AETHLON MEDICAL INC
Form POS AM
December 08, 2005

As filed with the Securities and Exchange Commission on December 8, 2005
Commission File No. 333--117203_____

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

POST-EFFECTIVE AMENDMENT NO. 1
FORM SB-2
REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

AETHLON MEDICAL, INC.
(NAME OF SMALL BUSINESS ISSUER IN ITS CHARTER)

NEVADA	13-3632859
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)

3826
(PRIMARY STANDARD INDUSTRIAL CLASSIFICATION CODE NUMBER)

JAMES A. JOYCE
CHIEF EXECUTIVE OFFICER
3030 BUNKER HILL STREET, SUITE 4000
SAN DIEGO, CALIFORNIA 92109
(858) 459-7800

(ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF REGISTRANT'S PRINCIPAL EXECUTIVE OFFICES)

(NAME, ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF AGENT FOR SERVICE OF PROCESS)

Copies to

NIMISH PATEL, ESQ.
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Approximate date of proposed sale to public: From time to time after the effective date of this registration statement. If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box. |X|

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [ ]_____

If this Form is a post effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act

registration statement number of the earlier effective registration statement for the same offering: [ ]_____

If this form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering: [ ]_____

If delivery of this prospectus is expected to be made pursuant to Rule 434, please check the following box: [ ]

EXPLANATORY NOTE

Pursuant to Rule 429 under the Securities Act, the prospectus included in this Post-Effective Amendment updates and replaces the prospectus included in the Registration Statement on Form SB2/A (File No. 333-117203). Which was originally filed and declared effective on December 7, 2004, and also constitutes the prospectus for this Registration Statement.

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(A) OF THE SECURITIES ACT OF 1933 OR UNTIL THE REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE COMMISSION, ACTING PURSUANT TO SAID SECTION 8(A), MAY DETERMINE.

PRELIMINARY PROSPECTUS SUBJECT TO COMPLETION, DATED DECEMBER 8, 2005

THE INFORMATION IN THIS PROSPECTUS IS NOT COMPLETE AND MAY BE CHANGED. WE MAY NOT SELL THESE SECURITIES UNTIL THE REGISTRATION STATEMENT FILED WITH THE SECURITIES AND EXCHANGE COMMISSION IS EFFECTIVE. THIS PROSPECTUS IS NOT AN OFFER TO SELL THESE SECURITIES AND WE ARE NOT SOLICITING OFFERS TO BUY THESE SECURITIES IN ANY STATE WHERE THE OFFER OR SALE IS NOT PERMITTED.

PROSPECTUS

AETHLON MEDICAL, INC.

Up to 8,174,960 Shares of Common Stock

This prospectus relates to the sale of up to 8,174,960 shares of our common stock. Up to 6,574,906 shares of our common stock are being offered hereby by Fusion Capital Fund II, LLC, a selling shareholder under this prospectus. Up to 1,600,054 shares of our common stock are being offered by other selling shareholders. The prices at which the selling shareholders may

sell the shares will be determined by the prevailing market price for the shares or in negotiated transactions. We will not receive proceeds from the sale of our shares by the selling shareholders.

Our common stock is quoted on the NASDAQ Over-the-Counter Bulletin Board under the symbol "AEMD." On November 9, 2005, the last reported sale price for our common stock as reported on the NASDAQ Over-the-Counter Bulletin Board was $0.34 per share.

INVESTING IN THE COMMON STOCK INVOLVES CERTAIN RISKS. SEE "RISK FACTORS" BEGINNING ON PAGE 3 FOR A DISCUSSION OF THESE RISKS.

Fusion Capital Fund II, a selling shareholder, is an "underwriter" within the meaning of the Securities Act of 1933, as amended.

NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR DETERMINED IF THIS PROSPECTUS IS TRUTHFUL OR COMPLETE. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

The date of this Prospectus is December 8, 2005.

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PROSPECTUS SUMMARY

This summary highlights important information about our company and business. Because it is a summary, it may not contain all of the information that is important to you. To understand this offering fully, you should read this entire prospectus and the financial statements and related notes included in this prospectus CAREFULLY,, including the "Risk Factors" section. Unless the context requires otherwise, "WE," "US," "OUR", " and the "COMPANY" and similar terms collectively refer to Aethlon Medical, Inc. and our subsidiaries.

THE COMPANY

We are a development stage medical device company focused on expanding the applications of our Hemopurifier (TM) platform technology, which is designed to rapidly reduce the presence of infectious viruses and other toxins from human blood. In this regard, our core focus is the development of therapeutic devices that treat HIV/AIDS, Hepatitis-C, and pathogens targeted as potential biological warfare agents. The Hemopurifier(TM) combines the established scientific principals of affinity chromatography and hemodialysis as a means to mimic the immune system's response of clearing viruses and toxins from the blood before cell and organ infection can occur. The Hemopurifier(TM) cannot cure HIV and Hepatitis-C but prevents virus and toxins from infecting unaffected tissues and cells. We have completed pre-clinical blood testing of Hemopurifiers(TM) to treat HIV and Hepatitis-C, and have commenced human safety trials for Hepatitis-C in India, but have yet to receive regulatory approval to initiate human trials in the United States. The commercialization of each Hemopurifier(TM) application involves significant hurdles which include the completion of human efficacy clinical trials. The approval of any application of the Hemopurifier(TM) in the United States will require the approval of the FDA to initiate human studies. Such studies could take years to demonstrate safety and effectiveness in humans, and there is no assurance that the Hemopurifier(TM) will be cleared by the FDA as a device we can market to the medical community. We also anticipate that similar regulatory challenges will be expected from foreign regulatory agencies, should we attempt to commercialize and market the Hemopurifier(TM) outside of the United States. As a result, we have not generated revenues from the sale of any Hemopurifier(TM) application. Additionally, there have been no independent validatioN STUDIES of our Hemopurifiers(TM) to treat infectious disease. We manufacture our products on a small scale for testing purposes but have yet to manufacture our products on a large scale for commercial purposes. All of our pre-clinical human blood studies have been conducted in our laboratories under the direction of Dr. Richard Tullis, our Chief Science Officer.

As of November 9, 2005 we had issued and outstanding 19,427,201 common shares, and common share purchase options and warrants entitling the holders to purchase up to 17,160,648 common shares. We are a Nevada corporation. Our principal executive offices are located at 3030 Bunker Hill Street, Suite 4000, San Diego, California 92109. Our telephone number is (858) 459-7800. The address of our website is www.aethlonmedical.com. Information on our website is not a part of this prospectus.

THE OFFERING

This prospectus relates to the offer and sale by some of our shareholders during the period in which the registration statement containing this prospectus is effective of up to 8,174,960 common shares. 6,574,906 shares of our common stock are being offered hereby by Fusion Capital Fund II, LLC,

also referred to throughout this prospectus as Fusion Capital, a selling shareholder under this prospectus, including up to 568,181 shares issuable under common share purchase warrants. On May 20, 2004, we entered into a common stock purchase agreement with Fusion Capital pursuant to which Fusion Capital has purchased $700,001 of our common stock and has agreed to purchase, on each trading day, at least $10,000 of our common stock up to an aggregate, under certain conditions, of $5,299,999 in addition to the $700,001 already purchased by Fusion Capital. Fusion Capital would not be obligated to purchase $10,000 of our common stock on each trading day if (1) we elect not to sell our shares to Fusion Capital on such a date, (2) if an event of default occurs or (3) where the price of our common stock is below $0.25 per share. At our discretion, we may elect to sell more or less of our common stock to Fusion Capital than the minimum daily amount. The number of shares ultimately offered for sale by Fusion Capital is dependent upon the number of shares purchased by Fusion Capital under the common stock purchase agreement. Up to 1,600,054 shares of our common shares, including up to 1,186,363 shares issuable under common share purchase warrants, are being offered by other selling shareholders. As of November 9, 2005, there were 19,427,201 common shares outstanding. If the shares offered by this prospectus were outstanding as of November 9, 2005, such shares would represent approximately 35.41% of the total common stock outstanding on that date.

As of November 9, 2005, Fusion Capital beneficially owns 1,562,495 shares of our common stock, representing 8.04% of the 19,427,201 common shares outstanding. Contractual ownership limitations prohibit Fusion Capital, together with its affiliates, from beneficially owning more than 9.9% of our common stock. Fusion Capital may not purchase shares of our common stock under the common stock purchase agreement if Fusion Capital, together with its affiliates, would beneficially own more than 9.9% of our common stock outstanding at the time of the purchase by Fusion Capital. However, even though Fusion Capital may not receive additional shares of our common stock in the event that the 9.9% limitation is ever reached, Fusion Capital is still obligated to pay to us $10,000 on each trading day, unless the common stock purchase agreement is suspended, an event of default occurs or the agreement is terminated. Under these circumstances, Fusion Capital would be issued additional shares in the future should its ownership subsequently become less than the 9.9%. Fusion Capital would have no right to receive such shares until its ownership subsequently becomes less that the 9.9%. The number of shares to be issued to Fusion Capital would be calculated using the price of the daily purchase amount on the date we elect to sell our shares to Fusion Capital. There are no penalties owed under such circumstances. Fusion Capital has the right at any time to sell any shares purchased under the common stock purchase agreement which would allow it to avoid the 9.9% limitation. Therefore, we do not believe that Fusion Capital will ever reach the 9.9% limitation. Fusion Capital would not be obligated to purchase $10,000 of our common stock on each trading day if (1) we elect not to sell our shares to Fusion Capital on such date, (2) if shares of our common stock are trading at lower than $0.25 on such date or (3) if an event of default occurs.

The common shares offered under this prospectus may be sold by the selling shareholders on the public market, in negotiated transactions with a broker-dealer or market maker as principal or agent, or in privately negotiated transactions not involving a broker or dealer. Information regarding the selling shareholders, the common shares they are offering to sell under this prospectus, and the times and manner in which they may offer and sell those shares is provided in the sections of this prospectus captioned "SELLING SHAREHOLDERS" and

"PLAN OF Distribution". We will not receive any of the proceeds from those sales. Should the selling shareholders in their discretion exercise any of the common share purchase warrants underlying the common shares offered under this prospectus, we would, however, receive the exercise price for those warrants. The registration of common shares pursuant to this prospectus does not necessarily mean that any of those shares will ultimately be offered or sold by the selling shareholders.

SUMMARY FINANCIAL DATA

The following tables summarize the consolidated statements of operations and balance sheet data for our company.

CONSOLIDATED STATEMENTS OF OPERATIONS DATA:	SIX MONTHS ENDED SEPTEMBER 30, (UNAUDITED)	
	2005	2004
Revenue	$ 0	$ 0
Gross profit	$ 0	$ 0
Net loss	(1,475,323)	$ (829,945)
Preferred stock dividends	N/A	N/A
Net loss attributed to common shareholders	$ (1,475,323)	$ (829,945)
Loss per common share, basic and diluted	$ (0.08)	$ (0.06)
Weighted average common shares outstanding, basic and diluted	18,373,416	12,906,408

CONSOLIDATED BALANCE SHEET DATA:	SEPTEMBER 30, 2005 (UNAUDITED)
Current assets	$ 85,508
Total assets	$ 347,731
Total current liabilities	$ 3,624,606
Total stockholders' deficit	$(3,276,875)
Total liabilities and stockholders' deficit	$ 347,731

RISK FACTORS

An investment in our common shares involves a high degree of risk and is subject to many uncertainties. These risks and uncertainties may adversely affect our business, operating results and financial condition. In such an event, the trading price for our common shares could decline substantially, and you could lose all or part of your investment. In order to attain an appreciation for these risks and uncertainties, you should read this prospectus in its entirety and consider all of the information and advisements contained in

this prospectus, including the following risk factors and uncertainties.

RISKS RELATING TO OUR BUSINESS

WE HAVE A LIMITED OPERATING HISTORY WITH SIGNIFICANT LOSSES AND EXPECT LOSSES TO CONTINUE FOR THE FORESEEABLE FUTURE.

We have yet to establish any history of profitable operations. We have not had any revenues for the past three years. We have incurred annual operating losses of $2,183,377, $995,549 and $1,971,385, respectively, during the past three fiscal years of operation and an operating loss of $1,289,455 in the six months ended September 30, 2005. As a result, at March 31, 2005, we had an accumulated deficit of $19,142,264. We have incurred net losses from continuing operations of $2,096,951 and $1,518,798 for the fiscal years ending March 31, 2005 and 2004 and $1,475,323 and $829,945 for the six months ended September 30, 2005 and 2004. As a result, at September 30, 2005, we had an accumulated deficit of $20,617,587. Our revenues have not been sufficient to sustain our operations. We expect that our revenues will not be sufficient to sustain our operations for the foreseeable future. Our profitability will require the successful commercialization of our Hemopurifier(TM) technology. No assurances can be given when or if this will occur or that we will ever be profitable.

WE HAVE RECEIVED AN OPINION FROM OUR AUDITORS REGARDING OUR ABILITY TO CONTINUE AS A GOING CONCERN

Our independent auditors noted in their report accompanying our financial statements for our fiscal year ended March 31, 2005 that we had a significant deficit accumulated during the development stage, had a working capital deficit and that a significant amount of additional capital, approximately $5,000,000 as estimated by management, will be necessary to advance the development of our products to the point at which we may become commercially viable and stated that those conditions raised substantial doubt about our ability to continue as a going concern. Note 1 to our financial statements addressed management's plans to address these matters. We cannot assure you that our business plans will be successful in addressing these issues. This opinion about our ability to continue as a going concern could affect our ability to obtain additional financing at favorable terms, if at all, as such an opinion may cause investors to lose faith in our long term prospects. If we cannot successfully continue as a going concern, our shareholders may lose their entire investment in our common shares.

WE WILL REQUIRE ADDITIONAL FINANCING TO SUSTAIN OUR OPERATIONS AND WITHOUT IT WE WILL NOT BE ABLE TO CONTINUE OPERATIONS.

At March 31, 2005 and September 30, 2005, we had a working capital deficit of approximately $3,348,510 and $3,539,098, respectively. The independent auditors' report for the year ended March 31, 2005, includes an explanatory paragraph stating that our recurring losses from operations and working capital deficiency raise substantial doubt about our ability to continue as a going concern. We had a net operating cash flow deficit of $745,950 for the six months ended September 30, 2005, a net operating cash flow deficit of $1,559,366 for the year ended March 31, 2005, a net operating cash flow deficit of $542,056 for the year ended March 31, 2004 and for the year ended March 31, 2003, a net operating cash flow deficit of $514,503. We do not currently have sufficient financial resources to fund our operations or those of our subsidiaries. Therefore, we need additional funds to continue these operations.

We have the right to receive $10,000 per trading day under the agreement with Fusion Capital unless our stock price equals or exceeds $1.00, in which case the daily amount may be increased under certain conditions as the price of our common stock increases. Fusion Capital shall not have the right or the obligation to purchase any shares of our common stock on any trading days

that the market price of our common stock is less than $0.25. Since we are registering 6,006,725 shares for sale by Fusion Capital pursuant to this Prospectus (excluding the warrant to purchase 568,181 shares of common stock), the market price of our common stock to Fusion Capital will have to average approximately $0.63 per share for us to receive, in addition to the $950,001 we have already received from Fusion Capital, the maximum proceeds of $6,250,000 without registering additional shares of common stock. Assuming a purchase price of $0.34 per share (the closing market price of our common stock on November 9, 2005) and the purchase by Fusion Capital of the full 5,538,536 shares under the common stock purchase agreement, proceeds to us would only be $1,835,502 in addition to the $950,001 we have already received, unless we choose to register more than 6,006,725 shares, which we have the right, but not the obligation, to do.

The extent we rely on Fusion Capital as a source of funding will depend on a number of factors including, the prevailing market price of our common stock and the extent to which we are able to secure working capital from other sources, such as through the commercialization or licensing of our Hemopurifier(TM) technology. If obtaining sufficient financing from Fusion Capital were to prove prohibitively expensive and if we are unable to commercialize and sell our Hemopurifier(TM) technology, we will need to secure another source of funding in order to satisfy our working capital needs. Even if we are able to access the remaining $5,299,999 under the common stock purchase agreement with Fusion Capital (in addition to the $950,001 we have already received), we may still need additional capital to fully implement our business, operating and development plans. Should the financing we require to sustain our working capital needs be unavailable or prohibitively expensive when we require it, the consequences would be a material adverse effect on our business, operating results, financial condition and prospects.

WE MAY FAIL TO OBTAIN GOVERNMENT CONTRACTS TO DEVELOP OUR HEMOPURIFIER(TM) TECHNOLOGY FOR BIODEFENSE APPLICATIONS.

The U.S. Government has undertaken commitments to help secure improved countermeasures against bioterrorism. To date, we have submitted two Small Business Innovative Research ("SBIR") grant proposals, one in 2002 and the other in April 2004, with the National Institutes of Health that relate to the use of our Hemopurifier(TM) as a treatment countermeasure against certain biological weapon candidates and we anticipate that we will submit additional proposals to obtain U.S. Government grants. The first proposal in 2002 was reviewed but not scored. We expanded the proposal, submitted the proposal in 2004 and it was again reviewed but not scored as the term countermeasures in SBIR and other related Request for Proposal ("RFP") grants includes drugs and vaccines, but not medical devices such as the Hemopurifier(TM). As a result, future attempts to obtain grant income from the Federal Government will be sought through direct communication to government health and military agencies, and may include unsolicited proposals to provide the Hemopurifier(TM) as a treatment countermeasure.

At present, the Hemopurifier(TM) has not been approved for use by any government agency, nor have we received any contracts to purchase the Hemopurifier(TM). Since inception, we have not generated revenues from the sale of any product based on our Hemopurifier(TM) technology platform. The process of obtaining government contracts is lengthy with the uncertainty that we will be successful in obtaining announced grants or contracts for therapeutics as a medical device technology. Accordingly, we cannot be certain that we will be awarded any future

government grants or contracts utilizing our Hemopurifier(TM) platform technology.

IF THE U.S. GOVERNMENT FAILS TO PURCHASE SUFFICIENT QUANTITIES OF ANY FUTURE BIODEFENSE CANDIDATE UTILIZING OUR HEMOPURIFIER(TM) PLATFORM TECHNOLOGY, WE MAY BE UNABLE TO GENERATE SUFFICIENT REVENUES TO CONTINUE OPERATIONS.

We cannot be certain of the timing or availability of any future funding from the U.S. Government, and substantial delays or cancellations of funding could result from protests or challenges from third parties once such funding is obtained. If we develop products utilizing our Hemopurifier(TM) platform technology that are approved by the U.S. Food and Drug Administration (the "FDA"), but the U.S. Government does not place sufficient orders for these products, our future business will be harmed.

U.S. GOVERNMENT AGENCIES HAVE SPECIAL CONTRACTING REQUIREMENTS, WHICH CREATE ADDITIONAL RISKS.

Our business plan to provide biodefense product candidates and HIV-Hemopurifier(TM) candidates may involve contracts with the U.S. Government. U.S. Government contracts typically contain unfavorable termination provisions and are subject to audit and modification by the government at its sole discretion, which subjects us to additional risks. These risks include the ability of the U.S. Government to unilaterally:

- suspend or prevent us for a period of time from receiving new contracts or extending existing contracts based on violations or suspected violations of laws or regulations;
- audit and object to our contract-related costs and fees, including allocated indirect costs;
- control and potentially prohibit the export of our products; and
- change certain terms and conditions in our contracts.

