FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-K
March 11, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2010

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

PENNSYLVANIA	25-1440803
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

20 South Main Street, Chambersburg, PA (Address of principal executive offices) 17201-0819 (Zip Code)

(717) 264-6116

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act

NONE

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $1.00 per share

(Title of class)

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceeding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company.

Large accelerated filer o Accelerated filer x Non-accelerated filer o Smaller reporting company o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act) Yes o No x

The aggregate market value of the 3,571,040 shares of the Registrant s common stock held by nonaffiliates of the Registrant as of June 30, 2010 based on the price of such shares was $63,207,408.

There were 3,931,930 outstanding shares of the Registrant s common stock as of February 28, 2011.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive annual proxy statement to be filed, pursuant to Reg. 14A within 120 days after December 31, 2010, are incorporated into Part III.

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Part I

Item 1. Business

General

Franklin Financial Services Corporation (the Corporation) was organized as a Pennsylvania business corporation on June 1, 1983 and is a registered bank holding company under the Bank Holding Company Act of 1956, as amended (the BHCA). On January 16, 1984, pursuant to a plan of reorganization approved by the shareholders of Farmers and Merchants Trust Company of Chambersburg (F&M Trust or the Bank) and the appropriate regulatory agencies, the Corporation acquired all the shares of F&M Trust and issued its own shares to former F&M Trust shareholders on a share-for-share basis.

The Corporation s common stock is not actively traded in the over-the-counter market. The Corporation s stock is listed under the symbol FRAF on the OTC Bulletin Board, an automated quotation service. The Corporation s Internet address is *www.franklinfin.com*. Electronic copies of the Corporation s 2010 Annual Report on Form 10-K are available free of charge by visiting the Investor Information section of *www.franklinfin.com*. Electronic copies of quarterly reports on Form 10-Q and current reports on Form 8-K are also available at this Internet address. These reports are posted as soon as reasonably practicable after they are electronically filed with the Securities and Exchange Commission (SEC).

The Corporation conducts substantially all of its business through its direct banking subsidiary, F&M Trust (the Bank), which is wholly owned. Other direct subsidiaries of the Corporation include Franklin Financial Properties Corp. and Franklin Future Fund Inc. F&M Trust, established in 1906, is a full-service, Pennsylvania-chartered commercial bank and trust company, which is not a member of the Federal Reserve System. F&M Trust operates twenty-five community banking offices in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania, and engages in general commercial, retail banking and trust services normally associated with community banks and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (the FDIC). F&M Trust offers a wide variety of banking services to businesses, individuals, and governmental entities. These services include, but are not necessarily limited to, accepting and maintaining checking, savings, and time deposit accounts, providing investment and trust services, making loans and providing safe deposit facilities. Franklin Financial Properties Corp. is a qualified real estate subsidiary established to hold real estate assets used by F&M Trust in its banking operations. Franklin Future Fund Inc. is a non-bank investment company that makes venture capital investments within the Corporation s primary market area.

The Corporation s banking subsidiary is not dependent upon a single customer or a few customers for a material part of its business. Thus, the loss of any customer or identifiable group of customers would not materially affect the business of the Corporation or the Bank in an adverse manner. Also, none of the Corporation s business is seasonal. The Bank s lending activities consist primarily of commercial real estate, construction and land development, agricultural, commercial and industrial loans, installment and revolving loans to consumers and residential mortgage loans. Secured and unsecured commercial and industrial loans, including accounts receivable and inventory financing, and commercial equipment financing, are made to small and medium-sized businesses, individuals, governmental entities, and non-profit organizations. F&M Trust also participates in Pennsylvania Higher Education Assistance Act student loan programs, Pennsylvania Housing Finance Agency programs and is a Small Business Administration approved lender.

Consumer loans are comprised of direct, indirect (primarily automobile) and unsecured personal lines of credit. However, the Bank discontinued its indirect lending activities in 2010. The Bank s mortgage loans include long-term loans to individuals and to businesses secured by mortgages on the borrower s real property. Construction loans are made to finance the purchase of land and the construction of residential and commercial buildings thereon, and are secured by mortgages on real estate. Commercial loans are made to businesses of various sizes for a variety of purposes including construction, property, plant and equipment, and working capital. Commercial loans also include loans to government municipalities. Commercial lending is concentrated the Bank s primary market but also includes purchased loan participations originated primarily in south-central Pennsylvania. In certain situations, the Bank acquires properties through foreclosure on delinquent mortgage loans. The Bank holds these properties at their fair value at the date of foreclosure until such time as they are sold.

F&M Trust s Investment and Trust Services Department offers all of the personal and corporate trust services normally associated with trust departments of area banks including: estate planning and administration, corporate and personal trust fund management, pension, profit sharing and other employee benefit funds management, and custodial services. F&M Trust s Personal Investment Center sells mutual funds, annuities and selected insurance products.

The Corporation s primary market area continues to be affected by the recession, as has most of the country. Despite the negative affects of the recession on the economy, the Corporation has continued to provide community-banking services as it has for over 100 years. Commercial lending activity was steady in 2010, but consumer lending activity has slowed as consumer customers have reduced their borrowing. However, the Bank continues to lend money to credit worthy customers. Consumer lending and mortgage lending is expected to be down in 2011. The Bank stopped making indirect consumer loans in 2010 and this action is expected to substantially decrease the balance of consumer loans by year-end 2011. Likewise, it is expected that the number of commercial loan participations available for purchase will be lower in 2011. However, the Bank does expect lending activity to continue, but at a slower rate until consumer confidence increases. For more economic information about the Corporation s market area, see the Economy discussion in Item 7, Management s Discussion and Analysis.

With short-term interest rates at very low levels during 2010 and the financial uncertainty of the recession, consumers have moved deposits to short-term liquid deposit products. As a result, the Bank has experienced a reduction in longer-term certificates of deposit and an increase in money management accounts. Until short-term rates increase and the economy begins to recover, the Bank expects that customers will continue to prefer shorter, liquid deposits and certificates of deposit will decline.

The recession has resulted in a growing amount of nonperforming loans. Commercial nonperforming loans have increased as businesses have seen their sales reduced during the recession and real estate developers have become delinquent as a result of little or no sales during the past two years. In turn, workers have seen job layoffs or pay reductions and consequently more consumer loan delinquencies. Until business activity starts to recover and consumers feel confident in their employment situation, it is expected that nonperforming loans, both commercial and consumer, will continue to increase.

Acquisition

On November 29, 2008, Franklin Financial Services Corporation completed its acquisition of Community Financial, Inc. (Community). Community was the holding company of Community Trust Company, a Pennsylvania trust company headquartered in Camp Hill, Pennsylvania. In connection with the Community merger, Community Trust Company merged with and into Farmers and Merchants Trust Company. The acquisition increased the Bank s trust assets under management by approximately $62 million. The acquisition provided the Bank quick entry into an attractive market for asset management services and presents the opportunity for the expansion of retail and commercial banking services via an established office.

Competition

The Corporation and its banking subsidiary operate in a highly competitive environment. The principal market of F&M Trust is in south central Pennsylvania, primarily the counties of Franklin, Cumberland, Fulton and Huntingdon. There are approximately 26 competing commercial banks that have offices within the Corporation s primary market area. These banks range from large regional banks to independent community banks. In addition, credit unions, savings and loan associations, mortgage banks, brokerage firms and other competitors with only an Internet site are present in the market. The Bank has 25 community offices and approximately 10% of the total deposits, ranking it

third in its market region. The majority of the Bank s loan and deposit customers are in Franklin County. There are 7 commercial bank competitors in Franklin County and the Bank has approximately 26% of the deposit market share.

Because of increasing competition, profit margins in the traditional banking business of lending and gathering deposits have declined and many nonbanking institutions offer services similar to those offered by the Bank. Some competitors have access to resources (e.g., financial and technological) that are unavailable to the Bank, thereby creating a competitive disadvantage for the Bank in terms of product and service pricing and delivery. The Bank utilizes various strategies including its long history of local customer service and convenience as part of a relationship management culture, a wide variety of products and services and, to a lesser extent, the pricing of loans and deposits, to compete. F&M Trust is the largest financial institution headquartered in Franklin County and had total assets of approximately $951.9 million on December 31, 2010.

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Staff

As of December 31, 2010, the Corporation and its banking subsidiary had 263 full-time equivalent employees. The officers of the Corporation are employees of the Bank. Most employees participate in pension, incentive compensation plans, 401(k) plan and employee stock purchase plans and are provided with group life and health insurance. Management considers employee relations to be excellent.

Supervision and Regulation

Various requirements and restrictions under the laws of the United States and under Pennsylvania law affect the Corporation and its subsidiaries.

General

The Corporation is registered as a bank holding company and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System under the Bank Holding Act of 1956, as amended. The Corporation has also made an effective election to be treated as a financial holding company. Financial holding companies are bank holding companies that meet certain minimum capital and other standards and are therefore entitled to engage in financially related activities on an expedited basis; see further discussion below. Bank holding companies are required to file periodic reports with and are subject to examination by the Federal Reserve Board. The Federal Reserve Board has issued regulations under the Bank Holding Company Act that require a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. As a result, the Federal Reserve Board, pursuant to such regulations, may require the Corporation to stand ready to use its resources to provide adequate capital funds to its Bank subsidiary during periods of financial stress or adversity.

The Bank Holding Company Act prohibits the Corporation from acquiring direct or indirect control of more than 5% of the outstanding shares of any class of voting stock, or substantially all of the assets of any bank, or from merging or consolidating with another bank holding company, without prior approval of the Federal Reserve Board. Additionally, the Bank Holding Company Act prohibits the Corporation from engaging in or from acquiring ownership or control of more than 5% of the outstanding shares of any class of voting stock of any company engaged in a non-banking business, unless such business is determined by the Federal Reserve Board to be so closely related to banking as to be a proper incident thereto. Federal law and Pennsylvania law also require persons or entities desiring to acquire certain levels of share ownership (generally, 10% or more, or 5% or more for another bank holding company) of the Corporation to first obtain prior approval from the Federal Reserve and the Pennsylvania Department of Banking.

As a Pennsylvania bank holding company for purposes of the Pennsylvania Banking Code, the Corporation is also subject to regulation and examination by the Pennsylvania Department of Banking.

The Bank is a state chartered bank that is not a member of the Federal Reserve System, and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (FDIC). Accordingly, the Bank s primary federal regulator is the FDIC, and the Bank is subject to extensive regulation and examination by the FDIC and the Pennsylvania Department of Banking. The Bank is also subject to requirements and restrictions under federal and state law, including requirements to maintain reserves against deposits, restrictions on the types and amounts of loans that may be granted and the interest that may be charged thereon, and limitations on the types of investments that may be made and the types of services that may be offered. The Bank is subject to extensive regulation and reporting requirements in a variety of areas, including helping to prevent money laundering, to preserve financial privacy, and

to properly report late payments, defaults, and denials of loan applications. The Community Reinvestment Act requires the Bank to help meet the credit needs of the entire community where the Bank operates, including low and moderate-income neighborhoods. The Bank s rating under the Community Reinvestment Act, assigned by the FDIC pursuant to an examination of the Bank, is important in determining whether the bank may receive approval for, or utilize certain streamlined procedures in, applications to engage in new activities. The Bank s present CRA rating is satisfactory. Various consumer laws and regulations also affect the operations of the Bank. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the Federal Reserve Board as it attempts to control the money supply and credit availability in order to influence the economy.

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Capital Adequacy Guidelines

Bank holding companies are required to comply with the Federal Reserve Board s risk-based capital guidelines. The required minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) is 8%. At least half of the total capital is required to be Tier 1 capital, consisting principally of common shareholders equity less certain intangible assets. The remainder (Tier 2 capital) may consist of certain preferred stock, a limited amount of subordinated debt, certain hybrid capital instruments and other debt securities, and a limited amount of the general loan loss allowance and deferred tax accounts. The risk-based capital guidelines are required to take adequate account of interest rate risk, concentration of credit risk, and risks of nontraditional activities.

In addition to the risk-based capital guidelines, the Federal Reserve Board requires a bank holding company to maintain a leverage ratio of a minimum level of Tier 1 capital (as determined under the risk-based capital guidelines) equal to 3% of average total consolidated assets for those bank holding companies which have the highest regulatory examination ratings and are not contemplating or experiencing significant growth or expansion. All other bank holding companies are required to maintain a ratio of at least 1% to 2% above the stated minimum. The Bank is subject to almost identical capital requirements adopted by the FDIC. In addition to FDIC capital requirements, the Pennsylvania Department of Banking also requires state chartered banks to maintain a 6% leverage capital level and 10% risk based capital, defined substantially the same as the federal regulations.

Prompt Corrective Action Rules

The federal banking agencies have regulations defining the levels at which an insured institution would be considered well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. The applicable federal bank regulator for a depository institution could, under certain circumstances, reclassify a well-capitalized institution as adequately capitalized or require an adequately capitalized or undercapitalized institution to comply with supervisory actions as if it were in the next lower category. Such a reclassification could be made if the regulatory agency determines that the institution is in an unsafe or unsound condition (which could include unsatisfactory examination ratings). At December 31, 2010, the Corporation and the Bank each satisfied the criteria to be classified as well capitalized within the meaning of applicable regulations.

Regulatory Restrictions on Dividends

Dividend payments by the Bank to the Corporation are subject to the Pennsylvania Banking Code, the Federal Deposit Insurance Act, and the regulations of the FDIC. Under the Banking Code, no dividends may be paid except from accumulated net earnings (generally, retained earnings). The Federal Reserve Board and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks that are not classified as well capitalized or adequately capitalized may not pay dividends.

Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 21, 2010, the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). This legislation is one of the most comprehensive reform bills ever introduced to the financial services industry. Financial service providers from small community banks to the largest Wall Street firms will be affected by this legislation. Many of aspects of this Act will take effect over several years and the Corporation is still reviewing

the details of the Act. At this time, it is difficult to predict the extent to which each component of Dodd-Frank will affect the Corporation. However, it is likely that the Act will impose a greater regulatory burden on the Corporation and increase its cost of compliance. Some of the key provisions included in Dodd-Frank that are likely to affect the Corporation are:

Consumer Financial Protection Bureau (CFPB). The CFPB has been created to set rules and regulations regarding consumer lending activities. Banks with less than $10 billion in assets are exempt from examination by the CFPB, but the CFPB can require community banks to submit any information it requests for review. The CFPB will also require new disclosure requirements for all banks.

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FDIC Insurance. Changes include permanently increasing the insurance limit to $250,000, changing the assessment base from a deposit-based calculation to an asset-based calculation, and extending unlimited FDIC insurance on certain non-interest bearing depository accounts through December 31, 2012.

