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MFS INTERMEDIATE INCOME TRUST  
Form POS AMI  
February 28, 2006

AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON

FEBRUARY 28, 2006

1940 ACT FILE NO. 811-5400

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM N-2

REGISTRATION STATEMENT  
UNDER THE INVESTMENT COMPANY ACT OF 1940           |X|

Amendment No. 11                                       |X|

MFS(R) INTERMEDIATE INCOME TRUST  
(Exact Name of Registrant as Specified in Charter)

500 Boylston Street, Boston, Massachusetts 02116  
(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, including Area Code: 617-954-5000

Susan S. Newton  
Assistant Secretary and Assistant Clerk

MFS Intermediate Income Trust  
c/o Massachusetts Financial Services Company  
500 Boylston Street  
Boston, Massachusetts 02116  
(Name and Address of Agent for Service)

1

MFS INTERMEDIATE INCOME TRUST

PART A.

INFORMATION REQUIRED IN A PROSPECTUS

Items 1 and 2: Omitted pursuant to General Instruction G.3 to Form N-2.

Item 3.1 Fee Table: Inapplicable - 1940 Act filing only.

Items 3.2, 4, 5, 6 and 7: Omitted pursuant to General Instruction G.3 to Form N-2.

Item 8. General Description of Registrant:

8.1. General: The MFS Intermediate Income Trust ("Trust") is a closed-end, diversified management investment company which was organized as a business

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trust under the laws of The Commonwealth of Massachusetts on December 30, 1987.

8.2, 8.3, and 8.4. Investment Objectives and Policies, Risk Factors and Other Policies:

### INVESTMENT OBJECTIVE AND POLICIES

The Trust's investment objective is to preserve capital and provide high current income. The investment objective and policies of the Trust may, unless otherwise specifically stated, be changed by the Trustees of the Trust without a vote of the shareholders. A change in a Trust's objective may result in the Trust having an investment objective different from the objective which the shareholder considered appropriate at the time of investment in the Trust. The Trust will attempt to achieve this objective by investing in obligations issued or guaranteed by the U.S. Government, its agencies, authorities or instrumentalities ("U.S. Government Securities") and in obligations issued or guaranteed by a foreign government or any of its political subdivisions, authorities, agencies or instrumentalities, which are not traded on a U.S. exchange ("Foreign Government Securities"). The Trust will maintain an average weighted portfolio maturity of approximately seven years or less and will invest substantially all of its assets in securities with remaining maturities less than or equal to ten years. Equivalent maturities are utilized with respect to certain securities, including Government Agencies. Under normal market conditions, at least 65% of the Fund's total assets will be invested in income producing securities. Under normal market conditions, the Trust's average weighted portfolio maturity will not be less than three years. Contractual rights to dispose of a security will be considered in calculating average maturity, because such rights limit the period during which the Trust bears a market risk with respect to the security. The investment adviser, Massachusetts Financial Services Company, a Delaware corporation ("MFS" or "Investment Adviser") believes that this strategy will enable the Trust to preserve capital while seeking high current income. Shorter term U.S. and Foreign Government Securities generally are more stable and less susceptible to principal loss than longer term securities. While shorter term securities in most cases offer lower yields than securities with longer maturities, the Trust may seek to enhance income by writing options on U.S. and Foreign Government Securities. Option writing can result in the loss of principal under certain market conditions. Although the percentage of the Trust's assets invested in Foreign Government

2

Securities will vary depending on the state of the economies of the principal countries around the world, their financial markets and the relationship of their currencies to the U.S. dollar, under normal conditions the Trust's portfolio is expected to be globally diversified. See "Special Considerations" below. There can be no assurance that the Trust will achieve its investment objective.

For purposes of the foregoing investment policy, securities having a certain maturity will be deemed to include securities with an equivalent "duration" of such securities. "Duration" is a commonly used measure of the longevity of a debt instrument that takes into account the full stream of payments received on a debt instrument, including both interest and principal payments, based on their present values. A debt instrument's duration is derived by discounting principal and interest payments to their present value using the instrument's current yield to maturity and taking the dollar-weighted average time until those payments will be received. Contractual rights to dispose of a security, call options and prepayment assumptions may be considered in calculating

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duration and average maturity because such rights limit the period during which the Trust bears a market risk with respect to the security.

U.S. Government Securities. The U.S. Government Securities in which the Trust intends to invest include (i) U.S. Treasury obligations, which differ only in their interest rates, maturities and times of issuance: U.S. Treasury bills (maturities of one year or less), U.S. Treasury notes (maturities of one to 10 years), and U.S. Treasury bonds (generally original maturities of greater than 10 years), all of which are backed by the full faith and credit of the United States; (ii) obligations issued or guaranteed by U.S. Government agencies, authorities or instrumentalities, some of which are backed by the full faith and credit of the U.S. Treasury, e.g., direct pass-through certificates of the Government National Mortgage Association ("GNMA"); some of which are supported by the right of the issuer to borrow from the U.S. Government, e.g., obligations of Federal Home Loan Banks; and some of which are backed only by the credit of the issuer itself, e.g., obligations of the Federal National Mortgage Association ("FNMA"); and (iii) interests in trusts or other entities representing interests in obligations that are issued and guaranteed by the U.S. Government, its agencies, authorities or instrumentalities. For a description of obligations issued or guaranteed by U.S. Government agencies or instrumentalities, see "Description of Obligations Issued or Guaranteed by U.S. Government Agencies or Instrumentalities" below.

Some U.S. Government Securities do not generally involve the credit risks associated with other types of interest bearing securities, although, as a result, the yields available from U.S. Government Securities are generally lower than the yields available from other interest bearing securities. Like other interest bearing securities, however, the values of U.S. Government Securities change as interest rates fluctuate. Shorter-term U.S. and Foreign Government Securities generally are more stable and less susceptible to principal loss than longer-term securities.

Foreign Government Securities. The Trust may invest up to 50% of its net assets in Foreign Government Securities, including up to 20% of the Trust's net assets in securities of government, government-related, and supranational issuers located, or primarily conducting their business, in emerging markets (see "Emerging Markets Securities" below). Up to 10% of the Trust's net assets may be invested in non-convertible fixed income securities rated BB or lower by Standard & Poor's Ratings Services, Inc. ("S&P"), Fitch IBCA, Inc. ("Fitch") and Duff & Phelps Credit Rating Co ("Duff & Phelps") or Ba or lower by Moody's Investors Service, Inc. ("Moody's") or, if unrated, will be determined by the Adviser to be comparable quality (commonly referred to as "junk

bonds"). The percentage of the Trust's assets invested in Foreign Government Securities will vary depending on the relative yields of such securities, the economies of the countries in which the investments are made and such countries' financial markets, the interest rate climate of such countries and the relationship of such countries' currencies to the U.S. dollar.

Investments in Foreign Government Securities and currency will be evaluated on the basis of fundamental economic criteria (e.g., relative inflation levels and trends, growth rate forecasts, balance of payments status, and economic policies) as well as technical and political data. In addition to the foregoing, interest rates are evaluated on the basis of differentials or anomalies that may exist between different countries. The Trust's portfolio, under normal conditions, will include securities of a number of foreign countries. The

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Foreign Government Securities in which the Trust intends to invest will generally consist of obligations supported by national, state or provincial governments or similar political subdivisions. The Trust may hold foreign currency for hedging purposes to protect against declines in the U.S. dollar value of foreign securities held by the Trust and against increases in the U.S. dollar value of the foreign securities which the Trust might purchase. The Trust may also hold foreign currency for non-hedging purposes.

Consistent with the Fund's investment objective and policies, the Trust may also invest in fixed income securities of corporate issuers.

Brady Bonds. The Trust may invest in Brady Bonds, which are securities created through the exchange of existing commercial bank loans to public and private entities in certain emerging markets for new bonds in connection with debt restructurings under a debt restructuring plan introduced by former U.S. Secretary of the Treasury, Nicholas F. Brady (the "Brady Plan"). Brady Plan debt restructurings have been implemented to date in Argentina, Brazil, Bulgaria, Costa Rica, Croatia, the Dominican Republic, Ecuador, Jordan, Mexico, Morocco, Nigeria, Panama, Peru, the Philippines, Poland, Slovenia, Uruguay and Venezuela. Brady Bonds have been issued only recently, and for that reason do not have a long payment history. Brady Bonds may be collateralized or uncollateralized, are issued in various currencies (but primarily the U.S. dollar) and are actively traded in over-the-counter secondary markets. U.S. dollar-denominated, collateralized Brady Bonds, which may be fixed-rate bonds or floating-rate bonds, are generally collateralized in full as to principal by U.S. Treasury zero coupon bonds having the same maturity as the bonds. Brady Bonds are often viewed as having three or four valuation components: the collateralized repayment of principal at final maturity; the collateralized interest payments; the uncollateralized interest payments; and any uncollateralized repayment of principal at maturity (these uncollateralized amounts constituting the "residual risk"). In light of the residual risk of Brady Bonds and the history of defaults of countries issuing Brady Bonds with respect to commercial bank loans by public and private entities, investments in Brady Bonds may be viewed as speculative.

American Depositary Receipts. The Trust may invest in American Depositary Receipts ("ADRs") which are certificates issued by a U.S. depository (usually a bank) and represent a specified quantity of shares of an underlying non-U.S. stock on deposit with a custodian bank as collateral. ADRs may be sponsored or unsponsored. A sponsored ADR is issued by a depository which has an exclusive relationship with the issuer of the underlying security. An unsponsored ADR may be issued by any number of U.S. depositories. Under the terms of most sponsored arrangements, depositories agree to distribute notices of shareholder meetings and voting instructions, and to provide shareholder communications and other information to the ADR holders at the request of the issuer of the deposited securities. The depository of an unsponsored ADR, on the other hand, is under no obligation to distribute shareholder communications received from the issuer of

the deposited securities or to pass through voting rights to ADR holders in respect of the deposited securities. The Trust may invest in either type of ADR. Although the U.S. investor holds a substitute receipt of ownership rather than direct stock certificates, the use of the depository receipts in the United States can reduce costs and delays as well as potential currency exchange and other difficulties. The Trust may purchase securities in local markets and direct delivery of these ordinary shares to the local depository of an ADR agent bank in the foreign country. Simultaneously, the ADR agents create a certificate which settles at the Trust's custodian in five days. The Trust may also execute trades on the U.S. markets using existing ADRs. A foreign issuer of the security

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underlying an ADR is generally not subject to the same reporting requirements in the United States as a domestic issuer. Accordingly the information available to a U.S. investor will be limited to the information the foreign issuer is required to disclose in its own country and the market value of an ADR may not reflect undisclosed material information concerning the issuer of the underlying security. ADRs may also be subject to exchange rate risks if the underlying foreign securities are traded in foreign currency.

**Emerging Market Securities.** Emerging markets in which the Trust may invest include countries or regions with relatively low gross national product per capita compared to the world's major economies, and in countries or regions with the potential for rapid economic growth. Emerging markets will include any country: (i) having an "emerging stock market" as defined by the International Finance Corporation; (ii) with low-to middle-income economies according to the International Bank for Reconstruction and Development (the "World Bank"); (iii) listed in World Bank publications as developing, or (iv) determined by the Adviser to be an emerging market as defined above.

**Other Investments.** When the Investment Adviser believes that investing for defensive purposes is appropriate, such as during periods of unusual market conditions, part or all of the Trust's assets may be temporarily invested in cash (including foreign currency) or cash equivalent short-term obligations including, but not limited to, certificates of deposit, commercial paper, notes, U.S. Government Securities, Foreign Government Securities and repurchase agreements. The Trust may also invest in similar instruments when relative yields are attractive, provided that it adheres to the 65% policy stated below.

