Overview

This document sets out the key financial events and actions and how they have influenced the OSC's operations during the past year and provides an outlook on its 2010–2011 plans. The environment and challenges that the OSC faces and details on the key elements that were considered in developing the plans are also set out. Additional details on 2010–2011 plans are set out in the OSC Statement of Priorities which is available at www.osc.gov.on.ca.

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. The words "believe," "plan," "intend," "estimate," "expect" or "anticipate" and similar expressions, as well as future or conditional verbs such as "will," "should," "would" and "could" often identify forward-looking statements. The OSC has based these forward-looking statements on its current views with respect to future events and financial performance. 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, 2010, with 2009 comparatives and accompanying notes. Unless otherwise specified, references to years, for example 2010, refer to the fiscal years of the OSC ended March 31 of that year. The factors which affected the OSC's operations during 2010, 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 revenues 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.

OSC 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, market participants and marketplaces:

- Investors – both retail and institutional, who seek to invest in fair and efficient markets. Ontario residents hold about 43% of the financial assets held by individual Canadians and 81% 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 25% of Canadian-listed corporate issuers are based in Ontario, accounting for 43% of Canada's equity market value.
  - Intermediary firms – registered to provide investment services to both users and suppliers of capital. There are 1,424 registrant firms (out of 1,639 in Canada) and 64,637 individuals (out of 119,853 in Canada) registered in Ontario.
  - Marketplaces – There are currently 19 marketplaces (e.g. TSX, Pure Trading, Alpha ATS, etc.) operating within Ontario.

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

OSC approach

The OSC is a Crown corporation without share capital and is the body responsible for regulating Ontario's capital markets. Protecting investors and 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;
> 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;
> Providing summary financial information to the Board each month;
> 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
> Certifying the design and effectiveness of Internal Control over Financial Reporting (ICFR) by the Chair and the Director of Corporate Services.

Current environment and issues

A range of environmental factors continue to pose challenges for those that the OSC regulates and the OSC itself. The main environmental factors affecting the OSC's work are set out below.

Economic environment and OSC activity levels

The OSC's operating environment remains challenging. Despite improving global economic conditions there remain a range of uncertainties around the possible outcomes for the economy. The timing and strength of a recovery remain uncertain and financial market volatility persists. 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 the Canadian financial system to better respond to future events that could adversely affect our markets.

The pace of change in capital markets, in Ontario and in other jurisdictions, has generated significant structural change, including shifts from single marketplaces to multiple and increasingly complex marketplaces. At the same time, there has been a proliferation of complex securities products and investment advice (including the use of leverage, derivatives and exposure to commodities) and an increasing technological sophistication in the operations of market participants. Adapting OSC resources and skills to meet these issues continues to be a key challenge.

The financial crisis also revealed weaknesses in the global financial regulatory system, highlighting the need for a co-ordinated global response to address systemic risk and develop a more effective system of oversight and regulation. During the year, the CSA, including the OSC, formed a Systemic Risk Committee that is developing a process to identify, analyse and monitor systemic risks within the Canadian capital markets. This group will consult with other regulators with an interest in systemic risk and will report to the CSA Chairs, at least annually, on emerging systemic risks in the capital markets. The OSC also works in this area with partners such as Office of the Superintendent of Financial Institutions, the Bank of Canada, provincial insurance and other federal and provincial securities regulators. The OSC has continued to collaborate with the International Organization of Securities Commissions and other international standard setters and regulators to address regulatory gaps and implement the G20 action plan to strengthen transparency and accountability, enhance sound financial regulation, promote integrity, and reinforce international cooperation.

Ontario securities laws must evolve to meet these changing markets and products. To help prospective investors make informed investment decisions, the OSC is trying to better understand the information investors need, as well as how and when they need this information. The OSC must work to ensure that market participants meet the regulatory standards for disclosure and advice that investors require. To provide increased focus on investor issues, the OSC initiated work toward the establishment of an independent, funded Investor Advisory Panel during the last quarter of 2010.

Growing public expectations/accountability

Market participants and industry watchers continue to want regulators to move faster and more decisively in responding to current and potential problems. While the OSC seeks to be responsive to these demands, its response must be balanced and guided by its mandate, the scope of its authority and its operational capabilities.

Accountability to Ontario's investors and market participants is integral to the planning and implementation of the OSC's operational priorities. The OSC will continue to outline its regulatory goals and outcomes, how it will seek to achieve these goals and outcomes, and the challenges it faces. During 2010, the OSC held the consultation process for the OSC Statement of Priorities earlier in order to better consider stakeholder feedback as part of the annual budget approval process. The OSC will continue this process going forward, since listening to and communicating with interested stakeholders is essential to meeting the challenges it faces in fulfilling its mandate and addressing expectations about what it can accomplish.