Corporate Checking. The prohibition against paying interest on corporate checking accounts has been lifted effective July 21, 2011. The Bank is currently researching the best way to take advantage of this change. The Bank currently has $51 million in a sweep Repo that currently it uses, for all intents and purposes, to pay interest on corporate checking accounts. The net effect on interest expense cannot currently be determined, but will be dependent on the type of product developed and customers response to it. Any reduction in the Repo product balance will improve the Bank s liquidity by freeing up securities used as collateral.

Debit Card Fees. The Durbin Amendment to Dodd-Frank requires that the amount of any interchange fee charged by a debit card issuer must be reasonable and proportional to the cost incurred by the issuer. The Federal Reserve is charged with establishing standards for reasonable and proportional fees. This price regulation applies only to banks with assets greater than $10 billion; however, the Bank expects market forces to push the regulated prices down to all banks, potentially reducing the Bank s fee income substantially.

Mortgage Licensing. Residential mortgage loan originators must register with the Nationwide Mortgage Licensing System and Registry. This registry is a database created by the states to support the licensing of mortgage originators. Employees of agency-related institutions must register prior to originating residential mortgage loans. This requirement will increase compliance costs for the Corporation.

Appraisals. New appraisal guidance sets forth the minimum regulatory standard for appraisals. It requires institutions to utilize strong internal controls to ensure reliable appraisals and evaluations to monitor and periodically update valuations of collateral for existing real estate loans. This is expected to increase compliance costs for the Corporation.

Compensation. At least once every three years, companies must conduct a non-binding shareholder vote (say-on-pay) to approve the compensation of the CEO and the company s named executive officers . At least once every 6 years, shareholders must also vote on whether to hold the non-binding vote on executive compensation every 1,2, or 3 years. Additionally, banking regulators have established guidance that prohibits incentive-based compensation arrangements that encourage inappropriate risks that could lead to material financial loss to the institution. Bank compensation plans will be required to be submitted to the appropriate regulator for review and monitoring of compliance. This is expected to increase compliance costs for the Corporation.

FDIC Insurance

The Bank is a member of the Deposit Insurance Fund (DIF), which is administered by the FDIC. The FDIC insures deposit accounts at the Bank, generally up to a maximum of $250,000 for each separately insured depositor. In addition, The Dodd-Frank Act, signed July 21, 2010, extends unlimited FDIC insurance to non-interest bearing transaction accounts through December 31, 2012. Prior to Dodd-Frank, certain transaction accounts were provided unlimited insurance until December 31, 2010 through the FDIC s Transaction Account Guarantee Program (TAGP). Under TAGP, Banks paid an additional fee to provide unlimited coverage. Under Dodd-Frank, the assessment for unlimited coverage will be included as part of the Bank s regular assessment rate.

The FDIC charges a premium to depository institutions for deposit insurance. This rate is based on the risk category of the institution and the total premium is calculated based on total deposits. As of December 31, 2010, the Bank s assessment rate was approximately 15 basis points. The Dodd-Frank Act requires the assessment base to be changed

from total deposits to an assessment method based on average total assets less average tangible equity. The change to the new assessment base will take affect for the quarter beginning April 1, 2011. The Bank does not expect its 2011 FDIC premium to change substantially as a result of the new calculation methodology.

In May 2009, the FDIC implemented a special assessment on insured depository institutions. The Bank accrued $450 thousand for the assessment as of June 30, 2009 and it was collected on September 30, 2009.

On September 29, 2009, the FDIC adopted an Amended Restoration Plan to allow the DIF to return to its statutorily mandated minimum reserve ratio of 1.15 % within 8 years. At the same time, the FDIC adopted higher risk-based assessment rates effective beginning January 1, 2011. It also imposed a prepaid assessment on insured institutions payable December 30, 2009 that required insured institutions to prepay their estimated quarterly risk-based assessment for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. The Bank paid an assessment of approximately $4.0 million on December 30, 2009 and it was recorded as a pre-paid asset that will be recognized through 2012 or until it is depleted, whichever is earlier.

Despite these actions in 2009 to recapitalize the DIF, Dodd-Frank established a new minimum DIF ratio set at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020 and its efforts to achieve this ratio could greatly influence future premium rates.

Insurance of deposits may be terminated by the FDIC upon a finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. We do not currently know of any practice, condition or violation that might lead to termination of our deposit insurance.

In addition to the FDIC assessments, the Financing Corporation (FICO) is authorized to impose and collect, with the approval of the Federal Deposit Insurance Corporation, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the former Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature from 2017 to 2019. At December 31, 2010, the Bank s annualized FICO assessment was approximately 1 basis point of total deposits.

New Legislation

Congress is often considering new financial industry legislation, and the federal banking agencies routinely propose new regulations. The Corporation cannot predict how any new legislation, or new rules adopted by the federal banking agencies, may affect its business in the future.

Selected Statistical Information

Certain statistical information is included in this report as part of Management s Discussion and Analysis of Financial Condition and Results of Operations.

Item 1A. Risk Factors

The following is a summary of the primary risks associated with the Corporation s business, financial condition and results of operations, and common stock.

Risk Factors Relating to the Corporation

A focus on real estate related loans may increase the risk of substantial credit losses.

The Bank offers a variety of loan products, including residential mortgage, consumer, construction and commercial loans. The Bank requires real estate as collateral for many of its loans. At December 31, 2010, approximately 79% of its loans were secured by real estate. Loans to fund residential real estate construction are 11% of total loans; loans secured by residential real estate are 27% of the total, and commercial, industrial and agricultural real estate loans total 41% of the total loan portfolio. These real estate loans are located primarily in the Bank s market area of south central Pennsylvania. Real estate values tend to follow changes in general economic cycles. As a result, if a loan becomes delinquent as the result of an economic downturn and the Bank becomes dependent on the real estate collateral as a source of repayment, it is likely that the value of the real estate collateral has also declined. A decline in real estate values means it is possible that the real estate collateral may be insufficient to cover the outstanding balance of a delinquent or foreclosed loan, resulting in a loss to the Bank. In addition, the real estate collateral is concentrated in a small market area of south central Pennsylvania. As a result, localized events that affect real estate prices and collateral values could have a more negative affect on the Bank as compared to other competitors with a more geographically

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diverse portfolio. As the Bank grows, it is expected that the percentage of real estate loans, specifically commercial real estate, will grow. Risk of loan default is unavoidable in the banking industry, and Management tries to limit exposure to this risk by carefully monitoring the amount of loans in specific industries and by exercising prudent lending practices and securing appropriate collateral. However, this risk cannot be eliminated and substantial credit losses could result in reduced earnings or losses.

The allowance for loan losses may prove to be insufficient to absorb inherent losses in our loan portfolio.

The Bank maintains an allowance for loan losses that Management believes is appropriate to provide for any inherent losses in the loan portfolio. The amount of the allowance is determined through a periodic review and consideration of several factors, including an ongoing review of the quality, size and diversity of our loan portfolio; evaluation of nonperforming loans; historical loan loss experience; and the amount and quality of collateral, including guarantees, securing the loan.

Although Management believes the loan loss allowance is adequate to absorb inherent losses in the loan portfolio, such losses cannot be predicted and the allowance may not be adequate. Excess loan losses could have a material adverse effect on the Bank s financial condition and results of operations.

The Bank s lending limit is smaller than many of our competitors, which affects the size of the loans it can offer customers.

The Bank s lending limit is approximately $12.2 million. Accordingly, the size of the loans that can be offered to potential customers is less than the size of loans that many of our competitors with larger lending limits can offer. This limit affects the Bank s ability to seek relationships with larger businesses in its market area. Loan amounts in excess of the lending limits can be accommodated through the sale of participations in such loans to other banks. However, there can be no assurance that the Bank will be successful in attracting or maintaining customers seeking larger loans or that it will be able to engage in participation of such loans or on terms favorable to the Bank.

There is strong competition in the Bank s primary market areas.

The Bank encounters strong competition from other financial institutions in its primary market area, which consists of Franklin, Cumberland, Fulton and Huntingdon County, Pennsylvania. In addition, established financial institutions not already operating in the Bank s primary market area may open branches there at future dates or can compete in the market via the internet. In the conduct of certain aspects of banking business, the Bank also competes with savings institutions, credit unions, mortgage banking companies, consumer finance companies, insurance companies and other institutions, some of which are not subject to the same degree of regulation or restrictions as are imposed upon the Bank. Many of these competitors have substantially greater resources and lending limits and can offer services that the Bank does not provide. In addition, many of these competitors have numerous branch offices located throughout their extended market areas that provide them with a competitive advantage. No assurance can be given that such competition will not have an adverse effect on the Bank s financial condition and results of operations.

Changes in interest rates could have an adverse impact upon our results of operations.

The Bank s profitability is in part a function of the spread between interest rates earned on investments, loans and other interest-earning assets and the interest rates paid on deposits and other interest-bearing liabilities. Recently, interest rate spreads have generally narrowed due to changing market conditions and competitive pricing pressure. Interest rates are highly sensitive to many factors that are beyond the Bank s control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, will influence not only the interest received on loans and investment securities and the amount of interest we pay on deposits and borrowings, but will also affect the Bank s ability to originate loans and obtain deposits and the value of our investment portfolio. If the rate of interest paid on deposits and other borrowings increases more than the rate of interest earned on loans and other investments, the Bank s net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the rates on loans and other investments fall more quickly than those on deposits and other borrowings. While Management takes measures to guard against interest rate risk, there can be no assurance that such measures will be effective in minimizing the exposure to interest rate risk.

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Risk Factors Relating to the Common Stock

There is a limited trading market for the Corporation s common stock.

There is currently only a limited public market for the Corporation s common stock. It is listed on the OTC Bulletin Board, an automated quotation service, under the symbol FRAF. Because it is thinly traded, you may not be able to resell your shares of common stock for a price that is equal to the price that you paid for your shares. The Corporation has no plans to apply to have its common stock listed for trading on any stock exchange or the NASDAQ market.

The Bank s ability to pay dividends to the Corporation is subject to regulatory limitations that may affect the Corporation s ability to pay dividends to its shareholders.

As a holding company, the Corporation is a separate legal entity from the Bank and does not have significant operations of its own. It currently depends upon the Bank s cash and liquidity to pay dividends to its shareholders. The Corporation cannot assure you that in the future the Bank will have the capacity to pay dividends to the Corporation. Various statutes and regulations limit the availability of dividends from the Bank. It is possible; depending upon the Bank s financial condition and other factors, that the Bank s regulators could assert that payment of dividends by the Bank to the Corporation would constitute an unsafe or unsound practice. In the event that the Bank is unable to pay dividends to the Corporation, the Corporation may not be able to pay dividends to its shareholders.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

The Corporation s headquarters is located in the main office of F&M Trust at 20 South Main Street, Chambersburg, Pennsylvania. This location also houses a community banking office as well as operational support services for the Bank. The Corporation owns or leases thirty-six properties in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania as described below:

Property	Owned	Leased
Community Banking Offices	18	7
Remote ATM Sites	2	5
Other Properties	3	1

Item 3. Legal Proceedings

The nature of our business generates a certain amount of litigation involving matters arising in the ordinary course of business. However, in management s opinion, there are no proceedings pending to which the Corporation is a party or to which our property is subject, which, if determined adversely to the Corporation, would be material in relation to

our shareholders equity or financial condition. In addition, no material proceedings are pending nor are known to be threatened or contemplated against us by governmental authorities or other parties.

Item 4. (Removed and Reserved)

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Part II

Item 5. Market for Registrant s Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities

Market and Dividend Information

The Corporation s common stock is not actively traded in the over-the-counter market. The Corporation s common stock is listed under the symbol FRAF on the OTC Bulletin Board, an automated quotation service. Current price information is available from account executives at most brokerage firms as well as the registered market makers of Franklin Financial Services Corporation common stock as listed below under Shareholders Information.

The range of high and low bid prices is shown in the following table for the years 2010 and 2009, as well as cash dividends declared for those periods. The bids reflect interdealer quotations, do not include retail mark-ups, markdowns or commissions, and may not necessarily represent actual transactions. The closing price of Franklin Financial Services Corporation common stock recorded from an actual transaction on December 31, 2010 was $18.25. The Corporation had 2,095 shareholders of record as of December 31, 2010.

Market and Dividend Information Bid Price Range Per Share

	2010			2009		
(Dollars per share)	High	Low	Dividends Declared	High	Low	Dividends Declared
First quarter	**$ 17.00**	**$ 15.19**	**$ 0.27**	$ 19.00	$ 14.00	$ 0.27
Second quarter	**18.75**	**16.75**	**0.27**	17.50	14.50	0.27
Third quarter	**17.50**	**16.50**	**0.27**	17.00	15.75	0.27
Fourth quarter	**18.40**	**16.50**	**0.27**	20.50	15.46	0.27
			$ 1.08			$ 1.08

For limitations on the Corporation s ability to pay dividends, see Supervision and Regulation Regulatory Restrictions on Dividends in Item 1 above.

The information related to equity compensation plans is incorporated by reference to the materials set forth under the heading Executive Compensation Compensation Tables in the Corporation s Proxy Statement for the 2011 Annual Meeting of Shareholders.

Common Stock Repurchases:

The Corporation announced a stock repurchase plan on July 8, 2010 to repurchase up to 100,000 shares of the Corporation s common stock over a twelve month time period ending on July 8, 2011. The common shares of the Corporation will be purchased in the open market or in privately negotiated transactions. The Corporation uses the repurchased common stock (Treasury stock) for general corporate purposes including stock dividends and splits,

employee benefit and executive compensation plans, and the dividend reinvestment plan. There were no shares repurchased in 2010 under this plan. A plan approved July 9, 2009 that authorized the repurchase of up 100,000 shares expired in 2010 with 4,179 shares repurchased during the plan year.

The following graph compares the cumulative total return to shareholders of Franklin Financial with the NASDAQ Total U.S. Index (a broad market index prepared by the Center for Research in Security Prices at the University of Chicago Graduate School of Business) and with the Northeast OTC-BB and Pink Banks Index (an industry-specific index prepared by SNL Financial LC) for the five year period ended December 31, 2010, in each case assuming an initial investment of $100 on December 31, 2005 and the reinvestment of all dividends.

