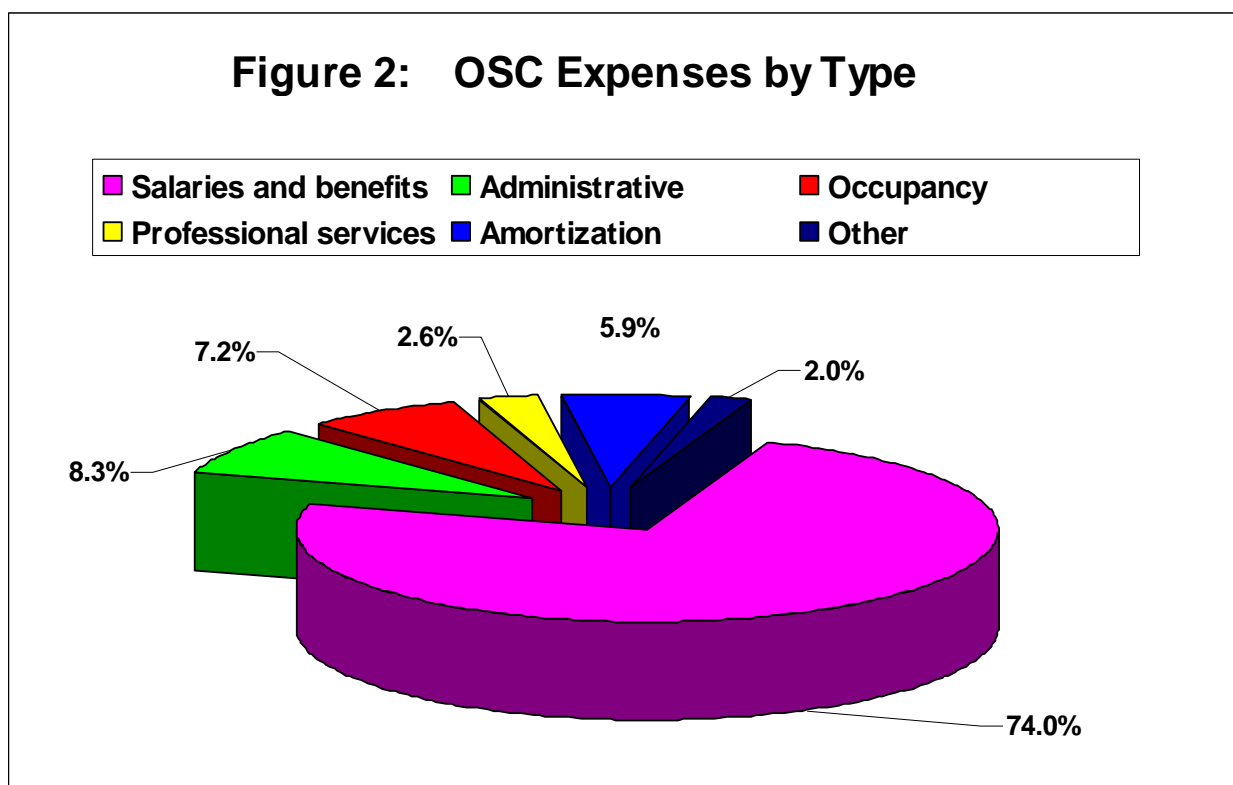
**Investment income** generated by deposits and other investments increased 21.6% to \$1.7 million and accounted for 2.2% (2003 - 2.0%) of total revenues. Investment income of \$659K (2003 – \$349K) was earned from interest on cash balances. These balances earn interest at a rate of 1.75% below the prime rate or 0.25% below bankers' acceptance. Investment returns on OSC reserves, which are invested in short and mid term instruments through the Ontario Financing Authority, totalled \$1.0 million (2003 - \$1.0 million). Investment income exceeded forecast because the negative impact of lower than expected interest rates was more than offset by having higher than expected cash balances.

### *Expenses*

Total expenses for 2004 (Figure 2) decreased 1.6% to \$55.0 million (2003 - \$55.9 million) against a budget of \$57.8 million.