OSC 2011 budget and fees

In developing the 2011 budget, the OSC carefully balanced the need for restraint with its need to move forward on initiatives which are necessary to achieve 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.

Securities market participants fund OSC operations through fees they pay. The OSC's fee structure is designed to generate fees that recover its cost of providing services to market participants. From 2003 to 2008, the OSC generated accumulated surpluses. These surpluses were largely due to higher than anticipated market growth in that period. Since 2008, the OSC has operated at a deficit. The OSC used a portion of its surplus to defer a planned fee increase for 2010.

An amended fee rule was approved by the Minister of Finance with an effective date of April 5, 2010. Even with these fee increases, the OSC expects to operate at a deficit in each of the next three years. These deficits are expected to largely eliminate the OSC's accumulated surplus. The OSC expects a revenue shortfall of $22 million in 2011. The OSC's goal is to return to full cost recovery by 2013.

Additional details on OSC 2011 budget and fees are provided in the "2011 Outlook" section.

Internal control over financial reporting

During the year, the design of ICFR was updated and 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. Staff performed an evaluation, under the supervision and with the participation of management, of the effectiveness of the OSC's ICFR as at March 31, 2010. Based on this evaluation, the OSC has concluded that the ICFR was 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 year ended March 31, 2010, 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

(Thousands)	**2010**	2009	2008
Revenues	**$ 61,466**	$ 68,562	$ 78,238
Expenses	**80,320**	81,053	75,190
Surplus/(deficiency) of revenue over expenses (before recoveries)	**(18,854)**	(12,491)	3,048
Recoveries of enforcement costs	**870**	2,831	1,569
Surplus/(deficiency) of revenue over expenses	**$ (17,984)**	$ (9,660)	$ 4,617
Capital expenditures	**$ 1,373**	$ 5,297	$ 917

Analysis of operating results

Certain numbers have been rounded for presentation purposes. As a result, small differences in calculations may arise. Where these occur, they are not considered to be material.

Overview

The OSC had a net deficit of $18.0 million in 2010 ($9.7 million – 2009). The OSC's deficiency of revenues over expenses was reduced by the recovery of $870,000 in enforcement costs through settlements and orders. Recoveries were down $2.0 million from 2009 and were about $420,000 lower than the average for the previous five years.

2010 actual to 2009 actual

Revenues decreased by $7.1 million or 10.4% mainly due to lower participation fee revenues and reduced investment income which were partially offset by slightly higher activity fee revenues.

Expenses were $733,000 or 0.9% lower. Increased costs for salaries and benefits ($585,000) and amortization ($1.5 million) were more than offset by decreases in professional services ($2.5 million) and travel and related expenses ($326,000). Employee compensation and occupancy costs account for 84.8% (2009 – 83.4%) of expenses (before recoveries).

The premises and equipment balance decreased by $1.3 million or 20.0% as amortization exceeded capital additions.

Detailed analysis of fiscal 2010 operating results

The OSC fee structure is designed to generate fees that reflect the OSC's cost of providing services to market participants. The OSC was able to defer a fee increase in 2010 by using a portion of its surplus. As a result, other than a change in fees for late payment of participation fees, the current fee schedule has been in place since April 1, 2006. An amended fee rule was approved by the Minister of Finance with an effective date of April 5, 2010. Even with these fee increases, the OSC expects to operate at a deficit in each of the next three years.

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

(Thousands)	% of total 2010 fees	**Actual 2010**	Actual 2009	Change	% change
Participation fees	80.5	**$ 49,068**	$ 54,831	$ (5,763)	(10.5)
Activity fees	16.1	**9,828**	9,048	780	8.6
Late fees	3.4	**2,032**	2,556	(524)	(20.5)
Total fees	100.0	**60,928**	66,435	(5,507)	(8.3)
Investment income		**460**	2,085	(1,625)	(77.9)
Miscellaneous		**77**	42	35	83.3
Total revenues		**$ 61,465**	$ 68,562	$ (7,097)	(10.4)

Figure 1
OSC fees by type

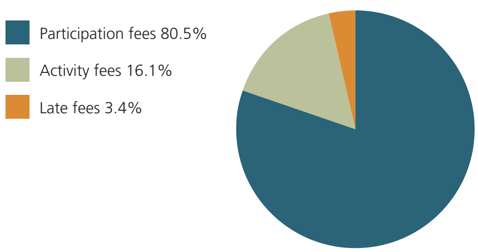


Figure 1 shows the sources of the OSC's fee revenues:

The impact of weak market performance late in 2009 and in early 2010 had a negative impact on OSC revenues. Revenues for the year were $61.5 million, down from $68.6 million in 2009. The variance is explained below:

Participation fees were lower by $5.8 million or 10.5%, reflecting the continued impact of the market downturn in 2009 which resulted in lower revenues for registrants and reduced market capitalization levels for issuers.

