

EATON CORP
Form 424B3
March 11, 2009

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The information in this prospectus supplement and the accompanying prospectus is not complete and may be changed. This prospectus supplement and the accompanying prospectus are not an offer to sell these securities and are not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

Filed Pursuant to Rule 424(b)(3)
File No: 333-157597

**SUBJECT TO COMPLETION
PRELIMINARY PROSPECTUS SUPPLEMENT DATED MARCH 11, 2009**

**PROSPECTUS SUPPLEMENT
(To Prospectus Dated February 27, 2009)**

\$
Eaton Corporation
% Notes due 2014

The % Notes due 2014 (the Notes) will bear interest from , 2009. Interest on the Notes will be payable semi-annually in arrears on and of each year, beginning on , 2009. The Notes will mature on , 2014. We may redeem the Notes, in whole or in part, at any time at the make-whole premium redemption price described under Description of Notes Optional Redemption in this prospectus supplement. If a Change of Control Triggering Event as described herein occurs, unless we have exercised our option to redeem the Notes by notifying the noteholders to that effect, we will be required to offer to repurchase the Notes at the price described in this prospectus supplement.

The Notes will be unsecured obligations of our company and will rank equally with all of our other senior unsecured indebtedness from time to time outstanding.

Investing in our Notes involves risks. See the Risk Factors section in our Annual Report on Form 10-K for the year ended December 31, 2008.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	Per Note	Total
Public Offering Price(1)	%	\$
Underwriting Discount	%	\$

Proceeds to Eaton Corporation (before expenses) % \$

(1) Plus accrued interest, if any, from March , 2009, if settlement occurs after that date.

The underwriters expect to deliver the Notes to investors in book-entry form only through the facilities of The Depository Trust Company for the accounts of its participants, including Clearstream Banking, société anonyme, Luxembourg (Clearstream Luxembourg) and/or Euroclear Bank S.A./N.V. (Euroclear), on or about March , 2009.

Joint Book-Running Managers

Banc of America Securities LLC

Goldman, Sachs & Co.

UBS Investment Bank

March , 2009

You should rely only on the information contained or incorporated by reference in this prospectus supplement, the accompanying prospectus and any permitted free writing prospectus prepared by us. We have not authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus supplement, the accompanying prospectus and the documents incorporated by reference is accurate only as of their respective dates. Our business, financial condition, results of operations and prospects may have changed since those dates.

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WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and special reports and other information with the Securities and Exchange Commission (SEC). You may read and copy any document we file at the SEC 's Public Reference Room at 100 F Street, N.E., Washington D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on its public reference rooms. Our SEC filings are also available to the public from the SEC 's web site at <http://www.sec.gov>. Our common shares are listed on the New York Stock Exchange and the Chicago Stock Exchange, and information about us is also available there.

This prospectus supplement is part of a registration statement that we have filed with the SEC. The SEC allows us to incorporate by reference the information we file with it, which means that we can disclose important information to you by referring you to other documents that we identify as part of this prospectus supplement. Our subsequent filings of similar documents with the SEC will automatically update and supersede this information. We incorporate by reference the documents listed below and any future filings we make with the SEC under Sections 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), until we sell all of these securities.

Annual Report on Form 10-K for the year ended December 31, 2008.

Current Reports on Form 8-K filed on January 28, 2009 (two filings) and March 2, 2009.