	% of Total Expenses	2004	2003	Change	% Change
Salaries and benefits	74.0	\$40,688,739	\$38,278,354	\$2,410,385	6.3
Administrative	8.3	4,561,661	6,617,364	(2,055,703)	-31.1
Occupancy	7.2	3,972,891	3,726,817	246,074	6.6
Amortization	5.9	3,233,401	3,069,103	164,298	5.4
Professional services	2.6	1,415,905	3,122,824	(1,706,919)	-54.7
Other	2.0	1,098,577	1,059,811	38,766	3.7
Total expenses	100.0	54,971,174	55,874,273	(903,099)	-1.6

## Figure 2: OSC Expenses by Type



The key contributors to the expenditure changes were as follows:

**Salaries and Benefits** costs increased by 6.3% to \$40.7 million (2003 - \$38.3 million) and accounted for 74.0% of the OSC's total expenditures. A number of factors contributed to this increase, including annual salary adjustments (\$2.1 million), an increase in staffing levels (\$255K), higher benefit costs (\$165K) and lower severance costs (\$84K). The OSC had 352 permanent employees on board (10.9% positions vacant) at the end of the year compared to 356 (3.8% positions vacant) at the end of 2003.

**Administrative** costs accounted for 8.3% (2003 - 11.8%) of the OSC's total expenditures. Expenditures on administrative costs decreased by 31.1% to \$4.6 million (2003 - \$6.6 million). Administrative costs were higher in 2003 as they included a one-time payment to CDS Inc. of \$2.0 million representing the OSC's portion of the \$4.25 million payment agreed to by CDS Inc., the OSC, the Alberta Securities Commission, the British Columbia Securities Commission and the Investment Dealers Association.

**Professional Services** costs decreased by 54.7% to \$1.4 million and accounted for 2.6% (2003 - 5.6%) of the OSC's total expenditures. This continues a trend toward reduced reliance on external resources as internal expertise has been hired.

Approximately 19.1% of the professional services cost was for enforcement-related matters. The OSC will continue to have an ongoing need for specialized external legal and forensic accounting resources for enforcement activities. The OSC recovers a portion of its enforcement costs through settlements and orders of the Commission. During 2004, \$1.6 million was collected (2003 - \$855K) and applied to offset enforcement-related expenditures.

The OSC is a member of the Canadian Securities Administrators (CSA), which is a forum composed of provincial securities regulators. A central project office co-ordinates all CSA projects, including the development of harmonized securities policies and rules. A CSA systems office has also been established to manage the CSA's business relationships with third party technology providers. The operating costs for these offices are allocated on a formula basis to CSA members. In 2004, the OSC contributed \$38K (2003 - \$57K) to the cost of the project office and \$119K (2003 - \$114K) to the cost of the systems office.

Total CSA spending on projects was \$1.8 million in 2004 (2003 - \$1.9 million), of which the OSC contributed \$854K (2003 - \$851K). Key initiatives funded through this process included:

Uniform Securities Legislation	\$148K
Investor Education initiatives	\$143K
Uniform Securities Transfer Act	\$108K
National Registration Database	\$ 96K
Mutual Fund Financial Disclosure Reform	\$ 82K
SEDI implementation	\$ 75K

**Amortization** costs accounted for approximately 5.9% (2003 - 5.5%) of the OSC's total expenditures. Amortization expenses increased to \$3.2 million (2003 - \$3.1 million).

**Occupancy** costs accounted for approximately 7.2% (2003 - 6.7%) of the OSC's total expenditures. Expenditures on occupancy increased 6.6% to \$4.0 million (2003 - \$3.7 million) due to higher operating costs and the annualized impact of additional space acquired in 2003.

**Other** costs, which includes travel and related expenses, were unchanged at \$1.1 million and accounted for 2.0% (2003 -1.9%) of the OSC's total expenditures.

## Liquidity and Financial Position

### *Liquidity*

The OSC requires liquidity to finance its operations and capital purchases. As at March 31, 2004, the OSC held \$30.7 million (2003 - \$22.7 million) in cash, had current assets of \$32.5 million (2003 - \$25.2 million) and current liabilities of \$8.1 million (2003 - \$24.3 million) for a current ratio of 4:1 (2003 - 1:1).

