Management’s discussion and analysis

Overview
This document will explain the key financial events and actions that have brought the OSC to its current financial position. It will explain in detail the OSC’s operations during the past year and provide an outlook on its 2009–2010 plans. The environment and challenges that the OSC faces and details on the key elements that were considered in developing the plan are also set out.

Certain statements included in this annual report are forward looking and are subject to risks and uncertainties. The results or events forecast 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 any assumptions, although reasonable at the time of publication, are not guarantees of future performance.

This document should be read in conjunction with the financial statements. The financial statements present the OSC’s results for the year ended March 31, 2009, with 2008 comparatives and accompanying notes. Unless otherwise specified, references to years, for example 2009, refer to the fiscal years of the OSC ended March 31. The factors which affected the OSC’s operations during 2009 as well as the factors that reasonably may be expected to affect future operations and financial results are set out in the document.

The preparation of financial statements that conform with Canadian generally accepted accounting principles (GAAP) requires estimates and assumptions to be made that affect the reported amounts of assets and liabilities and disclosures of contingent liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Estimates are calculated based on historical experience, current trends and other assumptions that are believed to be reasonable under the circumstances. Actual results could differ from those estimates.

Our responsibilities
The OSC plays a major role in securities regulation in Canada. The OSC is accountable to the Ontario Government. As a self-funded agency, the OSC is wholly dependent on fees from market participants. Its work affects investors and market participants:

> Investors – both retail and institutional, who seek to invest in fair and efficient markets. Ontario residents hold about 45% of the financial assets held by individual Canadians; and 84% of investment fund assets are held by fund companies based in Ontario.

> Market participants –
  - Issuers – public and private companies which rely on the capital markets to fund growth and diversification. Approximately 24% of Canadian-listed corporate issuers are based in Ontario, accounting for 40% of Canada’s equity market value.
  - Intermediary firms – registered to provide investment services to both users and suppliers of capital. Approximately 1,700 registrant firms (out of 2,000 in Canada) and 70,000 individuals (out of 130,000 in Canada) are registered in Ontario.

As a member of the Canadian Securities Administrators (CSA), the OSC works with other Canadian securities regulators to improve, coordinate and harmonize the regulation of Canada’s capital markets.

Our approach
The OSC is a Crown corporation without share capital and is the body responsible for regulating Ontario’s capital markets. Fostering fair and efficient capital markets in Ontario involves striving to strike an appropriate balance between facilitating timely access to the material information needed by investors to make informed investment decisions and avoiding the imposition of undue regulatory burdens on market participants.

The OSC achieves its objectives through a variety of regulatory tools, including:

> Imposing requirements through rules and other regulatory instruments;
> Providing guidance to market participants (e.g. disclosure);
> Assessing compliance and directing corrective action; and
> Taking enforcement action.
The OSC is also an administrative tribunal with quasi-judicial powers. Panels of Commissioners hear enforcement proceedings and contested applications and consider applications for discretionary exemptions from the requirements of Ontario securities laws.

Financial oversight and accountability is achieved by:

- Preparing an annual budget, which is reviewed by the Audit and Finance Committee and approved by the Board;
- Continually assessing and improving its processes;
- Reporting actual versus budget performance and updated full-year forecasts every quarter to the Audit and Finance Committee and the Board;
- Requiring Board approval of significant unbudgeted expenses or re-allocations; and
- Certification of the design and effectiveness of Internal Control over Financial Reporting (ICFR) by the Chair and the Director of Corporate Services.

There is more detail on these matters in the Policy and Governance section of the Annual Report.

**Current environment and issues**

Current economic conditions continue to pose challenges for those that the OSC regulates as well as increased demands on its operations. They continue to directly impact OSC activity levels, its fees and surplus and the way the OSC manages.

**Economic environment and OSC activity levels**

The OSC’s operating environment remains challenging due to weak global economic conditions, continued financial market volatility and general uncertainty on the timing of a recovery. Canada and the United States have substantial economic and financial linkages. The risk remains for a persistent recession south of the border which could have significant impacts, both direct and indirect, on Canadian businesses, households and capital markets. The OSC continues to work closely with domestic and international regulators to review securities market regulation and identify possible weaknesses in the international financial system. The goal is to develop strategies to position our financial system to better respond to future events that could adversely affect our markets.

This matter is also addressed elsewhere in the Annual Report. In particular, see the Message from the Chair.

The OSC has intensified ongoing efforts in its own operations to refocus priorities, seek efficiencies and redeploy resources to priority areas. Although activity levels in some areas, such as prospectus reviews, are lower, there have been significant workload increases in other areas including additional continuous disclosure reviews, compliance, enforcement and market regulation activities to protect investors and address market issues. During 2009, responding to market turmoil resulted in significant demands on OSC staff as they conducted increased numbers of focused reviews of money market funds, exchange traded funds and hedge funds.

There is more detail on these activities in the Compliance section of the Annual Report.