You may obtain a copy of these filings at no cost by writing to or telephoning us at the following address:

Eaton Corporation
Eaton Center
1111 Superior Avenue
Cleveland, Ohio 44114-2584
(216) 523-5000

You should rely only on the information incorporated by reference or provided in this prospectus supplement and the accompanying prospectus. We have not authorized anyone else to provide you with different information. This prospectus supplement is an offer to sell or buy only the securities described in this document, but only under circumstances and in jurisdictions where it is lawful to do so. The information contained in this prospectus supplement is current only as of the date of this prospectus supplement.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

Some of the statements included or incorporated by reference in the accompanying prospectus or this prospectus supplement constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as expects , intends , plans , projects , believes , estimates , anticipates and variations of similar expressions are used to identify these forward-looking statements. These forward-looking statements refer to, among other things, our plans, strategies and prospects, both business and financial. Although we believe that our plans, intentions and expectations reflected in or suggested by these forward-looking statements are reasonable, we can give no assurance that we will achieve or realize these plans, intentions or expectations. Forward-looking statements are inherently subject to risks, uncertainties and assumptions. Important factors that could cause actual results to differ materially from the forward-looking statements we make in those documents are set forth in those documents, and include those described under Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2008. All forward-looking statements attributable to us or persons acting on our behalf are

expressly qualified by those cautionary statements. We will not update these forward-looking statements even though our situation will change in the future.

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SUMMARY

This summary may not contain all of the information that may be important to you. You should read the entire prospectus supplement and the accompanying prospectus, as well as the documents incorporated by reference into this prospectus supplement and the accompanying prospectus, before making an investment decision.

The Company

We are a diversified power management company with 2008 sales of \$15.4 billion. We are a global technology leader in: electrical components and systems for power quality, distribution and control; hydraulics components, systems and services for industrial and mobile equipment; aerospace fuel, hydraulics and pneumatic systems for commercial and military use; and truck and automotive drivetrain and powertrain systems for performance, fuel economy and safety. We have approximately 75,000 employees and sell products to customers in more than 150 countries.

Our principal executive office is located at Eaton Center, 1111 Superior Avenue, Cleveland, Ohio 44114-2584, and our telephone number is (216) 523-5000.

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USE OF PROCEEDS

We expect the net proceeds from the sale of the Notes offered hereby to be approximately \$ million, after deducting underwriting discounts and commission and offering expenses. We will use these proceeds to repay commercial paper having an average maturity of 16 days and bearing an average interest rate of 0.75% as of February 27, 2009.

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The following table sets forth the capitalization of Eaton and its consolidated subsidiaries at December 31, 2008. The As Adjusted capitalization set forth below gives effect to the issuance of the Notes offered hereby.

	As of December 31, 2008	
	Unaudited	
	Historical	As Adjusted
	Millions	
Short-term debt	\$ 812	\$
Current portion of long-term debt	269	269
Total short-term debt and current portion of long-term debt	\$ 1,081	\$
Long-term debt		
Floating rate senior notes due 2010	281	281
5.75% Notes due 2012	300	300
7.58% Notes due 2012	12	12
4.90% Notes due 2013	300	300
5.80% Notes due 2013	7	7
12.5% British Pound Debentures due 2014	8	8
4.65% Notes due 2015	100	100
5.30% Notes due 2017	250	250
7.09% Notes due 2018	25	25
6.89% Notes due 2018	6	6
7.07% Notes due 2018	2	2
6.875% Notes due 2018	3	3
5.60% Notes due 2018	450	450
4.215% Japan Yen Notes due 2018	110	110
87/8% Debentures due 2019	38	38
8.10% Debentures due 2022	100	100
7.625% Debentures due 2024	66	66
6 1/2% Debentures due 2025	145	145
7.875% Debentures due 2026	72	72
7.65% Debentures due 2029	200	200
5.45% Debentures due 2034	150	150
5.25% Notes due 2035	72	72
5.80% Notes due 2037	240	240
% Notes due 2014 offered hereby		
Other	253	253
Total long-term debt	3,190	
Shareholders' equity		
Common Shares	82	82
Capital in excess of par value	3,879	3,879
Retained earnings	3,917	3,917

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Accumulated other comprehensive loss	(1,538)	(1,538)
Deferred compensation plans	(23)	(23)
Total shareholders' equity	6,317	6,317
Total capitalization (long-term debt and shareholders' equity)	\$ 9,507	\$

Eaton's authorized capital as of December 31, 2008 consisted of common shares, par value \$0.50 per share (500 million shares authorized and 165.0 million shares outstanding).