### *Accounts Receivable*

Accounts receivable declined 33% to \$1.4 million (2003 - \$2.1 million). Outstanding late fees increased to \$748K in 2004 and accounted for 52% of accounts receivable. Key decreases in accounts receivable included collection of a loan to CDS Inc. (\$913K), a reduction in interest receivable on investments (\$415K) and an increase in our allowance for doubtful accounts (\$283K).

### *Reserve*

The new OSC fee structure has reduced the potential for significant fluctuations in revenues arising from market volatility. Revenue generation remains a source of risk for the OSC as all revenues are still correlated to market activity to some extent. To manage this uncertainty, the OSC has a \$20 million reserve as an operating contingency for revenue shortfalls or unexpected expenditures. The OSC has an additional \$12.0 million reserve that may only be used to offset

costs incurred related to the proposed merger of the OSC with the Financial Services Commission of Ontario.

Due to an increase in the value of funds invested, investment income increased 21.6% to \$1.7 million (2003 - \$1.4 million). The rate of return on investments is low as the funds are invested in Province of Ontario treasury bills. The prime investment consideration for the reserve is the protection of capital and the appropriate liquidity to meet unanticipated cash flow needs. The OSC takes income generated by the reserve into general operations.

#### *Capital Transactions*

Capital expenditures of \$1.4 million (2003 - \$1.6 million) were made during 2004. Purchases were primarily technology related (\$1.3 million), including the purchase of equipment for increased staff complement and an upgrade of the computer network.

#### *Liabilities*

Accounts payable and accrued liabilities decreased 18.0% to \$8.1 million (2003 - \$9.9 million). The decrease occurred because the provision for refunds for prospectus fees (2003 - \$1.7 million) is no longer required under the new fee schedule.

The accrued benefit liability represents obligations relating to supplementary pension plans. The unfunded supplemental pension plans had an accrued benefit obligation of \$735K (2003 - \$545K) at March 31, 2004. The OSC's related expense for the year was \$115K (2003 - \$282K) and is included in salaries and benefits. The decrease occurred due to the resignation of a Vice Chair during the year.

In support of the development of the Mutual Fund Dealers Association (MFDA), the OSC guaranteed 61% of a total \$12 million line of credit as assistance during start-up of MFDA operations. The Alberta Securities Commission and the British Columbia Securities Commission also guaranteed a specific percentage of the total indebtedness. As at March 31, 2004, the MFDA line of credit had a zero balance (2003 - \$3.0 million). As the MFDA is now fully operational, the parties to the agreement have approached the MFDA to obtain a release from this loan guarantee. A response to this request is expected by June 2004.

#### *Designated Settlements*

In August 2000, the Commission established a not-for-profit corporation, the Investor Education Fund, in order to increase knowledge and awareness among investors and potential investors and to support research and develop programs and partnerships which promote investor education. A Board of Directors governs the Investor Education Fund and is responsible for developing criteria for, and approving, the disbursement of funds.

In 2004, the OSC approved \$2.0 million (2003 - \$150K) in settlements arising from enforcement proceedings. To date \$1.6 million has been collected. The *Securities Act* allows the Commission, subject to approval from the Minister, to allocate designated settlement funds to or for the benefit of third parties such as the Investor Education Fund. The OSC is seeking Ministerial approval to transfer the designated settlement balance to third parties.

## **Risks and Uncertainties**

### *Reliance on CDS Inc.*

CDS Inc. operates a number of major systems on behalf of the CSA and the OSC. In 2004, more than 90% (2003 - 58%) of fee revenue was collected through the System for Electronic Document Analysis and Retrieval (SEDAR) and the National Registration Database (NRD) systems. CDS Inc. recovers its costs to operate these systems by charging user fees to filers.