The investment objective and policies described above may be changed without shareholder approval, except that, as a fundamental policy, at least 65% of the Trust's assets under normal circumstances will be invested in U.S. and Foreign Government Securities. This fundamental policy may not be changed without the approval of the holders of a majority of the Trust's shares (as defined below under "Investment Restrictions").

**Lower-Rated Fixed Income Securities.** The Trust may invest in lower-rated fixed income securities. No minimum rating standard is required by the Trust. These securities are considered speculative and, while generally providing greater income than investments in higher rated securities, will involve greater risk of principal and income (including the possibility of default or bankruptcy of the issuers of such securities) and may involve greater volatility of price (especially during periods of economic uncertainty or change) than securities in the higher rating categories. However, since yields vary over time, no specific level of income can ever be assured). These lower-rated high yielding fixed income securities generally tend to be reflect economic changes,

5

short-term corporate and industry developments to a greater extent than higher rated securities, which react primarily to fluctuations in the general level of interest rates (although these lower-rated fixed income securities are also affected by changes in interest rates, the market's perception of their credit quality, and the outlook for economic growth). In the past, economic downturns or an increase in interest rates have, under certain circumstances, caused a higher incidence of default by the issuers of these securities and may do so in the future, especially in the case of highly leveraged issuers. During certain periods, the higher yields on the Trust's lower-rated high yielding fixed income securities are paid primarily because of the increased risk of loss of principal and income, arising from such factors as the heightened possibility of default or bankruptcy of the issuers of such securities. Due to the fixed income payments of these securities, the Trust may continue to earn the same level of

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interest income while its net asset value declines due to portfolio losses, which could result in an increase in the Trust's yield despite the actual loss of principal. The market for these lower-rated fixed income securities may be less liquid than the market for investment grade fixed income securities, and judgment may at time play a greater role in valuing these securities than in the case of investment grade fixed income securities. Changes in the value of securities subsequent to their acquisition will not affect cash income or yield to the Trust but will be reflected in the net asset value of shares of the Trust.

While the Adviser may refer to ratings issued by established credit rating agencies, it is not the Trust's policy to rely exclusively on ratings issued by these rating agencies, but rather to supplement such ratings with the Adviser's own independent and ongoing review of credit quality. The Trust's achievement of its investment objective may be more dependent on the Adviser's own credit analysis than in the case of an investment company primarily investing in higher quality fixed income securities. For a description of these and other rating categories, see "Description of Bond Ratings" below.

### INVESTMENT PRACTICES

The following investment practices apply to the portfolio investments of the Trust. These practices may be changed without shareholder approval.

**Options on U.S. and Foreign Government Securities.** The Trust may write covered put and call options and purchase put and call options on U.S. and Foreign Government Securities that are traded on United States and foreign securities exchanges and over-the-counter. This practice may result in the loss of principal under certain market conditions. Other than the requirement that options written on U.S. and Foreign Government Securities be covered, there are no limitations on the use of such options. For a further discussion of the use, risks and costs of options trading, see "Options and Futures" below.

**Futures Contracts and Options on Futures Contracts.** The Trust may enter into contracts for the purchase or sale for future delivery of fixed income securities or foreign currencies, or contracts based on financial indices including any index of U.S. or Foreign Government Securities ("Futures Contracts") and may purchase and write options to buy or sell Futures Contracts ("Options on Futures Contracts"). Futures Contracts and Options on Futures Contracts to be written or purchased by the Trust will be traded on U.S. or foreign exchanges. These investment techniques are designed only to hedge against anticipated future changes in interest or exchange rates which otherwise might either adversely affect the value of the Trust's portfolio securities or

6

adversely affect the prices of securities which the Trust intends to purchase at a later date. Should interest or exchange rates move in an unexpected manner, the Trust may not achieve the anticipated benefits of Futures Contracts or Options on Futures Contracts or may realize a loss. For further discussion of the use, risks and costs of Futures Contracts and Options on Futures Contracts, see "Options and Futures" below.

**Options on Foreign Currencies.** The Trust may purchase and write put and call options on foreign currencies for the purpose of protecting against declines in the dollar value of foreign portfolio securities and against increases in the dollar cost of foreign securities to be acquired. As in the case of other kinds of options, however, the writing of an option on foreign currency will constitute only a partial hedge, up to the amount of the premium received, and

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the Trust could be required to purchase or sell foreign currencies at disadvantageous exchange rates, thereby incurring losses. The purchase of an option on foreign currency may constitute an effective hedge against fluctuations in exchange rates although, in the event of rate movements adverse to the Trust's position, it may forfeit the entire amount of the premium plus related transaction costs. Options on foreign currencies to be written or purchased by the Trust will be traded on U.S. or foreign exchanges or over-the-counter. Other than the requirement that options written on foreign currencies only be used for hedging purposes, there are no limitations on the use of such options. For further discussion of the use, risks and costs of options on foreign currencies, see "Options and Futures" below.

Forward Foreign Currency Exchange Contracts. The Trust may enter into forward foreign currency exchange contracts for the purchase or sale of a specific currency at a future date at a price set at the time of the contract (a "Forward Contract"). The Trust will enter into Forward Contracts for hedging purposes as well as for non-hedging purposes. Transactions in Forward Contracts entered into for hedging purposes will include forward purchases or sales of foreign currencies for the purpose of protecting the dollar value of securities denominated in a foreign currency or protecting the dollar equivalent of interest or dividends to be paid on such securities. The Trust may also enter into a Forward Contract on one currency in order to hedge against risk of loss arising from fluctuations in the value of a second currency (referred to as a "cross hedge") if, in the judgment of the Adviser, a reasonable degree of correlation can be expected between movements in the values of the two currencies. By entering into such transactions, however, the Trust may be required to forego the benefits of advantageous changes in exchange rates. The Trust may also enter into transactions in Forward Contracts for other than hedging purposes. For example, if the Investment Adviser expects that the value of a particular foreign currency will increase or decrease relative to the value of the U.S. dollar, the Trust may purchase or sell such currency, respectively, through a Forward Contract. If the expected changes in the value of the currency occur, the Trust will realize profits which will increase its gross income. Where exchange rates do not move in the direction or to the extent anticipated, however, the Trust may sustain losses which will reduce its gross income. Such transactions could involve significant risk of loss.

The Trust has established procedures consistent with the General Statement of Policy of the Securities and Exchange Commission (the "SEC") and its staff regarding the use of Forward Contracts by registered investment companies which require the use of segregated assets or "cover" in connection with the purchase and sale of such contracts. In those instances in which the Trust satisfies this requirement through segregation of assets, it will segregate liquid assets, which will be marked to market on a daily basis, in an amount equal to the value of its

7

commitments under Forward Contracts entered into by the Trust. While these contracts are not presently regulated by the Commodity Futures Trading Commission ("CFTC"), the CFTC may in the future assert authority to regulate Forward Contracts. In such event, the Trust's ability to utilize Forward Contracts in the manner set forth above may be restricted.

Zero Coupon Bonds. U.S. and Foreign Government Securities in which the Trust may invest also include zero coupon bonds. Zero coupon bonds are debt obligations which are issued at a significant discount from face value and do not require the periodic payment of interest. The discount approximates the total amount of interest the bonds will accrue and compound over the period until maturity or the first interest payment date at a rate of interest reflecting the market rate

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of the security at the time of issuance. Zero coupon bonds benefit the issuer by mitigating its need for cash to meet debt service, but also require a higher rate of return to attract investors who are willing to defer receipt of such cash. Such investments may experience greater volatility in market value than debt obligations which make regular payments of interest. The Trust will accrue income on such investments for tax and accounting purposes, which is distributable to shareholders and which, because no cash is received at the time of accrual, may require the liquidation of other portfolio securities to satisfy the Trust's distribution obligations.

Collateralized Mortgage Obligations. The Trust may invest a portion of its assets in collateralized mortgage obligations or "CMOs", which are debt obligations collateralized by mortgage loans or mortgage pass-through securities which, in the case of U.S. Government Securities, are issued or guaranteed by the U.S. Government, its agencies, authorities or instrumentalities. Typically, CMOs are collateralized by certificates issued by GNMA, FNMA or the Federal Home Loan Mortgage Corporation (such collateral collectively hereinafter referred to as "Mortgage Assets"). Payments of principal and interest on the Mortgage Assets, and any reinvestment income thereon, provide the funds to pay debt service on the CMOs. CMOs may be issued by agencies or instrumentalities of the U.S. or foreign governments or by private originators of, or investors in, mortgage loans, including savings and loan associations, mortgage banks, commercial banks, investment banks and special purpose subsidiaries of the foregoing.

In a CMO, a series of bonds or certificates may be issued in multiple classes. Each class of CMOs, often referred to as a "tranche", is issued at a specific fixed or floating coupon rate and has a stated maturity or final distribution date. Principal prepayments on the Mortgage Assets may cause the CMOs to be retired substantially earlier than their stated maturities or final distribution dates resulting in a loss of all or part of the premium if any has been paid. Interest is paid or accrued on all classes of the CMOs on a monthly, quarterly or semi-annual basis. The principal of and interest on the Mortgage Assets may be allocated among the several classes of a series of a CMO in innumerable ways. In a common structure, payments of principal, including any principal prepayments, on the Mortgage Assets are applied to the classes of the series of a CMO in the order of their respective stated maturities or final distribution dates, so that no payment of principal will be made on any class of CMOs until all other classes having an earlier stated maturity or final distribution date have been paid in full. Certain CMOs may be stripped (securities which provide only the principal or interest factor of the underlying security). See "Stripped Mortgage-Backed Securities" below for a discussion of the risks of investing in these stripped securities and of investing in classes consisting primarily of interest payments or principal payments.

The Trust may also invest in parallel pay CMOs and Planned Amortization Class CMOs ("PAC Bonds"). Parallel pay CMOs are structured to provide payments of principal on each payment date to

more than one class. These simultaneous payments are taken into account in calculating the stated maturity date or final distribution date of each class, which, as with other CMO structures, must be retired by its stated maturity date or final distribution date but may be retired earlier. PAC Bonds generally require payments of a specified amount of principal on each payment date. PAC Bonds are always parallel pay CMOs with the required principal payment on such securities having the highest priority after interest has been paid to all classes.



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Indexed Securities. The Trust may purchase securities whose prices are indexed to the prices of other securities, securities indices, currencies, precious metals or other commodities, or other financial indicators. Indexed securities typically, but not always, are debt securities or deposits whose value at maturity (i.e., principal value) or coupon rate is determined by reference to a specific instrument or statistic. Gold-indexed securities, for example, typically provide for a maturity value that depends on the price of gold, resulting in a security whose price tends to rise and fall together with gold prices. Currency-indexed securities typically are short-term to intermediate-term debt securities whose maturity values or interest rates are determined by references to the values of one or more specified foreign currencies, and may offer higher yields than U.S. dollar-denominated securities of equivalent issuers. Currency-indexed securities may be positively or negatively indexed; that is, their maturity value or interest rates may increase when the specified currency value increases, resulting in a security that performs similarly to a foreign-denominated instrument, or their maturity value may decline when foreign currencies increase, resulting in a security whose price characteristics are similar to a put on the underlying currency and could involve the loss of all or a portion of the principal amount of or interest on the instrument. Currency-indexed securities may also have prices that depend on the values of a number of different foreign currencies relative to each other.

The performance of indexed securities depends to a great extent on the performance of the security, currency, or other instrument to which they are indexed, and may also be influenced by interest rate changes in the U.S. and abroad. At the same time, indexed securities are subject to the credit risks associated with the issuer of the security, and their values may decline substantially if the issuer's creditworthiness deteriorates. Recent issuers of indexed securities have included banks, corporations, and certain U.S. government agencies.