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DESCRIPTION OF NOTES

General

The following description of the particular terms of the Notes offered hereby supplements the description of the general terms and provisions of debt securities under the heading "Description of Debt Securities" in the accompanying prospectus. Capitalized terms used in this section of this prospectus supplement that are otherwise not defined have the meanings given to them in the accompanying prospectus.

The Notes will be senior unsecured debt issued under the Indenture dated as of April 1, 1994, as supplemented from time to time (the "Senior Indenture"), between us and The Bank of New York Mellon Trust Company, N.A., as successor to JPMorgan Chase Bank, N.A. (formerly known as Chemical Bank), as Senior Trustee. The Notes will rank equally with all our other senior unsecured indebtedness from time to time outstanding. The Notes will constitute a separate series of securities under the Senior Indenture.

We will issue the Notes in the aggregate principal amount of \$ _____ million. The Notes will mature on _____, 2014. We will issue the Notes only in book-entry form, in denominations of \$2,000 and integral multiples of \$1,000 in excess of \$2,000. The Notes will not be subject to any sinking fund and will not be convertible into or exchangeable for any of our equity interests.

We may, without the consent of the holders of the Notes, issue additional debt securities having the same ranking and the same interest rate, maturity and other terms as the Notes. Any such additional debt securities and the Notes will constitute a single series under the Senior Indenture. None of these additional Notes may be issued if an Event of Default has occurred and is continuing with respect to the Notes.

Principal and Interest

The Notes will mature on _____, 2014, bear interest at the annual rate shown on the cover of this prospectus supplement and accrue interest from March _____, 2009 or from the most recent date to which interest has been paid or provided for. Interest will be payable semi-annually, on _____ and _____, beginning on _____, 2009, to each person in whose name the Notes are registered at the close of business on the _____ and _____ (whether or not that date is a business day as that term is defined in the Senior Indenture), as the case may be, immediately preceding the interest payment date. We will compute interest on the Notes on the basis of a 360-day year consisting of twelve 30-day months. If any interest payment date or maturity or redemption date falls on a day that is not a business day, then the payment will be made on the next business day without additional interest and with the same effect as if it were made on the originally scheduled date.

Optional Redemption

All or a portion of the Notes may be redeemed at our option at any time or from time to time. The redemption price for the Notes to be redeemed on any redemption date will be equal to the greater of the following amounts:

100% of the principal amount of the Notes being redeemed on the redemption date; and

the sum of the present values of the remaining scheduled payments of principal and interest on the Notes being redeemed on that redemption date (not including any portion of any payments of interest accrued to the redemption date), discounted to the redemption date on a semi-annual basis (assuming a 360-day year

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consisting of twelve 30-day months) at the Treasury Rate (as defined below), plus basis points, as determined by the Quotation Agent (as defined below),

plus, in each case, accrued and unpaid interest on the Notes to the redemption date. Notwithstanding the foregoing, installments of interest on the Notes that are due and payable on interest payment dates falling on or prior to a redemption date will be payable on the interest payment date to the registered holders as of the close of business on the relevant record date according to the Notes and the Senior Indenture.

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We will mail notice of any redemption to each registered holder of the Notes at least 30 days but not more than 60 days before the redemption date. Once notice of redemption is mailed, the Notes will become due and payable on the redemption date and at the applicable redemption price, plus accrued and unpaid interest to the redemption date.

Treasury Rate means, with respect to any redemption date, the rate per annum equal to the semi-annual equivalent yield to maturity of the Comparable Treasury Issue, assuming a price for the Comparable Treasury Issue (expressed as a percentage of its principal amount) equal to the Comparable Treasury Price for the redemption date. The Treasury Rate will be determined on the third business day prior to the redemption date.

Comparable Treasury Issue means the United States Treasury security selected by the Quotation Agent as having a maturity comparable to the remaining term of the Notes that would be utilized, at the time of selection and in accordance with customary financial practice, in pricing new issues of corporate debt securities of comparable maturity to the remaining term of the Notes.