**OSC fees and surplus**

The OSC’s fee structure is designed to generate fees that reflect its cost of providing services to market participants. The OSC’s fee rates were last set in April 2006. At that time the OSC projected revenues of $181.4 million for the three fiscal years ending March 31, 2009. Actual revenues for the three fiscal years were $217.8 million, $36.4 million or 20.1% above those forecast in 2006. This variance was due to higher than anticipated growth in the financial markets. The OSC’s fees are difficult to predict because its revenues fluctuate in proportion to market activity. The variance between actual and projected costs across the three-year period was only 0.2%. Therefore, higher than expected revenues have been the reason for the OSC’s surplus. The OSC’s surplus as at March 31, 2009, was $46.8 million.
Management’s discussion and analysis

During 2009 the OSC reviewed fee approaches used by other regulators. The goal was to review best practices that could be used to improve the predictability of the OSC’s revenues and to reduce the likelihood of significant surpluses or deficits in the future. On October 3, 2008, the OSC published proposed fee rules for public comment. After publishing the draft rules, the economic situation in Ontario and around the world worsened. On March 13, 2009, following a careful review of the comments from respondents, and in light of prevailing market conditions, the OSC, in consultation with the Ontario Government, announced its decision to maintain participation fees and activity fees at existing rates until March 31, 2010.

Fee rates are not at levels sufficient to recover the OSC’s costs for 2010. The OSC projects a revenue shortfall of $22 million during 2010. The OSC will use a considerable portion of its surplus to offset this deficit. Future increases to fee rates will need to be sufficient to fully recover the Commission’s costs of operations, and market participants should anticipate increases.

Over the next year, the OSC will further review its fee model. The OSC’s goal is to develop a more predictable fee structure that will allow full recovery of its costs in a way that is fair and transparent to market participants.

There is more commentary on this matter in the Message from the Chair and Accountable Organization sections of the Annual Report.

Recoveries of enforcement costs
Settlements and orders often include amounts to recover enforcement costs. Cost recoveries are very difficult to predict as they vary significantly each year. They have ranged from $220,000 to over $2.8 million over the past 5 years, as follows:

<table>
<thead>
<tr>
<th>(Thousands)</th>
<th>2009</th>
<th>2008</th>
<th>2007</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost recoveries</td>
<td>$2,831</td>
<td>$1,569</td>
<td>$220</td>
<td>$1,102</td>
<td>$744</td>
</tr>
</tbody>
</table>

Because of the significant variability of the recoveries, the OSC has decided to present recoveries of enforcement costs separately in the financial statements and budget. This will facilitate year-over-year comparisons of operating costs.

OSC 2010 budget approach
In developing the OSC’s 2010 budget, the OSC carefully balanced the need for restraint in these challenging times with its duty to continue to take appropriate steps to vigorously pursue its mandate of providing protection to investors and fostering fair and efficient capital markets. The OSC’s fiscal approach recognizes the circumstances faced by market participants. The budget focuses on redeployment of resources to priority areas and increased focus on internal efficiencies and controllable cost areas.

Additional details on the OSC’s budget are presented in 2010 Outlook in the MD&A.

Adoption of International Financial Reporting Standards (IFRS)
In 2008, the Canadian Accounting Standards Board confirmed that GAAP for publicly accountable enterprises will be IFRS, for interim and annual reporting purposes, beginning on or after January 1, 2011. Although the OSC is not a publicly accountable enterprise as defined, if available as an option, the OSC intends to voluntarily adopt IFRS for the year ending March 31, 2012. For the OSC, the adoption date of April 1, 2011, would require the restatement, for comparative purposes, of amounts reported by the OSC for its year ending March 31, 2011, and of the opening balance sheet as at April 1, 2010.

In February 2009, the Public Sector Accounting Board (PSAB) issued an Invitation to Comment (ITC) regarding financial reporting by government organizations. Based on the results of this ITC, some government organizations may be reclassified and directed to a different source of GAAP. Based on the information contained in the ITC, the OSC concluded that it should be classified as an “Other Government Organization,” and is therefore able to self-select the accounting standards it wishes to apply. The OSC would elect to apply IFRS.

The PSAB expects to issue an exposure draft in June 2009 and approve amendments to the “Introduction to the Public Sector Standards” in September 2009. In light of these developments, the OSC’s plans for transition are at the preliminary stage.
Internal control over financial reporting

As part of its comprehensive corporate governance, the OSC has decided to apply the reporting issuer provisions of National Instrument 52-109 as they relate to ICFR.

During the year, the design of internal controls was updated and their operating effectiveness tested using the framework and criteria established in “Internal Control – Integrated Framework” issued by the Committee of Sponsoring Organizations of the Treadway Commission. An external consultant was retained by the OSC to assist management in evaluating the design of internal controls and, under the supervision of management, to complete testing in certain areas, and provide guidance and a review of the operating effectiveness testing of ICFR performed by the OSC. Based on this evaluation, the OSC has concluded that the ICFR were operating effectively and that there are no material weaknesses.

There have been no changes in the OSC’s ICFR that occurred during the most recent period ended March 31, 2009, that have materially affected, or are reasonably likely to materially affect, the OSC’s ICFR. The Chair and the Director of Corporate Services certify the design and effectiveness of ICFR in the Statement of Management’s Responsibility and Certification.