Inverse Floating Rate Obligations. The Trust may invest in so-called "inverse floating rate obligations" or "residual interest" bonds or other obligations or certificates relating thereto structured to have similar features. Such obligations generally have floating or variable interest rates that move in the opposite direction of short-term interest rates and generally increase or decrease in value in response to changes in short-term interest rates at a rate which is a multiple of the rate at which fixed-rate long-term securities increase or decrease in response to such changes. As a result, such obligations have the effect of providing investment leverage and may be more volatile than long-term fixed-rate obligations.

Mortgage "Dollar Roll" Transactions. The Trust may enter into mortgage "dollar roll" transactions with selected banks and broker-dealers pursuant to which the Trust sells mortgage-backed securities for delivery in the future (generally within 30 days) and simultaneously contracts to repurchase substantially similar (same type, coupon and maturity) securities on a specified future date. The Trust records these transactions as sale and purchase transactions rather than as borrowing transactions. The Trust will only enter into covered rolls. A "covered roll" is a specific type of "dollar roll" for which there is an offsetting cash position or

a cash equivalent security position which matures on or before the forward settlement date of the "dollar roll" transaction. During the roll period, the Trust foregoes principal and interest paid on the mortgage-backed securities.

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The Trust is compensated for the lost interest by the difference between the current sales price and the lower price for the future purchase (often referred to as the "drop") as well as by the interest earned on the cash proceeds of the initial sale. The Trust may also be compensated by receipt of a commitment fee.

Stripped Mortgage-Backed Securities. The Trust may invest a portion of its assets in stripped mortgage-backed securities ("SMBS"), which are derivative multi-class mortgage securities issued by agencies or instrumentalities of the U.S. Government, or by private originators of, or investors in, mortgage loans, including savings and loan associations, mortgage banks, commercial banks and investment banks.

SMBS are usually structured with two classes that receive different proportions of the interest and principal distributions from a pool of mortgage assets. A common type of SMBS will have one class receiving some of the interest and most of the principal from the Mortgage Assets, while the other class will receive most of the interest and the remainder of the principal. In the most extreme case, one class will receive all of the interest (the interest-only or "IO" class) while the other class will receive all of the principal (the principal-only or "PO" class). The yield to maturity on an IO is extremely sensitive to the rate of principal payments (including prepayments) on the related underlying Mortgage Assets, and a rapid rate of principal payments may have a material adverse effect on such security's yield to maturity. If the underlying Mortgage Assets experience greater than anticipated prepayments of principal, the Trust may fail to fully recoup its initial investment in these securities. The market value of the class consisting primarily or entirely of principal payments may be unusually volatile in response to changes in interest rates.

Swaps and Related Transactions. As one way of managing its exposure to different types of investments, the Trust may enter into interest rate swaps, currency swaps or structures with embedded swaps and other types of available swap agreements, such as caps, collars and floors. Swaps involve the exchange by the Trust with another party of cash payments based upon different interest rate indexes, currencies, and other prices or rates such as the value of mortgage prepayment rates. For example, in the typical interest rate swap, the Trust might exchange a sequence of cash payments based on a floating rate index for cash payments based on a fixed rate. Payments made by both parties to a swap transaction are based on a notional principal amount determined by the parties.

The Trust may also purchase and sell caps, floors and collars. In a typical cap or floor agreement, one party agrees to make payments only under specified circumstances, usually in return for payment of a fee by the counterparty. For example, the purchase of an interest rate cap entitles the buyer, to the extent that a specified index exceeds a predetermined interest rate, to receive payments of interest on a contractually-based principal amount from the counterparty selling such interest rate cap. The sale of an interest rate floor obligates the seller to make payments to the extent that a specified interest rate falls below an agreed-upon level. A collar arrangement combines elements of buying a cap and selling a floor.

Swap agreements could be used to shift a Fund's investment exposure from one type of investment to another. For example, if a Fund agreed to exchange payments in dollars for payments in foreign currency, in each case based on a fixed rate, the swap agreement would tend to decrease a Fund's

exposure to U.S. interest rates and increase its exposure to foreign currency and interest rates. Caps and floors have an effect similar to buying or writing

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options. Depending on how they are used, swap agreements may increase or decrease the overall volatility of a Fund's investments and its share price and yield.

Swap agreements are sophisticated hedging instruments that typically involve a small investment of cash relative to the magnitude of risks assumed, or no investment of cash. As a result, swaps can be highly volatile and may have a considerable impact on the Trust's performance. Swap agreements are subject to risks related to the counterparty's ability to perform, and may decline in value if the counterparty's creditworthiness deteriorates. The Trust may also suffer losses if it is unable to terminate outstanding swap agreements or reduce its exposure through offsetting transactions.

Swaps, caps, floors and collars are highly specialized activities which involve certain risks. Swap agreements may be individually negotiated and structured to include exposure to a variety of different types of investments or market factors. Depending on their structure, swap agreements may increase or decrease the Trust's exposure to long or short-term interest rates (in the U.S. or abroad), foreign currency values, mortgage securities, corporate borrowing rates, or other factors such as securities prices or inflation rates. Swap agreements can take many different forms and are known by a variety of names. The Trust is not limited to any particular form or variety of swap agreements if MFS determines it is consistent with the Trust's investment objective and policies.

The Trust will maintain liquid assets to cover its current obligations under swap transactions. If the Trust enters into a swap agreement on a net basis (i.e., the two payment streams are netted out, with the Trust receiving or paying, as the case may be, only the net amount of the two payments), the Trust will maintain liquid assets with a daily value at least equal to the excess, if any, of the Trust's accrued obligations under the swap agreement over the accrued amount the Trust is entitled to receive under the agreement. If the Trust enters into a swap agreement on other than a net basis, it will maintain liquid assets with a value equal to the full amount of the Trust's accrued obligations under the agreement.

The most significant factor in the performance of swaps, caps, floors and collars is the change in the specific interest rate, currency or other factor that determines the amount of payments to be made under the arrangement. If MFS is incorrect in its forecasts of such factors, the investment performance of the Trust would be less than what it would have been if these investment techniques had not been used. If a swap agreement calls for payments by the Trust, the Trust must be prepared to make such payments when due. In addition, if the counterparty's creditworthiness declines, the value of the swap agreement would be likely to decline, potentially resulting in losses. If the counterparty defaults, the Trust's risk of loss consists of the net amount of payments that the Trust is contractually entitled to receive. The Trust anticipates that it will be able to eliminate or reduce its exposure under these arrangements by assignment or other disposition or by entering into an offsetting agreement with the same or another counterparty.

Yield Curve Options. The Trust may also enter into options on the "spread", or differential, between two U.S. or Foreign Government Securities, in a transaction referred to as a

"yield curve" option. In contrast to other types of options, a yield curve option is based on the difference between the yields of designated U.S. or Foreign Government Securities, rather than the prices of the individual

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securities, and is usually settled through cash payments. Accordingly, a yield curve option is profitable to the holder if this differential widens (in the case of a call) or narrows (in the case of a put), regardless of whether the yields of the underlying securities increase or decrease.

Yield curve options may be used for the same purposes as other options on securities. Specifically, the Trust may purchase or write such options in order to protect against the adverse effects of a potential widening or narrowing of the spreads between U.S. or Foreign Government Securities, or other interest rate sensitive instruments, held in the Trust's portfolio. The Trust may also purchase or write yield curve options for other than hedging purposes if, in the judgment of the Adviser, the Trust will be able to profit from movements in the spread between the yields of the underlying U.S. or Foreign Government Securities. The trading of yield curve options is subject to all of the risks associated with the trading of other types of options. In addition, however, such options present risk of loss even if the yield of one of the underlying securities remains constant, if the spread moves in a direction or to an extent which was not anticipated. Yield curve options written by the Trust will be covered. A call (or put) option is covered if the Trust holds another call (or put) option on the spread between the same two securities and segregates liquid assets sufficient to cover the Trust's net liability under the two options. Yield curve options may also be covered in such other manner as may be in accordance with the requirements of the counterparty with which the option is traded and applicable laws and regulations. Yield curve options are traded over-the-counter and, because they have been only recently introduced, established trading markets for these securities have not yet developed. Because these securities are traded over-the-counter, the SEC has taken the position that yield curve options are illiquid, and, therefore, cannot exceed the SEC illiquidity ceiling.

"Reset Options". In certain instances, the Trust may enter into options on Treasury securities which provide for periodic adjustment of the premium during the term of each such option. Like other types of options, these transactions, which may be referred to as "reset options" or "adjustable strike options", grant the purchaser the right to purchase (in the case of a call) or sell (in the case of a put), a specified type and series of U.S. Treasury security at any time up to a stated expiration date (or, in certain instances, on such date). In contrast to other types of options, however, the price at which the underlying security may be purchased or sold under a "reset option" is determined at various intervals during the term of the option, and such price fluctuates from interval to interval based on changes in the market value of the underlying security. As a result, the strike price of a "reset option", at the time of exercise, may be less advantageous to the Trust than if the strike price had been fixed at the initiation of the option. In addition, the premium paid for the purchase of the option may be determined at the termination, rather than the initiation, of the option. If the premium is paid at termination, the Trust assumes the risk that (i) the premium may be less than the premium which would otherwise have been received at the initiation of the option because of such factors as the volatility in yield of the underlying Treasury security over the term of the option and adjustments made to the strike price of the option, and (ii) the option purchaser may default on its obligation to pay the premium at the termination of the option.

Lending of Portfolio Securities. The Trust may seek to increase its income by lending portfolio securities to the extent consistent with present regulatory policies, including those of the Board of Governors of the Federal Reserve System and the SEC. Such loans will usually be made only

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to member banks of the Federal Reserve System and member firms (and subsidiaries thereof) of a national securities exchange ("Exchange"), and would be required to be secured continuously by collateral, including cash, or U.S. Government Securities, an irrevocable letter of credit or other collateral permissible under SEC policies and maintained on a current basis at an amount at least equal to the market value of the securities loaned. The Trust would have the right to call a loan and obtain the securities loaned at any time on customary industry settlement notice (which will usually not exceed five days). For the duration of a loan, the Trust would continue to receive the equivalent of the interest or dividends paid by the issuer on the securities loaned. The Trust would also receive a fee from the borrower. The Trust would also receive compensation from the investment of the collateral), less a fee paid to the borrower, if the collateral is in the form of cash. . The Trust would not, however, have the right to vote any securities having voting rights during the existence of the loan, but the Trust would call the loan in anticipation of an important vote to be taken among holders of the securities or of the giving or withholding of their consent on a material matter affecting the investment. As with other extensions of credit, there are risks of delay in recovery or even loss of rights in the collateral should the borrower of the securities fail financially. However, the loans would be made only to firms deemed by the Investment Adviser to be of good standing, and when, in the judgment of the Investment Adviser, the consideration which can be earned currently from securities loans of this type justified the attendant risk. If the Investment Adviser determines to make securities loans, it is intended that the value of the securities loaned would not exceed 30% of the value of the Trust's total assets.

"When-Issued Securities". Securities may be purchased on a "when-issued" or on a "forward delivery" basis, which means that the obligations will be delivered at a future date beyond customary settlement time. The commitment to purchase a security for which payment will be made on a future date may be deemed a separate security. Although the Trust is not limited to the amount of securities for which it may have commitments to purchase on such basis, it is expected that under normal circumstances, the Trust will not commit more than 30% of its assets to such purchases. The Trust does not pay for the securities until received or start earning interest on them until the contractual settlement date. While awaiting delivery of securities purchased on such bases, the Trust will segregate liquid assets sufficient to cover its commitments. Although the Trust does not intend to make such purchases for speculative purposes, purchases on such bases may involve more risk than other types of purchases.