Activity fees rose by $780,000 or 8.6%, as market activity improved slightly resulting in increased numbers of prospectus and private placement filings.

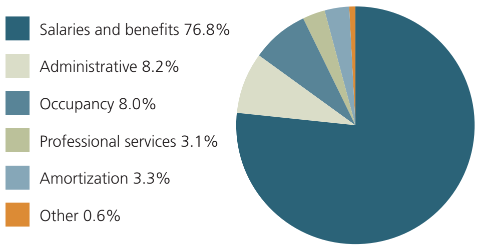
Late fees were $524,000 or 20.5% lower than last year. The reduction was due to a decrease in late filings of insider trade reports and due to the change in fees levied for late payment of participation fees.

Investment income fell $1.6 million or 77.9%, reflecting lower rates of interest on lower cash balances. The average rate of return on cash balances and investments was 0.9% (2009 – 2.71%), which was 181 basis points lower than in 2009.

Expenses

(Thousands)	% of total 2010 expenses	**Actual 2010**	Actual 2009	Change	% change
Salaries and benefits	76.8	**$ 61,673**	$ 61,088	$ 585	1.0
Administrative	8.2	**6,567**	6,443	124	1.9
Occupancy	8.0	**6,445**	6,501	(56)	(0.9)
Professional services	3.1	**2,466**	4,987	(2,521)	(50.6)
Amortization	3.3	**2,705**	1,243	1,462	117.6
Other	0.6	**464**	791	(327)	(41.3)
Total expenses	100.0	**80,320**	81,053	(733)	(0.9)
Recoveries		**870**	2,831	(1,961)	(69.3)
Total (net of recoveries)		**$ 79,450**	$ 78,222	$ 1,228	1.6

Figure 2
OSC expenses by type



Total expenses for 2010 (Figure 2) decreased 0.9% to $80.3 million (2009 – $81.1 million).

The key contributors to the expenditure decrease were as follows:

Salaries and benefits costs increased by 1.0% to $61.7 million (2009 – $61.1 million) and accounted for 76.8% of total expenses. The 2010 expenses included the full-year cost impact of staff hired during 2009, as well as the costs for two additional staff in registrant regulation and compliance. Also contributing to the increase was the impact of the salary increases put in place at the beginning of the fiscal year totalling approximately $620,000 (2009 – $2.1 million). Offsetting these increases was a $783,000 reduction in bonus payments and an $84,000 reduction in the use of temporary staff.

Administrative costs increased by 1.9% to $6.6 million (2009 – $6.4 million) and accounted for 8.2% (2009 – 7.9%) of total expenses. Key contributors to the increase were higher spending on supplies and additional Commission expenses. Commissioners on adjudicative panels sat for a total of 305 or 23% more sitting days (2009 – 248 days).

Occupancy costs accounted for 8.0% (2009 – 8.0%) of the OSC's total expenses. Expenditures on occupancy decreased $56,000 or 0.9% to $6.4 million.

Professional services spending decreased 50.6% from $5.0 million to $2.5 million and accounted for 3.1% (2009 – 6.2%) 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. Enforcement-related professional services were $1.5 million lower as more work was undertaken internally. Recruitment expenses were lower due to low turnover rates. The need to adapt to government procurement directives had an impact on operations and resulted in delays and reductions in planned spending on general professional services. For example, plans to develop and integrate an enterprise risk management program into the OSC's operations were delayed due to changed requirements to the procurement process. Work was initiated on this important initiative late in 2010.

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 2010 was slightly higher at $2.5 million (2009 – $2.3 million); the OSC contributed $952,000 (2009 – $886,000). All CSA projects, including the development of harmonized securities policies and rules, are co-ordinated through a central secretariat. The CSA's business relationships with third-party technology providers are managed through the CSA systems office. In 2010, the OSC contributed $195,000 (2009 – $246,000) to the cost of the CSA Secretariat and $306,000 (2009 – $259,000) to the cost of the systems office.

Amortization costs increased to $2.7 million (2009 – $1.2 million) and accounted for about 3.3% (2009 – 1.5%) of the OSC's total expenses. Amortization expenses rose reflecting the increases to the OSC capital base as a result of the renovations and expansion completed primarily in 2009.

Other expenses, which are travel and related expenses, declined by $327,000 or 41.3% to $464,000 (2009 – $791,000) and accounted for 0.6% (2009 – 1.0%) 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. Travel was also deferred while changes to government directives were clarified.

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 as they are made up of a large number of debtors owing individually immaterial balances.

Liquidity

The OSC holds cash and marketable securities to ensure that sufficient liquidity is available to meet forecasted cash requirements. The OSC has sufficient liquidity to finance its operations and purchases of premises and equipment. The OSC's general surplus decreased by $18.0 million, reflecting the anticipated deficit of revenues over expenses. As a result, the OSC's cash position decreased by $16.4 million or 31.5% in 2010. Cash flows from operating activities are an outflow of $15.2 million. Purchases of premises and equipment used $1.4 million.