If we were to become a U.S. Government contractor, we would be required to comply with applicable laws, regulations and standards relating to our accounting practices and would be subject to periodic audits and reviews. As part of any such audit or review, the U.S. Government may review the adequacy of, and our compliance with, our internal control systems and policies, including those relating to our purchasing, property, estimating, compensation and management information systems. Based on the results of its audits, the U.S. Government may adjust our contract-related costs and fees, including allocated indirect costs. In addition, if an audit or review uncovers any improper or illegal activity, we would possibly be subject to civil and criminal penalties and administrative sanctions, including termination of our contracts, forfeiture of profits, suspension of payments, fines and suspension or prohibition from doing business with the U.S. Government. We could also suffer serious harm to our reputation if allegations of impropriety were made against us. Although adjustments arising from government audits and reviews have not seriously harmed our business in the past, future audits and reviews could cause adverse effects. In addition, under U.S. Government purchasing regulations, some of our costs, including most financing costs, amortization of intangible assets, portions of our research and development costs, and some marketing expenses, would possibly

not be reimbursable or allowed under such contracts. Further, as a U.S. Government contractor, we would be subject to an increased risk of investigations, criminal prosecution, civil fraud, whistleblower lawsuits and other legal actions and liabilities to which purely private sector companies are not.

WE WILL FACE INTENSE COMPETITION FROM COMPANIES THAT HAVE GREATER FINANCIAL, PERSONNEL AND RESEARCH AND DEVELOPMENT RESOURCES THAN OURS. THESE COMPETITIVE FORCES MAY IMPACT OUR PROJECTED GROWTH AND ABILITY TO GENERATE REVENUES AND PROFITS, WHICH WOULD HAVE A NEGATIVE IMPACT ON OUR BUSINESS AND THE VALUE OF YOUR INVESTMENT.

Our competitors are developing vaccine candidates, which could compete with the Hemopurifier(TM) medical device candidates we are developing. Our commercial opportunities will be reduced or eliminated if our competitors develop and market products for any of the diseases we target that:

- are more effective;
- have fewer or less severe adverse side effects;
- are better tolerated;
- are more adaptable to various modes of dosing;
- are easier to administer; or

- are less expensive than the products or product candidates we are developing.

Even if we are successful in developing effective Hemopurifier(TM) products, and obtain FDA and other regulatory approvals necessary for commercializing them, our products may not compete effectively with other successful products. Researchers are continually learning more about diseases, which may lead to new technologies for treatment. Our competitors may succeed in developing and marketing products that are either more effective than those that we may develop, alone or with our collaborators, or that are marketed before any products we develop are marketed.

The Congress' recent passage of the Project BioShield Bill, a comprehensive effort to develop and make available modern, effective drugs and vaccines to protect against attack by biological and chemical weapons or other dangerous pathogens, may encourage competitors to develop their own product candidates. We cannot predict the decisions that will be made in the future by the various government agencies as a result of such legislation.

Our competitors include fully integrated pharmaceutical companies and biotechnology companies as well as universities and public and private research institutions. Many of the organizations competing with us, have substantially greater capital resources, larger research and development staffs and facilities, greater experience in product development and in obtaining regulatory approvals, and greater marketing capabilities than we do.

The market for medical devices is intensely competitive. Many of our potential competitors have longer operating histories, greater name recognition, more employees, and significantly greater financial, technical, marketing,

public relations, and distribution resources than we have. This intense competitive environment may require us to make changes in our products, pricing, licensing, services or marketing to develop, maintain and extend our current technology. Price concessions or the emergence of other pricing or distribution strategies of competitors may diminish our revenues (if any), adversely impact our margins or lead to a reduction in our market share (if any), any of which may harm our business.

WE HAVE LIMITED MANUFACTURING EXPERIENCE.

To achieve the levels of production necessary to commercialize our Hemopurifier(TM) products, we will need secure manufacturing agreements with manufacturers which comply with good manufacturing practices standards and other standards prescribed by various federal, state and local regulatory agencies in the U.S. and any other country of use.

We have limited experience manufacturing products for testing purposes and no experience manufacturing products for large scale commercial purposes. We will likely outsource the manufacture of our Hemopurifier(TM) products to third parties operating FDA-certified facilities. To date, we have manufactured devices on a small scale for testing purposes. There can be no assurance that manufacturing and control problems will not arise as we attempt to commercialize our products or that such manufacturing can be completed in a timely manner or at a commercially reasonable cost. Any failure to surmount such problems could delay or prevent commercialization of our products and would have a material adverse effect on us.

OUR HEMOPURIFER(TM) TECHNOLOGY MAY BECOME OBSOLETE.

Our Hemopurifier(TM) products may be made unmarketable by new scientific or technological developments where new treatment modalities are introduced that are more efficacious and/or more economical than our Hemopurifier(TM) products. The Homeland Security industry is growing rapidly with many competitors trying to develop products or vaccines to protect against infectious disease. Any one of our competitors could develop a more effective product which would render our technology obsolete.

OUR USE OF HAZARDOUS MATERIALS, CHEMICALS AND VIRUSES REQUIRE US TO COMPLY WITH REGULATORY REQUIREMENTS AND EXPOSES US TO POTENTIAL LIABILITIES.

Our research and development involves the controlled use of hazardous materials, chemicals and viruses. The primary hazardous materials include chemicals needed to construct the Hemopurifier(TM) cartridges and HIV and Hepatitis C infected plasma samples used in preclinical testing of the Hemopurifier(TM). All other chemicals are fully inventoried and reported to the

appropriate authorities, such as the fire department, who inspect the facility on a regular basis. We are subject to federal, state, local and foreign laws governing the use, manufacture, storage, handling and disposal of such materials. Although we believe that our safety procedures for the use, manufacture, storage, handling and disposal of such materials comply with the standards prescribed by federal, state, local and foreign regulations, we cannot completely eliminate the risk of accidental contamination or injury from these materials. We have had no incidents or problems involving hazardous chemicals or biological samples. In the event of such an accident, we could be held liable for significant damages or fines. We currently carry a limited amount of

insurance to protect us from these damages. In addition, we may be required to incur significant costs to comply with regulatory requirements in the future.

WE ARE DEPENDENT FOR OUR SUCCESS ON A FEW KEY EXECUTIVE OFFICERS. OUR INABILITY TO RETAIN THOSE OFFICERS WOULD IMPEDE OUR BUSINESS PLAN AND GROWTH STRATEGIES, WHICH WOULD HAVE A NEGATIVE IMPACT ON OUR BUSINESS AND THE VALUE OF YOUR INVESTMENT.

Our success depends to a critical extent on the continued services of our Chief Executive Officer, James A. Joyce and our Chief Science Officer, Richard H. Tullis. Were we to lose one or more of these key executive officers, we would be forced to expend significant time and money in the pursuit of a replacement, which would result in both a delay in the implementation of our business plan and the diversion of limited working capital. The loss of Dr. Tullis would harm the clinical development of our products due to his unique experience with the Hemopurifier(TM) technology. The loss of Dr. Tullis and/or Mr. Joyce would be detrimental to our growth as they possess unique knowledge of our business model and infectious disease which would be difficult to replace within the biotechnology field. We can give you no assurance that we can find satisfactory replacements for these key executive officers at all, or on terms that are not unduly expensive or burdensome to our company. Although Mr. Joyce and Mr. Tullis have signed employment agreements providing for their continued service to our company, these agreements will not preclude them from leaving our company. We do not currently carry key man life insurance policies on any of our key executive officers which would assist us in recouping our costs in the event of the loss of those officers.

OUR INABILITY TO ATTRACT AND RETAIN QUALIFIED PERSONNEL COULD IMPEDE OUR ABILITY TO GENERATE REVENUES AND PROFITS AND TO OTHERWISE IMPLEMENT OUR BUSINESS PLAN AND GROWTH STRATEGIES, WHICH WOULD HAVE A NEGATIVE IMPACT ON OUR BUSINESS AND COULD ADVERSELY AFFECT THE VALUE OF YOUR INVESTMENT.

We currently have an extremely small staff comprised of five full time employees consisting of our Chief Executive Officer, our Chief Science Officer, our Chief Financial Officer, a research scientist, a research associate, as well as other personnel employed on a contract basis. Although we believe that these employees, together with the consultants currently engaged by our company, will be able to handle most of our additional administrative, research and development and business development in the near term, we will nevertheless be required over the longer-term to hire highly skilled managerial, scientific and administrative personnel to fully implement our business plan and growth strategies. Due to the specialized scientific nature of our business, we are highly dependent upon our ability to attract and retain qualified scientific, technical and managerial personal. Competition for these individuals, especially in San Diego where many bio-technology companies are located, is intense and we may not be able to attract, assimilate or retain additional highly qualified personnel in the future. We cannot assure you that we will be able to engage the services of such qualified personnel at competitive prices or at all, particularly given the risks of employment attributable to our limited financial resources and lack of an established track record.

WE PLAN TO GROW VERY RAPIDLY, WHICH WILL PLACE STRAINS ON OUR MANAGEMENT TEAM AND OTHER COMPANY RESOURCES TO BOTH IMPLEMENT MORE SOPHISTICATED MANAGERIAL, OPERATIONAL AND FINANCIAL SYSTEMS, PROCEDURES AND CONTROLS AND TO TRAIN AND MANAGE THE PERSONNEL NECESSARY TO IMPLEMENT THOSE FUNCTIONS. OUR INABILITY TO MANAGE OUR GROWTH COULD IMPEDE OUR ABILITY TO GENERATE REVENUES AND PROFITS AND TO OTHERWISE IMPLEMENT OUR BUSINESS PLAN AND GROWTH STRATEGIES, WHICH WOULD HAVE A NEGATIVE IMPACT ON OUR BUSINESS AND THE VALUE OF YOUR INVESTMENT.

We will need to significantly expand our operations to implement our longer-term business plan and growth strategies. We will also be required to

manage multiple relationships with various strategic partners, technology licensors, customers, manufacturers and suppliers, consultants and other third parties. This expansion and these expanded relationships will require us to significantly improve or replace our existing managerial, operational and

financial systems, procedures and controls; to improve the coordination between our various corporate functions; and to manage, train, motivate and maintain a growing employee base. The time and costs to effectuate these steps may place a significant strain on our management personnel, systems and resources, particularly given the limited amount of financial resources and skilled employees that may be available at the time. We cannot assure you that we will institute, in a timely manner or at all, the improvements to our managerial, operational and financial systems, procedures and controls necessary to support our anticipated increased levels of operations and to coordinate our various corporate functions, or that we will be able to properly manage, train, motivate and retain our anticipated increased employee base.

WE MAY HAVE DIFFICULTY IN ATTRACTING AND RETAINING MANAGEMENT AND OUTSIDE INDEPENDENT MEMBERS TO OUR BOARD OF DIRECTORS AS A RESULT OF THEIR CONCERNS RELATING TO THEIR INCREASED PERSONAL EXPOSURE TO LAWSUITS AND SHAREHOLDER CLAIMS BY VIRTUE OF HOLDING THESE POSITIONS IN A PUBLICLY-HELD COMPANY

The directors and management of publicly traded corporations are increasingly concerned with the extent of their personal exposure to lawsuits and shareholder claims, as well as governmental and creditor claims which may be made against them, particularly in view of recent changes in securities laws imposing additional duties, obligations and liabilities on management and directors. Due to these perceived risks, directors and management are also becoming increasingly concerned with the availability of directors and officers liability insurance to pay on a timely basis the costs incurred in defending such claims. We currently do carry limited directors and officers liability insurance. Directors and officers liability insurance has recently become much more expensive and difficult to obtain. If we are unable to continue or provide directors and officers liability insurance at affordable rates or at all, it may become increasingly more difficult to attract and retain qualified outside directors to serve on our board of directors. We may lose potential independent board members and management candidates to other companies in the biotechnology field that have greater directors and officers liability insurance to insure them from liability or to biotechnology companies that have revenues or have received greater funding to date which can offer greater compensation packages. The fees of directors are also rising in response to their increased duties, obligations and liabilities as well as increased exposure to such risks. As a company with a limited operating history and limited resources, we will have a more difficult time attracting and retaining management and outside independent directors than a more established company due to these enhanced duties, obligations and liabilities.

IF WE FAIL TO COMPLY WITH EXTENSIVE REGULATIONS OF DOMESTIC AND FOREIGN REGULATORY AUTHORITIES, THE COMMERCIALIZATION OF OUR PRODUCT CANDIDATES COULD BE PREVENTED OR DELAYED.

Our pathogen filtration devices, or Hemopurifier(TM) products, are subject to extensive government regulations related to development, testing, manufacturing and commercialization in the United States and other countries. The determination of when and whether a product is ready for large scale

purchase and potential use will be made by the government through consultation with a number of governmental agencies, including the FDA, the National Institutes of Health, the Centers for Disease Control and Prevention and the Department of Homeland Security. Our product candidates are in the pre-clinical and clinical stages of development and have not received required regulatory approval from the FDA to be commercially marketed and sold. The process of obtaining and complying with FDA and other governmental regulatory approvals and regulations is costly, time consuming, uncertain and subject to unanticipated delays. Such regulatory approval (if any) and product development requires several years. Despite the time and expense exerted, regulatory approval is never guaranteed. We also are subject to the following risks and obligations, among others.

- The FDA may refuse to approve an application if they believe that applicable regulatory criteria are not satisfied.
- The FDA may require additional testing for safety and effectiveness.
- The FDA may interpret data from pre-clinical testing and clinical trials in different ways than we interpret them.
- If regulatory approval of a product is granted, the approval may be limited to specific indications or limited with respect to its distribution.

- The FDA may change their approval policies and/or adopt new regulations.

Failure to comply with these or other regulatory requirements of the FDA may subject us to administrative or judicially imposed sanctions, including:

- warning letters;
- civil penalties;
- criminal penalties;
- injunctions;
- product seizure or detention;
- product recalls; and
- total or partial suspension of productions.

DELAYS IN SUCCESSFULLY COMPLETING OUR CLINICAL TRIALS COULD JEOPARDIZE OUR ABILITY TO OBTAIN REGULATORY APPROVAL OR MARKET OUR HEMOPURIFIER(TM) PRODUCT CANDIDATES ON A TIMELY BASIS.

Our business prospects will depend on our ability to complete clinical trials, obtain satisfactory results, obtain required regulatory approvals and successfully commercialize our Hemopurifier(TM) product candidates. Completion of our clinical trials, announcement of results of the trials and our ability to obtain regulatory approvals could be delayed for a variety of reasons, including:

- serious adverse events related to our medical device candidates;
- unsatisfactory results of any clinical trial;
- the failure of our principal third-party investigators to perform our clinical trials on our anticipated schedules; and/or
- different interpretations of our pre-clinical and clinical data, which could initially lead to inconclusive results.

Our development costs will increase if we have material delays in any clinical trial or if we need to perform more or larger clinical trials than planned. If the delays are significant, or if any of our Hemopurifier(TM) product candidates do not prove to be safe or effective or do not receive required regulatory approvals, our financial results and the commercial prospects for our product candidates will be harmed. Furthermore, our inability to complete our clinical trials in a timely manner could jeopardize our ability to obtain regulatory approval.

THE INDEPENDENT CLINICAL INVESTIGATORS THAT WE RELY UPON TO CONDUCT OUR CLINICAL TRIALS MAY NOT BE DILIGENT, CAREFUL OR TIMELY, AND MAY MAKE MISTAKES, IN THE CONDUCT OF OUR CLINICAL TRIALS.

We depend on independent clinical investigators to conduct our clinical trials. The investigators are not our employees, and we cannot control the amount or timing of resources that they devote to our product development programs. If independent investigators fail to devote sufficient time and resources to our product development programs, or if their performance is substandard, it may delay FDA approval of our medical device candidates. These independent investigators may also have relationships with other commercial entities, some of which may compete with us. If these independent investigators assist our competitors at our expense, it could harm our competitive position.

THE APPROVAL REQUIREMENTS FOR MEDICAL PRODUCTS USED TO FIGHT BIOTERRORISM ARE STILL EVOLVING, AND WE CANNOT BE CERTAIN THAT ANY PRODUCTS WE DEVELOP, IF EFFECTIVE, WOULD MEET THESE REQUIREMENTS.

We are developing product candidates based upon current governmental policies regulating these medical countermeasure treatments. For instance, we intend to pursue FDA approval of our proprietary pathogen filtration devices to treat infectious agents under requirements published by the FDA that allow the FDA to approve certain medical devices used to reduce or prevent the toxicity of chemical, biological, radiological or nuclear substances based on human clinical data to demonstrate safety and immune response, and evidence of effectiveness derived from appropriate animal studies and any additional supporting data. Our business is subject to substantial risk because these policies may change suddenly and unpredictably and in ways that could impair our ability to obtain regulatory approval of these products, and we cannot guarantee that the FDA will approve our proprietary pathogen filtration devices.

OUR PRODUCT DEVELOPMENT EFFORTS MAY NOT YIELD MARKETABLE PRODUCTS DUE TO RESULTS OF STUDIES OR TRIALS, FAILURE TO ACHIEVE REGULATORY APPROVALS OR MARKET ACCEPTANCE, PROPRIETARY RIGHTS OF OTHERS OR MANUFACTURING ISSUES.

Our success depends on our ability to successfully develop and obtain regulatory approval to market new filtration devices. We expect that a significant portion of the research that we will conduct will involve new and unproven technologies. Development of a product requires substantial technical, financial and human resources even if the product is not successfully completed.

Our previously planned products have not become marketable products due in part to our transition in 2001 from a focus on utilizing our Hemopurifier(TM) technology on treating harmful metals to treating infectious diseases prior to our having completed the FDA approval process. Our transition was made in order to focus on larger markets with an urgent need for new treatment and to take advantage of the sense of greater sense of urgency surrounding acute and chronic infectious diseases. Prior to initiating the development of infectious disease Hemopurifiers(TM), we successfully completed an FDA approved Phase I human safety trial of a Hemopurifier(TM) to treat aluminum and iron intoxication. Since changing the focus to infectious disease research, we have not initiated an FDA approved human clinical trial as the development of the technology is still continuing and will require both significant capital and scientific resources. Our pending products face similar challenges of obtaining successful clinical trials in route to gaining FDA approval prior to commercialization. Additionally, our limited financial resources hinder the speed of our product development due to personal constraints.

Our potential products may appear to be promising at various stages of development yet fail to reach the market for a number of reasons, including the:

- lack of adequate quality or sufficient prevention benefit, or unacceptable safety during pre-clinical studies or clinical trials;
- failure to receive necessary regulatory approvals;
- existence of proprietary rights of third parties; and/or
- inability to develop manufacturing methods that are efficient, cost-effective and capable of meeting stringent regulatory standards.

POLITICAL OR SOCIAL FACTORS MAY DELAY OR IMPAIR OUR ABILITY TO MARKET OUR PRODUCTS.

Products developed to treat diseases caused by or to combat the threat of bioterrorism will be subject to changing political and social environments. The political and social responses to bioterrorism have been highly charged and unpredictable. Political or social pressures may delay or cause resistance to bringing our products to market or limit pricing of our products, which would harm our business. Bioterrorism has become the focus of political debates especially with the upcoming presidential elections, both in terms of how to approach bioterrorism and the amount funding the government should provide for any programs involving homeland protection. Government funding for products on bioterrorism could be reduced which would hinder our ability to obtain governmental grants.

OUR INABILITY TO PROTECT OUR INTELLECTUAL PROPERTY RIGHTS COULD NEGATIVELY IMPACT OUR PROJECTED GROWTH AND ABILITY TO GENERATE REVENUES AND

PROFITS, WHICH WOULD HAVE A NEGATIVE IMPACT ON OUR BUSINESS AND THE VALUE OF YOUR INVESTMENT.

We rely on a combination of patents, patents pending, copyrights, trademark and trade secret laws, proprietary rights agreements and non-disclosure agreements to protect our intellectual properties. We cannot give you any assurance that these measures will prove to be effective in protecting our intellectual properties.