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Franklin Financial Services Corporation

Total Return Performance

	Period Ending					
Index	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10
Franklin Financial Services Corporation	$ 100.00	$ 112.32	$ 106.75	$ 81.84	$ 78.04	$ 92.90
NASDAQ Composite	$ 100.00	$ 110.39	$ 122.15	$ 73.32	$ 106.57	$ 125.91
SNL Northeast OTC-BB & Pink Banks	$ 100.00	$ 103.34	$ 100.64	$ 81.97	$ 77.02	$ 83.86

Shareholders Information

Dividend Reinvestment Plan:

Franklin Financial Services Corporation offers a dividend reinvestment program where by record holders of shares of the Corporation s common stock may reinvest their dividends in additional shares of the Corporation. Beneficial owners of shares of the Corporation s common stock may participate in the program by making appropriate arrangements through their ban, broker or other nominee. Information concerning this optional program is available by contacting the Corporate Secretary at 20 South Main Street, P.O. Box 6010, Chambersburg, PA 17201-6010, telephone 717-264-6116.

Dividend Direct Deposit Program:

Franklin Financial Services Corporation offers a dividend direct deposit program whereby whereby recordholders of shares of the Corporation s common stock may choose to have their dividends deposited directly into the bank account of their choice on the dividend payment date. Information concerning this optional program is available by contacting the Corporate Secretary at 20 South Main Street, P.O. Box 6010, Chambersburg, PA 17201-6010, telephone 717-264-6116.

Annual Meeting:

The Annual Shareholders Meeting will be held on Tuesday, April 26, 2011, at the Orchard Restaurant & Banquet Facility, 1580 Orchard Drive, Chambersburg, Pennsylvania. The Business Meeting will begin at 10:30 a.m. followed by a luncheon.

Website:

www.franklinfin.com

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Stock Information:

The following brokers are registered as market makers of Franklin Financial Services Corporation s common stock:

RBC Wealth Management	2101 Oregon Pike, Lancaster, PA 17601	800/646-8647
Boenning & Scattergood, Inc.	1700 Market Street, Suite 1420, Philadelphia, PA 19103-3913	800/883-1212
Ryan, Beck & Co.	3 Parkway, Philadelphia, PA 19102	800/223-8969
Morgan Keegan	Two Buckhead Plaza, 3050 Peachtree Road, NW, Suite 704 Atlanta, GA 30305	866/353-7522

Registrar and Transfer Agent:

The registrar and transfer agent for Franklin Financial Services Corporation is Fulton Financial Advisors, N.A., P.O. Box 4887, Lancaster, PA 17604.

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Item 6. Selected Financial Data

(Dollars in thousands, except per share)	Summary of Selected Financial Data for the Year Ended December 31, 2010	2009	2008	2007	2006
Summary of operations					
Interest income	**$43,284**	$43,757	$46,156	$49,487	$40,902
Interest expense	**12,443**	14,674	16,037	23,796	19,956
Net interest income	**30,841**	29,083	30,119	25,691	20,946
Provision for loan losses	**3,235**	3,438	1,193	990	240
Net interest income after provision for loan losses	**27,606**	25,645	28,926	24,701	20,706
Noninterest income	**9,366**	8,880	6,538	10,107	8,257
Noninterest expense	**26,423**	25,929	23,189	22,793	19,296
Income before income taxes	**10,549**	8,596	12,275	12,015	9,667
Income tax	**2,937**	2,011	3,680	2,759	2,097
Net income	**$7,612**	$6,585	$8,595	$9,256	$7,570
Performance measurements					
Return on average assets	**0.78%**	0.69 %	1.01 %	1.14 %	1.07 %
Return on average equity	**9.34%**	8.69 %	10.99 %	12.62 %	11.92 %
Return on average tangible assets[1]	**0.82%**	0.74 %	1.05 %	1.18 %	1.09 %
Return on average tangible equity[1]	**11.27%**	10.79 %	13.19 %	15.41 %	13.42 %
Efficiency ratio[2]	**63.43%**	65.35 %	61.25 %	61.28 %	63.06 %
Net interest margin	**3.53%**	3.44 %	4.03 %	3.67 %	3.45 %
Current dividend yield	**5.92%**	6.61 %	5.92 %	4.17 %	3.66 %
Dividend payout ratio	**55.10%**	62.95 %	47.66 %	42.77 %	47.03 %
Shareholders' Value (per common share)					
Diluted earnings per share	**$1.96**	$1.71	$2.24	$2.40	$2.10
Basic earnings per share	**1.96**	1.71	2.24	2.41	2.11
Regular cash dividends paid	**1.08**	1.08	1.07	1.03	0.99
Book Value	**21.09**	20.39	19.10	20.18	19.01
Market value	**18.25**	16.33	18.25	24.95	27.30
Market value/book value multiple	**0.87**	0.80	0.96	1.24	1.44
Price/earnings multiple	**9.31**	9.55	8.15	10.40	13.00
Balance Sheet Highlights					
Total assets	**$951,889**	$979,373	$902,460	$820,371	$799,333
Investment securities (includes restricted stock)	**123,775**	149,770	154,041	168,906	192,487
Loans, net	**739,841**	730,626	668,860	564,256	521,684
Deposits and customer repurchase agreements	**785,495**	794,220	691,653	674,434	673,705
Shareholders' equity	**82,639**	78,766	73,059	77,642	71,614
Safety and Soundness					
Leverage ratio (Tier 1)	**8.16%**	7.50 %	7.84 %	8.18 %	7.60 %
Risk-based capital ratio (Tier 1)	**11.73%**	10.89 %	11.02 %	12.28 %	10.59 %
Tangible common equity ratio[3]	**8.21%**	7.47 %	7.72 %	8.13 %	7.52 %

Nonperforming loans/gross loans	**3.68%**	2.47	%	0.59	%	1.01	%	0.57	%
Nonperforming assets/total assets	**2.96%**	1.93	%	0.44	%	0.73	%	0.29	%
Allowance for loan losses as a % of loans	**1.18%**	1.21	%	1.09	%	1.29	%	1.30	%
Net charge-offs/average loans	**0.45%**	0.26	%	0.19	%	0.09	%	0.04	%
Average equity to average asset ratio	**8.36%**	7.98	%	9.18	%	8.98	%	8.96	%
Trust assets under management (market value)	**$490,420**	$460,233		$497,215		$507,920		$538,152	

(1) Excludes core deposit intangibles, goodwill and intangible amortization

(2) Noninterest expense/tax equivalent net interest income plus noninterest income less net securities gains

(3) Total equity less AOCI, goodwill and intangibles/total assets less goodwill and intangibles

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

Application of Critical Accounting Policies:

Disclosure of the Corporation s significant accounting policies is included in Note 1 to the consolidated financial statements. These policies are particularly sensitive requiring significant judgments, estimates and assumptions to be made by Management. Senior management has discussed the development of such estimates, and related Management Discussion and Analysis disclosure, with the Audit Committee of the Board of Directors. The following accounting policies are the ones identified by management to be critical to the results of operations:

Allowance for Loan Losses The allowance for loan losses is the estimated amount considered adequate to cover credit losses inherent in the outstanding loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses, charged against income. In determining the allowance for loan losses, Management makes significant estimates and, accordingly, has identified this policy as probably the most critical for the Corporation.

Management performs a monthly evaluation of the adequacy of the allowance for loan losses by asset class. Consideration is given to a variety of factors in establishing this estimate including, but not limited to, current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, borrowers actual or perceived financial and managerial strengths, the adequacy of the underlying collateral (if collateral dependent) and other relevant factors. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans.

The analysis has two components, specific and general allocations. Expected cash flow or collateral values discounted for market conditions and selling costs are used to establish specific allocations. The Bank s historical loan loss experience and other qualitative factors derived from economic and market conditions are used to establish general allocations for the remainder of the portfolio. The allowance for loan losses was $8.8 million at December 31, 2010.

Management monitors the adequacy of the allowance for loan losses on an ongoing basis and reports its adequacy assessment quarterly to the Credit Risk Oversight Committee of the Board of Directors.

Mortgage Servicing Rights In the past, the Bank originated fixed rate mortgages that it subsequently sold to the secondary market. However, the Bank retained the rights to service these loans for its customers. As required by FASB Accounting Standard Codification (ASC) Topic 860, Transferred Financial Assets , upon the sale of mortgage loans, the Bank capitalizes the value allocated to the servicing rights in other assets. The capitalized servicing rights are amortized against noninterest income in proportion to, and over the periods of, the estimated net servicing income of the underlying financial assets.

Capitalized servicing rights are carried at the lower of cost or market and are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. The rights are deemed to be impaired when the fair value of the rights is less than the amortized cost. If impaired, the Bank records a charge against noninterest income from mortgage banking activities through a mortgage servicing rights valuation allowance. The amount charged to the valuation allowance can be reversed in future periods if the rights are determined to no longer be impaired. However, the amount of impairment reversed may not exceed the balance of the valuation allowance.

The fair value of the servicing rights is determined through a discounted cash flow analysis and calculated using a computer-pricing model. The pricing model is based on the objective characteristics of the mortgage servicing portfolio (e.g, loan balance and interest rate) and commonly used industry assumptions (e.g., prepayment speeds, discount rates). The assumptions take into account those that many active purchasers of servicing rights employ in their evaluations of portfolios for sale in the secondary market. The unique characteristics of the secondary servicing market often dictate adjustments to the assumptions over short periods of time. Subjective factors are also considered in the derivation of market values, including levels of supply and demand for servicing, interest rate trends, and perception of risk not incorporated into prepayment assumptions.

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Financial Derivatives As part of its interest rate risk management strategy, the Bank has entered into interest rate swap agreements. A swap agreement is a contract between two parties to exchange cash flows based upon an underlying notional amount. Under the swap agreements, the Bank pays a fixed rate and receives a variable rate from an unrelated financial institution serving as counter-party to the agreements. The swaps are designated as cash flow hedges and are designed to minimize the variability in cash flows of the Bank s variable rate liabilities attributable to changes in interest rates. The swaps in effect convert a portion of a variable rate liability to a fixed rate liability.

The interest rate swaps are recorded on the balance sheet at fair value as an asset or liability. To the extent the swaps are effective in accomplishing their objectives, changes in the fair value are recorded in other comprehensive income. To the extent the swaps are not effective, changes in fair value are recorded in interest expense. Cash flow hedges are determined to be highly effective when the Bank achieves offsetting changes in the cash flows of the risk being hedged. The Bank measures the effectiveness of the hedges on a quarterly basis and it has determined the hedges are highly effective. Fair value is heavily dependent upon the market s expectations for interest rates over the remaining term of the swaps.

Temporary Investment Impairment Investment securities are written down to their net realizable value when there is impairment in value that is considered to be other-than-temporary. The determination of whether or not other-than-temporary impairment exists is a matter of judgment. Management reviews investment securities regularly for possible impairment that is other-than-temporary by analyzing the facts and circumstances of each investment and the expectations for that investment s performance. Other-than-temporary impairment in the value of an investment may be indicated by the length of time and the extent to which market value has been less than cost; the financial condition and near term prospects of the issuer; and whether the Corporation has the intent to sell or is likely to be forced to sell the investment prior to any anticipated recovery in market value.

Stock-based Compensation The Corporation has two stock compensation plans in place consisting of an Employee Stock Purchase Plan (ESPP) and an Incentive Stock Option Plan (ISOP).

The Corporation accounts for stock compensation plans in accordance with FASB Accounting Standards Codification Topic 718, Stock Compensation. ASC Topic 718 requires compensation costs related to share-based payment transactions to be recognized in the financial statements (with limited exceptions). The amount of compensation cost is measured on the grant-date fair value of the equity or liability instruments issued. Compensation cost is recognized over the period that an employee provides services in exchange for the award.

The Corporation calculates the compensation cost of the options by using the Black-Scholes method to determine the fair value of the options granted. In calculating the fair value of the options, the Corporation makes assumptions regarding the risk-free rate of return, the expected volatility of the Corporation s common stock, dividend yield and the expected life of the option. These assumptions are made independently for the ESPP and the ISOP and if changed, would change the compensation cost of the options and net income.

Note 1 of the accompanying financial statements provides additional information about stock option expense.

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GAAP versus Non-GAAP Presentations The Corporation supplements its traditional GAAP measurements with Non-GAAP measurements. The Non-GAAP measurements include Return on Average Tangible Assets and Return on Average Tangible Equity. As a result of merger transactions, intangible assets (primarily goodwill, core deposit intangibles and customer list) were created. The Non-GAAP disclosures are intended to eliminate the effects of the intangible assets and allow for better comparisons to periods when such assets did not exist. The following table shows the adjustments made between the GAAP and NON-GAAP measurements:

GAAP Measurement	Calculation
Return on Average Assets	Net Income/Average Assets
Return on Average Equity	Net Income/Average Equity

Non- GAAP Measurement	Calculation
Return on Average Tangible Assets	Net Income plus Intangible Amortization/Average Assets less Average Intangible Assets
Return on Average Tangible Equity	Net Income plus Intangible Amortization/Average Equity less Average Intangible Assets

Results of Operations:

Management s Overview

The following discussion and analysis is intended to assist the reader in reviewing the financial information presented and should be read in conjunction with the consolidated financial statements and other financial data presented elsewhere herein.

2010 ended the year much the way it began, with the economy struggling through the recession, high unemployment and foreclosure rates, and short-term rates remaining at historic lows. These conditions continued to place stress on banks and 2010 saw 157 banks fail. Even though Franklin Financial Services Corporation is not immune to the economic pressures, it is pleased with its 2010 earnings that increased 16% over 2009. In 2010 the Corporation earned $7.6 million compared to $6.6 million in 2009. Diluted earnings per share increased from $1.71 in 2009 to $1.96 in 2010. Net interest income was $30.8 million, $1.8 million more than in 2009. The provision expense was $3.2 million for the year compared to $3.4 million in 2009. Credit quality indicators declined in 2010 as net charge-offs increased to .45% of average loans and nonperforming assets as a percent of total assets increased to 2.96%. Shareholders equity increased to $82.6 million and the return on equity for 2010 was 9.34%. Total assets fell slightly, decreasing by approximately 3% to $951.9 million at year-end and the return on assets for 2010 was .78%. Other key performance measurements are presented above in Item 6, Selected Financial Data.

A more detailed discussion of the areas that had the greatest affect on the reported results follows.

Net Interest Income

The most important source of the Corporation s earnings is net interest income, which is defined as the difference between income on interest-earning assets and the expense of interest-bearing liabilities supporting those assets. Principal categories of interest-earning assets are loans and securities, while deposits, securities sold under agreements to repurchase (Repos), short-term borrowings and long-term debt are the principal categories of interest-bearing

liabilities. For the purpose of this discussion, balance sheet items refer to the average balance for the year and net interest income is adjusted to a fully taxable-equivalent basis. This tax-equivalent adjustment facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Corporation s 34% Federal statutory rate. The components of net interest income are detailed in Tables 1, 2 and 3.