Comparable Treasury Price means, with respect to any redemption date, (A) the average of the Reference Treasury Dealer Quotations for the redemption date, after excluding the highest and lowest of those Reference Treasury Dealer Quotations, or (B) if the Quotation Agent obtains fewer than three such Reference Treasury Dealer Quotations, the average of all those Quotations, or (C) if only one Reference Treasury Dealer Quotation is received, that Quotation.

Quotation Agent means a Reference Treasury Dealer selected by us for the purpose of performing the functions of the Quotation Agent with respect to the Notes.

Reference Treasury Dealer means (A) (i) Banc of America Securities LLC, (ii) Goldman, Sachs & Co. or (iii) UBS Securities LLC (or their respective affiliates which are Primary Treasury Dealers) and their respective successors; provided, however, that if any of them ceases to be a primary U.S. Government securities dealer in the United States (a Primary Treasury Dealer), we will substitute for them another Primary Treasury Dealer; and (B) any other Primary Treasury Dealer(s) we select.

Reference Treasury Dealer Quotation means, with respect to each Reference Treasury Dealer and any redemption date, the average, as determined by the Quotation Agent, of the bid and asked prices for the Comparable Treasury Issue (expressed in each case as a percentage of its principal amount) quoted in writing to the Quotation Agent by such Reference Treasury Dealer at 5:00 p.m. (New York City time) on the third business day preceding the redemption date.

On and after the redemption date, interest will cease to accrue on the Notes or any portion of the Notes called for redemption (unless we default in the payment of the redemption price and accrued interest). On or before the redemption date, we will deposit with a paying agent (or the trustee) money sufficient to pay the redemption price of and accrued interest on the Notes to be redeemed on that date. If less than all of the Notes are to be redeemed, the Notes to be redeemed shall be selected by lot by DTC, in the case of Notes represented by a global security, or by the trustee by a method the trustee deems to be fair and appropriate, in the case of Notes that are not represented by a global security.

Change of Control Offer

If a Change of Control Triggering Event occurs, unless we have exercised our option to redeem the Notes by notifying the noteholders to that effect as described above, we will be required to make an offer (a Change of Control Offer) to each holder of the Notes to repurchase all or any part (equal to \$2,000 or an integral multiple of \$1,000 in excess of \$2,000) of that holder's Notes on the terms set forth in the Notes. In a Change of Control Offer, we will be required to offer payment in cash equal to 101% of the aggregate principal amount of the Notes repurchased, plus accrued and

unpaid interest, if any, on the Notes repurchased to the date of repurchase (a Change of Control Payment). Within 30 days following any Change of Control Triggering Event or, at our option, prior to any Change of Control, but after public announcement of the transaction that constitutes or may constitute the Change of Control, a notice will be mailed to holders of the Notes, describing the transaction that constitutes or may constitute the Change of Control Triggering Event and offering to repurchase the Notes on the date specified in the notice, which date will be no earlier than

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30 days and no later than 60 days from the date that notice is mailed (a Change of Control Payment Date). The notice will, if mailed prior to the date of consummation of the Change of Control, state that the Change of Control Offer is conditioned on the Change of Control Triggering Event occurring on or prior to the applicable Change of Control Payment Date.

On each Change of Control Payment Date, we will, to the extent lawful:

accept for payment all Notes or portions of Notes properly tendered pursuant to the applicable Change of Control Offer;

deposit with the paying agent an amount equal to the Change of Control Payment in respect of all Notes or portions of Notes properly tendered; and

deliver or cause to be delivered to the trustee the Notes properly accepted together with an officers certificate stating the aggregate principal amount of Notes or portions of Notes being repurchased and that all conditions precedent provided for in the Senior Indenture to the Change of Control Offer and to the repurchase by the Company of the Notes pursuant to the Change of Control Offer have been met.