As at March 31, 2010, the OSC held $35.6 million (2009 – $52.0 million) in cash, had current assets of $37.1 million (2009 – $54.3 million) and current liabilities of $11.8 million (2009 – $12.3 million) for a current ratio of 3.2:1 (2009 – 4.4:1).

In 2011, the OSC projects an operating deficit of $17.2 million. The OSC will use its accumulated surplus to fund this deficit. This will result in lower cash balances going forward. Since a large portion of the OSC's revenues are normally received in the last quarter of the fiscal year, the cash balance decreases through the first three quarters, as the OSC funds its operations. The OSC expects to begin to use a portion of its reserve fund assets in December 2010. In January 2011, when the majority of registrant fees are received, the $20 million reserve will be restored. The cash balance is projected to increase to approximately $24.7 million in March 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. Additional discussion is provided under "Financial Risk" later in the document.

Reserves

Since 2001, the OSC has had a $20.0 million general reserve as an operating contingency for revenue shortfalls or unexpected expenses. 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.

In 2002, the OSC received approval to retain $12.0 million which could only be used toward implementation costs of a planned merger of the OSC and the Financial Services Commission of Ontario into a single agency that would provide regulation of the capital markets and financial services sectors. As the merger has not proceeded, the $12.0 million decline in the OSC reserve reflects the repayment of these funds to the Ministry of Finance during the year.

Accounts receivable

Accounts receivable decreased 30.5% to $1.0 million (2009 – $1.5 million). Outstanding late fees, which accounted for 36.3% of accounts receivable, decreased 32.1% to $379,000 (2009 – $559,000). The allowance for doubtful accounts decreased by $21,000 as a result of an increase in collection efforts. Other key receivables are interest receivable of $61,000 (2009 – $434,000), which fell due to smaller cash balances and lower interest rates, and $171,000 from the Investor Education Fund (2009 – $108,000) 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. 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. With regard to monetary sanctions imposed, a fair and appropriate use for these monies will be determined in accordance with applicable laws, court orders and in the public interest.

In 2010, the OSC received $29.8 million (2009 – $13.9 million) through designated settlements and orders. As authorized by the Board, the OSC paid $3.37 million to the Investor Education Fund (2009 – $1.75 million) as part of a two-year commitment. The OSC also paid $283,000 (2009 – $0) to the Attorney General of Ontario, as directed by an order of the Commission.

The OSC currently holds $43.5 million (2009 – $17.2 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 allocate 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, 2010, the OSC received $46.9 million (2009 – $33.1 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 2010 was $2.3 million (2009 – $2.1 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 2010, there were no SEDAR deficits. As at March 31, 2010, $22.4 million (2009 – $19.3 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.

During the year, work began on the redevelopment of these systems. As at March 31, 2010, payments related to this redevelopment project totalled $82,184. The CSA has also entered into a contract totalling $750,000 for the design of the Enterprise Architecture of these systems. Redevelopment work will be funded by the amount held in trust.

Premises and equipment

Expenditures on premises and equipment during 2010 included:

(Thousands)	**2010**	2009	% change
Furniture and equipment	**$ 11**	$ 679	(98)
PCs, laptops and other IT equipment	**1,306**	2,100	(38)
Leaseholds and other capital items	**56**	2,518	(98)
Total	**$ 1,373**	$ 5,297	(74)

Expenditures on premises and equipment declined to $1.4 million (2009 – $5.3 million). Expenditures on furniture and equipment and leaseholds and other capital items were significantly higher in 2009 as substantial renovations were undertaken to the OSC's premises. Technology-related purchases of $1.3 million (2009 – $2.1 million) reflected more typical levels. Purchases in 2009 were higher than usual as they included the replacement of the OSC electronic storage, new video conferencing, document management system, and the web content management system.

Liabilities

Accounts payable and accrued liabilities decreased 4.0% to $11.7 million (2009 – $12.2 million) mainly because there were additional charges and accruals related to the renovation project included in the prior year's totals. This was partially offset by a increase in payroll accruals.

The accrued pension liability of $1.7 million (2009 – $1.6 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, 2010 was $1.8 million (2009 – $1.4 million). The OSC's related expense for the year was $198,000 (2009 – $193,000) and is included in salaries and benefits.

The OSC is committed to lease payments as outlined in Note 13 to the financial statements.

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 as well as the reported amounts of revenues and expenditures for the period. Actual amounts can differ from these estimates to the extent future outcomes differ significantly from management's forecast expectations. To address this the OSC uses various estimating techniques and assumptions 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 professional expertise to assist in the calculation of these estimates. It is management's opinion that none of the estimates as described in Note 2 of the 2010 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."