2010 versus 2009

Summary: In 2010, tax equivalent net interest income increased by $1.6 million to $31.9 million when compared to the prior year. This represents an increase of 5.4% in 2010 versus a decline of 3.9% in 2009. Interest rates remained low throughout 2010 and this resulted in a decrease in interest income of $606 thousand. However, this decrease was more than offset by a decrease in interest expense of $2.2 million. The net interest margin improved from 3.44% in 2009 to 3.53% in 2010, primarily the result of a 31 basis point reduction in funding costs that more than offset a 19 basis point reduction in asset yield.

Assets: Interest earning assets averaged $903.9 million in 2010, an increase of 2.6% over the 2009 average of $880.9 million. The asset yield fell from 5.10% in 2009 to 4.91% in 2010 as nearly every earning asset category realized a reduction in yield over the year. Interest income declined slightly to $44.3 million, a decrease of 1.3% from the 2009 total of $45.0 million. The affect of a higher volume of earning assets was not enough to offset the negative affect of lower rates on interest income.

Investment securities averaged $137.3 million for the year, approximately $15 million less than the prior year average. The Bank has not been actively increasing its investment purchases choosing rather to reinvest the funds into loans. Investment purchases throughout the year were made primarily to provide collateral needed for secured deposit and Repo accounts. A smaller portfolio and lower yields have contributed almost equally to a drop in interest income of $1.3 million in the portfolio. The yield on the portfolio dropped from 4.5% in 2009 to 4.0% in 2010.

The loan portfolio grew in 2010 as average loans totaled $753.6 million compared to $710.1 million in 2009. However, only the commercial loan sector increased in 2010 while all other loan categories declined during the year. Despite the increase in total loans, the yield fell from 5.36% to 5.15% in 2010, but interest income on loans increased $679 thousand as higher volume more than offset the negative affect of lower rates on interest income.

Commercial loans grew by $64.5 million in 2010 to an average of $576.3 million. Commercial lending has remained steady with both new financing opportunities as well as refinancing of existing customers. Because rates have remained low, the yield on the commercial loan portfolio fell for the second straight year from 4.97% to 4.85%. In an effort to counter the affect of the low rate environment, the Bank has been implementing rate floors on new and renewed credits. Currently, approximately 53% of the commercial portfolio is variable rate and nearly $200 million of this total has a rate floor. While the rate floors provide an immediate benefit, they will delay any potential increase in interest income as rates rise.

The balance of residential mortgage loans continues to run-off with a 2010 average balance of $66.1 million. This is approximately $7 million less than the 2009 average and $17.6 million less than the 2008 balance. The Bank is retaining fewer of the mortgages it originates and the loans it retains are not sufficient to counter the run-off on the existing portfolio. The yield on this portfolio also continues to fall, averaging 5.68% in 2010 compared to 6.30% in 2009. Interest income is down $861 thousand versus 2009 and rate and volume declines contributed equally to the reduction. The Bank expects that its residential mortgage portfolio will continue to pay-down.

For the past several years, home equity lending has been a leader of retail activity. However, this trend ended in 2010 when home equity lending slowed and the balance of these loans fell by $8.9 million to a 2010 average of $89.3 million. Many consumers have seen their home s equity fall, have experienced a reduction or loss of income, or have reduced their spending. These factors have all contributed to a reduction in home equity lending. The yield on this product fell slightly to 6.35%, driven down primarily by lower volume. Until real estate prices recover and consumers begin to have confidence in the economy, home equity lending is expected to be slow.

Consumer lending continues to be slow, declining for a second straight year to an average balance of $21.9 million, $5.0 million less than in 2009. This decrease is primarily the result of the Bank s decision to end indirect lending in 2010 and as a result the average balance of the indirect portfolio fell by $5.4 million in 2010. The yield on the consumer portfolio fell by .09%, primarily the result of lower volume.

Liabilities: Interest bearing liabilities averaged $793.8 million in 2010 an increase of $13.2 million over the 2009 average. All of the deposit categories recorded an increase over 2009, except for time deposits. Repos and long-term debt also declined year over year. The expense of interest bearing liabilities was $12.4 million in 2010 compared to $14.7 million in 2009. Likewise, the cost of these funds fell from 1.88% in 2009 to 1.57% in 2010. The Bank was able to reduce the rate on selected interest bearing accounts and these efforts were the primary reason for the lower interest expense.

The Money Management product saw a significant increase in balances in 2010, averaging $272.6 million or 26% higher than the 2009 average. The competitive yield and liquidity offered by this product proved attractive to consumers in 2010. The Bank did see some internal funds transferred as time deposits matured and moved to the Money Management product. The cost of these funds fell from 1.61% in 2009 to 1.32% in 2010, but the higher volume more than offset the savings from lower rates and interest expense increased by approximately 3% year over year.

Partially offsetting the growth in Money Management was a reduction in the average balance of time deposits, which fell by approximately $25 million to an average of $221.4 million in 2010. Time deposit balances are comprised of both retail and brokered CDs. Some of the balance decrease can be attributed to maturing funds being moved to Money Management and to a $4.0 million reduction in the average balance of wholesale-brokered CDs in 2010. The cost of time deposits fell significantly from 2.68% in 2009 to 2.09% in 2010 and this reduction was the largest contributor to lower interest expense on both time deposits and to total interest expense.

The average balance of Repos fell for the third straight year to an average of $60.3 million in 2010. Repos are a cash management product used by corporate customers. As liquidity continued to tighten for many commercial customers, balances in the Repo continued to decline. The rate of this product remained constant at .25% year over year, but interest expense fell due to lower volume.

Long-term debt is comprised of advances from FHLB Pittsburgh. The Bank did not take any new advances in 2010 and the lower balance is reflective of scheduled amortization and maturities. Even though the balance and interest expense declined in 2010, the cost of these funds increased slightly because the rate on maturing funds was less than the weighted rate of the entire portfolio.

2009 versus 2008

Summary: Tax equivalent net interest income fell by approximately 3.9% in 2009 to $30.3 million. As short-term rates remained near historic lows during the year, the Bank experienced a larger decrease in tax-equivalent interest income than the decrease in interest expense. Therefore, the net interest margin fell to 3.44% in 2009 after two straight years of increases. As assets repriced during the year, tax-equivalent interest income dropped from $47.5 million in 2008 to $45.0 million in 2009. While earning asset growth increased interest income, the low rate environment more than offset this increase resulting in a reduction of net interest income year over year. Interest expense was lower in 2009 than in 2008, as deposit rates were reduced through the year. However, the rate reductions on deposits were not enough to offset the reduction in interest income.

Assets: Interest earning assets grew by approximately 13% during 2009, but produced $2.5 million less interest income than in 2008. The yield on earning assets decreased by nearly 1% year over year, as assets continued to reprice to lower rates throughout the year.

Short-term interest earning assets were substantially higher than in 2008. However, despite a balance nearly fourteen times higher than the prior year, interest income from this asset actually declined by $13 thousand.

The investment portfolio decreased by approximately $8 million as the majority of investment purchases made in 2009 were to replace collateral for secured borrowings. The composition of the portfolio did not change significantly from the prior year. The yield on the investment portfolio fell to 4.5% in 2009, a decrease of approximately 80 basis points when compared to the 2008 yield. Investment income declined by $1.7 million in 2009 and was due primarily to lower yields on investment assets.

The loan portfolio showed an increase of approximately $90 million in 2009, but was also affected by lower rates as the loan yield declined nearly 1%. The growth in loans was not enough to offset the effect of lower rates and loan interest fell by 2% to $38.1 million during the year. Loan growth was driven by an increase of $108 million in commercial loans in 2009. Despite the poor economy, the Bank was able to continue to originate loans in its markets and supplemented this growth with purchased participations primarily within south central Pennsylvania. The Bank was able to capture new business because some larger bank competitors had reduced their lending activity during the year. Approximately 54% of the commercial loan portfolio contains loans with variable rates that reprice with market rates.

The average balances of residential mortgage and consumer loan balances both decreased year over year and yielded lower rates than in 2008. As a result of these changes, both of these products generated $1.6 million less interest income than in 2008. The Bank s mortgage portfolio continued to decline because the Bank sells most of its mortgage loan production and it expects this trend to continue. In addition, the low rate environment of 2009 created a mortgage refinance boom that resulted in some of the Bank s portfolio mortgages being refinanced. Consumer lending activity was slow in 2009, with balances decreasing by $7.5 million from the 2008 average. The recession, higher unemployment and lower consumer confidence about jobs and the economy all caused consumer spending and borrowing to fall in 2009. Lower real estate values evaporated homeowners equity in 2009 and home equity lending declined year over year after several years of strong growth.

Liabilities: Interest earning assets averaged $880.9 million in 2009 compared to $782.2 million in the prior year and the yield fell from 6.08% in 2008 to 5.10% in 2009. Consequently, tax-equivalent interest income fell from $47.5 million in 2008 to $45.0 million in 2009. The growth in average interest earning assets produced $4.3 million in additional interest income, but this was more than offset by lower yields that reduced interest income by $6.9 million.

While lower rates negatively affected interest income, the same rate environment enabled the Bank to reduce its interest expenses by $1.4 million despite an increase in interest bearing liabilities of approximately $100 million. Interest expense in 2009 was $14.7 million compared to $16.0 million in 2008. Interest expense on deposits decreased $706 thousand while the interest expense on other interest bearing liabilities decreased by $657 thousand. The average balance of interest bearing deposits was $607.8 million in 2009, and increase of 18% compared to the prior year. However, the cost of these funds was 44 basis points less than in 2008. The Money Management product posted a modest increase of approximately 3% on average balances and the average rate fell from 2.01% in 2008 to 1.61% in 2009. While short-term rates remained low during 2009, they were fairly stable. Therefore, the Bank was not able to reduce interest expense on the Money Management product as much in 2009 as it did in 2008. Time deposits increased by approximately $72 million year over year and the cost fell from 3.61% to 2.68%. Despite the lower rate, the increase in balances offset any interest savings from lower rates and interest expense on time deposits was $298 thousand higher in 2009. Time deposit growth was split between in-market growth and brokered time deposits.

Securities sold under agreements to repurchase (Repos) averaged $67.0 million in 2009, down from the 2008 average of $75.2 million. During the recession, corporate cash managers did not have as much excess liquidity as in past years and this contributed to the decline in balances. The cost of these funds fell significantly in 2009 to a rate of .25% compared to 1.88% in 2008. Long-term debt (FHLB advances) increased by $25.3 million on average in 2009 and the cost fell to 4.03%. The increase in the average balance for 2009 is due the volume of advances taken in 2008, with the majority occurring in the fourth quarter of 2008. The Bank took only $379 thousand of FHLB advances in 2009.

Total average interest bearing liabilities were $780.6 million in 2009, 14.7% higher than the 2008 average. Interest expense declined by 8.5% and the rate on these funds fell from 2.36% in 2008 to 1.88% in 2009. The higher average balance of interest bearing liabilities increased interest expense by $3.2 million, but lower rates more than offset that by decreasing $4.5 million, resulting in a net decline in interest expense.

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See Tables 1, 2 and 3 for more information on net interest income, average balances, rates, and a rate-volume analysis of net interest income.

Table 1. Net Interest Income

(Dollars in thousands)	2010	% Change	2009	% Change	2008	% Change
Interest income	**$ 43,284**	**-1.08%**	$ 43,757	-5.20 %	$ 46,156	-6.73 %
Interest expense	**12,443**	**-15.20%**	14,674	-8.50 %	16,037	-32.61 %
Net interest income	**30,841**	**6.04%**	29,083	-3.44 %	30,119	17.24 %
Tax equivalent adjustment	**1,061**		1,194		1,369	
Tax equivalent net interest income	**$ 31,902**	**5.37%**	$ 30,277	-3.85 %	$ 31,488	15.03 %

Table 2 identifies increases and decreases in tax equivalent net interest income to either changes in average volume or to changes in average rates for interest-earning assets and interest-bearing liabilities. Numerous and simultaneous balance and rate changes occur during the year. The amount of change that is not due solely to volume or rate is allocated proportionally to both.

Table 2. Rate-Volume Analysis of Net Interest Income

	2010 Compared to 2009 Increase (Decrease) due to:			2009 Compared to 2008 Increase (Decrease) due to:		
(Dollars in thousands)	Volume	Rate	Net	Volume	Rate	Net
Interest earned on:						
Interest-bearing obligations in other banks and Federal funds sold	**$(10)**	**$13**	**$3**	$58	$(71)	$(13)
Investment securities:						
Taxable	**(426)**	**(639)**	**(1,065)**	(152)	(1,123)	(1,275)
Nontaxable	**(213)**	**(10)**	**(223)**	(286)	(124)	(410)
Loans:						
Commercial, industrial and agricultural	**3,141**	**(616)**	**2,525**	5,866	(5,149)	717
Residential mortgage	**(425)**	**(436)**	**(861)**	(663)	(102)	(765)
Home equity loans and lines	**(567)**	**(77)**	**(644)**	(294)	(269)	(563)
Consumer	**(318)**	**(23)**	**(341)**	(195)	(70)	(265)
Loans	**1,831**	**(1,152)**	**679**	4,714	(5,590)	(876)
Total net change in interest income	**1,182**	**(1,788)**	**(606)**	4,334	(6,908)	(2,574)
Interest expense on:						
Interest-bearing checking	**3**	**(9)**	**(6)**	36	(131)	(95)
Money market deposit accounts	**810**	**(701)**	**109**	140	(856)	(716)
Savings accounts	**1**	**(17)**	**(16)**	(3)	(190)	(193)
Time deposits	**(622)**	**(1,340)**	**(1,962)**	2,192	(1,894)	298
Securities sold under agreements to repurchase	**(17)**		**(17)**	(139)	(1,105)	(1,244)
Short-term borrowings	**(13)**		**(13)**	(106)	(80)	(186)
Long-term debt	**(477)**	**151**	**(326)**	1,031	(258)	773
Total net change in interest expense	**(315)**	**(1,916)**	**(2,231)**	3,151	(4,514)	(1,363)
Increase (decrease) in net interest income	**$1,497**	**$128**	**$1,625**	$1,183	$(2,394)	$(1,211)

2009 versus 2008

Nonaccruing loans are included in the loan balances. All nontaxable interest income has been adjusted to a tax-equivalent basis, using a tax rate of 34%.

The following table presents average balances, tax-equivalent interest income and expense, and yields earned or rates paid on the assets or liabilities.