In the case of patents, we cannot give you any assurance that our existing patents will not be invalidated, that any patents that we currently or prospectively apply for will be granted, or that any of these patents will ultimately provide significant commercial benefits. Further, competing companies may circumvent any patents that we may hold by developing products which closely emulate but do not infringe our patents. While we intend to seek patent protection for our products in selected foreign countries, those patents may not receive the same degree of protection as they would in the United States. We can give you no assurance that we will be able to successfully defend our patents and proprietary rights in any action we may file for patent infringement. Similarly, we cannot give you any assurance that we will not be required to defend against litigation involving the patents or proprietary rights of others, or that we will be able to obtain licenses for these rights. Legal and accounting costs relating to prosecuting or defending patent infringement litigation may be substantial. Since many of our patents were issued in the 1980's, they may expire before FDA approval, if any, is obtained. However, we believe that certain patent applications filed and/or other patents issued more recently will help to protect the proprietary nature of the Hemopurifier(TM) treatment technology.

The Hemopurifier(TM) is protected by four issued patents, in the United States, Europe and Japan, three of which we own and one in which we own an exclusive license. Three additional patent applications deal with treatments for virus infection and manufacturing methods, two of which we own and one of which we own an exclusive license.

We also rely on proprietary designs, technologies, processes and know-how not eligible for patent protection. We cannot give you any assurance that our competitors will not independently develop the same or superior designs, technologies, processes and know-how.

While we have and will continue to enter into proprietary rights agreements with our employees and third parties giving us proprietary rights to certain technology developed by those employees or parties while engaged by our company, we can give you no assurance that courts of competent jurisdiction will enforce those agreements.

THE PATENTS WE OWN COMPRISE A MAJORITY OF OUR ASSETS WHICH COULD LIMIT OUR FINANCIAL VIABILITY.

The Hemopurifier(TM) is protected by four issued patents, in the United States, Europe and Japan, three of which we own and one which we own the exclusive license. These patents comprise a majority of our assets. At September 30, 2005, our patents comprised 80.06% of our fixed assets, and 60.37% of all assets. If our existing patents are invalidated or if they fail to provide significant commercial benefits, it will severely hurt our financial condition as a majority of our assets would lose their value. Further, since our patents are written down over the course of their term until they expire, our assets comprised of patents will continually be written down until they lose value altogether.

LEGISLATIVE ACTIONS AND POTENTIAL NEW ACCOUNTING PRONOUNCEMENTS ARE LIKELY TO IMPACT OUR FUTURE FINANCIAL POSITION AND RESULTS OF OPERATIONS.

There have been regulatory changes, including the Sarbanes-Oxley Act of 2002, and there may potentially be new accounting pronouncements or additional regulatory rulings which will have an impact on our future financial position and results of operations. The Sarbanes-Oxley Act of 2002 and other rule changes as well as proposed legislative initiatives following the Enron bankruptcy have increased our general and administrative costs as we have incurred increased legal and accounting fees to comply with such rule changes. Further, proposed initiatives are expected to result in changes in certain accounting rules,

including legislative and other proposals to account for employee stock options as a compensation expense. These and other potential changes could materially increase the expenses we report under accounting principles generally accepted in the United States of America, and adversely affect our operating results.

OUR PRODUCTS MAY BE SUBJECT TO RECALL OR PRODUCT LIABILITY CLAIMS.

Our Hemopurifier(TM) products may be used in connection with medical procedures in which it is important that those products function with precision and accuracy. If our products do not function as designed, or are designed improperly, we may be forced by regulatory agencies to withdraw such products from the market. In addition, if medical personnel or their patients suffer injury as a result of any failure of our products to function as designed, or our products are designed inappropriately, we may be subject to lawsuits seeking significant compensatory and punitive damages. The risk of product liability claims, product recalls and associated adverse publicity is inherent in the testing, manufacturing, marketing and sale of medical products. We do not have general clinical trial liability insurance coverage. There can be no assurance that future insurance coverage will to be adequate or available. We may not be able to secure product liability insurance coverage on acceptable terms or at reasonable costs when needed. Any product recall or lawsuit seeking significant monetary damages may have a material affect on our business and financial condition. Any liability for mandatory damages could exceed the amount of our coverage. Moreover, a product recall could generate substantial negative publicity about our products and business and inhibit or prevent commercialization of other future product candidates.

RISKS RELATING TO AN INVESTMENT IN OUR SECURITIES

TO DATE, WE HAVE NOT PAID ANY CASH DIVIDENDS AND NO CASH DIVIDENDS WILL BE PAID IN THE FORESEEABLE FUTURE.

We do not anticipate paying cash dividends on our common shares in the foreseeable future, and we cannot assure an investor that funds will be legally available to pay dividends, or that even if the funds are legally available, that the dividends will be paid.

THE APPLICATION OF THE "PENNY STOCK" RULES COULD ADVERSELY AFFECT THE MARKET PRICE OF OUR COMMON SHARES AND INCREASE YOUR TRANSACTION COSTS TO SELL THOSE SHARES.

As long as the trading price of our common shares is below $5 per share, the open-market trading of our common shares will be subject to the "penny stock" rules. The "penny stock" rules impose additional sales practice requirements on broker-dealers who sell securities to persons other than established customers and accredited investors (generally those with assets in

excess of $1,000,000 or annual income exceeding $200,000 or $300,000 together with their spouse). For transactions covered by these rules, the broker-dealer must make a special suitability determination for the purchase of securities and have received the purchaser's written consent to the transaction before the purchase. Additionally, for any transaction involving a penny stock, unless exempt, the broker-dealer must deliver, before the transaction, a disclosure schedule prescribed by the SEC relating to the penny stock market. The broker-dealer also must disclose the commissions payable to both the broker-dealer and the registered representative and current quotations for the securities. Finally, monthly statements must be sent disclosing recent price information on the limited market in penny stocks. These additional burdens imposed on broker-dealers may restrict the ability or decrease the willingness of broker-dealers to sell our common shares, and may result in decreased liquidity for our common shares and increased transaction costs for sales and purchases of our common shares as compared to other securities.

OUR COMMON SHARES ARE THINLY TRADED, SO YOU MAY BE UNABLE TO SELL AT OR NEAR ASK PRICES OR AT ALL IF YOU NEED TO SELL YOUR SHARES TO RAISE MONEY OR OTHERWISE DESIRE TO LIQUIDATE YOUR SHARES.

Our common shares have historically been sporadically or "thinly-traded" on the OTCBB, meaning that the number of persons interested in purchasing our common shares at or near ask prices at any given time may be relatively small or non-existent. As of November 9, 2005, our average trading volume per day for the past three months was approximately 74,620 shares a day with a high of 475,600 shares traded and a low of 500 shares traded. This situation is attributable to a number of factors, including the fact that we are a small company which is relatively unknown to stock analysts, stock brokers, institutional investors and others in the investment community that generate or influence sales volume, and that even if we came to the attention of such

persons, they tend to be risk-averse and would be reluctant to follow an unproven company such as ours or purchase or recommend the purchase of our shares until such time as we became more seasoned and viable. As a consequence, there may be periods of several days or more when trading activity in our shares is minimal or non-existent, as compared to a seasoned issuer which has a large and steady volume of trading activity that will generally support continuous sales without an adverse effect on share price. We cannot give you any assurance that a broader or more active public trading market for our common shares will develop or be sustained, or that current trading levels will be sustained.

Fusion Capital's purchase of $10,000 of our common stock each trading day could cause our common stock price to decline due to the additional shares available in the market, particularly in light of the relatively thin trading volume of our common stock. Using the closing price on November 9, 2005 of $0.34 as an example, Fusion Capital would be issued approximately 29,411 shares each trading day if we elected to have them purchase the daily purchase amount, whereas our average trading volume for the prior three months is 74,620 per day. The market price of our common stock could decline given our minimal average trading volume compared to the number of shares potentially issuable to Fusion Capital and the voting power and value of your investment would be subject to continual dilution if Fusion Capital purchases the shares and resells those shares into the market, although there is no obligation for Fusion Capital to sell such shares. Any adverse affect on the market price of our common stock would increase the number of shares issuable to Fusion Capital each trading day which would increase the dilution of your investment. Although we have the right

to reduce or suspend Fusion Capital purchases at any time, our financial condition at the time may require us to waive our right to suspend purchases even if there is a decline in the market price. Additionally, up to 1,600,054 shares of our common stock are being offered in this prospectus by other selling shareholders. Sales of large amount of these shares in the public market could substantially depress the prevailing market prices for our shares, especially with our thin trading volume as there would be difficulty for the market to absorb the sale of such shares without an adverse effect on the share price. If that were to happen, the value of your investment could decline substantially.

Contractual 9.9% beneficial ownership limitations prohibit Fusion Capital, together with its affiliates, from beneficially owning more than 9.9% of our outstanding common stock. This 9.9% limitation does not prevent Fusion Capital from purchasing shares of our common stock and then reselling those shares in stages over time where Fusion Capital and its affiliates do not, at any given time, beneficially own shares in excess of the 9.9% limitation. Consequently, these limitations will not necessarily prevent substantial dilution of the voting power and value of your investment.

THE MARKET PRICE FOR OUR COMMON SHARES IS PARTICULARLY VOLATILE GIVEN OUR STATUS AS A RELATIVELY UNKNOWN COMPANY WITH A SMALL AND THINLY-TRADED PUBLIC FLOAT, LIMITED OPERATING HISTORY AND LACK OF REVENUES WHICH COULD LEAD TO WIDE FLUCTUATIONS IN OUR SHARE PRICE. THE PRICE AT WHICH YOU PURCHASE OUR COMMON SHARES MAY NOT BE INDICATIVE OF THE PRICE THAT WILL PREVAIL IN THE TRADING MARKET. YOU MAY BE UNABLE TO SELL YOUR COMMON SHARES AT OR ABOVE YOUR PURCHASE PRICE, WHICH MAY RESULT IN SUBSTANTIAL LOSSES TO YOU.

The market for our common shares is characterized by significant price volatility when compared to seasoned issuers, and we expect that our share price will continue to be more volatile than a seasoned issuer for the indefinite future. In fact, during the 52-week period ended November 9, 2005, the high and low sale prices of a share of our common stock were $0.63 and $0.19, respectively. The volatility in our share price is attributable to a number of factors. First, as noted above, our common shares are sporadically and/or thinly traded.As a consequence of this lack of liquidity, the trading of relatively small quantities of shares by our shareholders may disproportionately influence the price of those shares in either direction. The price for our shares could, for example, decline precipitously in the event that a large number of our common shares are sold on the market without commensurate demand, as compared to a seasoned issuer which could better absorb those sales without adverse impact on its share price. Secondly, we are a speculative or "risky" investment due to our limited operating history and lack of revenues or profits to date, and uncertainty of future market acceptance for our potential products. As a

consequence of this enhanced risk, more risk-adverse investors may, under the fear of losing all or most of their investment in the event of negative news or lack of progress, be more inclined to sell their shares on the market more quickly and at greater discounts than would be the case with the stock of a seasoned issuer. The following factors may add to the volatility in the price of our common shares: actual or anticipated variations in our quarterly or annual operating results; acceptance of our proprietary technology as viable method of augmenting the immune response of clearing viruses and toxins from human blood; government regulations, announcements of significant acquisitions, strategic partnerships or joint ventures; our capital commitments; and additions or departures of our key personnel. Many of these factors are beyond our control and may decrease the market price of our common shares, regardless of our

operating performance. We cannot make any predictions or projections as to what the prevailing market price for our common shares will be at any time, including as to whether our common shares will sustain their current market prices, or as to what effect that the sale of shares or the availability of common shares for sale at any time will have on the prevailing market price.

Shareholders should be aware that, according to SEC Release No. 34-29093, the market for penny stocks has suffered in recent years from patterns of fraud and abuse. Such patterns include (1) control of the market for the security by one or a few broker-dealers that are often related to the promoter or issuer; (2) manipulation of prices through prearranged matching of purchases and sales and false and misleading press releases; (3) boiler room practices involving high-pressure sales tactics and unrealistic price projections by inexperienced sales persons; (4) excessive and undisclosed bid-ask differential and markups by selling broker-dealers; and (5) the wholesale dumping of the same securities by promoters and broker-dealers after prices have been manipulated to a desired level, along with the resulting inevitable collapse of those prices and with consequent investor losses. Our management is aware of the abuses that have occurred historically in the penny stock market. Although we do not expect to be in a position to dictate the behavior of the market or of broker-dealers who participate in the market, management will strive within the confines of practical limitations to prevent the described patterns from being established with respect to our securities. The occurrence of these patterns or practices could increase the volatility of our share price.

VOLATILITY IN OUR COMMON SHARE PRICE MAY SUBJECT US TO SECURITIES LITIGATION.

The market for our common shares is characterized by significant price volatility when compared to seasoned issuers, and we expect that our share price will continue to be more volatile than a seasoned issuer for the indefinite future. In the past, plaintiffs have often initiated securities class action litigation against a company following periods of volatility in the market price of its securities. We may in the future be the target of similar litigation. Securities litigation could result in substantial costs and liabilities and could divert management's attention and resources.

OUR OFFICERS AND DIRECTORS BENEFICIALLY OWN OR CONTROL APPROXIMATELY 62% OF OUR OUTSTANDING COMMON SHARES AS OF SEPTEMBER 30, 2005, WHICH MAY LIMIT THE ABILITY OF YOURSELF OR OTHER SHAREHOLDERS, WHETHER ACTING INDIVIDUALLY OR TOGETHER, TO PROPOSE OR DIRECT THE MANAGEMENT OR OVERALL DIRECTION OF OUR COMPANY. ADDITIONALLY, THIS CONCENTRATION OF OWNERSHIP COULD DISCOURAGE OR PREVENT A POTENTIAL TAKEOVER OF OUR COMPANY THAT MIGHT OTHERWISE RESULT IN YOU RECEIVING A PREMIUM OVER THE MARKET PRICE FOR YOUR COMMON SHARES.

As of November 9, 2005, our officers and directors beneficially own or control approximately 62.25% of our outstanding common shares. These persons will have the ability to control substantially all matters submitted to our shareholders for approval and to control our management and affairs, including extraordinary transactions such as mergers and other changes of corporate control, and going private transactions.

A LARGE NUMBER OF COMMON SHARES ARE ISSUABLE UPON EXERCISE OF OUTSTANDING COMMON SHARE PURCHASE OPTIONS, WARRANTS AND CONVERTIBLE PROMISSORY NOTES. THE EXERCISE OR CONVERSION OF THESE SECURITIES COULD RESULT IN THE SUBSTANTIAL DILUTION OF YOUR INVESTMENT IN TERMS OF YOUR PERCENTAGE OWNERSHIP IN THE COMPANY AS WELL AS THE BOOK VALUE OF YOUR COMMON SHARES. THE SALE OF A LARGE AMOUNT OF COMMON SHARES RECEIVED UPON EXERCISE OF THESE OPTIONS OR WARRANTS ON THE PUBLIC MARKET TO FINANCE THE EXERCISE PRICE OR TO PAY ASSOCIATED INCOME TAXES, OR THE PERCEPTION THAT SUCH SALES COULD OCCUR, COULD SUBSTANTIALLY DEPRESS THE PREVAILING MARKET PRICES FOR OUR SHARES.

As of November 9, 2005, there are outstanding non-variable priced purchase options and warrants entitling the holders to purchase 17,160,648 common shares at a weighted average exercise price of $0.45 per share. There are 4,175,000 shares underlying promissory notes convertible into common stock at a weighted average exercise price of $ 0.20. The exercise price for all of the aforesaid warrants, may be less than your cost to acquire our common shares. In

the event of the exercise of these securities, you could suffer substantial dilution of your investment in terms of your percentage ownership in the company as well as the book value of your common shares. In addition, the holders of the common share purchase options or warrants may sell common shares in tandem with their exercise of those options or warrants to finance that exercise, or may resell the shares purchased in order to cover any income tax liabilities that may arise from their exercise of the options or warrants.

OUR ISSUANCE OF ADDITIONAL COMMON SHARES, OR OPTIONS OR WARRANTS TO PURCHASE THOSE SHARES, WOULD DILUTE YOUR PROPORTIONATE OWNERSHIP AND VOTING RIGHTS.

We are entitled under our certificate of incorporation to issue up to 50,000,000 shares of common stock. After taking into consideration our outstanding common stock at November 9, 2005, we will be entitled to issue up to 30,572,799 additional common shares. Our board may generally issue shares of common stock, or options or warrants to purchase those shares, without further approval by our shareholders based upon such factors as our board of directors may deem relevant at that time. It is likely that we will be required to issue a large amount of additional securities to raise capital to further our development. It is also likely that we will be required to issue a large amount of additional securities to directors, officers, employees and consultants as compensatory grants in connection with their services, both in the form of stand-alone grants or under our stock plans. We cannot give you any assurance that we will not issue additional shares of common stock, or options or warrants to purchase those shares, under circumstances we may deem appropriate at the time.

OUR ISSUANCE OF ADDITIONAL COMMON SHARES IN EXCHANGE FOR SERVICES OR TO REPAY DEBT, WOULD DILUTE YOUR PROPORTIONATE OWNERSHIP AND VOTING RIGHTS AND COULD HAVE A NEGATIVE IMPACT ON THE MARKET PRICE OF OUR COMMON STOCK.

Our board may generally issue shares of common stock to pay for debt or services, without further approval by our shareholders based upon such factors as our board of directors may deem relevant at that time. For the past three years and for the six months ended September 30, 2005, we issued a total of 2,306,103 shares for debt to reduce our obligations. The average price discount of common stock issued for debt in this period, weighted by the number of shares issued for debt in such period was 32.9%, 32%, 47.4% and 53.4% for the years ended 2003, 2004, 2005 and we issued no common stock for debt reduction for the six month period ended September 30, 2005. For the past three years and for the six months ended September 30, 2005, we issued a total of 3,645,101 shares in payment for services. The average price discount of common stock issued for services for services in this period, weighted by the number of shares issued for services in such period was 43.9%, 55.4%, 46.3% and 12.20% for the years ended 2003, 2004, 2005 and the six months ended September 30, 2005, respectively. It is likely that we will issue additional securities to pay for services and reduce debt in the future. We cannot give you any assurance that we will not issue additional shares of common stock under circumstances we may deem

appropriate at the time.

THE SALE OF OUR COMMON STOCK TO FUSION CAPITAL MAY CAUSE DILUTION AND THE SALE OF THE SHARES OF COMMON STOCK ACQUIRED BY FUSION CAPITAL COULD CAUSE THE PRICE OF OUR COMMON STOCK TO DECLINE.

The purchase price for the common stock to be issued to Fusion Capital pursuant to the common stock purchase agreement will fluctuate based on the price of our common stock. All shares in this offering are freely tradable. Fusion Capital may sell none, some or all of the shares of common stock purchased from us at any time. We expect that the shares offered by this prospectus will be sold over a period of up to 30 months from December 7, 2004. Depending upon market liquidity at the time, a sale of shares under this offering at any given time could cause the trading price of our common stock to decline. The sale of a substantial number of shares of our common stock under this offering, or anticipation of such sales, could make it more difficult for us to sell equity or equity-related securities in the future at a time and at a price that we might otherwise wish to effect sales.

THE ELIMINATION OF MONETARY LIABILITY AGAINST OUR DIRECTORS, OFFICERS AND EMPLOYEES UNDER OUR CERTIFICATE OF INCORPORATION AND THE EXISTENCE OF INDEMNIFICATION RIGHTS TO OUR DIRECTORS, OFFICERS AND EMPLOYEES MAY RESULT IN SUBSTANTIAL EXPENDITURES BY OUR COMPANY AND MAY DISCOURAGE LAWSUITS AGAINST OUR DIRECTORS, OFFICERS AND EMPLOYEES.