Risks and uncertainties

Globalization of financial entities and their operations continues to intensify. Overlap and integration across financial sectors continues to expand. Product and market complexity are increasing. Economic and financial market conditions, the expectations of public accountability, and the plans and actions of other regulatory agencies and jurisdictions affect OSC operations. Against this background, the importance of identifying and understanding the nature of specific risks the OSC must manage continues to grow. The OSC Board of Directors is responsible for sound corporate governance and oversight of risk.

Operational risk

Operational risk can be defined as the risk of direct or indirect loss resulting from the organizational environment or external events, or from inadequate internal processes, staff resources, or supporting systems. Management is responsible for the day-to-day control of operational risk by ensuring that appropriate procedures, internal controls and processes or other actions and compliance with such programs are established to reduce operational risk.

Specialist support groups, such as Human Resources, Corporate Services and the Office of the General Counsel, assist operational management by maintaining oversight in areas such as corporate data security, staff behaviour requirements, technology stability and reliability, financial controls, corporate insurance and legal compliance, among others. The OSC has established policies and processes to identify, manage and control operational risk. Key components include:

- A strong internal control environment, including management oversight that includes reviewing the design of internal control 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; and
- Separation of duties across key functions.

Operational risk can extend to risk to the OSC's reputation as can the risk of not meeting its mandate or regulatory requirements. Reputational risk is addressed at the OSC by its Code of Conduct and governance practices established by its Board of Directors (additional details available at www.osc.gov.on.ca) as well as other specific risk management programs, policies, procedures and training.

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. As this initiative becomes more defined the OSC may encounter more difficulty attracting or retaining staff. Although no evidence has been seen to date, the OSC will continue to monitor staffing and will develop strategies to address issues should they arise.

Key supplier dependency is another potential source of risk. A number of major applications (SEDAR, NRD and SEDI) are operated by CDS INC. (CDS) on behalf of the CSA including the OSC. CDS recovers its costs to operate these systems through the application of user fees to filers. In 2010, 91.8% (2009 – 92.7%) of total regulatory fee revenue at the OSC was collected through these national applications (SEDAR 35.7% and NRD 56.1%). No material change is expected in the volume of fees collected through these systems. The current operating agreement with CDS for these systems runs until October 2011 but can be extended up to two years at the option of the CSA. The CSA IT Systems Office is examining options for both the management and redevelopment of these mission critical systems beyond the expiration of the current operating agreements.

The CSA requires CDS to provide an annual third-party audit report (CICA 5970) on its operational and environmental controls for each system. In addition, CDS is required to have an operating disaster recovery site for these systems that is annually tested.

Financial risk

The majority of OSC revenue is generated through participation fees. The OSC fee model uses a tiered structure to moderate the impact of market fluctuations in an effort to provide revenue stability. While the fee model has achieved this objective across multi-year periods, in any given year, the predictability of OSC revenues is less certain as participation fees are still subject to market fluctuations.

As discussed earlier in the MD&A and elsewhere in the Annual Report, an amended fee rule was approved with an effective date of April 5, 2010. Under this new rule, fee rates were increased. Even with these fee increases, the OSC expects a revenue shortfall of $22 million in 2011 and to operate in a deficit position for each of the next three years. These deficits are planned to be offset by using the OSC's accumulated surplus. The OSC has assumed a 10% annual market growth in developing its revenue forecast. Should this growth rate not be achieved, revenues could be materially lower than forecast and further revisions to the fee rule could then be required.

Business continuity

In the event of an external disruption, the OSC maintains a robust Business Continuity Plan to ensure the continuation of critical regulatory services. Detailed business continuity plans are in place for each priority business function. Each functional plan includes documented recovery procedures including manual workarounds and other mitigation strategies. Offsite recovery services and facilities have been contracted and were successfully tested during 2010. Remote access capability exists to enable staff to access all critical OSC systems. The OSC's plan is continually reviewed and refined to include strategies to recover data and functionality and to resume operations under various disruption scenarios. Another key element of the OSC plan addresses its interfaces with SROs and other key market participants and includes strategies to effectively address various market disruption scenarios.

Contingencies

The OSC, from time to time, 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.

Risk management – Next steps

The broadening and deepening of risk management programs in the OSC's day-to-day operations has been identified as a key business priority for 2011 and beyond. The OSC is enhancing its ability to identify, assess and report on risks affecting the efficiency and fairness of Ontario's capital markets, as well as its ability to enhance investor protection, by:

- Developing a consistent understanding of risk;
- Establishing clear accountability for its management; and
- Setting out a framework for the ongoing monitoring and reporting on specific risk management activities across the organization.

Late in 2010, the OSC engaged consultants to assist in the ongoing development of an appropriate enterprise risk management framework. The scope of the project includes a comprehensive review and assessment of current risk management approaches employed by the OSC, assessment of their effectiveness, benchmarking and identification and recommendations for improvement. The OSC will use the increased understanding gained through this enterprise risk management process to refine its regulatory approaches.