Selected three-year annual information

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$68,562</td>
<td>$78,238</td>
<td>$71,067</td>
</tr>
<tr>
<td>Expenses</td>
<td>81,053</td>
<td>75,190</td>
<td>69,524</td>
</tr>
<tr>
<td>Surplus/(deficiency) of revenue over expenses (before recoveries)</td>
<td>(12,491)</td>
<td>3,048</td>
<td>1,543</td>
</tr>
<tr>
<td>Recoveries of enforcement costs</td>
<td>2,831</td>
<td>1,569</td>
<td>220</td>
</tr>
<tr>
<td>Surplus/(deficiency) of revenue over expenses</td>
<td>$ (9,660)</td>
<td>$4,617</td>
<td>$1,763</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>$ 5,297</td>
<td>$ 917</td>
<td>$ 988</td>
</tr>
</tbody>
</table>

Analysis of operating results

Overview

The OSC had a net deficit of $9.7 million in 2009 ($4.6 million surplus – 2008). The OSC’s deficiency of revenues over expenses was reduced significantly due to the recovery of $2.8 million in enforcement costs through settlements and orders. These recoveries were about $1.8 million higher than the average for the previous five years.

2009 actual to 2008 actual

Revenues decreased by $9.7 million or 12.4% due to weakening market conditions. Participation fees were $6.1 million or 10% lower. Activity fee revenues fell by $2.0 million or 18.0%. Revenue changes were due to declines in registrant revenues and issuer market capitalization and lower volumes for prospectuses and applications, as the fee schedule has remained unchanged since April 1, 2006.

Expenses increased $5.9 million or 7.8%. The increase in expenses primarily related to increased staff-related costs for salaries and benefits, including costs for eight additional staff, primarily in enforcement and compliance ($4.0 million) and occupancy ($968,000). Employee compensation and occupancy costs account for 83.4% (2008 – 83.3%) of expenses (before recoveries).

The premises and equipment balance increased by $4.0 million or 152% due to expansion and renovation of OSC facilities during 2009. Renovations related to the acquisition of additional space to accommodate staff growth and the need for expanded hearing room facilities and additional work areas for Commissioners to address significant growth in hearing activity.

There is more detail on hearing activity in the Adjudication section of the Annual Report.
Management’s discussion and analysis

Detailed analysis of fiscal 2009 operating results

Our fee structure is designed to generate fees that reflect the OSC’s cost of providing services to market participants. The current fee schedule has been in place since April 1, 2006. The fee schedule requires the payment of “activity fees” and “participation fees.”

**Activity fees** are set at a level to reflect an estimate of the direct cost of OSC staff resources used in undertaking those activities requested of staff by market participants. Activity fees are charged at flat rates based on the OSC’s average cost to provide the service.

**Participation fees** are based on the cost of a broad range of regulatory services that cannot be practically or easily attributed to individual activities or entities and are intended to serve as a proxy for the market participant’s use of the Ontario capital markets. Participation fee levels are set using a tiered structure. Fees for issuers are based on market capitalization; fees for registrants are based on their revenues. As a market participant grows, it moves through various tiers which have increasingly higher fees.

**Revenues**

<table>
<thead>
<tr>
<th>(Thousands)</th>
<th>% of total fees</th>
<th>Actual 2009</th>
<th>Actual 2008</th>
<th>Change</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participation fees</td>
<td>82.5</td>
<td><strong>$ 54,831</strong></td>
<td>$ 60,912</td>
<td>$(6,081)</td>
<td>(10.0)</td>
</tr>
<tr>
<td>Activity fees</td>
<td>13.6</td>
<td><strong>9,048</strong></td>
<td>11,028</td>
<td>(1,980)</td>
<td>(18.0)</td>
</tr>
<tr>
<td>Late fees</td>
<td>3.9</td>
<td><strong>2,556</strong></td>
<td>2,754</td>
<td>(198)</td>
<td>(7.2)</td>
</tr>
<tr>
<td>Total fees</td>
<td>100.0</td>
<td><strong>66,435</strong></td>
<td>74,694</td>
<td>(8,259)</td>
<td>(11.1)</td>
</tr>
<tr>
<td>Investment income</td>
<td></td>
<td><strong>2,085</strong></td>
<td>3,417</td>
<td>(1,332)</td>
<td>(39.0)</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td></td>
<td>42</td>
<td>127</td>
<td>(85)</td>
<td>(66.9)</td>
</tr>
<tr>
<td>Total revenues</td>
<td></td>
<td><strong>$ 68,562</strong></td>
<td><strong>$ 78,238</strong></td>
<td><strong>$(9,676)</strong></td>
<td><strong>(12.4)</strong></td>
</tr>
</tbody>
</table>

Figure 1 shows the sources of the OSC’s fee revenues:

Deteriorating market conditions resulted in lower than expected fee revenues. Revenues for the year were $68.6 million, down from $78.2 million in 2008. The variance is related to the following:

**Participation fees** were lower by $6.1 million or 10.0%. The significant market downturn during the past year resulted in lower revenues for registrants and reduced market capitalization levels for issuers.