The CSA is in the process of renewing the operating agreement for SEDAR. The NRD system was launched on March 31, 2003. The current operating agreement for the NRD expires March 2009. The System for Electronic Disclosure by Insiders (SEDI) became fully operational in May 2003. The current operating agreement for SEDI runs until May 2010.

If CDS becomes unwilling or unable to operate one or all of these systems, the OSC and the CSA will need to explore options to continue operating these systems.

### *Risk-Based Compliance*

Risk-based approaches are being used for disclosure review and compliance. As a result, fewer reviews are undertaken, but each review, on average, is carried out in more depth. Enforcement also uses a risk-based approach to ensure cases that are brought forward are subject to consistent scrutiny, involve significant breaches of Ontario securities law, and give appropriate consideration to Commission priorities.

### *Business Continuity Plan*

The OSC completed a Business Continuity Plan (BCP) to ensure the continuation of critical regulatory services should the OSC face a significant disruption to its operations. Detailed business continuity plans are in place for each priority business function. Each plan includes documented recovery procedures including manual workarounds and mitigation strategies. Offsite recovery services and facilities will be in place by June 2004.

### *Internal Audit*

The OSC has a three-year internal audit plan to address the key risks that could impact the achievement of our business objectives. In 2004, our third party internal auditors completed reviews of our contract management and project management processes. No major risk exposures were identified and implementation of the recommended process improvements is underway.

## **2005 Outlook**

In 2004, \$76.6 million was collected under the *Securities Act* and the *Commodity Futures Act*. The new OSC fee structure was designed to reduce the potential for significant fluctuations in revenues arising from market volatility. The revised fee structure has generated surpluses for the following reasons:

- fee levels were set to generate a small surplus given the newness of the fee model and because a significant number of variables had to be estimated;
- incomplete data resulted in conservative estimates for certain fee revenues;
- a year over year timing difference occurred due to early receipt of fees; and
- the level of fees from late filings was difficult to forecast.

The OSC revenue forecast for 2005 is \$67.3 million, 12.1% lower than actual 2004 revenues. The forecast was reduced due to the timing difference noted above and reflects our experience with the new fee structure. The forecast does not anticipate a material change in the level of market activity. The potential for material market fluctuations due to world events is a source of risk that could have a negative impact on OSC revenues.

In 2004, 90% of total OSC revenues were collected on behalf of the OSC through systems operated by CDS Inc. No material change is expected in the volume of fees collected through these systems.

Before the introduction of the new fee rule, the OSC had a \$7.0 million surplus. For the three year period ending 2006, the OSC is forecasting a \$22.2 million surplus for a total projected surplus of \$29.2 million. The introduction of CD Rule 51-102, which accelerated filing and fee payment dates, explains \$15.4 million of this surplus. The OSC remains committed to ensuring that our market participants pay fees equivalent to the costs of regulation. Before setting fees for the three year period ending 2009, we will review each service activity and its related cost. Activity fees will be set based on the cost to provide the service. Participation fees will be set at levels to generate a cumulative deficit equal to the surplus collected from market participants as at March 31, 2006. Fee levels will also reflect our goal to ensure that the fees paid by issuers and registrants reflect the projected costs to regulate each group.

The OSC budgeted net operating expenditures to increase 5.7% to \$61.1 million for 2005 (2004 - \$57.8 million). The budget increase is explained by:

- a 8.7% rise in salaries and benefits to \$44.2 million (2004 - \$40.7 million). The annualized cost impact of 2004 hiring and higher projected benefit rates explain this increase. The budget includes a 2.4% increase in approved staffing to 386.
- a 2.5% increase in 2005 occupancy costs to \$4.1 million (2004 - \$4.0 million) due to higher lease-related operating costs. Amortization costs are expected to remain constant in 2005.
- a 6.7% decrease in professional services costs to \$2.8 million for 2005 (2004 - \$3.0 million).

The 2005 capital budget is \$1.7 million, 21.4% higher than the \$1.4 million spent in 2004. More than 90.0% of the planned capital expenditures are information technology-related reflecting our continued commitment to maintaining state of the art information technology capabilities.

The ongoing national discussions on approaches to securities regulation in Canada could cause actual results to differ materially.