When the Trust commits to purchase a security on a "when-issued" or "forward delivery" basis, it will segregate liquid assets consistent with the General Statement of Policy of the SEC described in "Forward Foreign Currency Exchange Contracts" above, concerning such purchases. However, although the Trust does not intend to make such purchases for speculative purposes and intends to adhere to the provisions of the SEC policy, purchases of securities on such basis may involve more risk than other types of purchases. For example, if the Trust determines it is necessary to sell the "when-issued" or "forward delivery" securities before delivery, it may incur a gain or a loss because of market fluctuations since the time the commitment to purchase such securities was made. Purchasing securities on a when-issued basis involves a risk that the yields available in the market when delivery takes place may be higher than yields on the securities purchased.

Repurchase Agreements. The Trust may enter into repurchase agreements in order to earn income on available cash or as a temporary defensive measure. Under a repurchase agreement,

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the Trust acquires securities subject to the seller's agreement to repurchase at a specified time and price. If the seller becomes subject to a proceeding under the bankruptcy laws or its assets are otherwise subject to a stay order, the Trust's right to liquidate the securities may be restricted (during which time the value of the securities could decline).

The Trust may enter into repurchase agreements with sellers who are member firms, or a subsidiary thereof, of an Exchange or members of the Federal Reserve System, recognized primary U.S. Government Securities dealers or institutions which the Adviser has determined to be of comparable creditworthiness. The securities that the Trust purchases and holds through its agent are U.S. Government Securities, the values of which are equal to or greater than the repurchase price agreed to be paid by the seller. The repurchase price may be higher than the purchase price, the difference being income to the Trust, or the purchase and repurchase prices may be the same, with interest at a standard rate due to the Trust together with the repurchase price on repurchase. In either case, the income to the Trust is unrelated to the interest rate on U.S. Government Securities.

The repurchase agreement provides that in the event the seller fails to pay the amount agreed upon on the agreed upon delivery date or upon demand, as the case may be, the Trust will have the right to liquidate the securities. If at the time the Trust is contractually entitled to exercise its right to liquidate the securities, the seller is subject to a proceeding under the bankruptcy laws or its assets are otherwise subject to a stay order, the Trust's exercise of its right to liquidate the securities may be delayed and result in certain losses and costs to the Trust. The Trust has adopted and follows procedures which are intended to minimize the risks of repurchase agreements. For example, the Trust only enters into repurchase agreements after the Adviser has determined that the seller is creditworthy, and the Adviser monitors the seller's creditworthiness on an ongoing basis. Moreover, under such agreements, the value of the securities (which are marked to market every business day) is required to be greater than the repurchase price, and the Trust has the right to make margin calls at any time if the value of the securities falls below the agreed upon collateral. For additional information concerning repurchase agreements, see "Investment Restrictions" below.

Securities Purchased at a Discount. When and if available, fixed income securities may be purchased at a market discount from face value. However, the Trust does not intend to hold such securities to maturity for the purpose of achieving potential capital gains, unless current yields on these securities remain attractive.

### OPTIONS AND FUTURES

Options on U.S. and Foreign Government Securities. The Trust intends to write covered put and call options and purchase put and call options on U.S. and Foreign Government Securities that are traded on United States and foreign securities exchange and over-the-counter.

Call options written by the Trust give the holder the right to buy the underlying securities from the Trust at a stated exercise price; put options written by the Trust give the holder the right to sell the underlying security to the Trust at a stated exercise price. A call option written by the Trust is "covered" if the Trust owns the security covered by the call or has an absolute and immediate right to acquire that security without additional

cash consideration) upon conversion or exchange of other securities held in its portfolio. A call option is also covered if the Trust holds a call on the same security and in the same principal amount as the call written where the exercise price of the call held is (a) equal to or less than the exercise price of the call written or (b) liquid assets representing greater than the exercise price of the call written if the difference is segregated by the Trust. . A put option written by the Trust is "covered" if the Trust segregates liquid assets with a value equal to the exercise price , or else holds a put on the same security and in the same principal amount as the put written where the exercise price of the put held is (a) equal to or greater than the exercise price of the put written or (b) less than the exercise price of the put written if the difference is segregated by the Trust . The premium paid by the purchaser of an option will reflect, among other things, the relationship of the exercise price to the market price and volatility of the underlying security, the remaining term of the option, supply and demand and interest rates. Put and call options may also be covered in such other manner as may be in accordance with the requirements of the exchange on which, or the counterparty with which, the option is traded and applicable rules and regulations.

The writer of an option may have no control over when the underlying securities must be sold, in the case of a call option or purchased, in the case of a put option, since with regard to certain options, the writer may be assigned an exercise notice at any time prior to the termination of the obligation. Whether or not an option expires unexercised, the writer retains the amount of the premium. This amount, of course, may, in the case of a covered call option, be offset by a decline in the market value of the underlying security during the option period. If a call option is exercised, the writer experiences a profit or loss from the sale of the underlying security. If a put option is exercised, the writer must fulfill the obligation to purchase the underlying security at the exercise price, which will usually exceed the then-market value of the underlying security. Even if an option is exercised, the writer retains the amount of the premium.

The writer of an option that wishes to terminate its obligation may effect a "closing purchase transaction." This is accomplished by buying an option of the same series as the option previously written. The effect of the purchase is that the writer's position will be canceled by the clearing corporation. However, a writer may not effect a closing purchase transaction after being notified of the exercise of an option. Likewise, an investor who is the holder of an option may liquidate its position by effecting a "closing sale transaction". This is accomplished by selling an option of the same series as the option previously purchased. There is no guarantee that either a closing purchase or a closing sale transaction can be effected.

Effecting a closing transaction in the case of a written call option will permit the Trust to write another call option on the underlying security with either a different exercise price or expiration date or both, or in the case of a written put option will permit the Trust to write another put option to the extent that the exercise price thereof is secured by deposited cash or short-term securities. Also, effecting a closing transaction will permit the cash or proceeds from the concurrent sale of any securities subject to the option to be used for other Trust investments. If the Trust desires to sell a particular security from its portfolio on which it has written a call option, it will effect a closing transaction prior to or concurrent with the sale of the security.

The Trust will realize a profit from a closing transaction if the price of the

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transaction is less than the premium received from writing the option or is more than the premium paid to purchase

15

the option; the Trust will realize a loss from a closing transaction if the price of the transaction is more than the premium received from writing the option or is less than the premium paid to purchase the option. Because increases in the market price of a call option will generally reflect increases in the market price of the underlying security, any loss resulting from the repurchase of a call option is likely to be offset in whole or in part by appreciation of the underlying security owned by the Trust.

An option position may be closed out only where there exists a secondary market for an option of the same series. If a secondary market does not exist, it might not be possible to effect closing transactions in particular options with the result that the Trust would have to exercise the options in order to realize any profit. If the Trust is unable to effect a closing purchase transaction in a secondary market, it will not be able to sell the underlying security until the option expires or it delivers the underlying security upon exercise. Reasons for the absence of a liquid secondary market include the following: (i) there may be insufficient trading interest in certain options; (ii) restrictions may be imposed by an Exchange on opening transactions or closing transactions or both; (iii) trading halts, suspensions or other restrictions may be imposed with respect to particular classes or series of options or underlying securities; (iv) unusual or unforeseen circumstances may interrupt normal operations on an Exchange; (v) the facilities of an Exchange or the Options Clearing Corporation may not at all times be adequate to handle current trading volume; or (vi) one or more Exchanges could, for economic or other reasons, decide or be compelled at some future date to discontinue the trading of options (or a particular class or series of options), in which event the secondary market on that Exchange (or in that class or series of options) would cease to exist, although outstanding options on that Exchange that had been issued by the Options Clearing Corporation as a result of trades on that Exchange would continue to be exercisable in accordance with their terms.

The Trust may write options in connection with buy-and-write transactions; that is, the Trust may purchase a security and then write a call option against that security. The exercise price of the call the Trust determines to write will depend upon the expected price movement of the underlying security. The exercise price of a call option may be below ("in-the-money"), equal to ("at-the-money") or above ("out-of-the-money") the current value of the underlying security at the time the option is written. Buy-and-write transactions using in-the-money call options may be used when it is expected that the price of the underlying security will remain flat or decline moderately during the option period. Buy-and-write transactions using at-the-money call options may be used when it is expected that the price of the underlying security will remain fixed or advance moderately during the option period. Buy-and-write transactions using out-of-the-money call options may be used when it is expected that the premiums received from writing the call option plus the appreciation in the market price of the underlying security up to the exercise price will be greater than the appreciation in the price of the underlying security alone. If the call options are exercised in such transactions, the Trust's maximum gain will be the premium received by it for writing the option, adjusted upwards or downwards by the difference between the Trust's purchase price of the security and the exercise price. If the options are not exercised and the price of the underlying security declines, the amount of such decline will be offset in part, or entirely, by the premium received.

The writing of covered put options is similar in terms of risk/return



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characteristics to buy-and-write transactions. If the market price of the underlying security rises or otherwise is above the exercise price, the put option will expire worthless and the Trust's gain will be limited to the

16

premium received. If the market price of the underlying security declines or otherwise is below the exercise price, the Trust may elect to close the position or take delivery of the security at the exercise price and the Trust's return will be the premium received from the put option minus the amount by which the market price of the security is below the exercise price. Out-of-the-money, at-the-money, and in-the-money put options may be used by the Trust in the same market environments that call options are used in equivalent buy-and-write transactions.

The Trust may purchase put options to hedge against a decline in the value of its portfolio. By using put options in this way, the Trust will reduce any profit it might otherwise have realized in the underlying security by the amount of the premium paid for the put option and by transaction costs. The Trust, from time to time, may purchase securities such as FNMA bonds and Federal Housing Administration ("FHA") project loans which carry with them the right to sell them back to the issuer prior to the stated maturity. The Trust will consider these rights in determining the maturity of such securities.

The Trust may purchase call options to hedge against an increase in the price of U.S. or Foreign Government Securities that the Trust anticipates purchasing in the future. The premium paid for the call option plus any transaction costs will reduce the benefit, if any, realized by the Trust upon exercise of the option, and unless the price of the underlying security rises sufficiently, the option may expire worthless to the Trust.

Futures Contracts. The Trust may enter into contracts for the purchase or sale for future delivery of fixed income securities or foreign currencies, or contracts based on bonds or financial indices including any index of U.S. or Foreign Government Securities ("Futures Contracts"). A "sale" of a Futures Contract means the acquisition of a contractual obligation to deliver the securities or foreign currencies called for by the contract at a specified price on a specified date. A "purchase" of a Futures Contract means the acquisition of a contractual obligation to acquire the securities or foreign currencies called for by the contract at a specified price on a specified date. U.S. Futures Contracts have been designed by exchanges which have been designated "contracts markets" by the Commodity Futures Trading Commission ("CFTC"), and must be executed through a futures commission merchant, or brokerage firm, which is a member of the relevant contract market. Existing contract markets include the Chicago Board of Trade and International Money Market of the Chicago Mercantile Exchange. Futures Contracts trade on these markets, and, through their clearing corporations, the exchanges guarantee performance of the contracts as between the clearing members of the exchange. The Trust will enter into Futures Contracts which are based on debt securities that are backed by the full faith and credit of the U.S. Government, such as long-term U.S. Treasury Bonds, Treasury Notes and three-month U.S. Treasury Bills. The Trust may also enter into Futures Contracts which are based on non-U.S. Government bonds.

At the same time a Futures Contract is purchased or sold, the Trust must allocate cash or securities as a deposit payment ("initial deposit"). The initial deposit varies, but may be as low as 5% or less of a contract's face value. Daily thereafter, the Futures Contract is valued on a marked-to-market basis and the Trust may be required to pay or receive a "variation margin," which reflects any decline or increase in the contract's value.