Table 3. Analysis of Net Interest Income

Provision for Loan Losses

During 2010, the Corporation saw an increase in nonperforming assets and a second straight year of net loan charge-offs in excess of $3.0 million as the economy continued to be stressed by the effects of the recession. These factors coupled with continued loan growth contributed to the decision to add $3.2 million to the allowance for loan losses via the provision expense in 2010. In 2009, the provision expense was $3.4 million. The provision increased significantly during the fourth quarter of 2010 due primarily to one commercial real estate loan that was added to nonaccrual status and identified as impaired at December 31,

2010. As a result of this action, $1.0 million in additional provision expense was added at year-end. Net loan charge-offs were $3.4 million in 2010 and more than offset the provision expense, resulting in a net decrease to the allowance for loan losses (ALL) of $100 thousand. The ALL as a percentage of total loans was 1.18% at year-end compared to 1.21% at the end of 2009. Management performs a monthly analysis of the loan portfolio considering current economic conditions and other relevant factors to determine the adequacy of the allowance for loan losses and the provision for loan losses. For more information, refer to the Loan Quality discussion and Tables 12 17.

Noninterest Income

2010 versus 2009

Summary: Noninterest income totaled $9.4 million an increase of 5.5% over the 2009 total of $8.9 million. An increase in investment and trust service fees and security gains was partially offset by an increase in OTTI charges and the absence of a nonrecurring income event that occurred in 2009, but not in 2010.

Investment and Trust Services: These fees increased to $3.8 million in 2010, an increase of 9.2% over the 2009 total of $3.5 million. Compared to 2009, this area saw an increase in both recurring and nonrecurring fee income. Recurring fee income is generated by trust assets under management and benefited by both an increase in accounts and a recovery of market value. Trust assets under management increased $30 million from 2009 to 2010. Nonrecurring fee income which is produced by estate administration and settlement fees also increased in 2010. Income for the sale of investment and insurance products remained stable year over year. The Bank is actively pursuing new investment and trust accounts as some larger local competitors have implemented a minimum account size that has caused some of these customers to look elsewhere for service.

Loan service charges: The category was virtually flat at $1.1 million in 2010 versus $1.2 million in 2009. Fees collected as prepayment penalties on commercial loans increased in 2010, but were offset by a reduction in fees earned for the origination of mortgage loans. Mortgages originated for a fee totaled $22 million in 2010, down from $38 million in 2009. Consumer loan fees, including fees for a debt protection program, increased slightly in 2010. Also included in consumer loan fees are fees generated from indirect loans. With the indirect loan portfolio running off rapidly since the Bank stopped writing new business in 2010, this source of fee income is expected to decline in proportion to the loan balances.

Mortgage banking fees: Mortgage banking activities consist primarily of servicing mortgage loans originated and sold by the Bank. These fees remained stable at $146 thousand in 2010 compared to $145 thousand in 2009. However, in 2010 fees from servicing mortgages declined as the portfolio of mortgages serviced for others ($79.9 million) continues to pay down. Gains on sales of mortgages increased by $20 thousand in 2010 due to the fact that the Bank was changing its fee-based origination partner during the year and for a short time had to fund and sell mortgages rather than originating for a fee only. For loans that were previously sold with servicing retained, mortgage servicing rights (MSR) are recorded and represent the Bank s rights to receive future fee income from servicing these loans. MSR are measured and carried at the lower of cost or market value and in 2010 the Bank had net reversals of $146 thousand of previously recorded MSR impairment charges. However, this is less than the 2009 net reversal of $212 thousand. In addition, the amortization of MSR in 2010 was approximately $100 thousand less than in 2009, thereby enhancing mortgage banking fees. While the Bank does not expect to originate and sell mortgages with servicing retained in the future, it will retain the existing servicing portfolio until those loans are paid-off. See Note 9 of the accompanying consolidated financial statements for additional information on mortgage servicing rights.

Deposit fees: In 2010, this category produced $2.4 million in fees compared to $2.6 million in 2009, a decrease of 7.2%. Commercial account fees remained fairly constant year over year, but an increase in commercial overdraft fees was offset by a decrease in commercial account analysis fees. Retail checking fees and overdraft charges remained constant at approximately $1.0 million for both years. The Bank s overdraft coverage program saw fees decrease by $154 thousand in 2010. A portion of this decrease can be attributed to new overdraft protection regulations, targeted toward overdraft protection programs that went into effect in mid-2010. Under these new regulations, consumers are required to opt-in to such programs. The Bank made a

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significant effort to notify customers of this change and to educate them about the benefits and use of overdraft protection programs. The Bank is closely monitoring the affect this new regulation has on its fee income and because of it, does not expect to see this service generating a significant amount of new fee income in the future.

Other service charges and fees: These fees increased 7.6% from 2009 to $1.4 million. The largest contributing factor to the increase came from debit card fees. Debit card fees increased $152 thousand year over year and both business and retail debit card products recorded an increase in fee income over 2009. The business debit card offers a cash back rewards program based on usage and it continues to grow in popularity. In July 2011, components of the Durbin Act are expected to go into effect that will restrict interchange fees charged by Banks and in turn reducing fee income to all card issuing banks. As currently proposed, this price regulation is intended only for banks with assets greater than $10 billion. However, if implemented, it is expected that market forces will drive this change down to a point where all banks are essentially faced with lower fee income from interchange fees. If implemented as proposed, the Durbin Act has the potential to reduce the Bank s fee income by hundreds of thousands of dollars. There are currently alternative proposals to the Durbin Act being presented, but it is unknown at this time what the final outcome will be.

Other: This category decreased significantly as a result of a $278 thousand gain from life insurance proceeds in 2009 that did not occur in 2010.

Securities gains and losses: In 2010, other-than-temporary-impairment charges of $1.1 million was recorded on three equity securities and two bond securities that it considered to be other than temporarily impaired. These charges include $406 thousand on the merger of First Chester County Corporation into Tower Bancorp, Inc. and $335 thousand on two private label mortgage backed securities. In 2009, $422 thousand of impairment charges on four equity securities were recorded. Net securities gains were $673 thousand in 2010 compared to net losses of $522 thousand in 2009.

The following table presents a comparison of noninterest income for the years ended December 31, 2010 and 2009:

Table 4. Noninterest Income

	December 31		Change	
	2010	2009	Amount	%
	$3,844	$3,519	$325	
	1,132	1,151	(19)	
	146	145	1	
	2,390	2,575	(185)	
	1,390	1,292	98	
ife insurance	**672**	643	29	
	178	499	(321)	

The Valuation Committee will consider pricing methodologies it deems relevant and appr
value determination, based on the facts and circumstances specific to the portfolio instrum
determinations generally will be derived as follows, using public or private market inform

(i) If available, fair value determinations shall be derived by extrapolating from recent t
quoted prices for identical or comparable securities.

(ii) If such information is not available, an analytical valuation methodology may be use information including, but not limited to: analyst appraisals, research reports, corpor financial statements and shelf registration statements. Such analytical valuation meth are not limited to: multiple of earnings, discount from market value of a similar free cash flow analysis, book value or a multiple thereof, risk premium/yield analysis, yi fundamental investment analysis.

The purchase price of a portfolio instrument will be used to fair value the instrument only methodology is available or deemed appropriate, and it is determined that the purchase pri instrument s current value.

For each portfolio security that has been fair valued pursuant to the policies adopted by the compared against the last available and next available market quotations. The Valuation C of such testing and fair valuation occurrences are reported to the Board.

3. Portfolio Securities and Investments in Derivatives

Portfolio Securities

Repurchase Agreements

In connection with transactions in repurchase agreements, it is the Fund s policy that its c underlying collateral securities, the fair value of which exceeds the principal amount of the including accrued interest, at all times. If the counterparty defaults, and the fair value of th realization of the collateral may be delayed or limited.

The following table presents the repurchase agreements for the Fund that are subject to ne of the reporting period, and the collateral delivered related to those repurchase agreements

Counterparty	Short-Term Investments, at Value	Colla Pledged (F Counterp
Fixed Income Clearing Corporation	$ 8,343,440	$ (8,34

* As of the end of the reporting period, the value of the collateral pledged from the counte the repurchase agreements. Refer to the Fund s Portfolio of Investments for details on t

Notes to Financial Statements (Unaudited) (continued)

Zero Coupon Securities

A zero coupon security does not pay a regular interest coupon to its holders during the life
the holder of the security comes from accretion of the difference between the original purc
issuance and the par value of the security at maturity and is effectively paid at maturity. Th
coupon securities generally are more volatile than the market prices of securities that pay i

Investments in Derivatives

The Fund is authorized to invest in certain derivative instruments, such as futures, options
Fund limits its investments in futures, options on futures and swap contracts to the extent r
claim the exclusion from registration by the Commodity Futures Trading Commission as a
with respect to the Fund. The Fund records derivative instruments at fair value, with chang
on the Statement of Operations, when applicable. Even though the Fund s investments in
economic hedges, they are not considered to be hedge transactions for financial reporting p

Futures Contracts

Upon execution of a futures contract, the Fund is obligated to deposit cash or eligible secu
margin, into an account at its clearing broker equal to a specified percentage of the contra
broker to cover initial margin requirements on open futures contracts, if any, is recognized
on the Statement of Assets and Liabilities. Investments in futures contracts obligate the Fu
settle monies on a daily basis representing changes in the prior days mark-to-market of
has unrealized appreciation the clearing broker would credit the Fund s account with an a
and conversely if the Fund has unrealized depreciation the clearing broker would debit the
amount equal to depreciation. These daily cash settlements are also known as variation m
recognized as a receivable and/or payable for Variation margin on futures contracts on
Liabilities.

During the period the futures contract is open, changes in the value of the contract are reco
or loss by marking-to-market on a daily basis to reflect the changes in market value of t
as a component of Change in net unrealized appreciation (depreciation) of futures contra
Operations. When the contract is closed or expired, the Fund records a realized gain or los
between the value of the contract on the closing date and value of the contract when origin
recognized as a component of Net realized gain (loss) from futures contracts on the Sta

Risks of investments in futures contracts include the possible adverse movement in the pri
underlying the contracts, the possibility that there may not be a liquid secondary market fo
change in the value of the contract may not correlate with a change in the value of the und

During the current fiscal period, the Fund continued to purchase equity index futures contr
exposure where the portfolio holds cash.

The average notional amount of futures contracts outstanding during the current fiscal peri

Average notional amount of futures contracts outstanding*

* The average notional amount is calculated based on the absolute aggregate notional of c
beginning of the fiscal period and at the end of each quarter within the current fiscal per

The following table presents the fair value of all futures contracts held by the Fund as of th
the location of these instruments on the Statement of Assets and Liabilities and the primar

		Location on the Statement of Asse		
Underlying	Derivative	Asset Derivatives		
Risk Exposure	Instrument	Location	Value	Loc
Equity price	Futures contracts	Receivable for variation margin on futures contracts*	$ (13,053)	

* Value represents unrealized appreciation (depreciation) of futures contracts as reported
of Investments and not the asset and/or liability derivative location as described in the ta

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The following table presents the amount of net realized gain (loss) and change in net unrea
(depreciation) recognized on futures contracts on the Statement of Operations during the c
primary underlying risk exposure.

Underlying Risk Exposure	Derivative Instrument	Net Realized Gain (Loss) from Futures Contracts
Equity price	Futures contracts	$ 338,684

Options Transactions

When the Fund writes an option, an amount equal to the net premium received (the premiu
recognized as a component of Options written, at value on the Statement of Assets and
adjusted to reflect the current value of the written option until the option is exercised or ex
a closing purchase transaction. The changes in the value of options written during the fisca
component of Change in net unrealized appreciation (depreciation) of options written o
When an option is exercised or expires or the Fund enters into a closing purchase transacti
the net premium received and any amount paid at expiration or on executing a closing purc
commission, is recognized as a component of Net realized gain (loss) from options writte
Operations. The Fund, as a writer of an option has no control over whether the underlying
(called) or purchased (put) and as a result bears the risk of an unfavorable change in the m
or index underlying the written option. There is also the risk the Fund may not be able to e
because of an illiquid market.

During the current fiscal period, the Fund continued to write call options on a basket of sto
while investing in a portfolio of equities, to enhance returns while foregoing some upside p
portfolio.

The average notional amount of outstanding options written during the current fiscal perio

Average notional amount of outstanding options written*	

* The average notional amount is calculated based on the outstanding notional at the begi
at the end of each fiscal quarter within the current fiscal period.

The following table presents the fair value of all options written by the Fund as of the end
location of these instruments on the Statement of Assets and Liabilities and the primary ur

		Location on the Statement of Assets an			
		Asset Derivatives		(Lia	
Underlying Risk Exposure	Derivative Instrument	Location	Value	Location	
Equity price	Options		$	Options writt	

The following table presents the amount of net realized gain (loss) and change in net unrea
(depreciation) recognized on options written on the Statement of Operations during the cu

primary underlying risk exposure.

Underlying Risk Exposure	Derivative Instrument	Net Realized Gain (Loss) from Options Written
Equity price	Options written	$ 2,036,907

Market and Counterparty Credit Risk

In the normal course of business the Fund may invest in financial instruments and enter in
where risk of potential loss exists due to changes in the market (market risk) or failure of t
transaction to perform (counterparty credit risk). The potential loss could exceed the value
recorded on the financial statements. Financial assets, which potentially expose the Fund t
consist principally of cash due from counterparties on forward, option and swap transactio
extent of the Fund s exposure to counterparty credit risk in respect to these financial asset
value as recorded on the Statement of Assets and Liabilities.

The Fund helps manage counterparty credit risk by entering into agreements only with cou
believes have the financial resources to honor their obligations and by having the Adviser
of the counterparties. Additionally, counterparties may be required to pledge collateral dai
valuation of the financial asset) on behalf of the Fund with a value approximately equal to
gain above a pre-determined threshold. Reciprocally, when the Fund has an unrealized los
custodian to pledge

Notes to Financial Statements (Unaudited) (continued)

assets of the Fund as collateral with a value approximately equal to the amount of the unre
pre-determined threshold. Collateral pledges are monitored and subsequently adjusted if ar
fluctuate, either up or down, by at least the pre-determined threshold amount.

4. Fund Shares

The Fund did not have any transactions in shares during the current and prior fiscal period

5. Investment Transactions

Long-term purchases and sales (excluding derivative transactions) during the current fisca
$194,177,716 and $200,715,802, respectively.