2011 outlook

The 2010/2011 OSC Statement of Priorities sets out the Commission's priorities and proposed initiatives for the upcoming year. The document is available at www.osc.gov.on.ca. The 2011 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.

The OSC has identified five broad priorities for 2011:

1. Deepen our focus on investor protection.
2. Respond to market developments.
3. Address adequacy of regulatory coverage.
4. Maintain a strong and visible enforcement presence.
5. Improve the way we work.

OSC revenues and surplus

Securities market participants fund OSC operations through fees they pay. The current fee structure under the *Securities Act* (Ontario) and the *Commodity Futures Act* was established in 2003. The fee model is intended to recover the OSC's costs of operation in fulfilling its mandate while allowing it to remain financially stable. When the OSC implemented the fee model, it committed to re-evaluate fee levels every three years. Achieving the appropriate balance can be challenging because most of the OSC's costs are relatively fixed, while its revenues fluctuate with market activity. From 2003 to 2008, the OSC generated accumulated surpluses. These surpluses were largely due to higher than anticipated market growth in that period. The OSC was able to defer a fee increase in 2010 by using a portion of its surplus in 2010.

An amended fee rule was approved by the Minister of Finance with an effective date of April 5, 2010.

Activity fees – Most of the activity fees were unchanged from the rates set in 2006.

Participation fees – Total participation fees paid by market participants will rise by a weighted average of 12.2% per year. This will result in increases of approximately 9% per year for registrants and 17% per year for issuers from the participation fees set in 2006. However, the issuers' participation fees for comparable fee tiers will be less in each of the years covered by the proposed amendments (2011 to 2013) than in 2003, when these fees were first set. The difference in fee increases for issuers and registrants is intended to better align revenues generated from each group with its level of participation in the Ontario capital markets.

Even with these fee increases, the OSC expects to operate at a deficit in each of the next three years. For the three years ending March 2013, the OSC projects operating costs will exceed revenues by $27.3 million. This deficit will be offset by applying the expected March 2010 accumulated operating surplus of $28.9 million and will result in an ending operating surplus of $1.6 million in 2013.

2011 budget approach

In developing the 2011 budget, the OSC carefully balanced the need for restraint with its need to move forward on initiatives necessary to achieve its mandate of providing protection to investors and fostering fair and efficient capital markets. The OSC Board of Directors and management are committed to prudently managing the OSC's budget and expenditures. The OSC strives to provide value-for-money to its stakeholders and ensure that it delivers quality services efficiently.

The budget reflects a projected increase of $7.3 million or 9.2% over 2010 actual spending and 3.4% above the 2010 budget. Salaries and benefits, which comprise $65.2 million or 75.2% of the budget, reflect an increase of $4.3 million or 7.1% over 2010 spending. The increase in salaries and benefits cost reflects a number of factors including: the full-year costs for staff hired during 2010, six new positions, average salary increases of 1.6% and higher health benefits costs. It should be noted that 2010 spending was significantly below the amount budgeted. This was partly due to the need to adapt operations to accommodate government directives on travel and procurement of professional services which resulted in delays and reductions in planned spending. As a result, the 2010 spending is an artificially low baseline for comparison to 2011. Moving the costs for some of these deferred 2010 initiatives into the 2011 budget magnifies the variance and compounds the difficulties in making meaningful comparisons with 2010.

2011 budget comparisons

				2011 budget to 2010 budget		2011 budget to 2010 actual	
(Thousands)	2010 budget	**2010 actual**	2011 budget	Change	% change	Change	% change
Revenues	$ 61,900	**$ 61,465**	$ 69,497	$ 7,597	12.3	$ 8,032	13.1
Expenses	83,905	**79,450**	86,740	2,835	3.4	7,290	9.2
Deficiency of revenue compared with expenses	$ (22,005)	**$ (17,985)**	$ (17,243)	$ 4,762		$ 742	

The 2011 budget increase also includes two significant new initiatives. Additional funding is required for the recently announced independent, funded panel with a focus on investor issues. The other initiative is the planned establishment of a new group within the OSC to focus on the regulation of over-the-counter (OTC) derivatives. While these initiatives will be staffed in part by a re-allocation of existing resources, the scope of the initiatives is such that incremental resources will be needed and are reflected in the budget. These initiatives are consistent with the regulatory outcomes the OSC is seeking.

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, for years beginning on or after January 1, 2011.

In October 2009, the Public Sector Accounting Board (PSAB) approved an amendment to the Introduction to the PSA Handbook which allows an "Other Government Organization," such as the OSC, to determine by assessing its mandate, considering its purpose, objectives and limitations, and the user's needs, the appropriate accounting standards it wishes to apply. The OSC currently applies Canadian GAAP and intends to transition to IFRS, consistent with the disclosure required of the market participants the OSC regulates.