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At the time of delivery of securities pursuant to such a contract, adjustments are made to recognize differences in value arising from the delivery of securities with a different interest rate from that specified in the contract. In some (but not many) cases, securities called for by a Futures Contract

17

may not have been issued when the contract was written. A Futures Contract on an index of securities provides for a cash settlement based on changes in the value of the underlying index.

Although Futures Contracts by their terms call for the actual delivery or acquisition of securities, or in the case of futures on an index of securities, a cash settlement, in most cases the contractual obligation is fulfilled before the date of the contract without having to make or take delivery of the securities. The offsetting of a contractual obligation is accomplished by buying (or selling, as the case may be) on a commodities exchange an identical Futures Contract calling for delivery in the same month. Such a transaction, which is effected through a member of an exchange, cancels the obligation to make or take delivery of the securities. Since all transactions in the futures market are made, offset or fulfilled through a clearinghouse associated with the exchange on which the contracts are traded, the Trust will incur brokerage fees when it purchases or sells Futures Contracts.

The purpose of the acquisition or sale of a Futures Contract, in the case of a portfolio, such as the portfolio of the Trust, which hold or intends to acquire long-term fixed income securities, is to attempt to protect the Trust from fluctuations in interest or foreign exchange rates without actually buying or selling long-term fixed income securities or foreign currency. For example, if the Trust owns long-term bonds, and interest rates were expected to increase, the Trust might enter into Futures Contracts for the sale of debt securities. Such a sale would have much the same effect as selling an equivalent value of the long-term bonds owned by the Trust. If interest rates did increase, the value of the debt securities in the portfolio would decline, but the value of the Futures Contracts to the Trust would increase at approximately the same rate, thereby keeping the net asset value of the Trust from declining as much as it otherwise would have. The Trust could accomplish similar results by selling bonds with long maturities and investing in bonds with short maturities when interest rates are expected to increase. However, since the futures market is more liquid than the cash market the use of Futures Contracts as an investment technique allows the Trust to maintain a defensive position without having to sell its portfolio securities.

Similarly, when it is expected that interest rates may decline, Futures Contracts may be purchased to attempt to hedge against anticipated purchases of long-term bonds at higher prices. Since the fluctuations in the value of Futures Contracts should be similar to that of long-term bonds, the Trust could take advantage of the anticipated rise in the value of long-term bonds without actually buying them until the market had stabilized. At that time, the Futures Contracts could be liquidated and the Trust could then buy long-term bonds on the cash market. To the extent the Trust enters into Futures Contracts for this purpose, the Trust will segregate liquid assets in an amount equal to the difference between the fluctuating market value of such Futures Contracts and the aggregate value of the initial and variation margin payments made by the Trust with respect to such Futures Contracts, thereby assuring the position is unleveraged.

The ordinary spreads between prices in the cash and futures markets, due to differences in the natures of those markets, are subject to distortions. First,

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all participants in the futures market are subject to initial deposit and variation margin requirements. Rather than meeting additional variation margin requirements, investors may close Futures Contracts through offsetting transactions which could distort the normal relationship between the cash and futures markets. Second, the liquidity of the futures market depends on participants entering into offsetting transactions rather than making or taking delivery. To the extent participants decide to make or take delivery, liquidity in the futures market could be reduced, thus producing distortion. Third, from the point of view of

18

speculators, the margin deposit requirements in the futures market are less onerous than margin requirements in the securities market. Therefore, increased participation by speculators in the futures market may cause temporary price distortions. Due to the possibility of distortion, a correct forecast of general interest rate trends by the Investment Adviser may still not result in a successful transaction.

In addition, Futures Contracts entail risks. Although the Trust believes that use of such contracts will benefit the Trust, if the Investment Adviser's investment judgment about the direction of interest rates is incorrect, the Trust's overall performance would be poorer than if it had not entered into any such contract. For example, if the Trust had hedged against the possibility of an increase in interest rates which would adversely affect the price of bonds held in its portfolio and interest rates decrease instead, the Trust will lose part or all of the benefit of the increased value of its bonds which it has hedged because it will have offsetting losses in its futures positions. In addition, in such situations, if the Trust has insufficient cash, it may have to sell bonds from its portfolio to meet daily variation margin requirements. Such sales of bonds may be, but will not necessarily be, at increased prices which reflect the rising market. The Trust may have to sell securities at a time when it may be disadvantageous to do so.

Options on Futures Contracts. The Trust intends to purchase and write Options on Futures Contracts for hedging purposes. The purchase of a call option on a Futures Contract is similar in some respects to the purchase of a call option on an individual security. Depending on the pricing of the option compared to either the price of the Futures Contract upon which it is based or the price of the underlying debt securities, it may or may not be less risky than ownership of the Futures Contract or underlying debt securities. As with the purchase of Futures Contracts, when the Trust is not fully invested it may purchase a call option on a Futures Contract to hedge a market advance due to declining interest rates.

The writing of a call option on a Futures Contract constitutes a partial hedge against declining prices of the security or foreign currency which is deliverable upon exercise of the Futures Contract. If the futures price at expiration of the option is below the exercise price, the Trust will retain the full amount of the option premium which provides a partial hedge against any decline that may have occurred in the Trust's portfolio holdings. The writing of a put option on a Futures Contract constitutes a partial hedge against increasing prices of the security or foreign currency which is deliverable upon exercise of the Futures Contract. If the futures price at expiration of the option is higher than the exercise price, the Trust will retain the full amount of the option premium which provides a partial hedge against any increase in the price of securities which the Trust intends to purchase. If a put or call option the Trust has written is exercised, the Trust will incur a loss which will be reduced by the amount of the premium it receives. Depending on the degree of

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correlation between changes in the value of its portfolio securities and changes in the value of its futures positions, the Trust's losses from existing options on futures may to some extent be reduced or increased by changes in the value of portfolio securities.

The purchase of a put option on a Futures Contract is similar in some respects to the purchase of protective put options on portfolio securities. For example, the Trust may purchase a put option on a Futures Contract to hedge the Trust's portfolio against the risk of rising interest rates.

19

The amount of risk the Trust assumes when it purchases an Option on a Futures Contract is the premium paid for the option plus related transaction costs, although it may be necessary to exercise the option which will result in a position in the Futures Contract. In addition to the correlation risks discussed above, the purchase of an option also entails the risk that changes in the value of the underlying Futures Contract will not be fully reflected in the value of the option purchased. The writing of an Option on a Futures Contract involves all of the risks of purchases or sales of Futures Contracts, including initial and variation margin requirements.

The Trust's ability to engage in the options and futures strategies described above will depend on the availability of liquid markets in such instruments. Therefore, no assurance can be given that the Trust will be able to utilize these instruments effectively for the purposes set forth above. Furthermore, the Trust's ability to engage in options and futures transactions may be limited by tax considerations.

Options on Futures Contracts may be covered in any such manner as may be in accordance with the requirements of the exchange on which they are traded and applicable rules and regulations.

Options on Foreign Currencies. The Trust may purchase and write options on foreign currencies for hedging purposes in a manner similar to that in which Futures Contracts on foreign currencies, or Forward Contracts, will be utilized. For example, a decline in the dollar value of a foreign currency in which portfolio securities are denominated will reduce the dollar value of such securities, even if their value in the foreign currency remains constant. In order to protect against such diminutions in the value of portfolio securities, the Trust may purchase put options on the foreign currency. If the value of the currency does decline, the Trust will have the right to sell such currency for a fixed amount in dollars and will thereby offset, in whole or in part, the adverse effect on its portfolio which otherwise would have resulted.

Conversely, where a rise in the dollar value of a currency in which securities to be acquired are denominated is projected, thereby increasing the cost of such securities, the Trust may purchase call options thereon. The purchase of such options could offset, at least partially, the effects of the adverse movements in exchange rates. As in the case of other types of options, however, the benefit to the Trust deriving from purchases of foreign currency options will be reduced by the amount of the premium and related transaction costs. In addition, where currency exchange rates do not move in the direction or to the extent anticipated, the Trust could sustain losses on transactions in foreign currency options which would require it to forego a portion or all of the benefits of advantageous changes in such rates.

The Trust may write options on foreign currencies for the same types of hedging purposes. For example, where the Trust anticipates a decline in the dollar value

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of foreign-denominated securities due to adverse fluctuations in exchange rates it could, instead of purchasing a put option, write a call option on the relevant currency. If the expected decline occurs, the option will most likely not be exercised, and the diminution in value of portfolio securities will be offset by the amount of the premium received.

Similarly, instead of purchasing a call option to hedge against an anticipated increase in the dollar cost of securities to be acquired, the Trust could write a put option on the relevant currency which, if rates move in the manner projected, will expire unexercised and allow the Trust to hedge such increased cost up to the amount of the premium. As in the case of

20

other types of options, however, the writing of a foreign currency option will constitute only a partial hedge up to the amount of the premium, and only if rates move in the expected direction. If this does not occur, the option may be exercised and the Trust would be required to purchase or sell the underlying currency at a loss which may not be offset by the amount of the premium. Through the writing of options on foreign currencies, the Trust also may be required to forego all or a portion of the benefits which might otherwise have been obtained from favorable movements in exchange rates.

All call options written on foreign currencies will be covered. A call option written on a foreign currency by the Trust is "covered" if the Trust owns the underlying foreign currency covered by the call or has an absolute and immediate right to acquire that foreign currency without additional cash consideration (or for additional cash consideration segregated by the Trust ) upon conversion or exchange of other foreign currency held in its portfolio. A call option is also covered if the Trust has purchased a call on the same foreign currency and in the same principal amount as the call written where the exercise price of the call held is (a) equal to or less than the exercise price of the call written or (b) greater than the exercise price of the call written if liquid assets representing the difference is segregated by the Trust. Call and put options on foreign currencies may also be covered in such other manner as may be in accordance with the requirements of the exchange on which they are traded and applicable rules and regulations.

Call and put options and Options on Futures Contracts may be covered in any such manner as may be in accordance with the requirements of the exchange on which they are traded and applicable rules and regulations.

Options on securities may be traded over-the-counter. In an over-the-counter trading environment, many of the protections afforded to exchange participants will not be available. For example, there are no clearing house performance guarantees. In addition, there are no daily price fluctuation limits, and adverse market movements could therefore continue to an unlimited extent over a period of time. Although the purchaser of an option cannot lose more than the amount of the premium plus related transaction costs, this entire amount could be lost.

As a result of its investments in foreign securities, the Trust may receive interest payments, or the proceeds of the sale or redemption of such securities, in foreign currencies. In that event, the Trust may promptly convert such currencies into dollars at the then-current exchange rate. Under certain circumstances, alternatively, such as where the Investment Adviser anticipates that the exchange rate will improve, the Trust may hold such currencies for an indefinite period of time. The Trust may also hold foreign currency in anticipation of purchasing foreign securities.

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In addition, the Trust may be required or elect to receive delivery of the foreign currencies underlying options on foreign currencies or Forward Contracts it has entered into. This could occur, for example, if an option written by the Trust is exercised or the Trust is unable to close out a Forward Contract it has entered into. The Trust may also elect to take delivery of the currencies underlying options or Forward Contracts if, in the judgment of the Investment Adviser, it is in the best interest of the Trust to do so. The holding of currencies exposes the Trust to risk of loss if currency exchange rates move in a direction adverse to the Trust's position. Such losses could reduce any profits or increase any losses sustained by the Trust from the sale or redemption of securities, and could reduce the dollar value of

21

interest or dividend payments received. In addition, the holding of currencies could adversely affect the Trust's profit or loss on currency options or Forward Contracts, as well as its hedging strategies.