Transactions in options written during the current fiscal period were as follows:

	Nu **C**
Options outstanding, beginning of period	
Options written	
Options terminated in closing purchase transactions	
Options expired	
Options outstanding, end of period	

6. Income Tax Information

The Fund intends to distribute substantially all of its net investment company taxable inco
otherwise comply with the requirements of Subchapter M of the Internal Revenue Code ap
investment companies. In any year when the Fund realizes net capital gains, the Fund may
portion of its net capital gains to shareholders, or alternatively, to retain all or a portion of
federal corporate income taxes on such retained gains.

For all open tax years and all major taxing jurisdictions, management of the Fund has conc
significant uncertain tax positions that would require recognition in the financial statement
that are open for examination by taxing authorities (i.e., generally the last four tax year enc
since then). Furthermore, management of the Fund is also not aware of any tax positions fo
possible that the total amounts of unrecognized tax benefits will significantly change in the

The following information is presented on an income tax basis. Differences between amou
and federal income tax purposes are primarily due to timing differences in recognizing cer
investment transactions and the recognition of unrealized gain or loss for tax (mark-to-mar
certain options contracts. To the extent that differences arise that are permanent in nature,
within the capital accounts as detailed below. Temporary differences do not require reclass
permanent differences do not impact the NAV of the Fund.

As of June 30, 2017, the cost and unrealized appreciation (depreciation) of investments (ex
derivatives), as determined on a federal income tax basis, were as follows:

Cost of investments	
Gross unrealized:	
Appreciation	
Depreciation	
Net unrealized appreciation (depreciation) of investments	

As of December 31, 2016, the Fund s last tax year end, the Fund did not have any perman

The tax components of undistributed net ordinary income and net long-term capital gains a
the Fund s last tax year end, were as follows:

Undistributed net ordinary income	
Undistributed net long-term capital gains	

The tax character of distributions paid during the Fund s last tax year ended December 31
purposes of the dividends paid deduction as follows:

Distributions from net ordinary income[1]
Distributions from net long-term capital gains
Return of capital

[1] Net ordinary income consists of net taxable income derived from dividends and interest
gains, if any.

As of December 31, 2016, the Fund s last tax year end, the Fund has unused capital losse
federal income tax purposes to be applied against future capital gains, if any. The capital l
expiration.

Capital losses to be carried forward not subject to expiration

7. Management Fees

Management Fees

The Fund s management fee compensates the Adviser for overall investment advisory an
general office facilities. The Sub-Advisers are compensated for their services to the Fund
paid to the Adviser.

The Fund s management fee consists of two components a fund-level fee, based only o
Fund, and a complex-level fee, based on the aggregate amount of all eligible fund assets m
pricing structure enables Fund shareholders to benefit from growth in the assets within the
in the amount of complex-wide assets managed by the Adviser.

The annual Fund-level fee, payable monthly, is calculated according to the following sche

Average Daily Managed Assets*
For the first $500 million
For the next $500 million
For the next $500 million
For the next $500 million
For managed assets over $2 billion

The annual complex-level fee, payable monthly, is calculated by multiplying the current c
determined according to the following schedule by the Fund s daily managed assets:

Complex-Level Managed Asset Breakpoint Level*	Effective Rate
$55 billion	
$56 billion	
$57 billion	
$60 billion	
$63 billion	

$66 billion
$71 billion
$76 billion
$80 billion
$91 billion
$125 billion
$200 billion
$250 billion
$300 billion

* For the complex-level fees, managed assets include closed-end fund assets managed by attributable to certain types of leverage. For these purposes, leverage includes the funds borrowings and certain investments in the residual interest certificates (also called inver tender option bond (TOB) trusts, including the portion of assets held by a TOB trust tha financed by the trust s issuance of floating rate securities, subject to an agreement by th to limit the amount of such assets for determining managed assets in certain circumstanc calculated based upon the aggregate daily managed assets of all Nuveen funds that cons assets do not include assets attributable to investments in other Nuveen funds or assets i amount (originally $2 billion) added to the Nuveen fund complex in connection with the management of the former First American Funds effective January 1, 2011. As of June fee for the Fund was 0.1606%.

Notes to Financial Statements (Unaudited) (continued)

8. Borrowing Arrangements

Inter-Fund Borrowing and Lending

The Securities and Exchange Commission (SEC) has granted an exemptive order perm
closed-end Nuveen funds to participate in an inter-fund lending facility whereby the Nuve
and borrow money from each other for temporary purposes (e.g., to satisfy redemption req
securities fails, resulting in an unanticipated cash shortfall) (the Inter-Fund Program)
including the Fund covered by this shareholder report, will participate only as lenders, and
Inter-Fund Program because such closed-end funds rarely, if ever, need to borrow cash to
Inter-Fund Program is subject to a number of conditions, including, among other things, th
fund may borrow or lend money through the Inter-Fund Program unless it receives a more
typically available from a bank or other financial institution for a comparable transaction;
an unsecured basis through the Inter-Fund Program unless the fund s outstanding borrowi
immediately after the inter-fund borrowing total 10% or less of its total assets; provided th
secured borrowing outstanding from any other lender, including but not limited to another
must be secured on at least an equal priority basis with at least an equivalent percentage of
(3) if a fund s total outstanding borrowings immediately after an inter-fund borrowing wo
total assets, the fund may borrow through the inter-fund loan on a secured basis only; (4) n
the loan would cause its aggregate outstanding loans through the Inter-Fund Program to ex
the time of the loan; (5) a fund s inter-fund loans to any one fund shall not exceed 5% of t
(6) the duration of inter-fund loans will be limited to the time required to receive payment
event more than seven days; and (7) each inter-fund loan may be called on one business da
and may be repaid on any day by a borrowing fund. In addition, a Nuveen fund may partic
Program only if and to the extent that such participation is consistent with the fund s inve
investment policies. The Board is responsible for overseeing the Inter-Fund Program.

The limitations detailed above and the other conditions of the SEC exemptive order permi
are designed to minimize the risks associated with Inter-Fund Program for both the lending
fund. However, no borrowing or lending activity is without risk. When a fund borrows mo
is a risk that the loan could be called on one day s notice or not renewed, in which case th
from a bank at a higher rate or take other actions to payoff such loan if an inter-fund loan i
fund. Any delay in repayment to a lending fund could result in a lost investment opportuni
costs.

During May 2017, the Board approved the Nuveen funds participation in the Inter-Fund P
reporting period the Fund did not enter into any inter-fund loan activity.

9. New Accounting Pronouncements

Amendments to Regulation S-X

In October 2016, the SEC adopted new rules and amended existing rules (together, the fi
modernize the reporting and disclosure of information by registered investment companies
amend Regulation S-X and require standardized, enhanced disclosure about derivatives in
financial statements, as well as other amendments. The compliance date of the amendmen

August 1, 2017. Management is still evaluating the impact of the final rules, if any.

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Additional

Fund Information

Board of Trustees

Margo Cook*	Jack B. Evans	William C. Hunter	David J. Kundert	Albin F.
William J. Schneider	Judith M. Stockdale	Carole E. Stone	Terence J. Toth	Margare

*Interested Board Member.
**Effective July 1, 2017.

Fund Manager	Custodian	Legal Counsel	Independent Re Public Accounti
Nuveen Fund Advisors, LLC	State Street Bank & Trust Company	Chapman and Cutler LLP	Pricewaterhouse
333 West Wacker Drive	One Lincoln Street	Chicago, IL 60603	One North Wack
Chicago, IL 60606	Boston, MA 02111		Chicago, IL 606

Quarterly Form N-Q Portfolio of Investments Information

The Fund is required to file its complete schedule of portfolio holdings with the Securities (SEC) for the first and third quarters of each fiscal year on Form N-Q. You may obtain thi the SEC. Visit the SEC on-line at http://www.sec.gov or in person at the SEC s Public Re D.C. Call the SEC toll-free at (800) SEC-0330 for room hours and operation.

Nuveen Funds Proxy Voting Information

You may obtain (i) information regarding how each fund voted proxies relating to portfoli most recent twelve-month period ended June 30, without charge, upon request, by calling

257-8787 or on Nuveen s website at www.nuveen.com and (ii) a description of the polici
fund used to determine how to vote proxies relating to portfolio securities without charge,
Nuveen toll free at (800) 257-8787. You may also obtain this information directly from th
at http://www.sec.gov.

CEO Certification Disclosure

The Fund s Chief Executive Officer (CEO) has submitted to the New York Stock Exchan
certification as required by Section 303A.12(a) of the NYSE Listed Company Manual. Th
SEC the certification of its CEO and Chief Financial Officer required by Section 302 of th

Share Repurchases

The Fund intends to repurchase, through its open-market share repurchase program, shares
such times and in such amounts as is deemed advisable. During the period covered by this
shares of its common stock, as shown in the accompanying table. Any future repurchases
shareholders in the next annual or semi-annual report.

Shares repurchased

FINRA BrokerCheck

The Financial Industry Regulatory Authority (FINRA) provides information regarding the
FINRA member firms and associated investment professionals. This information as well a
describing FINRA BrokerCheck is available to the public by calling the FINRA BrokerCh
289-9999 or by visiting www.FINRA.org.

Glossary of Terms

Used in this Report

Average Annual Total Return: This is a commonly used method to express an investr
particular, usually multi-year time period. It expresses the return that would have been r
the investment s actual cumulative performance (including change in NAV or market p
and capital gains distributions, if any) over the time period being considered.

Blended Index: A blend of returns consisting of 1) 50% of the S&P 500® Index and 2)
Buy/write Index(BXM), which is a passive total return index based on selling the near-t
Index (SPX) call option against the S&P 500® Index portfolio each month, on the day th
Index returns assume reinvestment of distributions, but do not include the effects of any
management fees.

Net Asset Value (NAV) Per Share: A fund s Net Assets is equal to its total assets (sec
and receivables) less its total liabilities. NAV per share is equal to the fund s Net Asset
shares outstanding.

Russell 2000® Index: A market-weighted index published by the Frank Russell Compa
performance of the 2,000 smallest companies in the Russell 3000® Index. The Russell 3
the largest U.S. stocks and represents approximately 98% of the U.S. equity market. Th
benchmark for small-cap stocks in the U.S. Index returns assume reinvestment of distrib
applicable sales charges or management fees.

S&P 500® Index: An unmanaged index generally considered representative of the U.S.
assume reinvestment of distributions, but do not reflect any applicable sales charges or r

Reinvest Automatically,

Easily and Conveniently

Nuveen makes reinvesting easy. A phone call is all it takes to set up your reinvestmen

Nuveen Closed-End Funds Automatic Reinvestment Plan

Your Nuveen Closed-End Fund allows you to conveniently reinvest distributions in additi

By choosing to reinvest, you ll be able to invest money regularly and automatically, and w
through the power of compounding. Just like distributions in cash, there may be times whe
taxes may be payable on distributions that are reinvested.

It is important to note that an automatic reinvestment plan does not ensure a profit, nor doe
in a declining market.

Easy and convenient

To make recordkeeping easy and convenient, each quarter you ll receive a statement show
the date of investment, the shares acquired and the price per share, and the total number of

How shares are purchased

The shares you acquire by reinvesting will either be purchased on the open market or newl
shares are trading at or above net asset value at the time of valuation, the Fund will issue n
the net asset value or 95% of the then-current market price. If the shares are trading at less
for your account will be purchased on the open market. If the Plan Agent begins purchasin
market while shares are trading below net asset value, but the Fund s shares subsequently
asset value before the Plan Agent is able to complete its purchases, the Plan Agent may ce
and may invest the uninvested portion of the distribution in newly-issued Fund shares at a
the shares net asset value or 95% of the shares market value on the last business day im
date. Distributions received to purchase shares in the open market will normally be investe
distribution payment date. No interest will be paid on distributions awaiting reinvestment.
the shares may increase before purchases are completed, the average purchase price per sh
price at the time of valuation, resulting in the acquisition of fewer shares than if the distrib
issued by the Fund. A pro rata portion of any applicable brokerage commissions on open r
by Plan participants. These commissions usually will be lower than those charged on indiv

Flexible

You may change your distribution option or withdraw from the Plan at any time, should yo

You can reinvest whether your shares are registered in your name, or in the name of a brol
nominee. Ask your investment advisor if his or her firm will participate on your behalf. Pa
registered in the name of one firm may not be able to transfer the shares to another firm an
the Plan.

The Fund reserves the right to amend or terminate the Plan at any time. Although the Fund
the Plan to include a service charge payable by the participants, there is no direct service c
Plan at this time.

Call today to start reinvesting distributions

For more information on the Nuveen Automatic Reinvestment Plan or to enroll in or witho
with your financial advisor or call us at (800) 257-8787.

Annual Investment

Management Agreement Approval Process

The Board of Trustees (the *Board,* and each Trustee, a *Board Member*) of the Fund,
Members who are not parties to the Fund s advisory or sub-advisory agreements or inte
parties (the *Independent Board Members*), oversees the management of the Fund, inclu
Nuveen Fund Advisors, LLC, the Fund s investment adviser (the *Adviser*), and Nuvee
(*NAM*) and INTECH Investment Management LLC (*Intech*), the Fund s sub-advise
Sub-Advisers). As required by applicable law, after the initial term of the Fund followi
operations, the Board is generally required to consider annually whether to renew the man
Adviser (the *Investment Management Agreement*) and the sub-advisory agreements wit
Sub-Advisory Agreement and, together with the Investment Management Agreement, t
Accordingly, the Board met in person on April 11-12, 2017 (the *April Meeting*) and M
Meeting) to consider the approval of the Investment Management Agreement and the Su
NAM, each of which was up for renewal for an additional one-year period. As discussed b
Sub-Advisory Agreement with Intech is new and was not up for renewal.

On May 30, 2017, Janus Capital Group Inc., the parent company of Intech, merged with H
Transaction). The Transaction may have been deemed an assignment of the then-existi
with Intech, resulting in the termination of such agreement. In anticipation of the Transact
(the *February Meeting*), the Board, among other things, approved a new Sub-Advisory
recommended shareholders approve such agreement. On May 26, 2017, the shareholders
Sub-Advisory Agreement with Intech. In light of the foregoing, the new Sub-Advisory Ag
behalf of the Fund was not up for renewal at the May Meeting. The discussion of the Boa
Sub-Advisory Agreement with Intech at the February Meeting is set forth in Part II below
Board s approval of the remainder of the Fund s Advisory Agreements is set forth in Par
the term Advisory Agreements shall refer to the Investment Management Agreement a
with NAM, and the term Sub-Adviser shall refer to NAM.