**Activity fees** fell by $2.0 million or 18.0% as lower levels of market activity resulted in decreased numbers of prospectus filings (both for reporting issuers and investment funds), private placement filings, and applications for relief.

**Late fees** were $198,000 or 7.2% lower than last year. Across the year, the OSC saw a decrease in late filings of insider trade reports and financial statements. This was partially offset by an increase in late filings of registration-related documents.

**Investment income** fell $1.3 million or 39.0%, reflecting lower rates of return on smaller cash balances. The average rate of return on cash balances and investments was 2.71% (2008 – 4.23%), which was 152 basis points lower than in 2008.

**Miscellaneous revenue** was $85,000 or 66.9% lower as the OSC did not conduct “Dialogue with the OSC” during 2009 and the related revenues were not generated.
Expenses

<table>
<thead>
<tr>
<th>(Thousands)</th>
<th>% of total expenses</th>
<th>Actual 2009</th>
<th>Actual 2008</th>
<th>Change</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and benefits</td>
<td>75.4</td>
<td>$ 61,088</td>
<td>$ 57,089</td>
<td>$ 3,999</td>
<td>7.0</td>
</tr>
<tr>
<td>Administrative</td>
<td>7.9</td>
<td>6,443</td>
<td>5,655</td>
<td>788</td>
<td>13.9</td>
</tr>
<tr>
<td>Occupancy</td>
<td>8.0</td>
<td>6,501</td>
<td>5,533</td>
<td>968</td>
<td>17.5</td>
</tr>
<tr>
<td>Professional services</td>
<td>6.2</td>
<td>4,987</td>
<td>4,534</td>
<td>453</td>
<td>10.0</td>
</tr>
<tr>
<td>Amortization</td>
<td>1.5</td>
<td>1,243</td>
<td>1,483</td>
<td>(240)</td>
<td>(16.2)</td>
</tr>
<tr>
<td>Other</td>
<td>1.0</td>
<td>791</td>
<td>896</td>
<td>(105)</td>
<td>(11.7)</td>
</tr>
<tr>
<td>100.0</td>
<td>81,053</td>
<td>75,190</td>
<td>5,863</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Recoveries

| 2,831                 |

Total (net of recoveries)

| 78,222 | 73,621 | 4,601 | 6.3  |

Total expenses for 2009 (Figure 2) increased 7.8% to $81.1 million (2008 – $75.2 million).

The key contributors to the expenditure increase were as follows:

**Salaries and benefits costs** increased by 7.0% to $61.1 million (2008 – $57.1 million) and accounted for 75% of total expenses. The 2009 expenses included the full-year cost impact of staff hired during 2008, as well as the costs for eight additional staff, primarily in enforcement and compliance. Some of the new positions were hired to expand the Boiler Room unit. This unit was started in 2007 to address the sales of securities without a prospectus by unregistered individuals, frequently to small, often unsophisticated, investors.

Also contributing to the increase was the impact of the salary increases put in place at the beginning of the fiscal year totalling approximately $2.1 million (2008 – $1.9 million). As the OSC operates in a competitive environment for professional talent, its compensation system includes performance-based incentives. These incentives represented 9.0% of total salaries and benefits costs (2008 – 9.4%).

**Administrative costs** increased by 13.9% to $6.4 million (2008 – $5.7 million) and accounted for 7.9% (2008 – 7.5%) of total expenses. Spending on information technology maintenance was up due to costs related to redesigning the OSC’s website and improved information management. These expenditures will improve the OSC’s ability to interact with market participants electronically through electronic submissions, provide support for improved knowledge and document management, and provide additional support for new equipment and services due to the continued expansion of information storage requirements. Training costs were higher due to spending on National CSA Corporate Finance and Investment Funds Conference training which is held biennially and occurred in 2009 and because budgets for general staff training were more fully used.

**Occupancy costs** accounted for 8.0% (2008 – 7.4%) of the OSC’s total expenses. Expenditures on occupancy increased $968,000 or 17.5% to $6.5 million. The increase reflected the impact of higher lease costs and the acquisition of additional space to accommodate staff growth and provide additional facilities for Commission hearings.
Management’s discussion and analysis

**Professional services** spending increased 10% from $4.5 million to $5.0 million and accounted for 6.2% (2008 – 6.0%) of the OSC’s total expenses. The OSC contracts third-party professional services when it is not cost-effective to perform the work in-house, or when specialized skills are needed. Key drivers of the increase included expenditures for enforcement litigation and surveillance support, redesign of the OSC’s website (including web content migration); document management and development of enterprise information models; and one-time investments in IT infrastructure to upgrade and enhance internal systems.