Additional Risks of Options on U.S. and Foreign Government Securities, Options on Futures Contracts, Forward Contracts and Options on Foreign Currencies. Unlike transactions entered into by the Trust in Futures Contracts, options on foreign currencies and Forward Contracts are not traded on contract markets regulated by the CFTC or (with the exception of certain foreign currency options) by the SEC. To the contrary, such instruments are traded through financial institutions acting as market-makers, although foreign currency options are also traded on certain national securities exchanges, such as the Philadelphia Stock Exchange and the Chicago Board Options Exchange, subject to SEC regulation. Similarly, options on securities may be traded over-the-counter. In an over-the-counter trading environment, many of the protections afforded to exchange participants will not be available. For example, there are no daily price fluctuation limits, and adverse market movements could therefore continue to an unlimited extent over a period of time. Although the purchaser of an option cannot lose more than the amount of the premium plus related transaction costs, this entire amount could be lost. Moreover, the option writer and trader of Forward Contracts could lose amounts substantially in excess of their initial investments, due to the margin and collateral requirements associated with such positions. In addition, where the Trust enters into Forward Contracts as a "cross hedge" (i.e., the purchase or sale of a Forward Contract on one currency to hedge against risk of loss arising from changes in value of a second currency), the Trust incurs the risk of imperfect correlation between changes in the values of the two currencies, which could result in losses.

In order to assure that the Trust will not be deemed a "commodity pool" for purposes of the Commodity Exchange Act, regulations of the CFTC require that the Trust enter into transactions in Futures Contracts, Options on Futures Contracts and Options on Foreign Currencies traded on CFTC - regulated exchange only (i) for bona fide hedging purposes (as defined in CFTC regulations), or (ii) for non-bona fide hedging purposes, provided that the aggregate initial margin and premiums to establish such non-bona fide hedging positions do not exceed 5% of the liquidation value of the Trust's assets, after taking into account unrealized profits and unrealized losses on any such contracts the Trust has entered into, and excluding, in computing such 5%, the in-the-money amount with respect to an option that is in-the-money at the time of purchase.

The staff of the SEC has taken the position that purchased over-the-counter options and assets used to cover written over-the-counter options are illiquid; therefore, together with other illiquid securities, such options and assets cannot exceed a certain percentage of the Trust's assets (the "SEC illiquidity

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ceiling"). Although the Investment Adviser disagrees with this position, the Investment Adviser intends to limit the Trust's writing of over-the-counter options in accordance with the following procedure. Except as provided below, the Trust intends to write over-the-counter options only with primary U.S. Government Securities dealers recognized by the Federal Reserve Bank of New York. Also, the contracts which the Trust has in place with such primary dealers will provide that the Trust has the absolute right to repurchase an option it writes at any time at a price which represents the fair market value, as determined in good faith through negotiation between the parties, but which in no event will exceed a price determined pursuant to a formula in the contract. Although the specific formula may vary between contracts with different primary dealers, the formula will generally be based on a multiple of the premium received by the Trust for writing the option, plus the amount, if any, of the

22

option's intrinsic value (i.e., the amount that the option is in-the-money). The formula may also include a factor to account for the difference between the price of the security and the strike price of the option if the option is written out-of-the-money. The Trust will treat all or a part of the formula price as illiquid for purposes of the SEC illiquidity ceiling. The Trust may also write over-the-counter options with non-primary dealers, including foreign dealers, and will treat the assets used to cover these options as illiquid for purposes of such SEC illiquidity ceiling.

Options on foreign currencies traded on national securities exchanges are within the jurisdiction of the SEC, as are other securities traded on such exchanges. As a result, many of the protections provided to traders on organized exchanges will be available with respect to such transactions. In particular, all foreign currency option positions entered into on a national securities exchange are cleared and guaranteed by the Options Clearing Corporation ("OCC"), thereby reducing the risk of counterparty default. Further, a liquid secondary market in options traded on a national securities exchange may be more readily available than in the over-the-counter market, potentially permitting the Trust to liquidate open positions at a profit prior to exercise or expiration, or to limit losses in the event of adverse market movements.

The purchase and sale of exchange-traded foreign currency options, however, is subject to the risks of the availability of a liquid secondary market described above, as well as the risks regarding adverse market movements, margining of options written, the nature of the foreign currency market, possible intervention by governmental authorities and the effects of other political and economic events. In addition, exchange-traded options on foreign currencies involve certain risks not presented by the over-the-counter market. For example, exercise and settlement of such options must be made exclusively through the OCC, which has established banking relationships in applicable foreign countries for this purpose. As a result, the OCC may, if it determines that foreign governmental restrictions or taxes would prevent the orderly settlement of foreign currency option exercises, or would result in undue burdens on the OCC or its clearing member, impose special procedures on exercise and settlement, such as technical changes in the mechanics of delivery of currency, the fixing of dollar settlement prices or prohibitions, on exercise.

In addition, options on U.S. and Foreign Government Securities, Futures Contracts, Options on Futures Contracts, Forward Contracts and options on foreign currencies may be traded on foreign exchanges. Such transactions are subject to the risk of governmental actions affecting trading in or the prices

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of foreign currencies or securities. The value of such positions also could be adversely affected by (i) other complex foreign political and economic factors, (ii) lesser availability than in the United States of data on which to make trading decisions, (iii) delays in the Trust's ability to act upon economic events occurring in foreign markets during non-business hours in the United States, (iv) the imposition of different exercise and settlement terms and procedures and margin requirements than in the United States, and (v) lesser trading volume.

Future Developments. The Trust proposes to take advantage of opportunities in the area of options and Futures Contracts and Options on Futures Contracts which are not presently contemplated for use by the Trust or which are not currently available but which may be developed, to the extent such opportunities are both consistent with the Trust's investment objective and legally permissible for the Trust. Such opportunities, if they arise, may involve risks which exceed those involved in the options and futures activities described above.

23

### PORTFOLIO MANAGEMENT

The Trust's portfolio management may include the following strategies:

- (1) changing from one U.S. Government Security to an essentially similar U.S. Government Security when their respective yields are distorted due to market factors;
- (2) changing from U.S. Government Securities to Foreign Government Securities or from Foreign Government Securities to U.S. Government Securities when disparities arise in their relative yields;
- (3) selling one kind of U.S. Government Security (e.g., Treasury bonds) and buying another (e.g., FNMA direct pass-through certificates) when disparities arise in the relative values of each;
- (4) shortening the average maturity of its portfolio in anticipation of a rise in interest rates so as to minimize depreciation of principal; and
- (5) lengthening the average maturity of its portfolio in anticipation of a decline in interest rates so as to maximize appreciation of principal.

The Trust may also use the techniques described above under "Investment Practices" to manage its portfolio.

While these strategies are designed to increase the Trust's current income available for distribution to its shareholders, if the Trust's expectations of changes in interest rates or its evaluation of the normal yield relationship between two securities or obligations proves to be incorrect, the Trust's income and net asset value may be reduced.

### SPECIAL CONSIDERATIONS

The Trust is designed primarily as a long-term investment and not as a trading vehicle. The value of shares of the Trust will vary as the aggregate value of the Trust's portfolio securities increases or decreases. The net asset value of the Trust may change as the general levels of interest rates fluctuate. When interest rates decline, the value of a portfolio invested at higher yields can



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be expected to rise. Conversely, when interest rates rise, the value of a portfolio invested at lower yields can be expected to decline. If the Trust's expectations of changes in interest rates or its evaluation of the normal yield relationship between two securities proves to be incorrect, the Trust's income, net asset value and potential capital gain may be decreased or its potential capital loss may be increased.

Although changes in the value of the Trust's portfolio securities subsequent to their acquisition are reflected in the net asset value of shares of the Trust, such changes will not affect the income received by the Trust from such securities. The dividends paid by the Trust will increase or decrease in relation to the income received by the Trust from its investments, which will in any case be reduced by the Trust's expenses before being distributed to the Trust's shareholders.

24

The Trust's use of options, Futures Contracts, Options on Futures Contracts, Forward Contracts and options on foreign currencies may result in the loss of principal under certain market conditions. See "Options and Futures" above.

Investing in Foreign Government Securities involves considerations and possible risks not typically associated with investing in U.S. Government Securities. The value of Foreign Government Securities investments will be affected by changes in currency rates or exchange control regulations. Because interest and principal payments of Foreign Government Securities may be made in foreign currencies, if the exchange rate declines after the Trust receives these payments the Trust may not have sufficient cash to make distributions to shareholders without selling portfolio securities. A decline in the exchange rate would also result in a decrease in the value of certain portfolio securities. The Trust may enter into Forward Contracts and options on foreign currencies in an effort to protect against this risk. The value of Foreign Government Securities can also be affected by the application of foreign tax laws, including withholding taxes, changes in governmental administration or economic or monetary policy (in this country or abroad) or changed circumstances in dealings between nations. Costs may be incurred in connection with conversions between various currencies. Foreign brokerage commissions are generally higher than in the United States, and foreign securities markets may be less liquid, more volatile and less subject to governmental supervision than in the United States. Investments in foreign countries could be affected by other factors not present in the United States, including expropriation, confiscatory taxation and potential difficulties in enforcing contractual obligations and could be subject to extended settlement periods. A delay in settlement could hinder the ability of the Trust to take advantage of changing market conditions with a possible resulting adverse effect on net asset value.

The risks of investing in foreign securities may be intensified in the case of investments in emerging markets. Securities of many issuers in emerging markets may be less liquid and more volatile than securities of comparable domestic issuers. Emerging markets also have different clearance and settlement procedure, and in certain markets there have been times when settlements have been unable to keep pace with the volume of securities transactions, making it difficult to conduct such transactions. Delays in settlement could result in temporary periods when a portion of the assets of the Trust is uninvested and no return is earned thereon. The inability of the Trust to make intended security purchases due to settlement problems could cause the Trust to miss attractive investment opportunities. Inability to dispose of portfolio securities due to

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settlement problems could result either in losses to the Trust due to subsequent declines in value of the portfolio security or, if the Trust has entered into a contract to sell the security, in possible liability to the purchaser. Certain markets may require payment for securities before delivery. Securities prices in emerging markets can be significantly more volatile than in the more developed nations of the world, reflecting the greater uncertainties of investing in less established markets and economies. In particular, countries with emerging markets may have relatively unstable governments, present the risk of nationalization of businesses, restrictions on foreign ownership, or prohibitions of repatriation of assets, and may have less protection of property rights than more developed countries. The economies of countries of emerging markets may be predominantly based on only a few industries, may be highly vulnerable to changes in local or global trade conditions and may suffer from extreme and volatile debt burdens or inflation rates. Local securities markets may trade a small number of securities and may be unable to respond effectively to increases in trading volume potentially making prompt liquidation of substantial holdings difficult or impossible at times. Securities of issuers located in countries with

25

emerging markets may have limited marketability and may be subject to more abrupt or erratic price movements.

Certain emerging markets may require governmental approval for the repatriation of investment income, capital or the proceeds of sale of securities of foreign investors. In addition, if a deterioration occurs in an emerging market's balance of payments or for other reasons a country could impose temporary restrictions on foreign capital remittances. The Trust could be adversely effected by delays in, or a refusal to grant, any required governmental approval for repatriation of capital, as well as by the application to the Trust of any restrictions on investments.

Investment in certain foreign emerging market debt obligations may be restricted or controlled to varying degrees. These restrictions or controls may at times preclude investment in certain foreign emerging market debt obligations and increase the expenses of the Trust.

For these reasons, an investment in shares of the Trust should not constitute a complete investment program since it involves the risk of capital depreciation inherent in seeking higher income.