Our certificate of incorporation contains provisions which eliminate the liability of our directors for monetary damages to our company and shareholders. Our bylaws also require us to indemnify our officers and directors. We may also have contractual indemnification obligations under our agreements with our directors, officers and employees. The foregoing indemnification obligations could result in our company incurring substantial expenditures to cover the cost of settlement or damage awards against directors, officers and employees, which we may be unable to recoup. These provisions and resultant costs may also discourage our company from bringing a lawsuit against directors, officers and employees for breaches of their fiduciary duties, and may similarly discourage the filing of derivative litigation by our shareholders against our directors, officers and employees even though such actions, if successful, might otherwise benefit our company and shareholders.

ANTI-TAKEOVER PROVISIONS MAY IMPEDE THE ACQUISITION OF OUR COMPANY.

Certain provisions of the Nevada General Corporation Law have anti-takeover effects and may inhibit a non-negotiated merger or other business combination. These provisions are intended to encourage any person interested in acquiring us to negotiate with, and to obtain the approval of, our Board of Directors in connection with such a transaction. However, certain of these provisions may discourage a future acquisition of us, including an acquisition in which the shareholders might otherwise receive a premium for their shares. As a result, shareholders who might desire to participate in such a transaction may not have the opportunity to do so.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

In this prospectus we make a number of statements, referred to as "FORWARD-LOOKING STATEMENTS" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the

Securities Exchange Act of 1934 (the "Exchange Act"), which are intended to convey our expectations or predictions regarding the occurrence of possible future events or the existence of trends and factors that may impact our future plans and operating results. The safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995 does not apply to us. We note, however, that these forward-looking statements are derived, in part, from various assumptions and analyses we have made in the context of our current business plan and information currently available to us and in light of our experience and perceptions of historical trends, current conditions and expected future developments and other factors we believe to be appropriate in the circumstances. You can generally identify forward-looking statements through words and phrases such as "SEEK", "ANTICIPATE", "BELIEVE", "ESTIMATE", "EXPECT", "INTEND", "PLAN", "BUDGET", "PROJECT", "MAY BE", "MAY CONTINUE", "MAY LIKELY RESULT", and similar expressions. When reading any forward looking statement you should remain mindful that all forward-looking statements are inherently uncertain as they are based on current expectations and assumptions concerning future events or future performance of our company, and that actual results or developments may vary substantially from those expected as expressed in or implied by that statement for a number of reasons or factors, including those relating to:

- whether or not markets for our products develop and, if they do develop, the pace at which they develop;
- our ability to attract and retain the qualified personnel to implement our growth strategies,
- our ability to obtain approval from the Food and Drug Administration for our products;
- our ability to protect the patents on our proprietary technology;
- our ability to fund our short-term and long-term financing needs;
- changes in our business plan and corporate strategies; and

- other risks and uncertainties discussed in greater detail in the sections of this prospectus, including those captioned "RISK FACTORS" and "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS".

Each forward-looking statement should be read in context with, and with an understanding of, the various other disclosures concerning our company and our business made elsewhere in this prospectus as well as other pubic reports filed with the United States Securities and Exchange Commission (the "SEC"). You should not place undue reliance on any forward-looking statement as a prediction of actual results or developments. We are not obligated to update or revise any forward-looking statement contained in this prospectus to reflect new events or circumstances unless and to the extent required by applicable law.

USE OF PROCEEDS

This prospectus relates to shares of our common stock that may be

offered and sold from time to time by selling shareholders. We will receive no proceeds from the sale of shares of common stock in this offering. However, we may receive up to $5,299,999 in proceeds from the sale of our common stock to Fusion Capital under a common stock purchase agreement in addition to the $1,372,899 of proceeds we already received in connection with the common stock already purchased by Fusion Capital and other accredited investors. We have used the $1,372,899 of proceeds from Fusion Capital and the other accredited investors for general working capital purposes and no more than 20% of the such net proceeds for the satisfaction of any portion of our debt (other than payment of trade payables in the ordinary course of our business and prior practices), to redeem any of our equity or equity equivalent securities or to settle any outstanding litigation. Proceeds resulting from the sale of shares to Fusion Capital will be utilized to fund our ongoing human safety studies and to initiate further human and animal studies of Hemopurifier(TM) applications to treat HIV, pathogens that may be targeted as biological warfare candidates, Hepatitis-C and to provide for costs associated with the FDA approval process which we estimate will approximate $5,000,000 through the end of 2006 as well as for working capital and general corporate purposes. The Company may use part of of the proceeds to pay certain debts if the Company is unable to convert such debt into equity. If we were to receive less than $1 million in proceeds from the sale of our common stock to Fusion Capital, we estimate we will use approximately 90% of such funds for working capital and research and development, with the remaining 10% to be used for the repayment of debt. If we were to receive more than $1 million in proceeds from the sale of our common stock to Fusion Capital, we estimate we will use approximately 80% of such funds for working capital and research and development, with the remaining 20% to be used for the repayment of debt. Should any selling shareholder acquire the shares to be sold by exercising common share purchase warrants, we would receive the proceeds from the exercise price. In such an event we anticipate we would use the proceeds of such exercise for working capital and general corporate purposes.

THE FUSION TRANSACTION

General

On May 20, 2004, we entered into a common stock purchase agreement with Fusion Capital Fund II, LLC pursuant to which we sold to Fusion Capital, 2,033,283 shares of our common stock and warrants to purchase 568,181 shares of our common stock for aggregate consideration of $950,001. The warrants have an exercise price of $0.76 and are exercisable for five years from the date of the agreement. Under the common stock purchase agreement, Fusion Capital also agreed to purchase on each trading day during the term of the agreement, $10,000 of our common stock or an aggregate of $5,299,999 million in addition to the $950,001 already purchased by Fusion Capital. The remaining $5,299,999 million of common stock is to be purchased over a 30 month period from inception. The purchase price of the shares of common stock will be equal to a price based upon the future market price of the common stock without any fixed discount to the market price. Fusion Capital does not have the right or the obligation to purchase shares of our common stock in the event that the price of our common stock is less than $0.25.

Purchase Of Shares Under The Common Stock Purchase Agreement

Under the common stock purchase agreement, on each trading day Fusion Capital is obligated to purchase a specified dollar amount of our common stock.

Subject to our right to suspend such purchases at any time, and our right to terminate the agreement with Fusion Capital at any time, each as described below, Fusion Capital shall purchase on each trading day during the term of the agreement $10,000 of our common stock. Fusion Capital began making purchases coincident with our filing of an effective registration statement on December 7, 2004. This daily purchase amount may be decreased by us at any time. We also have the right to increase the daily purchase amount at any time, provided however, we may not increase the daily purchase amount above $10,000 unless our stock price is above $1.00 per share for five consecutive trading days. The purchase price per share is equal to the lesser of:

- the lowest sale price of our common stock on the purchase date; or

- the average of the three (3) lowest closing sale prices of our common stock during the twelve (12) consecutive trading days prior to the date of a purchase by Fusion Capital.

The purchase price will be adjusted for any reorganization, recapitalization, non-cash dividend, stock split, or other similar transaction occurring during the trading days in which the closing sale price is used to compute the purchase price. Fusion Capital may not purchase shares of our common stock under the common stock purchase agreement if Fusion Capital, together with its affiliates, would beneficially own more than 9.9% of our common stock outstanding at the time of the purchase by Fusion Capital. However, even though Fusion Capital may not receive additional shares of our common stock in the event that the 9.9% limitation is ever reached, Fusion Capital is still obligated to pay to us $10,000 on each trading day, unless the common stock purchase agreement is suspended, an event of default occurs or the agreement is terminated. Under these circumstances, Fusion Capital would be issued additional shares in the future should its ownership subsequently become less than the 9.9%. Fusion Capital would have no right to receive such shares until its ownership subsequently becomes less that the 9.9%. The number of shares to be issued to Fusion Capital would be calculated using the price of the daily purchase amount on the date we elect to sell our shares to Fusion Capital. There are no penalties owed under such circumstances. Fusion Capital has the right at any time to sell any shares purchased under the common stock purchase agreement which would allow it to avoid the 9.9% limitation. Therefore, we do not believe that Fusion Capital will ever reach the 9.9% limitation.

The following table sets forth the amount of proceeds we would receive from Fusion Capital from the sale of shares of our common stock offered by this prospectus at varying purchase prices in addition to the $950,001 already received from Fusion Capital:

ASSUMED AVERAGE PURCHASE PRICE	NUMBER OF SHARES TO BE ISSUED IF FULL PURCHASE	PERCENTAGE OUTSTANDING AFTER GIVING EFFECT TO THE ISSUANCE TO FUSION CAPITAL(1)
$0.34 (2)	5,398,536	21.75%
$0.75	5,398,536	21.75%
$1.00	5,299,999	21.43%

$1.50	3,533,333	15.39%
$2.00	2,649,999	12.00%
$5.00	1,060,000	5.17%

(1) Based on 19,427,201 shares outstanding as of November 9, 2005. Includes the number of shares issuable at the corresponding assumed purchase price set forth in the adjacent column.
(2) Closing sale price of our common stock on November 9, 2005.

We have the right to terminate the agreement without any payment or liability to Fusion Capital at any time.

Minimum Purchase Price

We have the right to set a minimum purchase price ("floor price") at any time. Currently, the floor price is $0.25. We can increase or decrease the floor price at any time upon one trading day prior notice to Fusion Capital. However, the floor price cannot be less than $0.25. Fusion Capital shall not have the right nor the obligation to purchase any shares of our common stock in the event that the purchase price is less than the then applicable floor price.

Our Right to Suspend

We have the unconditional right to suspend purchases at any time for any reason effective upon one trading day's notice. Any suspension would remain in effect until our revocation of the suspension. To the extent we need and are able to use the cash proceeds of the sales of common stock under the common stock purchase agreement for working capital or other business purposes, we do not intend to restrict purchases under the common stock purchase agreement.

Our Right To Increase and Decrease the Daily Purchase Amount

Under the common stock purchase agreement Fusion Capital has agreed to purchase on each trading day during the 30 month term of the agreement, at least $10,000 of our common stock or an aggregate of $5,299,999 in addition to the $950,001 previously purchased by Fusion Capital under the common stock purchase agreement. We have the unconditional right to decrease the daily amount to be purchased by Fusion Capital at any time for any reason effective upon one trading day's notice. At our discretion, we may elect to sell more of our common stock to Fusion Capital than the minimum daily amount.

We also have the right to increase the daily purchase amount as the market price of our common stock increases. Specifically, for every $0.25 increase in Threshold Price above $0.75, we shall have the right to increase the daily purchase amount by up to an additional $2,500. For example, if the Threshold Price is $1.50 we would have the right to increase the daily purchase amount up to an aggregate of $17,500. The "Threshold Price" is the lowest sale price of our common stock during the five trading days immediately preceding our notice to Fusion Capital to increase the daily purchase amount. If at any time during any trading day the sale price of our common stock is below the Threshold Price, the applicable increase in the daily purchase amount will be void.

Our Termination Rights

We have the unconditional right at any time after the commencement of sales of our common stock to Fusion Capital, excluding the $950,001 already sold, for any reason to give notice to Fusion Capital terminating the common stock purchase agreement. Such notice shall be effective one trading day after Fusion Capital receives such notice.

Effect of Performance of the Common Stock Purchase Agreement on our Shareholders

All shares registered in this offering will be freely tradable. It is anticipated that shares registered in this offering will be sold over a period of up to 30 months from the date of this prospectus. The sale of a significant amount of shares registered in this offering at any given time could cause the trading price of our common stock to decline and to be highly volatile. Fusion Capital may ultimately purchase all of the shares of common stock issuable under the common stock purchase agreement, and it may sell some, none or all of the shares of common stock it acquires upon purchase. Therefore, the purchases under the common stock purchase agreement may result in substantial dilution to the interests of other holders of our common stock. However, we have the right at any time for any reason to: (1) reduce the daily purchase amount, (2) suspend purchases of the common stock by Fusion Capital and (3) terminate the common stock purchase agreement.

No Short-Selling or Hedging by Fusion Capital

Fusion Capital has agreed that neither it nor any of its affiliates shall engage in any direct or indirect short-selling or hedging of our common stock during any time prior to the termination of the common stock purchase agreement.

Events of Default

Generally, Fusion Capital may terminate the common stock purchase agreement without any liability or payment to us upon the occurrence of any of the following events of default:

- the effectiveness of the registration statement of which this prospectus is a part of lapses for any reason (including, without limitation, the issuance of a stop order) or is unavailable to Fusion Capital for sale of our common stock offered hereby and such lapse or unavailability continues for a period of ten (10) consecutive trading days or for more than an aggregate of thirty (30) trading days in any 365-day period;

- suspension by our principal market of our common stock from trading for a period of three consecutive trading days;

- the de-listing of our common stock from our principal market provided our common stock is not immediately thereafter trading on the NASDAQ National Market, the NASDAQ National SmallCap Market, the New York Stock Exchange or the American Stock Exchange;

- the transfer agent's failure for five trading days to issue to Fusion Capital shares of our common stock which Fusion Capital is entitled to under the common stock purchase agreement;

- any material breach of the representations or warranties or covenants contained in the common stock purchase agreement or any related agreements which has or which could have a material adverse affect on us subject to a cure period of ten

trading days;

- a default by us of any payment obligation in excess of $1.0 million; or
- any participation or threatened participation in insolvency or bankruptcy proceedings by or against us.

Commitment Shares Issued to Fusion Capital

Under the terms of the common stock purchase agreement Fusion Capital has received 468,604 shares of our common stock as a commitment fee. In connection with each purchase of our common stock by Fusion Capital, we have issued 16,308 shares of common stock to Fusion Capital as portion of an aggregate additional commitment fee of 139,535 shares of common stock. These commitment shares are issued to Fusion Capital as a fee for its purchase commitment made under the common stock purchase agreement. These additional shares will be issued pro rata based on the proportion that a dollar amount purchased by Fusion bears to the $6.0 million amount under the purchase agreement with Fusion Capital. Unless an event of default occurs, these shares must be held by Fusion Capital until 30 months from the date of the common stock purchase agreement or the date the common stock purchase agreement is terminated.

No Variable Priced Financings

Until the termination of the common stock purchase agreement, we have agreed not to issue, or enter into any agreement with respect to the issuance of, any variable priced equity or variable priced equity-like securities unless we have obtained Fusion Capital's prior written consent.

DESCRIPTION OF BUSINESS

GENERAL

Aethlon Medical, Inc. ("Aethlon Medical", "We" or the "Company"), formerly Bishop Equities, Inc. ("Bishop"), was incorporated in Nevada in April 1991 to provide a public vehicle for participation in a business transaction through a merger with or acquisition of a private company. In March 1993, we successfully offered our common stock at $6.00 per share through an initial public offering. In March 1999, Bishop began doing business as "Aethlon Medical, Inc." In March 2000, the Company's Articles of Incorporation were amended to formally change the name of the Company from "Bishop Equities, Inc." to "Aethlon Medical, Inc."

BUSINESS DEVELOPMENT/ACQUISITIONS

On March 10, 1999, (1) Aethlon, Inc., a California corporation ("Aethlon"), (2) Hemex, Inc., a Delaware corporation ("Hemex"), the accounting predecessor to the Company, and (3) Bishop, a publicly traded "shell" company, completed an Agreement and Plan of Reorganization (the "Plan") structured to result in Bishop's acquisition of all of the outstanding common shares of Aethlon and Hemex (the "Reorganization"). The Reorganization was intended to

qualify as a tax-free transaction under Section 368 (a)(1)(B) of the 1986 Internal Revenue Code, as amended. Under the Plan's terms, Bishop issued 733,500 and 1,350,000 shares of its common stock to the common stock shareholders of Aethlon and Hemex, respectively, such that Bishop then owned 100% of each company.

Effective January 1, 2000, we entered into an agreement with Dr. Julian Ambrus, the son of Dr. Clara Ambrus who was the original founder of Hemex, Inc. Under this agreement, an invention and related patent rights for a method of removing HIV and other viruses from the blood were assigned to us. This

invention further expands the established blood filtration patents already owned by us. In addition to certain royalty payments equal to 8.75% of net sales of the patented product, the consideration for the acquired rights included the additional issuance of shares of our common stock to the inventors upon the issuance of the patent. The term of the agreement expires on the expiration date of the patents or any patent applications filed in connection with the invention. There have been no sales of the patented product as of November 9, 2005. We initially issued 12,500 shares of restricted common stock to the inventors upon the execution of the agreement. On March 4, 2003, the related patent was issued and we issued 196,078 shares of restricted common stock to the inventors.

On January 10, 2000, we acquired all the outstanding common stock of Syngen Research, Inc. ("Syngen") in exchange for 65,000 shares of our restricted common stock in order to establish research facilities in San Diego, California, as well as employ Dr. Richard Tullis, the founder of Syngen. Dr. Tullis is a recognized research scientist in the area of DNA synthesis and antisense. Syngen had no significant assets, liabilities, or operations, and primarily served as the entity through which Dr. Tullis performed research consulting services. As such, the acquisition has been accounted for as an acquisition of assets in the form of an employment contract with Dr. Tullis and not as a business combination. Dr. Tullis was appointed to the Board of Directors of Aethlon Medical and was elected its Vice President for Business Development. Effective June 1, 2001, Dr. Tullis was appointed Chief Science Officer of Aethlon Medical, replacing Dr. Clara Ambrus, who retired from the Company.

On April 6, 2000, we completed the acquisition of Cell Activation, Inc. ("Cell"). In accordance with the purchase agreement, we issued 99,152 shares of restricted common stock and issued 50,148 options to purchase common stock in exchange for all of the outstanding common shares and options to purchase common stock of Cell. After the transaction, Cell became our wholly-owned subsidiary. The acquisition was accounted for as a purchase. At March 31, 2001, management determined that goodwill recognized in the purchase of Cell was impaired due to the permanent suspension of operations by Cell, and, accordingly, treated the related goodwill as fully impaired.

BUSINESS OF ISSUER

We are a development stage therapeutic device company focused on expanding the applications of our Hemopurifier (TM) platform technology, which is designed to rapidly reduce the presence of infectious viruses and other toxins from human blood. In this regard, our core focus is the development of therapeutic devices that treat HIV/AIDS, Hepatitis-C, and pathogens targeted as potential biological warfare agents. To date, the Company has conducted and published studies that measured the ability of the Hemopurifier(TM) to capture

HIV, Hepatitis-C, and gp120, which is a HIV surface protein that destroys immune cells. The studies have been published in the following journals: American Clinical Laboratories (November 2001), Journal of Theoretical Medicine (2002), Therapeutic Apheresis (2001) and Blood Purification (2003 and 2004). All of the studies were conducted in Aethlon Medical laboratory facilities under the supervision of Dr. Richard Tullis, the Company's Chief Science Officer. The cost of materials required to perform each study did not exceed $100,000. Each of the studies encompassed the filling of hollow-fiber dialysis cartridges with antibodies that have been coupled to agarose beads and then sealed within the cartridge. As a result, the coupled antibodies surround the hollow-fibers, which have pores between 200-500 nanometers in size. Infected human blood was then circulated through the cartridge and data was obtained to measure the amount of the targeted pathogen that diffused through the fiber pores and was captured by the immobilized antibodies. In pre-clinical testing, we have published that our HIV-Hemopurifier(TM) removed 55% of HIV from human blood in three hours and in excess of 85% of HIV in twelve hours. Additionally, the HIV-Hemopurifier(TM) captured 90% of gp120, a toxic protein that depletes human immune cells, during a one-hour pre-clinical blood study. The Hemopurifier(TM) cannot cure HIV and Hepatitis-C but augments the immune response of clearing viruses and toxins from the blood before cell and organ infection can occur. We are currently conducting but have not published studies related to the capture of other pathogens with the Hemopurifier(TM) including the capture of pathogens with the Hemopurifier(TM) relating biological weapons which we are currently seeking to commercialize. Our potential customers may not accept our interpretation of results from our test sites until our customers repeat the tests and independently verify the tests. Since inception, our only source of revenue has been grants from certain agencies of the Federal Government, subcontract revenue and sale of research and development. From the date of our inception through 1999, we received a total of $1,424,012 in grant income. No grant revenues have been received after 1999. Since then, from time to time, we have applied for, but have not been awarded, any such grants. Since our current focus is to develop, test and obtain approval of our products, we do not expect to obtain subcontract revenue, nor do we expect to sell our research and development expertise. Any future income derived from grant submissions is likely to be the primary source of revenues until such time that our Hemopurifier(TM) has been approved for sale in the marketplace.