PART I

The Board considered its review of the Advisory Agreements as an ongoing process enco
received and the deliberations the Board and its committees have had throughout the year.
during the year and received materials and discussed topics that were relevant to the annu
renewal of the Advisory Agreements, including, among other things, overall market perfo
fund investment performance; investment team review; valuation of securities; complianc
management matters; and other developments. The Board had also established several sta
the Open-end Fund Committee and Closed-end Fund Committee, which met regularly thr
Board Members to delve deeper into the topics particularly relevant to the respective prod
continued its practice of seeking to meet periodically with the sub-adviser and their invest
information, knowledge, and experience the Board Members had gained during their tenu
Fund and working with the Fund Advisers (as defined below) were taken into account in t
Agreements.

In addition to the materials received by the Board or its committees throughout the year, t
additional materials prepared specifically for its annual review of the Advisory Agreemen
independent legal counsel on behalf of the Independent Board Members. The materials ad

including, but not limited to, a description of the services provided by the Adviser and Sub
the Sub-Adviser are each a *Fund Adviser*); an analysis of fund performance including c
a detailed focus on performance outliers; an analysis of the Sub-Adviser; an analysis of th
the Nuveen funds in absolute terms and in comparison to the fees and expenses of peers w
outliers; an assessment of shareholder services for the Nuveen funds and of the performan
providers; a review of initiatives instituted or continued during the past year; a review of p
leverage management for the closed-end funds; and information regarding the profitability

Fund Advisers, the compensation of portfolio managers, and compliance and risk matters.
connection with the annual review included information compiled and prepared by Broadr
(*Broadridge* or *Lipper*), an independent provider of investment company data, comp
Fund s fees and expenses with those of a comparable universe of funds (the *Peer Unive*
Broadridge (the *Broadridge Report*). The Independent Board Members also received a
independent legal counsel outlining their fiduciary duties and legal standards in reviewing

As part of its annual review, the Board met at the April Meeting to review the investment
to consider the Adviser s analysis of the Sub-Adviser evaluating, among other things, the
management, investment team, performance, organizational stability, and investment appr
Independent Board Members requested and received additional information from manage
the Board, including the Independent Board Members, continued its review and ultimately
the Advisory Agreements for an additional year. Throughout the year and throughout thei
Agreements, the Independent Board Members were assisted by independent legal counsel
separately without management present. In deciding to renew the Advisory Agreements, t
Members did not identify a particular factor as determinative, but rather the decision refle
consideration of all the information presented, and each Board Member may have attribut
various factors and information considered in connection with the approval process. The f
principal factors, but not all the factors, the Board considered in its review of the Advisory
conclusions.

A. Nature, Extent and Quality of Services

In evaluating the renewal of the Advisory Agreements, the Independent Board Members r
information regarding the nature, extent and quality of the applicable Fund Adviser s serv
the resulting performance of the Fund. The Board recognized the myriad of services the A
provided to manage and operate the Nuveen funds, including (a) product management (su
positioning the product in the marketplace, maintaining and enhancing shareholder comm
the Board); (b) investment oversight, risk management and securities valuation (such as o
and other service providers, analyzing investment performance and risks, overseeing risk
executing the daily valuation of securities, and analyzing trade execution); (c) fund admin
prepare fund tax returns and complete other tax compliance matters and helping to prepar
shareholder reports); (d) fund board administration (such as preparing board materials and
assistance for board meetings); (e) compliance (such as helping to devise and maintain the
program and test for adherence); (f) legal support (such as helping to prepare registration s
statements, interpreting regulations and policies and overseeing fund activities); (g) with r
funds, providing leverage, capital and distribution management services; and (h) with resp
with portfolios that have a leverage component, providing such leverage management serv

The Board further noted the Adviser s continued dedication to investing in its business to
breadth of the services provided to the Fund. The Board recognized the Adviser s investm
years to support the services provided to the Nuveen funds in key areas, including in inve
management, retail distribution and information technology, closed-end funds and structu
fund administration, operations and risk management. The Board further noted the Advise
enhancing its compliance program by, among other things, restructuring the compliance o
unified compliance program, adding compliance staff, and developing and/or revising pol
as building further infrastructure to address new regulatory requirements or guidance and

The Board also considered the enhancements to Nuveen s cybersecurity capabilities, syst
securities, stress test reporting and risk and control self-assessments.

In addition, the Independent Board Members considered information highlighting the vari
Adviser had implemented or continued over recent years to benefit the open-end fund and
lines and/or particular Nuveen funds. The Board noted the Adviser s continued efforts to
and closed-end fund product lines through, among other things, mergers, liquidations and
provide enhanced

Annual Investment Management Agreement Approval Process (continued)

shareholder value over the years through increased efficiency, reduced costs, improved pe
investment approaches that are more relevant to current shareholder needs. With respect to
such initiatives included (a) an increased level of leverage management activities in 2016 a
rollover of existing facilities, the negotiation of improved terms and pricing to reduce leve
new leverage structures, the rebalancing of leverage of various funds as a result of mergers
mandates, and the restructuring of tender option bonds to be compliant with new regulator
increased level of capital management activities (*i.e.,* the management of the issuance and
certain closed-end funds) during 2016 as a result of market demand as well as an impleme
review system for shares trading at certain discount levels; (c) continued refinements to a
analysis of the closed-end fund marketplace and shareholder base; (d) the development of
board reporting and commentary; (e) the reconfiguration of the framework for determining
fund benchmarks to permit more consistency across the complex; and (f) the development
new closed-end offerings, including target term funds. The Board also recognized the Adv
to supporting the closed-end product line through its award winning investor relations sup
Nuveen seeks to educate investors and financial advisers regarding closed-end funds.

In its review, the Board recognized that initiatives that attracted assets to the Nuveen fami
benefited the Nuveen funds in the complex as fixed costs would be spread over a larger as
below, through the complex-wide fee arrangement which generally provides that the mana
funds (subject to limited exceptions) are reduced as asset levels in the complex reach certa
schedule.

Similarly, the Board considered the sub-advisory services provided by the Sub-Adviser to
generally provided portfolio advisory services for the Fund. The Board reviewed the Advi
Sub-Adviser which evaluated, among other things, the investment team and any changes t
history of the organization, the assets under management, the investment approach and the
funds it sub-advises. The Board noted that the Adviser recommended the renewal of the S

Based on its review, the Board determined, in the exercise of its reasonable business judgm
the nature, extent and quality of services provided to the Fund under each Advisory Agree

B. The Investment Performance of the Fund and Fund Advisers

As part of its evaluation of the services provided by the Fund Advisers, the Board reviewe
quarter, one-, three- and five-year periods ending December 31, 2016 as well as performan
2017 ending March 31, 2017. The Board reviewed performance on an absolute basis and i
performance of peer funds (the *Performance Peer Group*) and a recognized or customiz
a benchmark derived from multiple recognized benchmarks). For closed-end funds, the Bo
Committee) also reviewed, among other things, the premium or discount to net asset value
funds as of a specified date and over various periods as well as in comparison to the premi
respective Lipper peer category. The Independent Board Members continued to recognize
market trading for the shares of the closed-end funds and the evaluation of the premium an
continuing priority for them. The review and analysis of performance information during t
Agreements incorporated the discussions and performance information the Board Member
quarterly meetings throughout the year.

In evaluating performance data, the Independent Board Members recognized some of the l
the difficulty in establishing appropriate peer groups and benchmarks for certain of the Nu
that each fund operates pursuant to its own investment objective(s), parameters and restric
that of the Performance Peer Group or benchmark. Certain funds may also utilize leverage
or risks to their portfolio compared to an unlevered benchmark. The Independent Board M
management had classified the Performance Peer Groups as low, medium and high in relev
as a result of these differences or other factors. The Independent Board Members recogniz
the Performance Peer Group or benchmark and the Fund will lead to differing performanc
value of the comparative performance data in assessing the Fund s performance.

In addition, the Independent Board Members recognized that the performance data is a sna
of the end of the 2016 calendar year or end of the first quarter of 2017. A different period
different results and longer term performance can be adversely affected by even one perio
underperformance. Further, a shareholder s experience in the Fund depends on his or her
differ from that reviewed by the Independent Board Members.

In their review of performance, the Independent Board Members focused, in particular, on
Nuveen funds determined to be underperforming performance outliers and the factors con
fund s performance and any efforts to address performance concerns. With respect to any
Board has identified performance issues, the Board monitors such funds closely until perfo
with the Adviser the reasons for such results, considers any steps necessary or appropriate
reviews the results of any efforts undertaken. The Board, however, acknowledged that sha
remain invested in a fund knowing that the Adviser and applicable sub-advisers manage th
investment strategy and seeking exposure to that strategy (even if the strategy was out of
knowing the fund s fee structure.

The Board noted that although the Fund underperformed its benchmark in the one-, three-
Fund ranked in the third quartile for the one-year period, the second quartile in the three-y
quartile in the five-year period. The Board was satisfied with the Fund s overall performa

C. Fees, Expenses and Profitability

1. Fees and Expenses

The Board evaluated the management fees and other fees and expenses of the Fund. The B
considered, among other things, the gross and net management fees paid by the Fund. The
net total expense ratio of the Fund (expressed as a percentage of average net assets) as the
reflective of the investors net experience in the Fund as it directly reflected the costs of i

In addition, the Board reviewed the Broadridge Report comparing, in relevant part, the Fu
fees and net total expense ratio with those of its Peer Universe. The Independent Board M
methodology regarding the construction of the Peer Universe by Broadridge. In reviewing
Board was aware that various factors may limit some of the usefulness of the data, such as
peers; the composition of the Peer Universe; changes each year of funds comprising the P
expense reimbursements and fee waivers; and differences in the type and use of leverage.
fund s fees and expenses compared to the fees and expenses of its peers (excluding levera
the Board generally considered a fund s expenses and fees to be higher if they were over
higher if they were 6 to 10 basis points higher, in line if they were within approximately 5
peer average and below if they were below the peer average of the Peer Universe. The Bo
majority of the Nuveen funds had a net expense ratio that was near or below their respecti

The Independent Board Members noted the Fund had a net management fee and a net exp
peer average.

In their evaluation of the management fee schedule, the Independent Board Members also
complex-wide breakpoint schedules, as described in further detail below. With respect to c
considered the effects of leverage on fees and expenses, including the calculation of mana
tender option bonds.

Based on their review of the information provided, the Board determined that the Fund s
applicable) to a Fund Adviser were reasonable in light of the nature, extent and quality of
Fund.

2. Comparisons with the Fees of Other Clients

The Board also reviewed information regarding the respective Fund Adviser s fee rates fo
to other types of clients. For the Adviser and/or the Sub-Adviser, such other clients may in
accounts (such as retail, institutional or wrap accounts), other investment companies that a
are sub-advised by

Annual Investment Management Agreement Approval Process (continued)

the Sub-Adviser, foreign investment companies offered by Nuveen, and collective investm
noted that the Adviser also advises certain exchange-traded funds (*ETFs*) sponsored by

In reviewing the fee rates assessed to other clients, the Board reviewed, among other thing
for managed accounts and the foreign investment companies offered by Nuveen. With res
Board noted that unlike the management fees for the Nuveen funds, the management fees
include distribution fees paid to intermediaries. The Board also reviewed the average fee r
offered by the Sub-Adviser.

The Board recognized the inherent differences between the Nuveen funds and the other ty
considered information regarding these various differences which included, among other t
average account sizes, types of investors targeted, legal structure and operations, and appli
The Independent Board Members recognized that the foregoing variations resulted in diffe
product structures and culminated in varying management fees among the types of clients
general, the Board noted that higher fee levels reflected higher levels of service provided b
increased investment management complexity, greater product management requirements
risk or some combination of the foregoing. The Board recognized the breadth of services t
support the Nuveen funds as summarized above and noted that many of such administrativ
required to the same extent or at all for the institutional clients or other clients. The Board
passive management of ETFs compared to the active management required of other Nuve
differing fee levels.

The Independent Board Members noted that the sub-advisory fee paid by the Adviser to th
generally for portfolio management services. The Board noted such sub-advisory fee was
of retail wrap accounts and other external sub-advisory mandates.

Given the inherent differences in the various products, particularly the extensive services p
Board concluded that such facts justify the different levels of fees.

3. **Profitability of Fund Advisers**

In conjunction with their review of fees, the Independent Board Members also considered
for its advisory services to the Nuveen funds for the calendar years 2016 and 2015. In cons
Independent Board Members considered the level of profitability realized by Nuveen befo
distribution and marketing expenses incurred by the firm from its own resources. In evalua
Independent Board Members evaluated the analysis employed in developing the profitabil
assumptions and methodology employed in allocating expenses. The Independent Board M
inherent limitations to any cost allocation methodology as different and reasonable approa
yield differing results. The Independent Board Members further reviewed an analysis of th
methodology used explaining any changes to the methodology over the years. The Board l
Independent Board Members, who along with independent legal counsel, helped to review
employed to develop the profitability analysis each year and any proposed changes thereto
apprised of such changes during the year.

In their review, the Independent Board Members evaluated, among other things, Nuveen
the gross and net revenue margins (pre-tax and after-tax) for advisory activities for the Nu
expenses, and net income (pre-tax and after-tax) of Nuveen for each of the last two calend
Board Members also reviewed an analysis of the key drivers behind the changes in revenu
impacted profitability in 2016 versus 2015. The Board, however, observed that Nuveen s
advisory activities in 2016 were similar to that of 2015.

In addition to reviewing Nuveen s profitability in absolute terms, the Independent Board
adjusted total company margins of other advisory firms that had publicly available inform
under management (based on asset size and asset composition). The Independent Board M
the usefulness of the comparative data may be limited as the other firms may have a differ
profitability data may be affected by numerous other factors such as the types of funds ma
methodology used, and their capital structure. Nevertheless, the Board noted that Nuveen
appeared comparable to the adjusted margins of the peers.

Further, the Adviser is a subsidiary of Nuveen, LLC, the investment management arm of T
Annuity Association of America (TIAA). To have a fuller picture of the financial condit
complex, together with Nuveen, the Board reviewed a balance sheet for TIAA reflecting it
and contingency reserves for the 2016 and 2015 calendar years.

In addition to the Adviser s profitability, the Independent Board Members also considered
Sub-Adviser from its relationship with the Nuveen funds. The Independent Board Membe
revenues, expenses and revenue margins (pre- and post-tax) for its advisory activities for t
December 31, 2016. The Independent Board Members also reviewed a profitability analys
expenses and revenue margin (pre- and post-tax) by asset type for the Sub-Adviser for the
December 31, 2016.