The OSC is a member of the CSA, which is a forum of Canadian securities regulators. Professional services include costs to operate CSA offices (allocated on a formula basis) as well as the OSC’s portion of professional services costs incurred on joint CSA projects. Total CSA spending on shared projects in 2009 was slightly higher at $2.3 million (2008 – $2.2 million); the OSC contributed $886,000 (2008 – $873,000). All CSA projects, including the development of harmonized securities policies and rules, are coordinated through a central secretariat. The CSA’s business relationships with third party technology providers are managed through the CSA systems office. In 2009, the OSC contributed $246,000 (2008 – $217,000) to the cost of the CSA Secretariat and $259,000 (2008 – $235,000) to the cost of the systems office.

**Amortization costs** decreased to $1.2 million (2008 – $1.5 million) and accounted for about 1.5% (2008 – 2.0%) of the OSC’s total expenses. Amortization expenses fell as the existing capital base was depreciated, but will increase next year as a result of the renovations and expansion completed in 2009.

**Other expenses**, which are travel and related expenses, declined by $105,000 or 11.7% to $791,000 (2008 – $896,000) and accounted for 1.0% (2008 – 1.2%) of the OSC’s total expenses. Decreases were achieved through management cost reductions, including postponement of some international work with IOSCO and replacement of some planned CSA-related travel with conference calls.

**Liquidity and financial position**

**Financial instruments**

Financial instruments used by the OSC consist of Cash, Funds held pursuant to designated settlements and orders, Funds in trust, and Reserve Fund assets, all of which are recorded at fair value. Accounts receivable and accounts payable and accrued liabilities are recorded at cost which approximates fair value given their short-term maturities. Cash, Funds held pursuant to designated settlements and orders and Funds in trust are held in a Canadian deposit account with a Schedule 1 bank, earning interest at 1.75% below the prime rate. Reserve fund assets are invested with the Ontario Financing Authority in highly liquid Government of Ontario treasury bills with maturities of one year or less. The carrying values of the OSC’s financial instruments approximate their fair values because of their short-term nature.

It is management’s opinion that the OSC is not exposed to significant interest rate, currency or liquidity risks arising from its financial instruments due to their short-term nature. The OSC’s concentrations of credit risk with respect to accounts receivable are limited due to the large number of debtors with individually immaterial balances owing.

**Liquidity**

The OSC has sufficient liquidity to finance its operations and purchases of premises and equipment. The OSC’s cash position decreased by $12.6 million or 19.5% in 2009. Cash flows from operating activities were an outflow of $8.3 million. Purchases of premises and equipment used $5.3 million.

As at March 31, 2009, the OSC held $52.0 million (2008 – $64.6 million) in cash, had current assets of $54.3 million (2008 – $66.8 million) and current liabilities of $12.3 million (2008 – $11.3 million) for a current ratio of 4.4:1 (2008 – 5.9:1). The OSC’s general surplus decreased by $9.7 million, reflecting the deficit of revenues over expenses.

The decision to maintain current fee levels for one year will reduce the OSC’s liquidity. In 2010, the OSC projects an operating deficit of $22.0 million. The OSC will fund this through its accumulated surplus. This will result in lower cash balances going forward.
The OSC’s cash balance is expected to decrease during 2010 to an estimated low of $7.6 million in December 2009 and then increase to approximately $23.0 million in March 2010. The OSC is investigating a number of alternatives to deal with short-term cash deficits that are expected to arise in 2011.

**Revenues**

Revenue generation remains a source of risk as all the OSC’s revenues are correlated to market activity. The degree to which the OSC’s revenues vary along with market fluctuations is greater than was anticipated when its fee structure was developed. As noted earlier in the MD&A and elsewhere in the Annual Report, fees have been frozen until March 31, 2010, which will result in a revenue shortfall for the OSC in 2010. During 2010 the OSC will be reviewing options to address the variability of its revenues as it needs to develop a more predictable fee structure that will allow full recovery of its costs in ways that remain fair and transparent to market participants.

**Reserves**

The OSC has a $20.0 million reserve as an operating contingency for revenue shortfalls or unexpected expenses. The OSC has an additional $12.0 million reserve that currently may only be used to offset costs incurred related to a past proposed merger of the OSC with the Financial Services Commission of Ontario.

The prime investment consideration for the reserve is the protection of capital and liquidity. The rate of return on investments is low as funds are invested in Government of Ontario treasury bills. The OSC records income generated by the reserve in general operations.

**Accounts receivable**

Accounts receivable decreased 9.0% to $1.5 million (2008 – $1.7 million). Outstanding late fees, which accounted for 37.1% of accounts receivable, decreased 5.1% to $559,000 (2008 – $592,000). The allowance for doubtful accounts increased by $38,000 as a result of an increase in late fees from private placements. Other key receivables are interest receivable $434,000 (2008 – $772,000) and $108,000 from the Investor Education Fund (2008 – $118,000) for services the OSC provides to the Fund.

**Funds held pursuant to designated settlements and orders**

The OSC has a number of settlement agreements and orders arising from enforcement proceedings where monies from these settlements and orders are to be set aside and allocated to such third parties as the OSC may determine. In 2009, the OSC received $13.9 million through designated settlements and orders. Funds that are not so designated at the time that settlements are approved or orders are made are to be paid to the Consolidated Revenue Fund of the Government of Ontario. In 2009, as authorized by the Board the OSC paid $1.75 million to the Investor Education Fund (2008 – $1.75 million) which was part of a two year commitment.