The Hemopurifier(TM)

The HemopurifierTM is an expansive platform technology that converges the established scientific principles of affinity chromatography (method of selective capture of proteins, sugars, fats and organic compounds) and hemodialysis (artificial kidneys) as a means to augment the natural immune response of clearing infectious viruses and toxins from the blood before cells and organs can be infected. The therapeutic goal of each Hemopurifier(TM) application is to improve patient survival rates by reducing viral load and preserving the immuNE function. We feel that the Hemopurifier(TM) will enhance and prolong the benefit of current infectious disease drUG therapies, and fill the void for patients who inevitably become resistant to drug therapies. The Hemopurifier(TM) is also being positioned to treat patients that might become infected by a biological agent with no established drug or vaccine treatment.

Traditionally, hemodialysis has been used to remove urea and other small metabolic toxins that build up in the blood of patients with acute or chronic kidney failure. Acute renal failure is generally handled in the intensive care unit using continuous renal replacement therapy ("CRRT") while

chronic renal failure is generally treated using thrice-weekly, intermittent hemodialysis ("IHD") in a stand-alone dialysis clinic.

While there are several variations of technique, a catheter is most often the primary method utilized to gain access to the blood, which is then pumped through a hollow-fiber hemodialysis cartridge. Within the cartridge, toxic salts, urea and excess water pass through small pores in the walls of the hollow-fibers and are removed. Proteins and blood cells that are too large to pass through the membrane are retained. The purified blood is then returned back into circulation.

There are two issues in kidney dialysis as it is practiced today that limit its application to a wide array of toxins and pathogens. Both issues are related to the separation membranes. First, hemodialysis cartridges non-selectively remove substances of a particular size from the blood. Thus in addition to removing toxins, the dialyzer may also remove important substances that the body would prefer to retain. Second, many important toxins are too large pass through the dialysis membrane and are therefore not removed even when it would be desirable.

We have solved these problems by designing a Hemopurifier(TM) cartridge which has pores large enough to let tHE largest toxins pass through (i.e. particles as large as whole viruses), yet selective enough to remove only the targeted toxins. We employ the established principles of hollow-fiber dialysis cartridges, but with pores large enough to allow for circulating infectious virus and toxins to separate from the blood and diffuse through the fibers so that it may be captured by binding agents or antibodies that surround the fibers. Since the blood serves as a transport mechanism for viruses to infect cells and organs, the Hemopurifier(TM) disrupts the viral infection cycle. Materials such as antibodies, which bind only to their corresponding antigen, provide selectivity, while the use of a sealed cartridge allows the process to use large pore sizes that are normally incompatible with kidney dialysis.

The Hemopurifier(TM) platform technology is based on the immobilization of antibodies or binding agents againST infectious disease within hemodialysis cartridges that traditionally have been used in treating kidney failure. The typical cartridge is a clear plastic cylinder, approximately twelve inches long and one and one-half inch in diameter. Sealed within the cartridge are up to 10,000 hollow micro-fibers through which the blood flows during treatment. The walls of each fiber are porous so that pathogens can diffuse out of the blood to be captured by the antibodies or binding agents that surround each of the fibers. The size of the fiber pores allows for the diffusion and capture of pathogens up to 500 nanometers in size.

The binding antibodies or other selective agents are chemically bound to the surface of glass or plastic beads located on the outside of the hollow-fibers. This effectively prevents the active materials from entering the bloodstream. Viruses and toxins in the blood diffuse or are transported through the pores in the hollow-fibers and become trapped by the immobilized antibody.

In this way, materials of very large sizes are allowed enter the cartridge while non-toxic materials of similar size readily leave and re-enter the bloodstream. Blood cells and platelets, which are too large to enter the membrane, remain in the hollow-fiber and are returned to the patient. Importantly, the Hemopurifier(TM) cartridge does not require the development of any new equipment. The cartridge fits directly onto the global infrastructure of

dialysis machines already located in hospitals and clinics.

Each Hemopurifier(TM) application is designed to be useful in clearing infectious viruses and toxins from the entire blood stream before cells and organs become infected. Science terminology defines this technique as a method to inhibit pathogens from entering cells and organs, which is more commonly known as "Entry Inhibitor" treatment. Traditionally, a vast majority of infectious disease treatments have been drug-based therapies whose action has been to inhibit or slow down the replication of viruses in cells that have already been infected.

Infectious Disease

The current treatment for viral illnesses include vaccines and antiviral drugs. Vaccines have been the most successful in curing viral diseases (e.g. polio and smallpox). Unfortunately, newly emerging pathogens (e.g. SARS), highly mutable RNA viruses (e.g., HIV and Hepatitis C virus) and exotic viruses that might be used in terrorist attacks often do not have vaccine treatments. Similarly, antiviral drugs are often useful in controlling viral infections. However, there do not seem to be any general, broad-spectrum antiviral agents similar to penicillin for bacteria and viruses capable of rapidly developing drug resistant mutations. In addition, it generally takes years and millions of dollars to develop vaccine and drug candidates that may or may not be approved by the FDA.

Our Hemopurifier(TM) technology represents a new approach to treating viral diseases. The treatment is designED to work with current treatments to remove infectious virus, toxic viral proteins and injurious immunological mediators directly from the blood of the patient. By removing circulating virus and toxins from the blood that are captured by the Hemopurifier(TM), the Hemopurifier(TM) cartridge prevents virus and toxins from infeCTING unaffected tissues and cells. The Hemopurifier(TM) cannot cure HIV and Hepatitis-C but augments the immune responSE of clearing viruses and toxins from the blood before cell and organ infection can occur. Scientifically, this action is known as a "Fusion Inhibitor" since the ability for the virus to enter or fuse with host cells or organs is inhibited.

The Hemopurifier(TM) is positioned as a therapeutic medical device that can be rapidly developed to treat genetically engineered and drug and vaccine resistant biowarfare agents. We recently demonstrated the ability to rapidly build and test new antibody cartridges upon the receipt on an antibody against HIV which was previously untested for its utility as an agent to be immobilized within the Hemopurifier(TM) treatment cartridge. The process included the attachment of the antibody to agarose beads to create an affinity or binding solution that was immobilized within the hollow-fiber treatment cartridge as means to capture HIV as it diffused through the fibers. Human blood infected with HIV was then circulated through the cartridge to measure the ability of the Hemopurifier(TM) to capture HIV over a range of time periods. Human blood infected with HIV was also circulated through a control cartridge without immobilized antibodies as a means to document an improved ability to capture infectious virus when the immobilized antibody was utilized in the treatment cartridge. Upon completion of the circulation of infected blood, diagnostic studies were implemented to verify the viral capture rate of the Hemopurfier(TM) with and without the immobilized antibody. The data was then provided in a confidential report to the antibody manufacturer within ten days of the original receipt of the antibody in our labs.

We have submitted proposals to the NIH regarding the use of the Hemopurifier(TM) as a potential treatment for patients infected with HIV and Hepatitis-C. We also plan to submit other proposals to the NIH related to the use of the Hemopurifier(TM) as a countermeasure against biological weapons. We will make these submissions upon the completion of animal studies that suggest a

potential relevance of the Hemopurifier(TM) as a treatment for pathogens considered to be the greatest threat as biological weapons. Additionally, we will seek beneficial relationships with other agencies and organizations upon the publication of animal studies related to the potential use of the Hemopurifier(TM) against biological weapon candidates. In this regard, we are developing a standard Hemopurifier(TM) to be utilized within the established infrastructure of dialysis machines, as well as Hemopurifiers(TM) that are designed to be wearable treatment cartridges. The initial application of the wearable cartridge relies on the blood pressure of the infected patient to drive the circulation of blood into the cartridge without the need for a pumping device such as a dialysis machine. Future generations of the Hemopurifier(TM) may involve the convergence of miniature cartridges with portable wearable pumps as a means to increase virus and toxin clearance through continuous blood circulation over extended periods time.

Biological Weapons

On January 29, 2004, we announced that we are developing treatments to combat infectious agents that may be used in biological warfare and terrorism. This expands our intent to treat infectious diseases beyond HIV/AIDS and Hepatitis-C. We are working to design Hemopurifiers(TM) that can be rapidly deployed by armed forces as wearable post-exposure treatments on the battlefield, as well as dialysis-based treatments for civilian populations. We are focusing our bio-defense strategy on treating "Category A" agents, which are considered by the Centers for Disease Control ("CDC") to be the worst bioterror threats. These agents include the viruses that cause Smallpox, hemorrhagic fevers such as Ebola and Marburg, the Anthrax bacteria, and Botulinum toxin which is a gangrene toxin. Each treatment device will be based on the same proprietary HemopurifierTM filtration technology that is utilized in advancing our HIV/AIDS, and Hepatitis-C treatments. We have not yet published any data related to the treatment of any "Category A" agent. We are currently conducting but have not published studies related to the capture of pathogens relating to biological weapons which we are currently seeking to commercialize.

Viral and bacterial illnesses have always been with us and have sometimes been used as weapons. In recent times, some nations have refined and weaponized several pathogens for use in warfare. Although there are specific differences between bioweapons grade organisms in the way they are transmitted or how they are designed to kill, nearly all result in sepsis.

Sepsis is essentially a dysregulation of the immune system, often described as a septic shock. Microbial invasion sets off an immunological chain reaction mediated by proteins produced by cells and tissues. Over expression of these protein immunological mediators "confuses" the immune system, ultimately resulting in major organ failure and death. Hemodialysis has been used for many years as a treatment in septic shock, which is generally acknowledged to be beneficial. Unfortunately, the technique is limited in the size of the toxins it can remove and is inherently non-selective, making it less than completely effective.

Perhaps just as important is the speed with which new treatment options can be developed. Each new bioweapon comes without a corresponding treatment. Typical biowarfare pathogens have been genetically engineered to contain genes that make them resistant to available drugs and vaccines. This presents a substantial problem since the development of new drugs or vaccines usually takes several years. However, our Hemopurifier(TM), when targeted TO the new pathogen

can often be constructed within a matter of a few months. All that is required is the existence of an antibody or binding protein that selectively adheres to the surface of the target pathogen or toxin. In this regard, our Hemopurifier(TM) is positioned as a rapid response countermeasure against untreatable pathogens that are released as biowarfare agents.

Manufacturing

We plan to manufacture a small number of cartridges sufficient to complete clinical trials in our current facilities. Ultimately we will outsource cartridge manufacturing to a GMP/ISO9001 compliant contract manufacturer. Hemopurifiers(TM) to treat pathogens that are bioweapons candidates will be sold directly to the U.S. military and the federal government. Sale of Hemopurifiers to treat HIV and Hepatitis C will be directed through organizations with established distribution channels.

Treatment Classification

Our treatments for infectious diseases are classified as "Immunotherapies" that augment or mimic the immune system's response of clearing infectious viruses, and as "Entry Inhibitors" that curb the re-infection process by physically removing infectious viruses before healthy cells are infected.

Immunotherapy - The "Immunotherapy" classification is a result of our ability to mimic the immune system's natural response of generating antibodies to fight foreign invaders such as viruses. Antibodies are specifically created by the immune system to attach themselves to the antigens (chemical compounds which cause antibodies to be produced e.g. proteins and other component parts of viruses), forming an antigen-antibody complex which neutralizes the invader. The neutralized antigens are then physically removed from the bloodstream by organs such as the liver.

Our treatment technology uses a hemodialysis cartridge (e.g. artificial kidney or plasmapheresis cartridge) modified to contain immobilized antibodies targeted against specific viruses. Plasmapheresis cartridges are utilized to separate blood plasma from blood cells in treating various diseases. Viruses in the blood are captured inside the cartridge through the formation of an antigen-antibody complex, physically removing the virus from circulation. As a result, the physical elimination of infectious virus occurs without the side-effects common in drug therapy.

Entry Inhibitor - Our treatment technology is also classified as an "Entry Inhibitor" since the re-infection process is interrupted when viruses are removed from circulation before cells can be infected. As a result, the replication cycle is inhibited as infectious virus is denied entry into the cells that it seeks to kill. From a therapeutic standpoint, entry inhibitors represent a departure from the traditional drug action of inhibiting viral replication within the cells that have already been infected. The novel therapeutic mechanism offered by "Entry Inhibitors", combined with the high level of treatment resistance to currently approved drugs, positions "Entry Inhibitors" as an important new treatment strategy to assist HIV/AIDS and Hepatitis-C infected individuals in managing their disease.

Research and Development

In fiscal year 2001, we realigned our research and development

activities from developing Hemopurifiers(TM) to treat harmful metals to developing Hemopurifiers(TM) for the treatment of HIV/AIDS and Hepatitis-C. As a result of this strategic realignment, we initiated the consolidation of all scientific and administrative functions into our San Diego facilities during the fourth quarter of fiscal year 2001. This consolidation was completed during the first quarter of fiscal year 2002 and our facilities in Buffalo, N.Y. were closed. In 2004, we expanded our research effort to include the development of Hemopurifiers(TM) as countermeasures against biological weapons.

The cost of research and development, all of which has been charged to operations, amounted to approximately $793,727 over the last two fiscal years.

Patents

Effective January 1, 2000, we entered into an agreement with a related party under which an invention and related patent rights for a method of removing HIV and other viruses from the blood using the Hemopurifier(TM) were assigned to us by the inventors in exchange for a royalty to be paid on future sales of the patented product or process and shares of our common stock. On March 4, 2003, the related patent was issued and we issued 196,078 shares of restricted common stock. The Hemopurifier(TM) is protected by four issued patents in the United States, Europe and Japan. Three additional patent applications deal with treatments for virus infection and manufacturiowrap align="left" valign="b

Steven F. Leer

x

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x

Marvin E. Lesser

x

x

* Chair

Audit Committee

The Audit Committee s responsibilities include

assisting the Board in monitoring the integrity of our financial statements, our compliance with financial reporting and related legal and statutory requirements and the independence and performance of our internal and external auditors, and

selecting and employing, subject to ratification by our stockholders, a firm of independent registered public accountants to audit our financial statements and internal control over financial reporting each year, which firm is ultimately accountable to the Audit Committee and the Board.

The Board of Directors has determined that each of the members of the Audit Committee is an audit committee financial expert as defined by the rules of the Securities and Exchange Commission. The Board has also determined that each member of the Audit Committee is independent as defined by the applicable New York Stock Exchange and Securities and Exchange Commission rules. The Audit Committee met seven times during 2010.

Compensation and Organization Committee

The Compensation and Organization Committee s responsibilities include

- reviewing and making recommendations to the Board regarding management organization, succession and development programs, and the election of Corporation officers,
- reviewing and approving, or recommending for approval, officers salaries, incentive compensation and bonus awards,
- making, itself or through a subcommittee, the decisions required by a committee of the Board under all equity compensation plans we have adopted, and
- reporting to the Board changes in salary ranges for all major position categories and changes in our retirement, group insurance, investment, management incentive compensation and other benefit plans.

The Compensation and Organization Committee met eight times during 2010.

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Finance Committee

The Finance Committee s responsibilities include

providing review and oversight of, and making recommendations to the Board regarding, financing requirements and programs, operating and capital expenditures budgets, relationships and communications with banks, other lenders and creditors and stockholders, dividend policy and acquisitions, divestitures and significant transactions affecting our capital structure and ownership,

reporting to the Board periodically regarding the funding and investment performance of our qualified retirement plans and authorizing necessary or desirable changes in actuarial assumptions for funding those retirement plans, and

considering any other matters as may periodically be referred to the Committee by the Board.

The Finance Committee met six times during 2010.

Governance Committee

The Governance Committee s responsibilities include

making recommendations to the Board concerning the size and composition of the Board and its committees,

recommending nominees for election or reelection as directors,

considering other matters pertaining to Board membership, such as the compensation of non-employee directors, and

evaluating Board performance and assessing the adequacy of, and compliance with, our Corporate Governance Guidelines and Code of Business Conduct.

The Governance Committee met five times during 2010.

Stockholder Nominee Recommendations and Criteria for Board Membership

The Governance Committee considers director nominee recommendations submitted by our stockholders. Director nominee recommendations from stockholders must be in writing and include a brief account of the nominee s business experience during the past five years, including principal occupations and employment during that period and the name and principal business of any corporation or organization of which the nominee is a director. Stockholder director nominee recommendations should be sent to the Governance Committee, USG Board of Directors, c/o Corporate Secretary, 550 West Adams Street, Chicago, Illinois 60661-3676. Recommendations may be submitted at any time, but will not be considered by the Governance Committee in connection with an annual meeting unless received on or before the date prior to the annual meeting determined as provided in our By-laws. The director nominee recommendation submission deadline for the 2012 annual meeting of stockholders is described under Deadline for Stockholder Proposals on page 55 of this proxy statement.

Our process for reviewing and selecting new director nominees involves seeking out a diverse group of candidates who possess the background, skills and expertise to make a significant contribution to the Board, USG and our stockholders. Desired qualities for our directors, including those recommended for nomination by our stockholders,

are described in our Corporate Governance Guidelines and on our website www.usg.com. Those qualities include high-level leadership experience in business activities, ability and willingness to contribute special competencies to Board activities and personal attributes such as integrity, willingness to apply sound and independent business judgment and assume broad fiduciary responsibility and awareness of a director s vital contribution to our corporate image. Additional search criteria may be determined by the Governance Committee. We do not have a formal policy with regard to the consideration of diversity in identifying directors. Our Corporate Governance Guidelines provide that candidates for Board membership will be considered without regard to race, color, religion, sex, ancestry, national origin or disability. When seeking new director candidates, the Governance Committee considers the subject matter expertise and geographic experience of existing Board members to

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determine whether a candidate with a particular expertise or experience set would be desirable. The Committee seeks to have a mix of directors with experience in one or more areas relevant to our businesses, including operations, manufacturing, marketing, finance, technology and innovation and international, as well as experience with cyclical businesses. Depending on current Board membership, it may also decide to seek a qualified candidate who is female or adds to the ethnic diversity of the Board.

Generally, to fill a vacancy or to add an additional director, the Governance Committee retains an executive search firm to assist in identifying and recruiting appropriate candidates. Any director candidate selected by this process or as a result of a stockholder recommendation is expected to meet with a number of directors, including the Chair of the Governance Committee, prior to any decision to nominate the candidate for election to the Board.

Communications with Directors

Stockholders and other interested parties may send communications to our directors as a group or individually by addressing them to the director or directors at USG Corporation, c/o Corporate Secretary, 550 West Adams Street, Chicago, IL 60661-3676. Stockholder communications will be reviewed by the Corporate Secretary for relevance to our business and then forwarded to the intended director(s), if appropriate. Stockholders may meet directors before or after the annual meeting. As a matter of policy, all directors are expected to attend the annual meeting. All of our current directors attended the 2010 annual meeting.