In evaluating the reasonableness of the compensation, the Independent Board Members als
paid to a Fund Adviser for its services to the Fund as well as indirect benefits (such as soft
the Fund Adviser and its affiliates received or were expected to receive that were directly
management of the Fund. See Section E below for additional information on indirect bene
receive as a result of its relationship with the Fund.

Based on a consideration of all the information provided, the Board noted that Nuveen s a
profitability was acceptable and not unreasonable in light of the services provided.

D. Economies of Scale and Whether Fee Levels Reflect These Economies of Scale

When evaluating the level of the advisory fees, the Independent Board Members considere
economies of scale that may be realized by the Fund Adviser as the Fund grows and the ex
economies were shared with the Fund and shareholders. The Board recognized that econor
measure with precision; however, the Board considered that there were several ways the F
benefits of economies of scale with the Nuveen funds, including through breakpoints in th
reducing the fee rates as asset levels grow, fee waivers and/or expense limitation agreemer
investment in its business which can enhance the services provided to the Nuveen funds. V
structure, the Independent Board Members have recognized that economies of scale may b
fund grows, but also when the total size of the fund complex grows (even if the assets of a
complex have not changed or have decreased). Accordingly, subject to certain exceptions,
complex pay a management fee to the Adviser which is generally comprised of a fund-leve
complex-level component, each of which has a breakpoint schedule. Subject to certain exc
component declines as the assets of the particular fund grow and the complex-level fee co
eligible assets of all the Nuveen funds (except for Nuveen ETFs which are subject to a uni
complex combined grow. In addition, with respect to closed-end funds, the Independent B
although such funds may from time-to-time make additional share offerings, the growth of
primarily through the appreciation of such funds investment portfolios.

The Independent Board Members reviewed the breakpoint and complex-wide schedules ar
fee reductions as a result of the fund-level and complex-level breakpoints for the 2016 cal

In addition, the Independent Board Members recognized the Adviser s ongoing investmer
enhance the services provided to the benefit of all of the Nuveen funds.

Based on their review, the Board concluded that the current fee structure was acceptable a
scale to be shared with shareholders when assets under management increase.

E. Indirect Benefits

The Independent Board Members received and considered information regarding other ber
Adviser or its affiliates may receive as a result of their relationship with the Nuveen funds
paid to affiliates of a Fund Adviser for services rendered to the funds and research services
from broker-dealers that execute fund trades. The Independent Board Members noted that
receive compensation for

Annual Investment Management Agreement Approval Process (continued)

serving as a co-manager for initial public offerings of new Nuveen closed-end funds and a
offerings for certain existing funds. The Independent Board Members considered the comp
services in 2016.

In addition to the above, the Independent Board Members considered that the Fund s port
by the Sub-Adviser (and Intech) and the Sub-Adviser may benefit from research received
execute Fund portfolio transactions. The Board noted, however, that with respect to transa
securities, such securities generally trade on a principal basis and do not generate soft doll
Board recognized the Sub-Adviser may benefit from a soft dollar arrangement if it does no
research out of its own assets, the Board also recognized that the research may benefit the
enhances the ability of the Sub-Adviser to manage the Fund.

Based on their review, the Board concluded that any indirect benefits received by a Fund A
relationship with the Fund were reasonable and within acceptable parameters.

F. Other Considerations

The Board Members did not identify any single factor discussed previously as all-importa
Members, including the Independent Board Members, concluded that the terms of each Ad
and reasonable, that the respective Fund Adviser s fees were reasonable in light of the ser
that the Advisory Agreements be renewed.

PART II

At the February Meeting, the Board, including the Independent Board Members, unanimo
sub-advisory agreement with Intech (the *Sub-Advisory Agreement* for purposes of this P
that shareholders approve such agreement. The discussion of the Board s approval of the
Intech is set forth below.

The Board is responsible for determining whether to approve the Fund s advisory arrange
arrangements. At a meeting held on May 24-26, 2016 (the *May 2016 Meeting*), the Boa
Board Members, approved the continuance of the then-existing sub-advisory agreement w
Sub-Advisory Agreement). Following the May 2016 Meeting, the Board was apprised of
that if the Transaction was consummated, it may be deemed to cause an assignment, res
termination of the Original Sub-Advisory Agreement in accordance with its terms and the
Investment Company Act of 1940. In light of the proposed Transaction, the Board was ask
Sub-Advisory Agreement at its February Meeting.

The Board recognized that in connection with its annual review at the May 2016 Meeting,
materials addressing a variety of topics including, among other things, the services provid
investment team responsible for such services; the performance of the Fund and, specifica
that is managed by Intech (the *Intech Sleeve*); the Fund s advisory and sub-advisory fe
regarding the fees rates that Intech charges to other clients; the profitability of Intech for it
Fund; the potential for economies of scale, if any; and any indirect benefits to Intech from
Fund. Because the Board determined that the differences between the Original Sub-Advis

Sub-Advisory Agreement were immaterial, the Board determined that much of its prior an
Sub-Advisory Agreement was equally applicable to its analysis of the Sub-Advisory Agre
Meeting, the Board received, among other things: (i) updated information regarding the pe
the Intech Sleeve; (ii) updated information regarding the fee rates that Intech charges to ot
profitability for its advisory activities with the Fund; and (iii) information regarding the Tr
other things, a discussion of its anticipated impact, if any, on the services Intech provides t
personnel providing such services and the sub-advisory fees paid to Intech.

In connection with their review of the Sub-Advisory Agreement, the Independent Board M
independent legal counsel. During the February Meeting, the Independent Board Members
independent legal counsel without management present and previously had received a mer
outlining their fiduciary duties and legal standards in reviewing advisory agreements. The
review of the Sub-Advisory Agreement reflected, in addition to the information specificall
agreement, an ongoing process that incorporated

their accumulated knowledge and experience gained from overseeing the Fund and from t
management throughout the year including, as noted, the information provided at the annu
Sub-Advisory Agreement at the May 2016 Meeting. It is with this background that the Ind
considered the Sub-Advisory Agreement. In deciding to approve the Sub-Advisory Agree
Members did not identify a particular factor as controlling, but rather the decision reflecte
consideration of all the information presented. Each Board Member may have accorded di
factors in reaching his or her conclusions about the Sub-Advisory Agreement. The followi
factors, but not all the factors, the Board considered in its review of the Sub-Advisory Agr

A. Nature, Extent and Quality of Services.

In reviewing the Sub-Advisory Agreement, the Board considered the nature, extent and qu
provided under the Sub-Advisory Agreement. The Independent Board Members recognize
provides portfolio advisory services and noted that the quality of services that Intech provi
expected to be materially impacted by the Transaction and that Intech was expected to reta
processes, compliance program, key personnel and support systems. Further, no changes w
result of the Transaction to the Fund s portfolio management team or to the method used
the portfolio managers on such team. At the May 2016 Meeting, the Independent Board M
the nature, extent and quality of services provided under the Original Sub-Advisory Agree
noted that the Adviser had recommended the renewal of the Original Sub-Advisory Agree
along with its considerations at the annual review and the Adviser s recommendation tha
be approved, the Board concluded that the Transaction was not expected to adversely affe
quality of services provided and that the services to be continued under the Sub-Advisory
be satisfactory.

B. Investment Performance.

In their review of the Sub-Advisory Agreement, the Independent Board Members conside
of the Fund and the Intech Sleeve over various time periods. In reviewing performance, th
other things, that performance data reflects a snapshot in time as of a particular period and
period could generate significantly different results. During their review of the Original S
May 2016 Meeting, the Independent Board Members reviewed, among other things, the F
both on an absolute basis and in comparison to peer funds and to a recognized benchmark
and five-year periods ending December 31, 2015, as well as performance information refl
2016. Additionally, at the May 2016 Meeting, the Independent Board Members had revie
returns of the Intech Sleeve relative to the benchmark of such sleeve for the quarter, one-,
ending December 31, 2015, as well as performance information reflecting the first quarter
at the May 2016 Meeting, the Board had determined that the Fund s performance had bee
with its review of the Sub-Advisory Agreement at the February Meeting, the Board consid
performance information which reflected, among other things, the Fund s historic perform
five-year periods as of December 31, 2016. In this regard, the Board noted that the Fund h
for the one-year period, the second quartile for the three-year period and the first quartile f
Specifically with respect to the Intech Sleeve, the Independent Board Members noted that
its benchmark for the one- and three-year periods ending December 31, 2016, although it r
for the five-year period ending December 31, 2016. The Board noted that detractors from
performance for 2016 included, among other things, an underweight to pro-cyclical sector

overweight to defensive sectors, although exposure to smaller capitalization stocks was a c
2016 which partially offset the detractors. Further, the Board recognized that the Intech Sl
benchmark on an annualized rolling three-year performance basis 95% of the time (gross c
also outperformed its benchmark for three of the past five calendar years. The Independen
the Fund s portfolio management team was not expected to change as a result of the Tran
foregoing, along with the prior findings regarding performance at the annual review, the B
Fund s performance (including the Intech Sleeve) continued to be satisfactory and suppor
Sub-Advisory Agreement.

Annual Investment Management Agreement Approval Process (continued)

C. Sub-Advisory Fees and Profitability.

The Board considered the sub-advisory fee rate to be paid by the Adviser under the Sub-A
that the fee rate would be the same as the fee rate paid by the Adviser under the Original S
the May 2016 Meeting, the Independent Board Members had considered the fee rates that
clients (*Other Client Information*) and noted that the fee rate paid to Intech for its sub-a
reasonable in relation to the fee rates charged to other clients. The Independent Board Mer
Intech was not affiliated with the Adviser, the fees paid to Intech were the result of arm s-
February Meeting, the Independent Board Members were provided with updated Other Cl
concluded that the sub-advisory fee rate continued to be reasonable in light of the nature, e
expected to be provided by Intech under the Sub-Advisory Agreement.

With respect to profitability, at the May 2016 Meeting, the Independent Board Members c
expenses and profitability margins (pre-tax and after-tax) for its advisory activities with th
Information) for the 2014 and 2015 calendar years and concluded that Intech s level of p
light of the services provided. At the February Meeting, the Independent Board Members
Information reflecting the 2016 calendar year and concluded that Intech s profitability fro
Fund continued to be reasonable in light of the services provided.

D. Economies of Scale.

The Independent Board Members acknowledged that Intech had not identified any anticipa
the Transaction that were expected to have a material impact on the Fund. The Independer
recognized, however, that Intech s sub-advisory fee (which, as stated above, is paid by the
schedule that includes breakpoints.

E. Indirect Benefits.

The Independent Board Members considered any indirect benefits Intech may receive as a
the Fund. In this regard, the Board recognized that Intech has not participated in soft dolla
to portfolio transactions for the Nuveen funds.

F. Conclusion.

Based on all of the information considered and the conclusions reached, the Board, includi
Members, determined that the terms of the Sub-Advisory Agreement were fair and reasona
the agreement is in the best interests of the Fund.

Notes

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dependable investment solutions through continued adherence to
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Item 2. Code of Ethics.

Not applicable to this filing.

Item 3. Audit Committee Financial Expert.

Not applicable to this filing.

Item 4. Principal Accountant Fees and Services.

Not applicable to this filing.

Item 5. Audit Committee of Listed Registrants.

Not applicable to this filing.

Item 6. Schedule of Investments.

(a) See Portfolio of Investments in Item 1.

(b) Not applicable.

Item 7. Disclosure of Proxy Voting Policies and Procedures for Closed-End Managen Companies.

Not applicable to this filing.

Item 8. Portfolio Managers of Closed-End Management Investment Companies.

Not applicable to this filing.

Item 9. Purchases of Equity Securities by Closed-End Management Investment Com Purchasers.

Not applicable.

Item 10. Submission of Matters to a Vote of Security Holders.

There have been no material changes to the procedures by which shareholders may recomr registrant s Board implemented after the registrant last provided disclosure in response to

Item 11. Controls and Procedures.

(a) The registrant s principal executive and principal financial officers, or persons perf concluded that the registrant s disclosure controls and procedures (as defined in Ru Investment Company Act of 1940, as amended (the 1940 Act) (17 CFR 270.30a- within 90 days of the filing date of this report that includes the disclosure required b their evaluation of the controls and procedures required by Rule 30a-3(b) under the

270.30a-3(b)) and Rules 13a-15(b) or 15d-15(b) under the Securities Exchange Act
Exchange Act) (17 CFR 240.13a-15(b) or 240.15d-15(b)).

(b) There were no changes in the registrant s internal control over financial reporting (a
under the 1940 Act (17 CFR 270.30a-3(d)) that occurred during the second fiscal qu
this report that has materially affected, or is reasonably likely to materially affect, th
over financial reporting.

Item 12. Exhibits.

File the exhibits listed below as part of this Form.

(a)(1) Any code of ethics, or amendment thereto, that is the subject of the disclosure requi
that the registrant intends to satisfy the Item 2 requirements through filing of an exhibit: N

(a)(2) A separate certification for each principal executive officer and principal financial o
required by Rule 30a-2(a) under the 1940 Act (17 CFR 270.30a-2(a)) in the exact form se
EX-99.CERT attached hereto.

(a)(3) Any written solicitation to purchase securities under Rule 23c-1 under the 1940 Act
given during the period covered by the report by or on behalf of the registrant to 10 or mo

(b) If the report is filed under Section 13(a) or 15(d) of the Exchange Act, provide the cert
30a-2 (b) under the 1940 Act (17 CFR 270.30a-2(b)), Rule 13a-14(b) or Rule 15d-14(b) u
CFR 240.13a-14(b) or 240.15d-14(b)), and Section 1350 of Chapter 63 of Title 18 of the U
1350) as an Exhibit. A certification furnished pursuant to this paragraph will not be deeme
Section 18 of the Exchange Act (15 U.S.C. 78r), or otherwise subject to the liability of tha
will not be deemed to be incorporated by reference into any filing under the Securities Act
Act, except to the extent that the registration specifically incorporates it by reference: See
hereto.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934 and the Investment C
registrant has duly caused this report to be signed on its behalf by the undersigned, thereun

(Registrant) Nuveen Core Equity Alpha Fund

By (Signature and Title) /s/ Gifford R. Zimmerman
Gifford R. Zimmerman
Vice President and Secretary
Date: September 7, 2017

Pursuant to the requirements of the Securities Exchange Act of 1934 and the Investment C
report has been signed below by the following persons on behalf of the registrant and in th
indicated.

By (Signature and Title) /s/ Cedric H. Antosiewicz
Cedric H. Antosiewicz
Chief Administrative Officer
(principal executive officer)
Date: September 7, 2017

By (Signature and Title) /s/ Stephen D. Foy
Stephen D. Foy
Vice President and Controller
(principal financial officer)
Date: September 7, 2017