The OSC currently holds $17.2 million (2008 – $4.9 million) pursuant to designated settlements and orders. Amendments to the Securities Act in December 2004 removed the requirement for Ministerial approval of allocations of designated funds. The Minister retained the right to establish guidelines for the allocation of these funds. The OSC is subject to Ministerial approval to transfer to third parties $1.9 million of the designated settlement balances relating to a settlement entered into in March 2004.

**Funds in trust**

To March 31, 2009, the OSC received $33.1 million (2008 – $22.4 million) from the operator of the System for Electronic Document Analysis and Retrieval (SEDAR), the National Registration Database (NRD) and the System for Electronic Disclosure by Insiders (SEDI), representing the accumulated surplus from the operations of SEDAR, NRD and SEDI from their inception. Interest earned on these funds to 2009 was $2.1 million (2008 – $1.5 million).

As described in Note 6 of the financial statements, these funds may be used to enhance the systems, reduce systems fees or offset shortfalls in revenue in SEDAR, SEDI, and NRD. In 2009, there were no SEDAR deficits. As at March 31, 2009, $19.3 million (2008 – $16.1 million) of the total funds held in trust are available for SEDAR. Should these funds not be available and SEDAR operating costs were to exceed revenues, the OSC is currently committed to pay 45.1% of any shortfalls.
Management’s discussion and analysis

Premises and equipment
Expenditures on premises and equipment during 2009 included:

<table>
<thead>
<tr>
<th>(Thousands)</th>
<th>2009</th>
<th>2008</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Furniture and equipment</td>
<td>$679</td>
<td>$66</td>
<td>929</td>
</tr>
<tr>
<td>PCs, laptops and other IT equipment</td>
<td>2,100</td>
<td>704</td>
<td>198</td>
</tr>
<tr>
<td>Leaseholds and other capital items</td>
<td>2,518</td>
<td>147</td>
<td>1,613</td>
</tr>
<tr>
<td>Total</td>
<td>$5,297</td>
<td>$917</td>
<td>478</td>
</tr>
</tbody>
</table>

Expenditures on premises and equipment increased to $5.3 million (2008 – $917,000). The significant increase in expenditures on furniture and equipment and leaseholds and other capital items relates to the substantial renovations to the OSC’s premises. Technology-related purchases of $2.1 million (2008 – $704,000) primarily related to replacement of computer equipment to ensure the currency of the technology base.

Liabilities
Accounts payable and accrued liabilities increased 9.4% to $12.2 million (2008 – $11.1 million). Key increases are due to outstanding charges and accruals mainly related to the renovation project. This was partially offset by a reduction in outstanding severance costs.

The accrued pension liability of $1.6 million (2008 – $1.5 million) represents future obligations relating to supplementary pension plans for the current and former Chairs and Vice-Chairs. The unfunded supplemental pension plans’ accrued benefit obligation at March 31, 2009, was $1.4 million (2008 – $1.3 million). The OSC’s related expense for the year was $193,000 (2008 – $238,000) and is included in salaries and benefits.

The OSC is committed to lease payments as follows:

Capital leases (PCs, laptops and other IT equipment)

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>Total minimum lease payments</th>
<th>Less: Amount representing interest at 6%</th>
<th>Balance of the obligation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$163,549</td>
<td>23,057</td>
<td>$346,281</td>
</tr>
<tr>
<td>2010</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>115,224</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>88,796</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1,769</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>369,338</td>
<td>23,057</td>
<td>$346,281</td>
</tr>
</tbody>
</table>

Operating leases (premises and office equipment)

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>&lt;1 year</th>
<th>1 to 3 years</th>
<th>4 to 5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$20,710,346</td>
<td>$6,013,593</td>
<td>$12,165,416</td>
<td>$2,531,337</td>
</tr>
</tbody>
</table>
Risks and uncertainties

Financial entities operate globally. Overlap and integration between financial sectors continues to grow. Products and markets are increasingly complex. The importance of identifying and understanding risk continues to grow.

Operational risk

The OSC has policies and processes to identify, manage and control operational risk. Key components of the approach to operational risk management include:

- A Board of Directors responsible for sound corporate governance;
- A strong internal control environment, including management oversight that includes reviewing the design of internal controls over financial reporting and testing operating effectiveness of key controls, as discussed earlier;
- Regular reviews of systems security measures to monitor controls and identify potential vulnerabilities to external parties accessing OSC data;
- Mitigation of risk to assets through insurance where practical and appropriate;
- Independent third-party internal auditors who, through periodic, risk-based audits, assist management in identifying significant risks, assessing the appropriateness of controls and recommending policies and processes to control those specific risks; and
- Separation of duties between key functions.

The OSC has a Business Continuity Plan to ensure the continuation of critical regulatory services should it 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 are in place and were successfully tested during 2009. Remote access capability exists to all critical OSC systems. The OSC’s plan is continually refined to include strategies to recover and resume operations for various disruption scenarios.