For the OSC, the date of transition is April 1, 2010 and the first set of IFRS financial statements is for the year ending March 31, 2012. For comparative purposes, amounts reported by the OSC for its year ending March 31, 2011 will be restated to IFRS along with the opening balance sheet as at April 1, 2010.

It should be noted that an Addendum to the 2010 Ontario Budget expressed concerns with the range of accounting standards in use across the Ontario public sector. It states that amendments will be proposed to the *Financial Administration Act* and other statutes "to clarify the government's authority to direct the organizations that are included in the Province's consolidated accounts on which accounting policies are to be applied in the preparation of their financial statements." No details and no timing are provided. The changeover plan below is based on conversion to IFRS, and may be affected by the government's plans.

1. IFRS changeover plan

IFRS uses a conceptual framework similar to Canadian GAAP, but there may be differences in recognition and measurement of assets and liabilities, and related disclosures, that may materially impact the OSC's financial statements. The OSC has developed an IFRS implementation plan to prepare the organization for this transition. This plan is comprised of three related phases:

- Scope and Planning
- Design and Build
- Implement and Review

The OSC's staff are participating in a CSA-wide IFRS training program over five years. The program includes two-hour sessions on each IFRS standard, as well as in-depth, customized, two-day IFRS sessions each year. Certain members of the Audit and Finance Committee have already received IFRS training. All Audit and Finance Committee members will receive sufficient IFRS training to assist them in fulfilling their oversight role in relation to the integrity of the OSC's financial statements.

2. Phase 1: Scope and planning phase

The objective of this phase is to identify the required changes to accounting policies and practices resulting from the changeover to IFRS to determine the scope of the work effort required for the Design and Implementation phases. In this first phase staff prioritize the assessment of standards that have a high likelihood of impacting the financial statements, where significant choices are available, or where significant process or system changes are anticipated.

3. Phase 2: Design and build phase

In this phase, each area identified from the scope and planning phase will be addressed in order of descending priority. This phase involves specification of changes required to existing accounting policies, information systems, business and control processes, IFRS training, together with an analysis of policy alternatives allowed under IFRS and development of draft IFRS financial statement content.

4. Phase 3: Implement and review phase

This phase includes implementing the required changes necessary for IFRS compliance. The focus of this phase is the finalization of IFRS conversion impacts, approval and implementation of accounting policies, including decisions on retrospective or prospective adoption, implementation and testing of new processes, systems and controls, IFRS training, and preparation of opening IFRS balances.

5. Status update and changeover plan

Phases and key activities	Milestones (expected timeframe)	Status and comments
Phase 1 – Scope and planning – 2010		
Develop an initial project plan. Initial assessment of all accounts to identify measurement, accounting, and disclosure differences between current accounting policies and IFRS. Identify IFRS 1 exemptions to be elected. Assess impact of IFRS on internal control over financial reporting (ICFR) and information systems. Staff participates in OSC training programs.	Identification of IFRS differences, IFRS 1 exemptions to be elected and impact on controls and systems.	Developed the detailed project plan. Completed the identification of IFRS differences, IFRS 1 exemptions that are applicable, and impact on controls and systems. IFRS training is ongoing.
Phase 2 – Design and build – 2011		
Staff to propose IFRS accounting policy choices including IFRS 1 exemptions to be elected. Engage in discussion with Audit and Finance Committee on policy choices and alternatives. Design and develop any required changes to ICFR and information systems. Develop draft IFRS financial statement content. IFRS training including training for Audit and Finance Committee members.	OSC's Audit and Finance Committee sign-off for policy recommendations and IFRS 1 exemptions to be elected. ICFR and information systems changes to be completed and draft IFRS financial statement content to be developed.	Requires detailed assessment of key IFRS standards including the determination of policy choices and quantification of the impact, if available. This assessment also includes the determination of key changes to ICFR and information systems. Phase 2 is in progress and expected to be completed on schedule.
Phase 3 – Implement and review – 2012		
Address impact of IFRS conversion on financial performance, the balance sheet, opening retained earnings, and MD&A disclosure. Engage in discussion with Audit and Finance Committee on the approval of draft statements. Test new processes, systems and controls. Prepare the draft format of 2011 comparative financial statements, including note disclosures. Prepare IFRS comparative financial statements including note disclosure at March 31, 2012. Compliance review and ongoing IFRS update and related change management.	Disclose quantitative impact of IFRS conversion, if available, in 2011 MD&A. Updated processes tested. OSC's Audit Committee approval on financial statement format. Approval of 2012 final IFRS statements.	Approval of 2012 IFRS statements in Q1 2013.

Overall, progress against the milestones is on track.