Risk Oversight

The NYSE Listing requirements provide that our Audit Committee must discuss our guidelines and policies that govern the process by which we assess and manage our exposure to risk. Consistent with this requirement, the Audit Committee s charter provides that the Committee s responsibilities include discussing our risk assessment and risk management policies. This discussion takes place at least once each year as part of our review of our enterprise risk management (ERM) program. That review includes discussion of management delegations of responsibility for the principal financial, governance, legal and operational risk exposures identified as part of our ERM program and delegations of responsibility for oversight of those risks to Board committees and/or the full Board. The Board committees consider risks related to matters within the scope of their responsibilities as part of their regular meeting agendas, and the committee chairs report to the full Board regarding matters considered by their committees following each committee meeting. Management also formally reviews strategic risks with the full Board at least once each year, typically as part of our strategic planning review with the Board. The Board also reviews individual risks as they relate to specific issues presented to the Board throughout the year.

In early 2010 management conducted, and in early 2011 it updated and reviewed with the Compensation and Organization Committee, a risk assessment of our compensation policies and practices for all employees, including our executive officers. As part of its assessment, management reviewed our compensation programs for certain design features that commentators have identified as having the potential to encourage excessive risk-taking, including

- too much focus on equity awards,
- total compensation opportunity that is overly weighted toward annual incentives,
- highly leveraged payout curves and uncapped payouts,
- unreasonable goals or thresholds, and

steep payout cliffs at certain performance levels that may encourage short-term business decisions to meet payout thresholds.

In its assessment, management noted several design features of our compensation programs that reduce the likelihood of excessive risk-taking, including

the program design for executive officers and other senior managers provides a balanced mix of cash and equity awards, annual and long-term incentives and operating and financial performance metrics that promote a focus on long-term performance without undue emphasis on short-term results,

maximum payout levels under most of our annual incentive programs are capped at 200% of target, or par,

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our annual incentive programs provide for payouts assuming achievement of a threshold level of performance, rather than requiring an all or nothing achievement of targeted performance,

the Compensation and Organization Committee has downward discretion over annual incentive program payouts,

the annual incentive program for our executive officers, and the agreements evidencing their 2009, 2010 and 2011 equity awards, allow the Board to clawback payments made to them under certain circumstances,

we use restricted stock units as well as stock options and performance shares in our long-term incentive plan because the restricted stock units retain value in a depressed market so that their holders are less likely to take unreasonable risks than they would to get or keep options in the money , and

the time-based vesting of equity awards coupled with stock ownership requirements for our executive officers and other senior managers aligns the interests of the holders of those awards with the interests of our stockholders.

Based on its assessment, management concluded that our compensation programs promote value creation, do not encourage excessive risk and are not reasonably likely to have a material adverse effect on us. The Compensation and Organization Committee and its consultant concurred with that conclusion based on management s review of its assessment with them.

Corporate Governance

Our By-laws, Corporate Governance Guidelines and Code of Business Conduct, and the charters of our Board committees, are posted on our website www.usg.com.

In January 2006, in connection with the rights offering we effected to finance a portion of the payments required by our plan of reorganization, we entered into an equity commitment agreement with Berkshire Hathaway Inc., our largest stockholder, to provide a backstop commitment with respect to the rights offering. In connection with that commitment, Berkshire Hathaway acquired 6,969,274 shares of our common stock. We also entered into a shareholder s agreement with Berkshire Hathaway pursuant to which it agreed to vote 469,274 of those shares, an additional 3,602,918 shares it has acquired subsequent to the rights offering and certain other shares it acquires in the future on all matters submitted to our stockholders, other than approval of a stockholder rights plan, in the same proportion as shares owned by all stockholders are voted. The shareholder s agreement also includes restrictions on Berkshire Hathaway s ownership of our common stock and acquisition proposals it may make.

In addition, we have a stockholder rights plan that became effective in January 2007. The plan helps to protect our net operating loss carryforwards and to prevent an acquisition of control without payment of an appropriate control premium to our stockholders. Under the plan, if any person becomes the beneficial owner of 15% or more of our voting stock, stockholders other than the 15% triggering stockholder will have the right to purchase additional shares of our common stock at half the market price, thereby diluting the triggering stockholder. The plan also provides that, during the seven-year standstill period under our shareholder s agreement with Berkshire Hathaway, its (or certain of its affiliates) acquisition of shares of our common stock will not trigger the rights to the extent Berkshire Hathaway complies with the terms of the shareholder s agreement and, following that seven-year standstill period, acquisitions of our common stock by any of them will not trigger the rights unless Berkshire Hathaway or its affiliates acquire beneficial ownership of more than 50% of our voting stock on a fully diluted basis.

The rights plan will expire on January 2, 2017. However, our Board of Directors has the power to accelerate or extend the expiration date of the rights. In addition, a Board committee composed solely of independent directors will review the rights plan at least once every three years to determine whether to modify the plan in light of all relevant factors. The first review was conducted in November 2009 and the next review is required by the end of 2012.

More information about, and copies of, the agreements referred to in this section and other related agreements are included in reports or statements we filed with the Securities and Exchange Commission on January 30, 2006, February 28, 2006, December 21, 2006 and December 5, 2008.

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SECURITY OWNERSHIP OF DIRECTORS AND EXECUTIVE OFFICERS

The following table sets forth information as of the record date regarding beneficial ownership of our common stock by each director and nominee for director, each executive officer named in the Summary Compensation Table and all directors, nominees and executive officers as a group, including any shares held by executive officers through the Investment Plan.

Name	Common Shares Beneficially Owned, Excluding Shares Subject to Options and Restricted Stock Units (a)	Shares Subject to Vested Options and Options and Restricted Stock Units that Vest Within 60 Days	Deferred Stock Units (b)	Total Beneficial Stock and Stock Unit Holdings	Percent of Class
Jose Armario	813	0	37,919	38,732	*
Robert L. Barnett	17,406	0	0	17,406	*
Lawrence M. Crutcher	21,175	0	0	21,175	*
Richard H. Fleming	109,322	125,259	0	234,581	*
William C. Foote(c)	203,532	571,178	0	774,710	*
W. Douglas Ford(d)	10,356	0	21,960	32,316	*
Christopher R. Griffin	10,775	35,636	0	46,411	*
Gretchen R. Haggerty	0	0	0	0	*
William H. Hernandez	15,000	0	0	15,000	*
Brian A. Kenney	0	0	0	0	*
Fareed A. Khan	9,904	47,649	0	57,553	*
Richard P. Lavin	0	0	0	0	*
Steven F. Leer	3,545	0	40,106	43,651	*
Marvin E. Lesser	18,166	0	7,254	25,420	*
James S. Metcalf	130,081	186,679	0	316,760	*
All directors and executive officers as a group (26 persons)(e)	710,431	1,355,424	107,239	2,173,094	2.08

* Less than one percent

(a) Unless otherwise noted, each individual or member of the group has sole voting power and investment power with respect to the shares shown in this column.

(b) Indicates the non-voting deferred stock units credited to the account of the individual director or members of the group under current and past director compensation programs. The units increase and decrease in value in direct proportion to the market value of our common stock and are paid in cash or stock following termination of Board service.

(c) Includes 10,000 shares held by Mr. Foote s spouse and 1,000 shares held for the benefit of his children. Mr. Foote disclaims beneficial ownership with respect to all of those shares.

(d) Includes 628 shares Mr. Ford holds in joint tenancy with his spouse as to which he shares voting power and investment power.

(e) Includes 2,000 shares held by an executive officer in joint tenancy with his wife as to which the executive officer shares voting power and investment power.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Policies and Procedures Regarding Related Party Transactions

Our Code of Business Conduct provides that all of our employees, including our executive officers, and our directors, must avoid conflicts of interest situations where their personal interest may be inconsistent with our interest and may interfere with the employee s or director s objectivity in making business decisions on our behalf.

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A conflict of interest may exist, for example, when an employee, officer or director (or one of their family members) has a financial interest in a company with which we do business or if an employee, officer or director in a position to influence business dealings with a company (a) has a direct or indirect interest in that company that would reasonably be viewed as significant to that person and (b) the amount of business done between us and that company is significant.

All of our employees and directors are required to report conflicts of interest so that we may address the situation properly. After disclosure, some conflicts of interest can be resolved through implementing appropriate controls for our protection. Where an appropriately disclosed conflict of interest is minor and not likely to adversely impact us, we may consent to the activity. In other cases where appropriate controls are not feasible, the person involved will be requested not to enter into, or to discontinue, the relevant transaction or relationship.

All of our executive officers and other salaried employees are required to disclose actual or potential conflicts of interest in which they may be personally involved in an annual certification reviewed by our Internal Audit and Legal Departments. In addition, all of our executive officers are required to disclose actual or potential conflicts of interest by quarterly certifications. Employees who complete these certifications are also required promptly to report in writing to the Internal Audit Department any conflict of interest situations that arise during the period between certifications.

Conflict of interest situations reported by employees are addressed by our Business Ethics Committee made up of representatives from our Internal Audit, Legal and Human Resources Departments, and, where appropriate, by senior management. If the conflict of interest involves one of our executive officers, the situation will be addressed by our Board of Directors or the Audit Committee of the Board. Quarterly reports of conflicts of interest and the resolution of them are provided to our Disclosure Committee and Chief Executive Officer in accordance with our disclosure controls and procedures.

We recognize that directors may be connected with other organizations with which we have business dealings from time to time. Under our Corporate Governance Guidelines, it is the responsibility of each director to advise the Chairman of the Board and the Governance Committee of the Board, through its Chair, of any affiliation with public or privately held businesses or enterprises that may create a potential conflict of interest, potential embarrassment to us, or possible inconsistency with our policies or values. Directors are also to advise the Chairman of the Board and the Governance Committee in advance of accepting an invitation to serve on the board of another public company.

We annually solicit information from our directors in order to monitor potential conflicts of interest. In accordance with our Corporate Governance Guidelines, any actual or potential conflict of interest involving a director will be investigated by the Governance Committee, with management assistance as requested, to determine whether the affiliation or transaction reported impairs the director s independence and whether it is likely to adversely impact us. If the Committee determines that the director s independence would be impaired, or the affiliation or transaction would likely impact us adversely, the director would generally be asked not to enter into, or to discontinue, the reported relationship or to resign from the Board. In other circumstances, the Committee will generally determine what, if any, controls, reporting and/or monitoring procedures are appropriate for our protection as a condition for approving the reported relationship or transaction. Relationships that give rise to potential conflicts of interest are generally not considered to adversely impact us if they are not required to be disclosed pursuant to Item 404(a) of the Securities and Exchange Commission s Regulation S-K because

the amount involved in the transaction is less than $120,000,

the director s only relationship to the other party involved in the transaction is as a director,

the director s interest arises solely from the ownership of our stock and all holders of our stock received the same benefit on a pro rata basis,

the transaction involves rates or charges determined by competitive bids, or

the transaction involves the rendering of services as a common or contract carrier, or public utility, at rates or charges fixed in conformity with law or governmental authority.

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The foregoing policies and procedures apply to transactions involving our directors and executive officers and their immediate family members required to be reported under Item 404 (a) of Regulation S-K. Pursuant to a written directive issued by our Chairman, transactions required to be reported under that Item involving holders of more than 5% of our common stock are subject to review by an officer at the level of Executive Vice President or above to determine whether they are on an arm s-length basis.

Compensation of all of our executive officers is approved by our Compensation and Organization Committee or the Board of Directors and compensation of our directors is approved by the Board.

Issuance of Convertible Senior Notes

In November 2008, we issued $400 million aggregate principal amount of 10% Contingent Convertible Senior Notes due 2018 to affiliates of Berkshire Hathaway Inc. and Fairfax Financial Holdings Limited. In connection with the issuance of notes, we entered into separate securities purchase agreements and registration rights agreements with Berkshire Hathaway and Fairfax. Pursuant to the securities purchase agreements, Berkshire Hathaway and Fairfax have the right, for so long as they own any notes, to participate in any of our future issuances of common stock, subject to certain exceptions. In the event we issue common stock, Berkshire Hathaway and Fairfax may each purchase up to that portion of the common stock being issued that equals their ownership percentage in our common stock prior to such issuance (assuming conversion of their notes).

Under the registration rights agreements, we granted Berkshire Hathaway and Fairfax demand and piggyback registration rights with respect to all of the notes and shares of common stock held by them and specified affiliates from time to time. The registration rights agreements entitle each of Berkshire Hathaway and Fairfax to make three demands for registration of all or part of the notes or common stock held by them and their affiliates, subject to certain conditions and exceptions. The registration rights agreements also provide that, subject to certain conditions and exceptions, if we propose to file a registration statement under the Securities Act of 1933, as amended, with respect to an offering of securities on a form that would permit registration of the notes or shares of common stock that are held by Berkshire Hathaway, Fairfax or the specified affiliates, then we will offer Berkshire Hathaway, Fairfax and their specified affiliates the opportunity to register all or part of their notes or shares of common stock on the terms and conditions set forth in the applicable registration rights agreement. The registration rights agreement with Berkshire Hathaway amended and restated the registration rights agreement we entered into with Berkshire Hathaway in January 2006.

The securities purchase agreements and registration rights agreements were approved by our Board of Directors. More information about, and copies of, the agreements referred to in this section and other related agreements are included in a report we filed with the Securities and Exchange Commission on November 26, 2008.

Shareholder s Agreement with Berkshire Hathaway

In connection with the equity commitment agreement we entered into with Berkshire Hathaway in January 2006, we entered into a shareholder s agreement with Berkshire Hathaway pursuant to which Berkshire Hathaway agreed, among other things, that for a period of seven years following completion of our rights offering, except in limited circumstances, it will not acquire additional beneficial ownership of our voting securities if, after giving effect to the acquisition, it would own more than 40% of our voting securities on a fully diluted basis. Berkshire Hathaway further agreed that, during that seven-year period, it would not solicit proxies with respect to our securities or submit a proposal or offer involving a merger, acquisition or other extraordinary transaction unless the proposal or offer is

requested by our Board, or

made to the Board on a confidential basis and is conditioned on approval by a majority of our voting securities not owned by Berkshire Hathaway and a determination by the Board as to its fairness to stockholders and, if the proposed transaction is not a tender offer for all shares of common stock or an offer for the entire company, is accompanied by an undertaking to offer to acquire all of our shares of common stock outstanding after completion of the transaction at the same price per share as was paid in the transaction.

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Under the shareholder s agreement, for the same seven-year period, we agreed to exempt Berkshire Hathaway from our existing or future stockholder rights plans to the extent that Berkshire Hathaway complies with the terms and conditions of the shareholder s agreement. If there is a shareholder vote on a stockholder rights plan that does not contain this agreed exemption, Berkshire Hathaway may vote without restriction all the shares it holds to approve or disapprove the proposed stockholder rights plan. On all other matters, Berkshire Hathaway is required to vote certain of the shares it owns as described under Corporate Governance on page 14 of this proxy statement. We and Berkshire Hathaway also agreed that, after the seven-year standstill period ends, during the time that Berkshire Hathaway owns our equity securities, Berkshire Hathaway will be exempted from our stockholder rights plans, except that our stockholder rights plans may require that Berkshire Hathaway does not acquire (although it may continue to hold) beneficial ownership of more than 50% of our voting securities, on a fully diluted basis, other than pursuant to an offer to acquire all shares of our common stock that is open for at least 60 calendar days.

The equity commitment agreement and shareholder s agreement were approved by our Board of Directors.

Transactions with Principal Stockholders

We purchase products, principally fiberglass and insulation, and services, including pipeline services, and lease equipment from subsidiaries of Berkshire Hathaway in the ordinary course of our business. The aggregate amount of those purchases and lease transactions in 2010 was approximately $16.6 million. We also sold products to subsidiaries of Berkshire Hathaway during 2010 in the aggregate amount of approximately $1.2 million. We purchase insulation from affiliates of Gebr. Knauf in the ordinary course of business. Those purchases aggregated approximately $15.2 million in 2010. We sold approximately $550,000 of products to affiliates of Gebr. Knauf in 2010. We are a partner with an affiliate of Gebr. Knauf in a joint venture that manufactures and markets cement-based panels in Europe and the former Soviet Union. The joint venture had sales of approximately $30.9 million in 2010.

We and our subsidiary L&W Supply Corporation are defendants, along with many other companies that include affiliates of Gebr. Knauf, in lawsuits relating to Chinese-made wallboard installed in homes. The lawsuits claim that the Chinese-made wallboard is defective and emits sulfur gases causing, among other things, an odor and corrosion of certain metal surfaces. Most of the lawsuits also allege that the Chinese-made wallboard causes health problems. L&W sold some of the allegedly defective wallboard primarily in the Florida region in 2006. The Chinese wallboard that L&W distributed was manufactured primarily by Knauf Plasterboard (Tianjin) Co. Ltd., or KPT, and two other Chinese affiliates of Gebr. Knauf. L&W has resolved some of the customer and homeowner claims relating to allegedly defective Chinese-made wallboard sold by L&W by paying a portion of the remediation costs for the homes at issue. In 2010 and early 2011, L&W was reimbursed approximately $4.1 million by an affiliate of Gebr. Knauf for a portion of L&W s costs incurred in resolving claims relating to wallboard manufactured by KPT, and L&W expects to be reimbursed approximately $1.2 million by an affiliate of Gebr. Knauf in the second quarter of 2011 for a portion of L&W s costs incurred in resolving additional claims. In addition, in March 2011 L&W and Gebr. Knauf and their respective affiliates executed an agreement that limits L&W s liability for all other pending and future property damage claims relating to homes to which L&W delivered wallboard manufactured by KPT. In accordance with the terms of the agreement, an affiliate of Gebr. Knauf will fund a substantial portion of the costs of resolving these property damage claims for homes covered by the agreement, and L&W s liability for such claims is currently estimated to be approximately $2.5 million.

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COMPENSATION OF EXECUTIVE OFFICERS AND DIRECTORS

This section of the proxy statement contains information regarding our executive and director compensation programs and policies. In particular, it describes the application of our executive compensation policies to our named executive officers, who are the individuals named in the Summary Compensation Table on page 35 of this proxy statement. Our named executive officers for 2010 are the individuals who served as our Chief Executive Officer and Chief Financial Officer during that year and our three other executive officers who received the most compensation for 2010. The information is organized as follows:

Compensation Discussion and Analysis: Contains a discussion of our compensation philosophy and objectives, a description of the specific types of compensation we provide to our executive officers, information regarding how our compensation policies were applied to our named executive officers for 2010 and other information that we believe may be useful to investors;

Executive Compensation Tables: Provides information regarding the amounts or value of various types of compensation paid to or earned by our named executive officers and related information;

Potential Payments upon Termination or Change in Control. Provides information regarding amounts that could become payable to our named executive officers following specified events; and

2010 Director Compensation Table. Contains information regarding the amounts or value of the compensation paid to our non-employee directors for 2010 and related information.

The first three parts of this section described above are intended to be read together. For background information regarding the Compensation and Organization Committee of our Board of Directors and its responsibilities, please see Committees of the Board of Directors Compensation and Organization Committee on page 11 of this proxy statement.

COMPENSATION DISCUSSION AND ANALYSIS

Executive Summary

USG s executive compensation program is designed to attract, motivate and retain talented executives with the skills required to develop and implement our long-term strategic and annual operating objectives to create value for our stockholders. The program seeks to align the interests of management with those of stockholders through a combination of base salary, annual and long-term incentive compensation awards, retirement and other benefits and limited perquisites. Generally, about 70% of compensation opportunity for our executive officers as a group is variable based on achievement of earnings, annual operating and financial targets and total stockholder return.

Compensation Governance

Our executive compensation practices include governance features that support our pay for performance philosophy, including

the Compensation and Organization Committee of our Board of Directors is comprised solely of independent directors with whom stockholders may communicate as discussed under Communications with Directors on page 13 of this proxy statement,

the Compensation and Organization Committee s consultant, Towers Watson, is retained directly by the Committee and performs no other consulting services for us other than relating to broad-based benefit plans and our casualty insurance programs, for which other services its aggregate 2010 fees were approximately $75,000, and

the Compensation and Organization Committee has reviewed compensation-related risk with management and Towers Watson and concurs in management s conclusion that our compensation programs do not create risks that are reasonably likely to have a material adverse effect on us.