### INVESTMENT RESTRICTIONS

The Trust has adopted the following policies which cannot be changed without the approval of the holders of a majority of its shares (which means the lesser of (i) more than 50% of the outstanding shares of the Trust, or (ii) 67% or more of the outstanding shares of the Trust present at a meeting at which holders of more than 50% of its outstanding shares are represented in person or by proxy). Except with respect to borrowings and investing in illiquid securities, all percentage limitations set forth below apply immediately after a purchase or initial investment and any subsequent change in any applicable percentage resulting from market fluctuations does not require elimination of any security from the portfolio. The Trust may not:

- (1) borrow money, except as a temporary measure for extraordinary or emergency purposes or for a repurchase of its shares or except as contemplated by clause (9) below, and in no event shall the Trust borrow in excess of 1/3 of its assets. The Trust will not

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purchase securities while borrowings are outstanding, except that it will honor prior commitments to purchase securities.

(2) purchase any security or evidence of interest therein on margin, except that the Trust may obtain such short-term credit as may be necessary for the clearance of purchases and sales of securities and except that the Trust may make deposits on margin in connection with options, Futures Contracts and Options on Futures Contracts;

(3) underwrite securities issued by other persons except insofar as the Trust may technically be deemed an underwriter under the Securities Act of 1933 in selling a portfolio security;

(4) invest in illiquid investments, including securities which are subject to legal or contractual restrictions on resale or for which there is no readily available market (e.g.,

26

trading in the security is suspended or, in the case of unlisted securities, where no market makers exist), if more than 10% of the Trust's assets (taken at market value) would be invested in such securities;

(5) purchase or sell real estate (including limited partnership interests but excluding securities secured by real estate or interests therein), interests in oil, gas or mineral leases, commodities or commodity contracts (except currencies, currency options or futures, Forward Contracts or Futures Contracts) in the ordinary course of the business of the Trust (the Trust reserves the freedom of action to hold and to sell real estate acquired as a result of the ownership of securities);

(6) purchase securities of any issuer if such purchase at the time thereof would cause more than 10% of the voting securities of such issuer to be held by the Trust;

(7) issue any senior security (as that term is defined in the 1940 Act), if such issuance is specifically prohibited by the 1940 Act or the rules and regulations promulgated thereunder (for the purpose of this restriction, collateral arrangements with respect to options, Futures Contracts and Options on Futures Contracts and collateral arrangements with respect to initial and variation margin are not deemed to be the issuance of a senior security);

(8) make loans to other persons except through the lending of its portfolio securities not in excess of 30% of its total assets (taken at market value) and except through the use of repurchase agreements, the purchase of commercial paper or the purchase of all or a portion of an issue of debt securities in accordance with its investment objective, policies and restrictions; or

(9) make short sales of securities or maintain a short position, unless at all times when a short position is open it owns an equal amount of such securities or securities convertible into or exchangeable, without payment of any further consideration, for securities of the same issue as, and equal in amount to, the securities sold short ("short sales against the box"), and unless not more than 10% of the Trust's net assets (taken at market value) is held as

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collateral for such sales at any one time .

The Trust's investment limitations and policies are adhered to at the time of purchase or utilization of assets; a subsequent change in circumstances will not be considered to result in a violation of policy.

27

### DESCRIPTION OF OBLIGATIONS ISSUED OR GUARANTEED BY U.S. GOVERNMENT AGENCIES OR INSTRUMENTALITIES

#### Federal Farm Credit System Notes and Bonds-

are bonds issued by a cooperatively owned nationwide system of banks and associations supervised by the Farm Credit Administration, an independent agency of the U.S. Government. These bonds are not guaranteed by the U.S. Government.

#### Maritime Administration Bonds-

are bonds issued and provided by the Department of Transportation of the U.S. Government and are guaranteed by the United States.

#### FHA debentures-

are debentures issued by the Federal Housing Administration of the U. S. Government and are guaranteed by the United States.

#### GNMA Certificates-

are mortgage-backed securities which represent a partial ownership interests in a pool of mortgage loans issued by lenders such as mortgage bankers, commercial banks and savings and loan associations. Each mortgage loan included in the pool is either insured by the Federal Housing Administration or guaranteed by the Veterans Administration.

#### FHLMC Bonds-

are bonds issued and guaranteed by the Federal Home Loan Mortgage Corporation and are not guaranteed by the U.S. Government.

#### FNMA Bonds-

are bonds issued and guaranteed by the Federal National Mortgage Association and are not guaranteed by the U.S. Government.

#### Federal Home Loan Bank Notes and Bonds-

are notes and bonds issued by the Federal Home Loan Bank System, and are not guaranteed by the U.S. Government.

Although this list includes a description of the primary types of U.S. Government agency or instrumentality obligations in which the Trust intends to invest, the Trust may invest in obligations of U.S. Government agencies or instrumentalities other than those listed above.

### DESCRIPTION OF BOND RATINGS

The ratings of Moody's, S&P and Fitch represent their opinions as to the quality of various debt instruments. It should be emphasized, however, that ratings are not absolute standards of quality. Consequently, debt instruments with the same maturity, coupon and rating may have different yields while debt instruments of the same maturity and coupon with different ratings may have the same yield.

MOODY'S INVESTORS SERVICE, INC.

Aaa: Obligations rated Aaa are judged to be of the highest quality with minimal credit risk.

Aa: Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.

A: Obligations rated A are considered upper-medium-grade and are subject to low credit risk.

Baa: Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics.

Ba: Obligations rated Ba are judged to have speculative elements and are subject to substantial credit risk.

B: Obligations rated B are considered speculative and are subject to high credit risk.

Caa: Obligations rated Caa are judged to be of poor standing and are subject to very high credit risk.

Ca: Obligations rated Ca are highly speculative and are likely in, or very near default, with some prospect of recovery of principal and interest.

C: Obligations rated C are the lowest rated class of bonds and are typically in default, with little prospect for recovery of principal or interest.

Note: Moody's applies numerical modifiers "1", "2" and "3" in each generic rating classification from "Aa" through "Caa." The modifier "1" indicates that the obligation ranks in the higher end of its generic rating category; the modifier "2" indicates a mid-range ranking; and the modifier "3" indicates a ranking in the lower end of that generic rating category.

STANDARD AND POOR'S RATINGS GROUP

Issue credit ratings are based in varying degrees, on the following considerations: (1) likelihood of payment capacity and willingness of the obligor to meet its financial commitment on an obligation in accordance with the terms of the obligation; (2) nature of and provisions of the obligation; and (3) protection afforded by, and relative position of, the obligation in the event of bankruptcy, reorganization, or other arrangement under the laws of bankruptcy and other laws affecting creditors' rights.

The issue ratings definitions are expressed in terms of default risk. As such, they pertain to senior obligations of an entity. Junior obligations are typically rated lower than senior obligations, to reflect the lower priority in bankruptcy, as noted above.

AAA: An obligation rated "AAA" has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitments on the obligation is extremely strong.

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AA: An obligation rated "AA" differs from the highest-rated obligations only in small degree. The obligor's capacity to meet its financial obligations is extremely strong.

29

A: An obligation rated "A" is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than debt in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.

BBB: An obligation rated "BBB" exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial obligations is very strong.

BB, B, CCC, CC, and C: Obligations rated "BB", "B", "CCC", "CC", and "C" are regarded as having significant speculative characteristics. `B' indicates the least degree of speculation and `C' the highest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions.

BB: An obligation rated "BB" is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.

B: An obligation rated "B" is more vulnerable to non-payment than obligations rated `BB', but the obligor currently has the capacity to meet its financial commitment on the obligations. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.

CCC: An obligation rated "CCC" is currently vulnerability to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions is not likely to have the capacity to meet its financial commitment on the obligation.

CC: An obligation rated "CC" is currently vulnerable to nonpayment.

C: The "C" rating may be used to cover a situation where a bankruptcy petition has been filed or similar action has been taken, but payments on this obligation are being continued.

CC: An obligation rated "CC" is currently highly vulnerable to nonpayment.

C: The "C" rating may be used to cover a situation where a bankruptcy petition has been filed or similar action has been taken, but payments on this obligation are being continued.

D: An obligation rated "D" is in payment default. The "D" rating category is used when payments on an obligation are not made on the date due even if the applicable grace period has not expired, unless S&P believes that such payments will be made during such grace period. The "D" rating also will be used upon the filing of a bankruptcy petition or the taking of a similar action if debt service payments are jeopardized.

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Plus (+) or Minus (-): The "AA" and "CCC" ratings may be modified by the addition of a plus or minus sign to show relative standing within the applicable rating category.

30

The `c' subscript is used to provide additional information to investors that the bank may terminate its obligation to purchase tendered bonds if the long-term credit rating of the issuer is below an investment-grade level and/or the issuer's bonds are deemed taxable.

The letter `p' indicates that the rating is provisional. A provisional rating assumes the successful completion of the project financed by the debt being rated and indicates that payment of debt service requirements is largely or entirely dependent upon the successful, timely completion of the project. This rating, however, while addressing credit quality subsequent to completion of the project, makes no comment on the likelihood of or the risk of default upon failure of such completion. The investor should exercise his own judgment with respect to such likelihood and risk.

Asterisk (\*): Continuance of the ratings is contingent upon Standard & Poor's receipt of an executed copy of the escrow agreement or closing documentation confirming investments and cash flows.

The `r' highlights derivative, hybrid, and certain other obligations that Standard & Poor's believes may experience high volatility or high variability in expected returns as a result of noncredit risks. Examples of such obligations are securities with principal or interest return indexed to equities, commodities, or currencies; certain swaps and options; and interest-only and principal-only mortgage securities. The absence of an `r' symbol should not be taken as an indication that an obligation will exhibit no volatility or variability in total return.

N.R.: Not rated.

Debt obligations of issuers outside the United States and its territories are rated on the same basis as domestic corporate and municipal issues. The ratings measure the creditworthiness of the obligor but do not take into account currency exchange and related uncertainties.

Bond Investment Quality Standards: Under present commercial bank regulations issued by the Comptroller of the Currency, bonds rated in the top four categories (`AAA', `AA', `A', `BBB', commonly known as investment-grade ratings) generally are regarded as eligible for bank investment. Also, the laws of various states governing legal investments impose certain rating or other standards for obligations eligible for investment by savings banks, trust companies, insurance companies, and fiduciaries in general.

FITCH

Investment Grade

AAA: Highest credit quality. "AAA" ratings denote the lowest expectation of credit risk. They are assigned only in case of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.

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AA: Very high credit quality. "AA" ratings denote a very low expectation of credit risk. They indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.

31

A: High credit quality. "A" ratings denote a low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.

BBB: Good credit quality. "BBB" ratings indicate that there is currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity. This is the lowest investment-grade category.

### Speculative Grade

BB: Speculative. "BB" ratings indicate that there is a possibility of credit risk developing, particularly as the result of adverse economic change over time; however, business or financial alternatives may be available to allow financial commitments to be met. Securities rated in this category are not investment grade.

B: Highly speculative. "B" ratings indicate that significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.

CCC, CC, C: High default risk. Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. A "CC" rating indicates that default of some kind appears probable. "C" ratings signal imminent default.

DDD, DD, D: Default. Entities rated in this category have defaulted on some or all of the obligations. The ratings of obligations in this category are based on their prospects for achieving partial or full recovery in a reorganization or liquidation of the obligor. While expected recovery values are highly speculative and cannot be estimated with any precision, the following serve as general guidelines. "DDD" obligations have the highest potential for recovery, around 90% - 100% of outstanding amounts and accrued interest. "DD" indicates expected recoveries in the range of 50% - 90% and "D" the lowest recovery potential, i.e. below 50%.