The broadening and deepening of risk management programs in the OSC’s day-to-day operations is a key business priority for 2010 and beyond. The OSC’s goal is to enhance its ability to identify risks and assess their impacts on markets, investors and its own strategic goals as well as to confirm that its internal processes are well designed to mitigate the adverse effects of potential risks. As part of this process, the OSC has increased risk management focus on specific activities such as complaint handling and internal file management practices.

Various branches employ a variety of risk-based approaches to assess disclosure review and compliance activities of market participants. The OSC will use the increased understanding gained through enterprise risk management activities to refine its regulatory approaches.

Reputational risk

Reputational risk is the risk that negative publicity or assessments regarding the OSC’s conduct or business practices, whether true or not, may adversely affect its effectiveness as a regulator in achieving its mandate. Reputational risk is managed and controlled throughout the OSC by its code of conduct, governance practices and risk management programs, policies, procedures and training. The following principles apply to the OSC’s overall management of reputational risk:

- The OSC must operate with integrity at all times in order to sustain its effectiveness as a regulator with a strong and positive reputation.
- Conducting itself with integrity is the responsibility of all its employees, including senior management, and extends to all members of the OSC Board of Directors.

Each year all Commissioners and employees must provide written certification that they have conducted themselves in accordance with the OSC’s Code of Conduct.

Additional details are presented in the Policy and Governance section of the Annual Report.
Management’s discussion and analysis

Financial risk
As discussed earlier in the MD&A and elsewhere in the Annual Report, OSC fees will remain at current levels for 12 months, to March 31, 2010, given the difficult economic situation. This will result in a revenue shortfall in 2010 that will be offset by using a substantial portion of its accumulated surplus. In order to maintain financial stability, the OSC needs to develop a more predictable fee structure that will allow it to better match its revenues and expenses.

Additional details are presented in the OSC Fees and Surplus section of the MD&A.

National approaches to securities regulation
The implications of the ongoing Federal initiative, supported by both the Ontario Government and the OSC, to establish a common securities regulator in Canada are a source of uncertainty and could have a material impact on OSC operations.

Reliance on CDS
CDS operates a number of major systems (SEDAR, NRD and SEDI) on behalf of the CSA and the OSC. The NRD system was launched on March 31, 2004, SEDI became fully operational in May 2003 and the SEDAR system was launched in January 1997. CDS recovers its costs to operate these systems by charging user fees to filers. In 2009, 92.7% (2008 – 90.0%) of total fee revenue was collected through national systems: SEDAR (34.8%) and the NRD (57.9%). No material change is expected in the volume of fees collected through these systems. The current operating agreement for these systems runs until October 2011. The CSA Project Office is reviewing the current CDS contract and is also examining options to manage these systems beyond the expiration of the current operating agreements.

The CSA requires CDS to provide an annual CICA 5970 audit report on their controls for each system. As well, CDS is required to have an operating and annually tested disaster recovery site for these systems. However, if CDS becomes unwilling or unable to operate one or all of these systems, the OSC and the CSA will need to ensure the continued operation of these systems as disruptions in processing fees through these systems would materially affect cash flows.

Contingencies
The OSC is involved in various legal actions arising from the ordinary course and conduct of business. Settlements, if any, concerning these contingencies will be accounted for in the period in which the settlement occurs. The outcome and ultimate disposition of these actions are not determinable at this time; however, OSC management does not expect the outcome of any of these proceedings, individually or in aggregate, to have a material impact on its financial position.

Critical accounting estimates
The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires that management make estimates and assumptions that affect the reported amounts of assets and liabilities as at the date of the financial statements and the reported amounts of revenues and expenditures for the period. Actual amounts could differ from these estimates because future events may differ significantly from management’s expectations. The OSC uses various estimates to prepare the financial statements. Estimates were used in the following accounts: collectability of accounts receivable, valuation of pension liabilities, estimated useful life of premises and equipment, total accrued liabilities and collectability of designated settlements and orders. Where appropriate, such as for pension matters, the OSC obtains independent expertise to assist in these estimates. It is management’s opinion that none of the estimates as described in Note 2 of the 2009 financial statements requires the OSC to make assumptions about matters that are highly uncertain. For these reasons, none of the estimates is considered a critical accounting estimate.
2010 outlook

The 2009/2010 OSC Statement of Priorities sets out its priorities and proposed initiatives for the upcoming year. The document is available at www.osc.gov.on.ca. The 2010 OSC budget is designed to achieve the following goals:

1. Identify the important issues and deal with them in a timely way.
2. Deliver fair, vigorous and timely enforcement and compliance programs.
3. Champion investor protection, especially for retail investors.
4. Support and promote a more flexible, efficient and accountable organization.

OSC revenues and surplus

The economic environment continues to have a material impact on OSC revenues and expenses. Revenues are expected to decline by approximately $6.7 million or about 10% in 2010. These declines are due to the impact of market conditions and will affect all revenue categories.