6. Summary of key expected changes

The OSC is in the process of evaluating the expected differences between the IFRS and the current accounting treatment under Canadian GAAP. The review consists of a detailed analysis of each IFRS standard applicable to OSC, a determination of the recognition and measurement differences, an action plan to address identified differences and an evaluation of the impact on the existing accounting policies, information systems, business and control processes. Based on the work performed to date, no significant differences were found between IFRS and Canadian GAAP. However, the following are the areas where OSC is expecting certain differences with respect to the recognition and measurement of certain balance sheet and income statement items.

7. Accounting policies

a. Premises and equipment

IAS 16 Property Plant & Equipment (IAS 16) permits the use of the cost model or the revaluation model for these assets. Under the cost model, assets are carried at cost less any accumulated depreciation and any accumulated impairment losses. Under the revaluation model, assets whose fair value can be reliably measured can be carried at the revalued amount.

IAS 16 requires the depreciation of an asset to begin when it is available for use. The OSC commences the depreciation of an asset in the beginning of fiscal year following the acquisition. The OSC is assessing the overall impact of this difference in timing of recording depreciation. Adoption of IAS 16 is expected to result in a reduction of net book value of its premises and equipment balance by increasing the accumulated depreciation at the transition date.

IFRS 1 allows a first-time adopter to measure an item of Property, Plant and Equipment (PP&E) at the date of transition to IFRS at fair value as deemed cost (or under certain circumstances, to use a previous GAAP revaluation) as opposed to full retrospective application of the cost model under IFRS. Under this option, fair value as deemed cost will become the new cost amount for qualifying assets at transition.

The OSC expects to apply the cost model for PP&E, and does not expect to elect to use the IFRS 1 exemption to restate PP&E to fair value as deemed cost under IFRS. The OSC expects to use the historical cost under Canadian GAAP as cost under IFRS at the date of transition.

b. Employee benefits

All eligible OSC employees are members of the Ontario Public Service Pension Plan, which is a multi-employer defined benefit plan. This plan is accounted for as a defined contribution plan, as the OSC has insufficient information to apply defined benefit accounting to this plan. The transition to IFRS is not expected to impact the accounting treatment.

The OSC also maintains unfunded supplemental pension plans for the current and former Chairs and Vice-Chairs.

In accordance with IAS 19 Employee Benefits, an entity may elect to use a "corridor" approach that requires, as a minimum, only a specified portion of actuarial gains and losses to be recognized. Retrospective application of this approach requires an entity to split the cumulative actuarial gains and losses from the inception of the plan until the date of transition to IFRS into a recognized portion and an unrecognized portion.

However, IFRS 1 permits a first-time adopter to elect to recognize all cumulative actuarial gains and losses at the date of transition to IFRS, even if it uses the corridor approach for later actuarial gains and losses. If a first-time adopter uses this election, it shall apply it to all plans.

Under IAS 19, the opening Accrued Benefit Obligation related to the supplementary pension plans that the OSC administers would remain the same as under Canadian GAAP. However, the accrued benefit liability would increase by the amount of the actuarial loss recorded as at the transition date. This adjustment will be recorded directly to retained earnings. The impact of this adjustment is expected to be immaterial. The OSC expects to elect the relevant IFRS 1 exemption, and to continue to use the corridor approach.

8. Business activities

The OSC has considered the impact of IFRS conversion on all areas of the business and determined that the adoption of IFRS will not have a significant impact on its business activities.

9. Internal control over financial reporting (ICFR)

At this point, the OSC has determined that ICFR applicable to its current reporting processes under Canadian GAAP is fundamentally the same as that required in its IFRS reporting environment. Changeover to IFRS will not significantly impact its ICFR.

10. Information systems and processes

Based on the work performed to date, the OSC does not expect that adoption of IFRS will have a pervasive impact on its information systems and processes. Due to the limited nature of the differences identified in the conversion process, the OSC believes that the current information system and processes can support the preparation of IFRS-compliant financial statements.

11. Financial reporting expertise

The OSC has implemented a detailed staff training plan, led by the OSC's Office of the Chief Accountant, addressing all aspects of the IFRS conversion project. A number of training sessions related to specific standards and customized training sessions related to the IFRS conversion were provided to relevant staff including those with financial reporting responsibilities. All Audit and Finance Committee members will receive sufficient IFRS training to assist them in fulfilling their oversight role.

12. Audit and finance committee involvement

As discussed in the changeover plan, the OSC's Audit and Finance Committee will be updated each quarter on the progress of the IFRS conversion plan including the review of timelines for implementation, the implication of IFRS standards to the Commission and an overview of the impact to the financial statements. The Committee will discuss with management all accounting policy choices and approve all selected policies as well as IFRS draft financial statements.

13. Changes to IFRS

Staff are monitoring proposed changes to IFRS. Staff will continue to evaluate whether any of the proposed changes impact the OSC, and whether the OSC should early adopt any of the new IFRS.