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These governance practices are complemented by specific compensation program elements designed to align the program with stockholder interests and encourage management not to take excessive risks, including

compensation recoupment, or clawback , provisions that will allow our Board of Directors to recoup excess incentive compensation paid to an executive officer if our financial statements are restated due to fraud or intentional wrongdoing of the executive officer,

a minimum EBITDA threshold that must be satisfied before any payouts can be made under our annual Management Incentive Program,

a limit on the payout under the annual Management Incentive Program to a maximum of two times the par, or target, incentive award,

stock ownership guidelines for our executive officers and non-employee directors, as described on pages 32 and 49, respectively, of this proxy statement, and

prohibitions on our executive officers engaging in speculative transactions involving our securities, including buying or selling puts or calls and short sales.

In addition, payouts under the annual Management Incentive Program for 2011 will not be made until we report a consolidated adjusted operating profit, as described in more detail under Annual Incentive beginning on page 28 of this proxy statement.

2010 Financial Performance and Executive Compensation

Our businesses are cyclical in nature and sensitive to changes in general economic conditions, in particular the conditions in the North American housing and construction-based markets. Those markets have experienced an extended downturn since 2006 and remained weak during 2010, although there were signs of stabilization in some of them. As a result of those adverse market conditions, our net sales have declined in each of the past four years, including a 9% decrease in 2010 following a 30% decrease in 2009. We have been scaling back our operations and taking other actions to reduce costs and improve operating efficiencies in response to market conditions. As a result of these actions and better than plan performance in some of our businesses, despite the year-over-year decreases in net sales, as reflected in the following table, we have reduced our adjusted operating loss by almost $40 million, or 20%, since 2008. In addition, our stock price more than doubled between December 31, 2008 and December 31, 2010.

	2010	2009	2008
	($ in millions, except per share amounts)		
Net sales	$ 2,939	$ 3,235	$ 4,608
Adjusted operating loss*	$ (150)	$ (159)	$ (188)
Operating loss	$ (260)	$ (185)	$ (512)
Closing stock price per share on December 31	$ 16.83	$ 14.05	$ 8.04

* Adjusted operating loss excludes the following: for 2010, restructuring and long-lived asset impairment charges of $110 million; for 2009, restructuring and long-lived asset impairment charges of $80 million, goodwill and other intangible asset impairment charges of $43 million and litigation settlement income of

$97 million; and for 2008, restructuring and long-lived asset impairment charges of $98 million and goodwill and other intangible asset impairment charges of $226 million.

Our results for 2010 reflect

record or near record safety, quality and customer satisfaction performance,

better than target performance for our domestic and international manufacturing businesses, reflecting strong gross margin performance for our ceilings, surfaces and substrates product lines,

better than target wallboard cost performance,

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the successful market introduction of Sheetrock Brand UltraLight Panels as a result of our continued focus on innovation, and

enhancement of our liquidity position as a result of our continued focus on working capital and our sale of $350 million of senior unsecured notes.

During 2010, we also announced our Chief Executive Officer succession plans, which were implemented effective January 1, 2011, and took other steps to solidify succession plans for senior management leadership positions in finance and operations.

A significant portion of compensation opportunity for our executives varies based on financial and operating performance. Actual compensation for 2010 for our named executive officers reflects the adverse market conditions in which our businesses have been operating, our financial performance for the past several years and the key compensation decisions and other factors described below.

Base Salary No annual merit salary increases were approved for our named executive officers in 2010 for the second consecutive year, and none were approved for 2011. Messrs. Griffin and Khan both received salary increases in connection with their promotions during 2010 and Mr. Metcalf s salary was increased effective January 1, 2011 in connection with his election as Chief Executive Officer.

Annual Incentive Awards Forty percent of the target award under our annual Management Incentive Program is based on net earnings. No payout was made under this segment of that Program for the third consecutive year in 2010. The balance of the target award is based on achievement of annual operating and financial objectives. In 2010, we were able to achieve, and in some cases exceed, our annual operating and financial objectives. As a result, awards to our named executive officers for 2010 under our annual Management Incentive Program ranged from 52.3% to 84.9% of target, or par, and averaged 65.9% of par. These awards reflect the outstanding performance in several of our businesses and our enhancement of our financial flexibility. We gave our executive officers the option of receiving some or all of their annual incentive awards for 2010 in shares of our common stock. Of our named executive officers, Mr. Metcalf elected to receive all of his 2010 award in stock and Messrs. Fleming and Griffin elected to receive one-half of their awards in stock. The annual Management Incentive Program and payouts for 2010 are discussed in more detail beginning on page 28 of this proxy statement.

Long-Term Incentive Awards We valued annual equity awards made in February 2010 at levels approximately equal to the levels of the equity awards we granted in 2008 after an almost 50% reduction in our equity award values in 2009 (the decrease in award values in 2009 compared to 2008 for our comparator companies was approximately 17%). Special equity awards were made during the year to Messrs. Fleming, Griffin and Khan for retention and succession-related purposes that increased the total value of their 2010 awards. The performance of our stock during the past several years reflects the adverse conditions in our markets, particularly the weak levels of demand for gypsum wallboard. The performance shares we award as part of our long-term incentive awards vest based on our total shareholder return relative to that of the Dow Jones U.S. Construction and Materials Index over a three-year period. Because our stock price has remained depressed relative to the performance of the Index, all performance shares granted in 2008 and 2007, for which the three-year performance periods expired on December 31, 2010 and December 31 2009, respectively, were forfeited. Our stock price remains significantly below the exercise price of all outstanding stock options granted before 2009. These earlier options are, and throughout 2010 were, out of the money. They will not provide realizable economic benefit to their holders unless the market price of our common stock exceeds their exercise price. Additionally, all outstanding restricted stock units awarded before 2009 have a value

substantially below their grant date value.

Compensation Philosophy and Objectives

USG s executive compensation philosophy is to provide a competitive total compensation package that aligns the interests of management with those of stockholders, motivates management to achieve our long-term strategic and annual operating objectives and enables us to attract and retain talented executives.

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We align management s interests with those of our stockholders by using equity-based long-term incentive awards, including awards that vest only upon the achievement of performance objectives, maintaining stock ownership guidelines and restricting hedging activity. We also align management s interests with those of stockholders by basing targeted annual incentive awards on our consolidated net earnings and on selected key operational and financial metrics.

We motivate management to achieve our strategic growth and annual operating objectives through compensation programs that reward performance. Our programs are designed with the intent that generally 70% of compensation opportunity for our executive officers as a group is variable based on achievement of earnings, annual operating and financial targets and total stockholder return. The percentage of compensation opportunity that is variable is highly dependent on the level of equity-based long-term incentive awards. The annual operating and financial targets are selected to motivate management to take actions that benefit both short-term operating and long-term strategic objectives.

We attract and retain talented managers by ensuring that compensation opportunity is competitive in relation to similar positions in similar organizations. In setting compensation opportunity for our executive officers, we use the median level of compensation opportunity for a comparator group of companies as the reference point. We generally seek to set the compensation opportunity for an individual executive officer within a band of 75% to 125% of the median based on the executive officer s performance, experience, skill and related factors. We also adjust compensation levels based on internal equity to appropriately reward the contributions of our executives and to facilitate succession planning objectives.

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We implement our executive compensation philosophy through the following programs:

Program	Description	Participants	Objectives Achieved
	ANNUAL CASH COMPENSATION		
Base Salary	Annual cash compensation based on competitive market data and individual performance	All salaried employees	Reward Performance Market Competitive Compensation
Annual Management Incentive Program	Annual incentive awards based on net earnings and annual achievement of operating and financial performance objectives	All executive officers and approximately 265 other managers	Reward Performance Market Competitive Compensation Stockholder Alignment
	LONG-TERM INCENTIVE COMPENSATION		
Long-Term Incentive Plan	Equity-based incentives, including stock options, restricted stock units and/or performance shares. The awards vary based on position, individual performance, potential and competitive practice.	All executive officers and approximately 225 other managers	Stockholder Alignment Reward Performance Market Competitive Compensation Retention
	BENEFITS / PERQUISITES		
Retirement, Health and Welfare Benefits	Retirement and investment plans, medical, dental, vision and other welfare benefits	All employees	Market Competitive Compensation Retention
Executive Benefits and Other Perquisites	Death, disability and personal liability	All executive officers and certain other senior	Market Competitive Compensation

insurance, financial planning, company automobile and other benefits	managers	Retention

In addition to these compensation programs, we provide two types of employment security agreements for our executive officers. Employment Agreements provide compensation if an executive officer is involuntarily terminated without cause. Change-In-Control Severance Agreements provide executive officers compensation if there is a change in control and the executive officer is either involuntarily terminated without cause or the executive leaves for good reason, as defined in the agreements. These agreements help us to attract and retain talented executives, protect our intellectual property, reduce the potential for employment litigation and avoid the loss of executives to our competitors and other corporations.

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Committee Position on Incentives and Excessive Risk

The Compensation and Organization Committee, or Committee, of our Board of Directors believes that the design of our compensation programs, as a result of their balance between salary, short-term incentives and long-term incentives, does not encourage management to take excessive risks to maximize earnings or meet performance objectives in a single year at the expense of our long-term objectives. Our annual Management Incentive Program, or Program, has a mix of financial and operating objectives and includes a limitation on the amount of payments and the clawback feature described under Executive Summary Compensation Governance beginning on page 19 of this proxy statement. Our Long-Term Incentive Plan uses a variety of equity compensation awards (stock options, restricted stock units and performance shares) that have extended vesting periods and provide different incentives. It also includes a clawback feature. Together with our stock ownership guidelines (discussed on page 32 of this proxy statement) and a prohibition on speculative transactions involving our securities), this balanced array of incentives encourages management to achieve both short-term operating and financial and long-term strategic objectives. The Committee and its consultant annually review a risk assessment of our compensation programs, and they believe that these programs do not create risks that are reasonably likely to have a material adverse effect on us.

Compensation and Organization Committee

Our executive compensation programs are overseen by the Committee. The Committee is comprised of independent directors as defined by the New York Stock Exchange s listing standards. The current Committee members are Steven F. Leer (Chair), Jose Armario, W. Douglas Ford and Marvin E. Lesser. The Committee s charter charges it with various accountabilities, including:

- to review and make recommendations to the Board of Directors with respect to management organization, succession and development programs, the election of corporate officers and their compensation;
- to make decisions required by a committee of the Board of Directors under all stock option and restricted and deferred stock plans; and
- to approve and report to the Board of Directors changes in salary ranges for all other major position categories and changes in retirement plans, group insurance plans, investment plans or other benefit plans and management incentive compensation or bonus plans.

The Committee s charter is reviewed at least annually. The charter can be found on our website www.usg.com.

Committee Calendar and Meetings

The Committee meets as necessary. Normally the Committee meets between four and six times a year. In 2010, the Committee held eight meetings and also acted twice by unanimous written consent in lieu of a meeting. The agendas for meetings and the annual Committee calendar are developed by management in consultation with the Committee Chair. The Committee has retained a compensation consultant, and one or more of its representatives are usually in attendance at its meetings. The Committee periodically holds meetings or executive sessions to review matters with its compensation consultant without management present. The Committee also periodically holds meetings or executive sessions with neither its compensation consultant nor management present.

Management s Role in Compensation

Our Human Resources Department is responsible for the administration of our executive compensation, benefits and related programs. The Senior Vice President, Human Resources is accountable for making proposals to the Committee

for changes in compensation and benefit programs at the request of either management or the Committee. The Senior Vice President, Human Resources is also the primary management contact for the Committee Chair.

The Chairman, President and Chief Executive Officer, Senior Vice President, Human Resources, Senior Director, Executive Compensation, and Director, Compensation usually attend Committee meetings to present matters for consideration by the Committee and to answer questions regarding those matters. Other executive officers and senior managers may attend meetings at the request of either management or the Committee to provide

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information and answer questions relevant to the Committee s consideration of matters presented to it. Management s consultant also attends these meetings to provide background and respond to questions.

The Chief Executive Officer recommends to the Committee any changes in compensation for executive officers (other than himself) based on his assessment of each individual s performance, contribution to our results and potential for future contributions to our success. The Committee meets in executive session without any members of management present to review the performance and compensation of the Chief Executive Officer, to evaluate compensation proposals made by management and to make decisions with respect to those proposals.

Once each year (typically in July) management provides the Committee with an overview of all compensation and benefit plans pertaining to executive officers, including the purpose and cost of the programs and the value delivered to the participants by the programs. The Committee uses this information when evaluating subsequent compensation proposals by management and in developing its own proposals for changes to executive officer compensation.

The Chief Executive Officer and the Senior Vice President, Human Resources also lead an annual review for the Board of our management succession plans. This review provides the Committee and other Board members with information regarding the performance and potential of our management team that can be taken into account when executive compensation decisions are made.

Compensation Consultants

The Committee has retained Towers Watson as a compensation consultant to provide the Committee with an independent review of our executive compensation program. Towers Watson was selected by the Committee and works under the direction of the Committee Chair. Towers Watson s primary role is to provide an independent analysis of competitive market data and to assist the Committee in evaluating compensation proposals made by management. The Committee has also on occasion asked Towers Watson to assist it in developing the compensation package for our Chief Executive Officer.

Towers Watson provides services to management related only to broad-based benefit plans and our casualty insurance programs, for which services its aggregate 2010 fees were approximately $75,000. At the direction of the Committee Chair, Towers Watson may meet with management and/or management s consultant to review management s proposals prior to the Committee s review. A representative of Towers Watson generally attends the Committee s meetings. USG pays Towers Watson s fees for consulting services provided to the Committee after approval of those fees by the Committee Chair.

Management also uses consultants to provide analysis and advice with respect to executive compensation programs and practices. Management s primary advisor for compensation-related matters is Exequity, LLP. Exequity assists management in analyzing competitive market practices and benchmark data and in developing proposals for review by the Committee. It does not provide any services to USG other than executive compensation consulting.

Management also contracts with Aon Hewitt (previously Hewitt Associates) to conduct an annual competitive review of our executive compensation pay practices against a comparator group of companies. The study assists management in comparing compensation levels for our executive officers to compensation levels of the comparator group. Hewitt does not assist management in formulating proposals for compensation changes for executive officers. Hewitt provides other services to us related to the administration of our retirement, health and welfare benefit plans.

Setting Compensation Levels Compensation Committee Annual Review

In February of each year, the Committee sets the level of each element of compensation for our executive officers. As part of this process, the Committee considers market competitiveness, current market conditions, performance for the prior year and internal equity.

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Market Competitiveness

Since 2003, management has engaged Aon Hewitt to conduct an annual Executive Compensation Competitive Review to compare elements of compensation for our executive officers to the compensation opportunity provided for similar positions by approximately 25 industrial and/or Chicago-based companies. Each executive officer s position, including the Chief Executive Officer s position, is compared to positions with similar responsibilities or at an equivalent level in this comparator group in terms of base salary, annual incentive, long-term incentive and total compensation. If there is no comparable position in the comparator group, the Committee generally sets compensation opportunity for the executive officer based on internal equity.

The review provides the Committee with market information that enables it to evaluate total compensation opportunity, the mix of fixed and variable compensation elements and how total compensation is divided between the various compensation elements. The Committee uses that information to evaluate recommendations made by management with respect to compensation of our executive officers other than the Chairman and the Chief Executive Officer and to develop its own recommendations with respect to the compensation of the Chairman and the Chief Executive Officer.

We select our comparator companies from among those for which data is available in Aon Hewitt s Total Compensation Measurement data base, based on their similarity to USG in terms of industry, annual revenue, complexity of operations, business cyclicality and geographic location. They are the types of companies with which we compete for talent, and the median revenue of the group approximates our annual revenues. For the 2010 study, the companies included in the comparator group were

Armstrong World Industries, Inc.	Fortune Brands, Inc.	Owens Corning Corporation
Ball Corporation	Foster Wheeler Corporation	PacTiv Corporation
The Black and Decker Corporation	Kennametal Inc.	The Sherwin-Williams Company
Boise Cascade LLC	Lennox International, Inc.	Temple-Inland Inc.
BorgWarner, Inc.	Martin Marietta Materials, Inc.	Texas Industries, Inc.
Brunswick Corporation	Masco Corporation	The Valspar Corp.
Cooper Industries, Inc.	MeadWestvaco Corporation	Vulcan Materials Company
Dover Corporation	Mueller Water Products	W.W. Grainger, Inc.

We have designed our executive compensation package to be market competitive in total. Our objective is to provide executive officers with total compensation opportunity generally within a band of 75% to 125% of the median of the comparator group for their individual positions in the case of our Chairman, President and Chief Executive Officer and Executive Vice Presidents and for their position level for our Senior Vice Presidents and Vice Presidents.

Total compensation opportunity for each executive officer is set based on performance, experience, skill and internal equity. Executives who are new in a position may be below the median for one or more elements of compensation. To reward extraordinary accomplishments, to promote retention and succession planning objectives and/or to maintain internal equity, we may pay an element of compensation in excess of 125% of the median. In circumstances where the scope of one of our executive s position differs significantly from the scope of responsibility of similarly titled positions in the comparator group companies, the Committee may set compensation opportunity for that executive outside the 75% to 125% of median range. The Committee is comfortable with setting one or more elements of an executive s compensation opportunity outside this range because the Committee is primarily concerned with the competitiveness of our executive officers total compensation opportunity rather than the opportunity represented by any one individual element of compensation.

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Total target net compensation (salary, annual incentive opportunity and long-term incentive opportunity) for each of our named executive officers for 2010 was initially set as follows:

	Percentage of Median
Mr. Foote	132%
Mr. Metcalf	128
Mr. Fleming	112
Mr. Griffin	137
Mr. Khan	105

Mr. Foote s total compensation opportunity for 2010 was initially targeted above 125% of the median in recognition of his long-tenured service as our Chairman and Chief Executive officer and our success in 2010 in maintaining our financial flexibility. The total compensation opportunity for 2010 for Messrs. Metcalf and Griffin was initially targeted above 125% of the median for succession planning purposes. In addition, total compensation opportunity for 2010 reflects the increase in the grant date value of our equity awards compared to the significantly lower grant date values reflected in the Aon Hewitt review, which reflects 2009 equity award practices.

As discussed under Executive Summary 2010 Financial Performance and Executive Compensation beginning on page 20 of this proxy statement, after their compensation for 2010 was initially set and in connection with their promotions to their current positions, Messrs. Griffin and Khan received salary increases and special retention and succession-related equity awards. Mr. Fleming received similar special equity awards at the same time.

Performance

The Committee assesses the performance of the Chief Executive Officer in executive session at the February Committee meeting. This assessment is the basis for the Committee s recommendations to the Board regarding the Chief Executive Officer s compensation. The Chief Executive Officer conducts a similar assessment of the performance of the other executive officers and summarizes the results for the Committee when making his compensation recommendations to the Committee at the February Committee meeting. Mr. Foote served as our Chairman and Chief Executive Officer during 2010. Mr. Metcalf succeeded him as Chief Executive Officer on January 1, 2011. Mr. Foote continues to serve as executive Chairman of the Board. The Committee assessed Mr. Foote s performance during 2010 in making its recommendation to the Board regarding his compensation for 2011.

The Committee s determination of our executive officers base salary adjustments, if any, and Plan awards is based on its assessment of each executive officer s contribution to our overall financial results for the year and to the accomplishment of our annual operating and financial objectives as well as internal equity.