- Participation fees are projected to fall by approximately $6.4 million or 12% due to the impact of market conditions.
- Activity fees are projected to rise by approximately $900,000 or 10% as the OSC is forecasting some increase in prospectus filings (both for reporting issuers and investment funds), private placement filings, and applications for relief due to continued market uncertainty.
- Late fees are projected to fall by approximately $330,000 or 13% due to reduced rates.
- Investment income is projected to fall by approximately $900,000 or 44% primarily due to lower cash balances.

On March 13, 2009, after consultation with the Ontario Government, the OSC announced its decision to maintain participation fees and activity fees at current rates over the next 12 months, for the year ending March 31, 2010. As a result, fee rates are not at levels sufficient to recover the OSC’s costs for fiscal 2010. The OSC projects a deficiency of revenue over expenses of about $22 million over the next fiscal year. The OSC will need to use a considerable portion of its surplus to offset this deficit.

Over the next year, the OSC will further review its fee model. The OSC’s goal is to develop a more predictable fee structure that will allow it to fully recover its costs in ways that remain fair and transparent to market participants. Future increases to fee rates will need to be sufficient to fully recover the OSC’s costs of operations, and market participants should anticipate increases.

OSC 2010 budget approach

The current economic environment poses a range of risks to investors and our capital markets. The OSC’s budget priorities reflect its assessment of these risks and their potential impacts. These challenging economic conditions continue to generate significant pressures for those that the OSC regulates as well as increased demands on the OSC’s own operations. Immediate issues include:

- Volume and complexity of continuous disclosure work is increasing as issuers struggle with disclosure in the current economic environment. The importance of disclosures related to potential going concern issues, asset impairments, liquidity and capital resources and other disclosures are increasingly important to help investors understand the risks facing issuers;
- Potential strains arising due to recent adverse market conditions may distract market participants from focusing on compliance requirements;
- Pressures for regulation or changes to the regulation of certain products, including derivatives and commodities, and certain activities such as rating agencies, commodities and short selling as well as greater needs for coordinated on-site compliance reviews (e.g. money market fund and non-conventional fund sweeps); and
- Market participants, in attempting to deal with the fallout from the market turmoil, may test regulatory and policy boundaries by creating novel products and/or requesting novel exemptive relief.
Management’s discussion and analysis

Downturns have historically exposed questionable practices and often occur at times when investors can be most vulnerable. The potentially poor financial health of issuers and registrants poses major, if unquantifiable, compliance and enforcement risks. In developing the OSC’s 2010 budget, the OSC carefully balanced the need for cost restraint in these challenging times with its duty to take appropriate steps as necessary to pursue its mandate of providing protection to investors and fostering fair and efficient capital markets. The OSC’s budget (before recoveries) will increase by $3.8 million or 4.7% over 2009 spending. The ability to limit the increase to this level was the result of an increased focus on internal efficiencies and controllable cost areas. In particular, the OSC held average salary increases to 1.6%. Total staff will increase modestly from 468 to 470.

<table>
<thead>
<tr>
<th>(Thousands)</th>
<th>2010 budget</th>
<th>2009 actual</th>
<th>Change</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$61,900</td>
<td>$68,562</td>
<td>$(6,662)</td>
<td>(9.7)</td>
</tr>
<tr>
<td>Expenses</td>
<td>84,900</td>
<td>81,053</td>
<td>(3,847)</td>
<td>4.7</td>
</tr>
</tbody>
</table>
| Deficiency of revenues over expenses (before recoveries) | (23,000) | (12,491) | (10,509) | -64.7%
| Recoveries                      | 1,000       | 2,831       | (1,831)| -64.7%   |
| Deficiency of revenues over expenses | $22,000     | $9,660      | (12,340)|         |
| Capital expenditures            | $1,758      | $5,297      | (3,539)| -66.8%   |

Salaries and benefits, which comprise $63.3 million or 74.6% of the budget, reflect an increase of $2.2 million or 3.6%. Most of the increase in salaries and benefits cost reflects prior staffing decisions, including the full-year costs for staff hired during 2009 and the planned hiring of previously approved positions. Higher pension contribution rates and increased health benefit costs are other factors. Increased staff costs are partially offset by an estimated $947,000 or 19.2% reduction in professional services costs. Amortization costs for 2010 will be $1.6 million higher. This non-cash cost accounts for more than 40% of the OSC’s total budget increase.

Travel costs are budgeted to increase 47.2% to $1.2 million (2009 – $791,000). The range of current and emerging market issues continues to grow. Proposed growth in travel requirements is necessary to allow us to participate in international regulatory efforts to address these issues. International travel must be pre-approved and is planned on a trip-by-trip basis, based upon the participation of the Chair, Vice-Chairs and staff on various committees and at the relevant meetings.

The OSC’s deficiency of revenues over expenses in 2009 was reduced significantly due to recovery of $2.8 million in costs through enforcement settlements. These amounts were about $1.8 million higher than the average for the previous five years.

Additional details on recoveries are presented in the Recoveries of Enforcement Costs section of the MD&A.

The projected decrease of $3.5 million or 66.8% in capital expenditures is due to the completion of the expansion and renovation of its premises in 2009. The resulting increase in the OSC’s capital base has generated the projected increase in amortization costs noted above.