"+" or "-" may be appended to a rating to denote relative status within major rating categories. Such suffixes are not added to the 'AAA' long-term rating category, or to categorize below 'CCC'.

NR indicates that Fitch Ratings does not rate the issuer or issue in question.

Withdrawn: A rating is withdrawn when Fitch Ratings deems the amount of information available to be inadequate for rating purposes, or when an obligation matures, is called, or refinanced.

Rating Watch: Ratings are placed on Rating Watch to notify investors that there



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is a reasonable probability of a rating change and the likely direction of such change. These are designated as "Positive", indicating a potential upgrade, "Negative", for a potential downgrade, or "Evolving", if ratings may be raised, lowered or maintained. Rating Watch is typically resolved over a relatively short period.

A Rating Outlook indicates the direction a rating is likely to move over a one- to two-year period. Outlooks may be positive, stable, or negative. A positive or negative Rating Outlook does not imply a

32

rating change is inevitable. Similarly, ratings for which outlooks are "stable" could be upgraded or downgraded before an outlook moves to positive or negative if circumstances warrant such an action. Occasionally, Fitch may be unable to identify the fundamental trend and in these cases, the Rating Outlook may be described as "evolving".

8.5. Share Price Data: Inapplicable.

8.6 Business Development Companies: Inapplicable.

Item 9. Management:

9.1.a. General - Board of Trustees: Management of the Trust's business and affairs is the responsibility of the Board of Trustees of the Trust.

9.1.b. General - Investment Advisers: MFS Investment Management ("MFS") is the Trust's Investment Adviser. MFS and its predecessor organizations have a history of money management dating from 1924, thus making MFS America's oldest mutual fund organization. MFS is a majority owned subsidiary of Sun Life of Canada (U.S.) Financial Services Holdings, Inc. 500 Boylston Street, Boston, MA 02116, which in turn is an indirect majority owned subsidiary of Sun Life Financial, Inc., (a diversified financial services organization) at the same address. The executive officers of MFS report to the Chairman of Sun Life. The principal business address of MFS is 500 Boylston Street, Boston, Massachusetts 02116.

MFS serves as investment adviser to the following open-end Funds comprising the MFS Family of Funds: Massachusetts Investors Growth Stock Fund; Massachusetts Investors Trust; MFS Government Limited Maturity Fund; MFS Government Securities Fund; MFS Growth Opportunities Fund; MFS Series Trust I (which has 8 series: MFS Cash Reserve Fund, MFS Core Equity Fund, MFS Core Growth Fund, MFS New Discovery Fund, MFS Research International Fund, MFS Strategic Growth Fund, MFS Technology Fund and MFS Value Fund); MFS Series Trust II (which has one series: MFS Emerging Growth Fund); MFS Series Trust III (which has three series: MFS High Income Fund, MFS High Yield Opportunities Fund and MFS Municipal High Income Fund); MFS Series Trust IV (which has four series: MFS Government Money Market Fund, MFS Mid Cap Growth Fund, MFS Money Market Fund and MFS Municipal Bond Fund); MFS Series Trust V (which has three series: MFS International New Discovery Fund, MFS Research Fund and MFS Total Return Fund); MFS Series Trust VI (which has three series: MFS Global Equity Fund, MFS Global Total Return Fund and MFS Utilities Fund); MFS Series Trust VII (which has one series: MFS Capital Opportunities Fund); MFS Series Trust VIII (which has two series: MFS Global Growth Fund and MFS Strategic Income Fund); MFS Series Trust IX (which has seven series: MFS Bond Fund, MFS Inflation-Adjusted Bond Fund, MFS Intermediate Investment Grade Bond Fund, MFS Limited Maturity Fund, MFS Municipal Limited Maturity Fund, MFS Research Bond Fund and MFS Research Bond Fund J); MFS Series Trust X (which has 12 series: MFS Aggressive Growth Allocation Fund, MFS Conservative Allocation Fund, MFS Emerging Markets Debt Fund, MFS Emerging

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Markets Equity Fund, MFS Floating Rate High Income Fund, MFS Growth Allocation Fund, MFS International Diversification Fund, MFS International Growth Fund, MFS International Value Fund, MFS Moderate Allocation Fund, MFS New Endeavor Fund and MFS Strategic Value Fund); MFS Series Trust XI (which has two series: MFS Mid Cap Value Fund and MFS Union Standard Equity Fund); MFS Series Trust XII (which has 5 series: MFS Lifetime Retirement Income Fund, MFS Lifetime 2010 Fund, MFS Lifetime 2020 Fund, MFS Lifetime 2030 Fund and MFS Lifetime 2040 Fund; and MFS

33

Municipal Series Trust (which has 16 series: MFS Alabama Municipal Bond Fund, MFS Arkansas Municipal Bond Fund, MFS California Municipal Bond Fund, MFS Florida Municipal Bond Fund, MFS Georgia Municipal Bond Fund, MFS Maryland Municipal Bond Fund, MFS Massachusetts Municipal Bond Fund, MFS Mississippi Municipal Bond Fund, MFS Municipal Income Fund, MFS New York Municipal Bond Fund, MFS North Carolina Municipal Bond Fund, MFS Pennsylvania Municipal Bond Fund, MFS South Carolina Municipal Bond Fund, MFS Tennessee Municipal Bond Fund, MFS Virginia Municipal Bond Fund and MFS West Virginia Municipal Bond Fund (the "MFS Funds"). The principal business address of each of the MFS Funds is 500 Boylston Street, Boston, Massachusetts, 02116.

MFS also serves as investment adviser of the following open-end Funds: MFS Institutional Trust ("MFSIT") (which has four series) and MFS Variable Insurance Trust ("MVI") (which has 16 series). The principal business address of each of the aforementioned funds is 500 Boylston Street, Boston, Massachusetts, 02116.

In addition, MFS serves as investment adviser to the following closed-end funds: MFS Charter Income Trust, MFS Government Markets Income Trust, MFS Intermediate Income Trust, MFS Multimarket Income Trust, MFS Municipal Income Trust and MFS Special Value Trust (the "MFS Closed-End Funds"). The principal business address of each of the MFS Closed-End Funds is 500 Boylston Street, Boston, Massachusetts, 02116.

Lastly, MFS serves as investment adviser to MFS/Sun Life Series Trust ("MFS/SL") (which has 28 series), Capital Appreciation Variable Account, Global Governments Variable Account, Government Securities Variable Account, High Yield Variable Account, Money Market Variable Account and Total Return Variable Account (collectively, the "Accounts"). The principal business address of MFS/SL is 500 Boylston Street, Boston, Massachusetts, 02116. The principal business address of each of the aforementioned Accounts is One Sun Life Executive Park, Wellesley Hills, Massachusetts, 02181.

MFS and its subsidiaries, provide investment advice to retail institutional clients. Net assets under the management of the MFS organization were approximately \$163 billion as of December 31, 2005.

### INVESTMENT ADVISORY AGREEMENT

General. The Investment Adviser manages the Trust pursuant to an Investment Advisory Agreement (the "Advisory Agreement"). Under the Advisory Agreement, the Investment Adviser provides the Trust with overall investment advisory services. Subject to such policies as the Trustees may determine, the Investment Adviser makes investment decisions for the Trust. For these services and facilities, the Investment Adviser receives an annual investment advisory fee, computed and paid monthly.

The Investment Adviser pays the compensation of the Trust's officers and of any

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Trustee who is an officer of the Adviser. The Investment Adviser also furnishes at its own expense investment advisory and administrative services, including office space, equipment, clerical personnel, investment advisory facilities, and all executive and supervisory personnel necessary for managing the Trust's investments and effecting its portfolio transactions.

34

The Trust pays the compensation of the Trustees who are "not affiliated" with the Investment Adviser and all expenses of the Trust (other than those assumed by the Investment Adviser) including but not limited to: governmental fees; interest charges; taxes; membership dues in the Investment Company Institute allocable to the Trust; fees and expenses of independent auditors, of legal counsel, and of any transfer agent, registrar or dividend disbursing agent of the Trust; expenses of repurchasing and redeeming shares and servicing shareholder accounts; expenses of preparing, printing and mailing stock certificates, shareholder reports, notices, proxy statements and reports to governmental officers and commissions; brokerage and other expenses connected with the execution, recording and settlement of portfolio security transactions; insurance premiums; fees and expenses of the Trust's custodian for all services to the Trust, including safekeeping of funds and securities and maintaining required books and accounts; expenses of calculating the net asset value of shares of the Trust; organizational and start up costs; and such non-recurring or extraordinary expenses as may arise, including those relating to actions, suits or proceedings to which the Trust is a party or otherwise may have an exposure, and the legal obligation which the Trust may have to indemnify the Trust's Trustees and officers with respect thereto. Expenses relating to the issuance, registration and qualification of shares of the Trust and the preparation, printing and mailing of prospectuses for such purposes are borne by the Trust except that the Distribution Agreement with MFD requires MFD to pay for prospectuses that are to be used for sales purposes.

The Advisory Agreement has an initial two year term and continues in effect thereafter only if such continuance is specifically approved at least annually by the Board of Trustees or by the affirmative vote of a majority of the outstanding voting securities of the Trust. The Advisory Agreement terminates automatically if it is assigned and may be terminated without penalty by the affirmative vote of the outstanding voting securities of the Trust, or by either party on not more than 60 days' nor less than 30 days' written notice.

The Advisory Agreement grants the Trust a non-exclusive and non-transferable right and sub-license to use the names "Massachusetts Financial Services," "MFS" or any derivatives or logos associated with those names. If MFS for any reason no longer serves as investment adviser to the Trust, the Trust will promptly cease to use these MFS marks. MFS may permit other clients to use these MFS marks in their names or other material.

The Advisory Agreement also provides that neither the Investment Adviser nor its personnel shall be liable for any error of judgment or mistake of law or for any loss arising out of any investment or for any act or omission in the execution and management of the Trust, except for willful misfeasance, bad faith, gross negligence, or reckless disregard of its or their duties and obligations under the Advisory Agreement.

The Investment Adviser is free to render investment and/or other services to others, but the Investment Adviser will at all times endeavor to treat all of its clients in a fair and equitable manner. Whenever the Trust and one or more

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other Trusts or accounts advised by the Investment Adviser have money available for investment, investments or opportunities to sell investments will be allocated in a manner believed by the Adviser to be fair and equitable to each client. The Investment Adviser may cause the Trust to pay a broker or dealer a higher commission than another broker or dealer might have charged for effecting that transaction, if the Investment Adviser determines, in good faith, that the higher commission was reasonable in relation to the value of brokerage and research services provided by the broker or dealer.

35

Advisory Fee. For the services provided by MFS under the Advisory Agreement, the Trust will pay MFS an annual fee computed and paid monthly in an amount equal to the lesser of the sum of 0.32% of the average daily net assets of the Trust and 5.65% of the daily gross income (i.e., income other than gains from the sale of securities, gains from options and futures transactions and premium income from options written) or 0.85% of the average daily net assets of the Trust for the Trust's then-current fiscal year. This advisory fee is greater than that paid by most funds.

A discussion regarding the basis for the Board of Trustees' approval of the Investment Advisory Agreement between the Trust and MFS is available in the Trust's Annual Report to shareholders for the fiscal year ended October 31, 2005.

9.1.c. General - Portfolio Management: James J. Calmas and Erik S. Weisman are the portfolio managers of the Trust. Mr. Calmas, a Senior Vice President of the Adviser, has been employed in the investment management area of the Adviser since 1988. Mr. Weisman, a Vice President of the Adviser, has been employed in the investment management area of the Adviser since 2002. Prior to joining MFS, Mr. Weisman was the Assistant to the U.S. Executive Director for the International Monetary Fund, where he was employed from 2000 to 200