As discussed above, the only increases in base salary or annual incentive award opportunity for our executive officers in 2010 related to promotions and adjustments for internal equity and succession planning purposes, including for Messrs. Griffin and Khan, and annual equity awards under the Plan in 2010 had grant date values comparable to the values of awards made in 2008. Among the 2009 accomplishments considered by the Committee in making its recommendation to the Board regarding 2010 equity awards for our named executive officers were our customer satisfaction performance, continued improvement in plant operating efficiencies, the implementation of restructuring initiatives to reduce production capacity, overhead and other costs and the significant improvement of our financial flexibility through the release of working capital, renegotiation of our revolving credit agreement and a $300 million senior note offering.

Internal Equity

The Committee also considers the level of compensation opportunity of executive officers based on its judgment of the relative importance of the responsibilities of each executive officer position to USG and each executive officer s contribution to corporate results. In addition, adjustments may be made to further our longstanding succession planning philosophy of preferring to develop and promote talent from within USG.

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The benchmarking methodology and compensation philosophies applied by the Committee in determining the compensation of our Chief Executive Officer are the same as those applied in determining the compensation of our other executive officers. The Chief Executive Officer s compensation has historically been significantly higher than that of our other named executive officers based on our philosophy of paying market competitive compensation and reflects his broader accountability and the greater percentage of his total compensation that is performance-based. We do not set the compensation level of our executive officers as a multiple of the compensation of any other employee or group of employees.

Elements of Total Compensation

Our total compensation program consists of the following elements:

base salary;

annual incentive;

long-term incentive; and

benefits and perquisites.

Base Salary

The starting point for determining base salaries for our executive officers is the annual Aon Hewitt Executive Compensation Competitive Review. Individual salaries for our executive officers range between 92% and 118% of the median for the comparator group. Factors that warrant paying above the median include individual performance, as assessed by the Chief Executive Officer (or in the case of the Chief Executive Officer, and in 2011 the executive Chairman, the Committee), experience, skills and retention considerations.

Annual Incentive

Our annual Management Incentive Program, or Program, provides a variable reward opportunity based on corporate net earnings and the achievement of operating and financial objectives derived from the annual operating plan. We believe that both components of the Program satisfy the currently applicable requirements of Internal Revenue Code Section 162(m) and the regulations promulgated thereunder regarding the deductibility of performance-based compensation in excess of $1 million paid to any of our named executive officers and that awards earned under those components of the Program in 2010 will be fully deductible as performance-based compensation. We pay annual incentive awards in the first quarter of the year following the year in which they are earned.

We designed the Program in recognition of the cyclical nature of our businesses. The Committee believes this design provides management with a strong incentive to maximize operational performance at all points of the business cycle as participants have an opportunity to earn at least a partial payout by achieving operational and/or financial targets even if no payout is earned for the net earnings segment. During peak years, corporate earnings may be driven in part by market conditions, but strong operational performance must be achieved to earn a maximum payout under the Program. Similarly, at the bottom of the cycle, when (as now) market conditions provide less earnings opportunity or we incur a net loss, management still has strong incentive to optimize operational efficiency and productivity, to enhance our market leadership positions and to maintain financial flexibility.

The target annual incentive opportunity for participants in the Program is expressed as a percentage of base salary. For 2010, the target annual incentive opportunity for executive officers ranged from 45% of base salary to 125% of base

salary for the Chief Executive Officer. Our Chief Executive Officer was eligible to receive a higher percentage annual incentive opportunity than our other executive officers in 2010 in recognition of the broader scope of his responsibilities and impact on corporate performance, and based on market data regarding compensation of chief executive officers of the companies in our comparator group. The amount of the target annual incentive opportunity for each of our named executive officers for 2010 is indicated under the heading Estimated Possible Payouts Under Non-Equity Incentive Plan Awards in the 2010 Grants of Plan-Based Awards Table on page 38 of this proxy statement.

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For 2010, the annual incentive award opportunity was comprised of the following segments that are designed to provide an incentive to maximize earnings and pursue operational excellence.

Share of Net Earnings: 40% of the 2010 annual Program award opportunity was based on a share of the earnings formula. We use a portion of our consolidated net earnings to fund a pool from which we pay awards to participants. Adjustments to net earnings may be made (with the Committee s approval) for the impact of acquisitions and new accounting pronouncements and other specified matters. For 2011, 50% of the annual award opportunity for our executive officers will be based on the share of the earnings formula.

We designed the share of the earnings concept to align our annual incentive awards with overall corporate results. As corporate performance (measured by consolidated net earnings) improves, more funds are allocated to the share of the earnings pool and participants receive larger awards. Similarly, if earnings decline, fewer funds are allocated to the pool resulting in lower, or no, awards for participants.

Due to the cyclical nature of our business, the allocation of consolidated net earnings to the pool is based on a schedule that is designed so that participants can earn 100% of the par award for this segment of the Program if consolidated net earnings in the current year are equal to 103% of the average of our consolidated net earnings for the prior seven years. The Committee periodically reviews the formula for reasonableness.

No award under the share of the earnings portion of the Program is earned if we do not generate positive consolidated net earnings for the year and an award of approximately two times par could be earned if our consolidated net earnings exceed our historical record high. For 2010, we reported a consolidated net loss, and participants received no award for this segment of the Program.

Focus Targets: 60% of the 2010 annual Program award opportunity was based on the achievement of annual operating and financial objectives, called focus targets. These targets are derived from our annual planning process and are measurable and verifiable. We use broad, high impact measures such as business unit profitability, liquidity and manufacturing cost that are designed to promote a balanced performance between operational and long-term growth objectives, to incentivize executives and to reward key achievements even if our net earnings performance does not merit a payout under the share of the earnings segment of the Program. The payout can range from zero to either 150% or 200% depending on the measure. For 2011, 50% of the annual award opportunity for our executive officers will be based on the achievement of focus targets.

The Committee approves the focus target measures and minimum, par and maximum performance levels for each measure early in the year. In February of the following year, the Committee reviews the prior year s performance, including the degree of achievement of each of the focus targets and the computation of the share of the earnings formula, before it and the Board approve the payment of annual incentive awards.

Our key objectives for 2010 included improving efficiency and profitability, reducing costs and maintaining our financial flexibility. The focus targets for our named executive officers for 2010 were chosen to support these objectives. As a result of this focus, during 2010 we increased our wallboard spread, improved margins in our ceilings business, took other actions to improve operating efficiency and increased our liquidity. These

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achievements contributed to the performance in relation to the 2010 focus targets for our named executive officers reflected in the table below, which also sets forth other information regarding those 2010 targets.

Measure	Minimum	Target	Maximum	2010 Performance % of Target	Payout Earned % of Par
Building Systems Adjusted Operating Profit (Loss) ($ in millions)(1)	$ (60)	$ (40)	$ 0	78.0%	78.0%
L&W Supply Adjusted Operating Profit (Loss) ($ in millions)(1)	(80)	(65)	0	81.8	61.0
International Adjusted Operating Profit ($ in millions)(1)	20	35	50	138.9	191.0
U.S. Wallboard Cost		(2)		101.6	124.0
U.S. Wallboard Spread		(2)		104.9	108.0
Adjusted EBITDA ($ in millions)(1)	30	62	100	72.7	74.0
Average Quarterly Liquidity ($ in millions)(3)	600	700	800	114.0	150.0

(1) Adjusted to eliminate the effect of non-cash charges, such as asset impairments, and restructuring charges and, in the case of Adjusted EBITDA, management incentive, profit sharing and bonus plans.

(2) We do not publicly disclose wallboard cost and spread because that information constitutes confidential commercial or financial information, the disclosure of which would cause us competitive harm.

(3) Available committed credit facilities and consolidated cash and cash equivalents and marketable securities at quarter end.

For 2010, each named executive officer was assigned the following focus targets with the weightings indicated:

	Building Systems Adjusted Operating Profit (Loss)	L&W Supply Adjusted Operating Profit (Loss)	International Adjusted Operating Profit	U.S. Wallboard Spread	Adjusted EBITDA	Average Quarterly Liquidity	U.S. Wallboard Cost
Mr. Foote	10%	10%	10%	10%	10%	10%	
Mr. Metcalf	10%	10%	10%	10%	10%		10%
Mr. Fleming	10%	10%	10%	10%	10%	10%	
Mr. Griffin	10%		30%		10%		10%
Mr. Khan	20%	10%		10%	10%		10%

For 2010, achievement for the focus target segment of the Program resulted in average payouts of approximately 65.9% of par for our named executive officers and 63.8% of par for all other executive officers. On an individual

basis, the payouts ranged from approximately 52.3% to 84.9% of par for our named executive offices and 48.9% to 66.2% of par for all of our other executive officers. Since there was no payout under the share of earnings segment of the Program, those ranges represent the total earned payout for our executive officers as a group for the 2010 Program.

Over the past seven years, the total payout under our annual Management Incentive Program for executive officers has varied from 43% to 156% of par, and has averaged approximately 85% of par.

Payouts under the 2011 annual Management Incentive Program will not be made until we report a consolidated adjusted operating profit for a full calendar year. Those payouts, if any, will be doubled if we report a consolidated adjusted operating profit for 2011 and increased by 25% if we report a consolidated adjusted operating profit for 2012 but not 2011. No payouts will be made if we do not report a consolidated adjusted operating profit for 2011, 2012 or 2013.

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Long-Term Incentive

Our equity-based Long-Term Incentive Plan, or Plan, was implemented in 2006. The purpose of the Plan is to align the interests of management with those of our stockholders, drive earnings and provide a competitive compensation opportunity that enables us to attract and retain talented managers. The Plan provides for the use of several types of awards, including stock options, stock appreciation rights, restricted stock, restricted stock units, or RSUs, performance shares, performance units and other stock and cash awards. Our stockholders approved an increase in the number of shares of our stock available for awards under the Plan in 2010.

As discussed above, at their regularly scheduled meetings in February 2010, the Committee and Board approved annual awards under the Plan for 2010. For executive officers:

37.5% of the grant date value of the total award was provided in the form of non-qualified stock options. We used stock options to align management and stockholder interests by providing an opportunity for management to achieve meaningful levels of stock ownership, to create a strong incentive for management to grow our business and to provide the opportunity for competitive compensation based on long-term stock price appreciation. The options generally vest at a rate of 25% per year, and the exercise price of the options is the closing price of our common stock on the New York Stock Exchange on the date the option grants were approved by the Board.

37.5% of the grant date value of the total award was provided in the form of RSUs. The RSUs generally vest at a rate of 25% per year. We used RSUs for the same reasons we used stock options and to promote retention. At grant, the value of the RSUs is equal to our stock price. Their value will increase if our stock price increases during the vesting period, which provides an incentive for management to maximize shareholder return. Because they also have value even if the stock price does not increase or if it decreases, they promote retention throughout the business cycle.

The remaining 25% of the grant date value of the total award was provided in the form of performance shares. The actual number of shares of common stock to be issued can range from zero to 200% of the number of performance shares awarded, based on a comparison of our total stockholder return over the three-year vesting period ending December 31, 2012 to the total stockholder return for the companies in the Dow Jones U.S. Construction and Materials Index. Adjustments may be made to the Index to reflect changes in the companies included in the Index during the vesting period. We use this Index because it is comprised of companies that participate in similar markets as our operating businesses and, therefore, provides an appropriate benchmark to measure the relative performance of our stock. We also use this Index in the performance graph included in our annual report on Form 10-K. We used performance shares, and total stockholder return as the measure to determine the number of shares that vest, to motivate management to achieve our long-term objectives. The vesting schedule for our performance shares is as follows:

Total USG Stockholder Return Relative to Index	**Percent of Award Earned(1)**
Below 35th percentile	0%
35th percentile	35
50th percentile	100
75th percentile	150
90th percentile or above	200

(1) Straight-line interpolation is used to determine values between vesting tiers.

During 2010, the Committee and Board also approved special awards of RSUs to promote retention and succession planning objectives. Retention awards that generally vest after four years from the date of grant were made to three executive officers, including Messrs. Griffin and Khan in connection with their promotions to Executive Vice President. A retention award and a succession-related award were made to Mr. Fleming. One of those awards will vest on the earlier of (1) May 1, 2013 or (2) with the Board s approval, his retirement and the other will vest upon the satisfaction of goals related to the development of his successor.

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Stock Ownership Guidelines

We have stock ownership guidelines for our executive officers and other senior managers. Participants are expected to own at a minimum the lesser of their salary multiple or the fixed number of shares set forth below.

Participant	Minimum No. of Shares	Multiple of Base Salary
Chairman	100,000	5X
Chief Executive Officer	100,000	5X
Executive Vice President	35,000	4X
Senior Vice President	15,000	3X
Vice President	10,000	2X
Director/Subsidiary VP	3,500	1X

The guidelines were set at these levels to ensure management owns meaningful levels of stock, taking into account competitive market practice. We expect all participants to reach at least the minimum level of ownership for their position level by the later of April 2012 and five years after their appointment to that position. Shares owned, performance shares that have vested and unvested restricted stock units count towards satisfaction of the guidelines. If a participant fails to meet or show sustained progress toward meeting these ownership requirements, we may reduce future long-term incentive program awards to that participant. All of our named executive officers meet or exceed their stock ownership guidelines.

Benefits and Perquisites

Broad-Based Retirement, Health and Welfare Benefits

We provide a comprehensive health and welfare package to all of our full-time employees. Our executive officers are eligible to participate in these plans on the same basis as other eligible employees. The package includes the following benefits:

Medical, Dental and Vision Plans: All participants contribute approximately 20% of the cost of the coverage for the medical plan and approximately 50% of the cost for the dental and vision plans. We do not provide any supplemental medical coverage or subsidy to any executive officer. All employees hired prior to January 1, 2002 are eligible for retiree medical coverage.

USG Corporation Investment Plan (401(k) Plan): This qualified defined contribution plan allows employees to invest up to 20% of salary and annual incentive awards (subject to the maximum level of contribution set by the Internal Revenue Service) in one of nine investment alternatives. We match employee contributions. As part of our cost reduction initiatives, the employee match was reduced from $.50 per dollar contributed up to 6% of pay to $.25 per dollar contributed up to 6% of pay, effective January 1, 2009, and further reduced to $.10 per dollar contributed up to 6% of pay, effective January 1, 2011.

USG Corporation Retirement Plan: This qualified defined benefit plan provides a pension benefit based on the participant s years of credited service in the plan and the participant s final average pay. The plan requires participants to contribute 2% of pensionable earnings toward benefits. Participants can elect early retirement, with the benefit reduced 5% for each year earlier than age 65 at retirement. Participants who have a combined number of years of age and service equaling 90 can retire at age 62 without a reduction in the benefit or can

retire earlier than age 62 with a 3% reduction per year. We amended the plan to replace the final average pay formula with a cash balance formula for employees hired after December 31, 2010.

We also provide the following plans for our more highly compensated employees, including our executive officers, that provide benefits to supplement those provided under our Investment Plan and Retirement Plan.

Supplemental Retirement Plan

Approximately 130 employees, including our executive officers, participate in the USG Corporation Supplemental Retirement Plan. This plan restores the benefits which otherwise would be delivered under the USG Corporation Retirement Plan but for the limits on pensionable compensation set by the Internal Revenue Service.

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The provisions of this plan mirror those of the Retirement Plan, including benefit formulas, definition of final average pay (without Internal Revenue Service limits) and the requirement for the contribution of 2% of pensionable earnings. Further information regarding our retirement plans and the present value of the qualified and supplemental pension benefits for our named executive officers appears under the heading 2010 Pension Benefits Table beginning on page 42 of this proxy statement.

Deferred Compensation Plan

Approximately 65 employees, including one of our named executive officers, participate in the USG Corporation Deferred Compensation Plan. Due to the contribution limits set by the Internal Revenue Service applicable to the USG Corporation Investment Plan, this nonqualified plan is designed to allow highly compensated employees the opportunity to defer compensation (and thus current income tax) generally until after termination of employment with USG. We do not match deferred amounts. Those amounts are invested as directed by the participant into investment options that mirror those of the USG Corporation Investment Plan. We are obligated to pay the deferred amounts, plus or minus any accumulated earnings or losses on those amounts, to the participants following the termination of the deferral period. Further information regarding the deferred compensation plan for our named executive officers appears under the heading 2010 Nonqualified Deferred Compensation Table on page 44 of this proxy statement.

Perquisites and Other Benefits

We make certain perquisites and other benefits available to our executive officers as part of providing them a competitive total compensation package and to facilitate their attention to the demands of our business. Executive officers are offered a company automobile and office parking, financial planning services, personal liability insurance and executive death benefit coverage, an annual medical examination, and on a limited basis, membership in luncheon clubs. In addition, Mr. Foote has been provided with a company car and driver. The value of these benefits is described in more detail in the table titled Supplemental Table on page 36 of this proxy statement.

Employment Security and Potential Post Employment Payments

We provide all of our executive officers with two employment security arrangements an employment agreement and a change-in-control severance agreement.

Employment Agreements

We provide these agreements to assist in attracting and retaining executives, to protect our assets and intellectual property and to reduce the potential for litigation related to termination of employment. By setting the terms for the involuntary termination of an executive officer in advance of the termination, these agreements facilitate the Board s and the Chief Executive Officer s ability to effectuate smooth transitions in the executive team. The employment agreements generally provide named executive officers with two years of salary and bonus and lump sum payments equal to the cost of continued medical benefits for 18 months and the present value of providing an additional two years of service and two years of age credit under our retirement plans. The agreements provide these benefits only upon an involuntary termination of the named executive officer s employment without cause. We established these benefit levels after reviewing competitive market practices for employment agreements used by similar types of organizations for executives at similar levels. We believe that the level of benefits provided by our agreements is in line with market practice for those companies that utilize employment agreements.

Consistent with our paying two years compensation as severance, the agreements include a requirement that after termination of employment, the executive officer will not compete with us for two years or solicit our employees for three years. Executive officers are required to sign a release waiving potential claims against us before any payments

are made.

Change-In-Control Severance Agreements

We provide these agreements to promote neutrality of our executive officers during potential change in control transactions so they will make the best decision for our stockholders, to retain the executive team in the event of a

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potential change in control transaction, to protect our intellectual property and to reduce the potential for litigation related to termination of employment. The agreements in effect for our named executive officers generally provide them with three years (two years for Messrs. Griffin and Khan) of salary and bonus and lump sum payments equal to the cost of continued medical benefits for 18 months and the present value of providing an additional three years of service and three years of age credit (two years in each case for Messrs. Griffin and Khan) under our retirement plans. The agreements provide these benefits only in the event that there is both a change in control and an involuntary termination of the named executive officer s employment by the Company without cause or by the executive for good reason . The definition of change in control is the same as in the Plan. Good reason includes, among other things, a reduction in salary or a material diminution in duties, responsibilities or total compensation. The agreements include a modified gross up provision. If the total amounts payable to the executive officer would constitute a parachute payment resulting in the imposition of an excise tax, the payment will be reduced to the extent necessary to avoid being a parachute payment, unless the reduction would be more than 10% of the total amounts payable. In that case, the payment will be increased to provide the executive officer a net after tax amount equal to the value of the excise tax imposed.

As with our employment agreements, we established these benefits after reviewing competitive market practices for change in control agreements used by similar types of organizations for similar purposes. We believe that the level of benefits provided by our change in control severance agreements is also in line with market practice for organizations that use change in control agreements.

In consideration of our paying severance compensation, these agreements include a requirement that after termination of employment, the named executive officer will not compete with us for one year or solicit our employees for three years (two years for Messrs. Griffin and Khan). Executive officers are required to sign a release waiving potential claims against us before any payments are made under these agreements.

Further information regarding the benefits our current named executive officers could receive under these agreements is provided in the tables titled Potential Payments Upon Termination or Change in Control beginning on page 44 of this proxy statement.

Tax and Accounting Implications