We will not be required to make a Change of Control Offer upon the occurrence of a Change of Control Triggering Event if a third party makes such an offer in the manner, at the times and otherwise in compliance with the requirements for an offer made by us and the third party repurchases all Notes properly tendered and not withdrawn under its offer. In addition, we will not repurchase any Notes if there has occurred and is continuing on the Change of Control Payment Date an event of default under the Senior Indenture, other than a default in the payment of the Change of Control Payment upon a Change of Control Triggering Event.

We will comply with the requirements of Rule 14e-1 under the Exchange Act and any other securities laws and regulations thereunder to the extent those laws and regulations are applicable in connection with the repurchase of the Notes as a result of a Change of Control Triggering Event. To the extent that the provisions of any such securities laws or regulations conflict with the Change of Control Offer provisions of the Notes, we will comply with those securities laws and regulations and will not be deemed to have breached our obligations under the Change of Control Offer provisions of the Notes by virtue of any such conflict.

For purposes of the Change of Control Offer provisions of the Notes, the following terms will be applicable:

Change of Control means the occurrence of any of the following: (1) the direct or indirect sale, lease, transfer, conveyance or other disposition (other than by way of merger or consolidation), in one or more series of related transactions, of all or substantially all of our assets and the assets of our subsidiaries, taken as a whole, to any person, other than our company or one of our subsidiaries; (2) the consummation of any transaction (including, without limitation, any merger or consolidation) the result of which is that any person becomes the beneficial owner (as defined in Rules 13d-3 and 13d-5 under the Exchange Act), directly or indirectly, of more than 50% of our outstanding Voting Stock or other Voting Stock into which our Voting Stock is reclassified, consolidated, exchanged or changed, measured by voting power rather than number of shares; (3) we consolidate with, or merge with or into, any person, or any person consolidates with, or merges with or into, us, in any such event pursuant to a transaction in which any of our outstanding Voting Stock or the Voting Stock of such other person is converted into or exchanged for cash, securities or other property, other than any such transaction where the shares of our Voting Stock outstanding immediately prior to such transaction constitute, or are converted into or exchanged for, a majority of the Voting Stock of the surviving person or any direct or indirect parent company of the surviving person immediately after giving effect to such transaction; (4) the first day on which a majority of the members of our Board of Directors are not Continuing Directors; or (5) the adoption of a plan relating to our liquidation or dissolution. Notwithstanding the

foregoing, a transaction will not be deemed to involve a Change of Control under clause (2) above if (i) we become a direct or indirect wholly-owned subsidiary of a holding company and (ii)(A) the direct or indirect holders of the Voting Stock of such holding company immediately following that transaction are substantially the same as the holders of our Voting Stock immediately prior to that transaction or (B) immediately following that transaction no person (other than a holding company satisfying the requirements of this sentence) is the beneficial owner, directly or indirectly, of more than 50% of the Voting Stock of such holding company. The

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term *person*, as used in this definition, has the meaning given thereto in Section 13(d)(3) of the Exchange Act.

Change of Control Triggering Event means the occurrence of both a Change of Control and a Rating Event.

Continuing Directors means, as of any date of determination, any member of our Board of Directors who (1) was a member of our Board of Directors on the date the Notes were issued or (2) was nominated for election, elected or appointed to our Board of Directors with the approval of a majority of the Continuing Directors who were members of our Board of Directors at the time of the nomination, election or appointment (either by a specific vote or by approval of our proxy statement in which that member was named as a nominee for election as a director, without objection to the nomination).

Fitch means Fitch Inc., and its successors.

Investment Grade Rating means a rating equal to or higher than Baa3 (or the equivalent) by Moody's, BBB- (or the equivalent) by S&P and BBB- (or the equivalent) by Fitch, and the equivalent investment grade credit rating from any replacement rating agency or rating agencies selected by us.

Moody's means Moody's Investors Service, Inc., and its successors.

Rating Agencies means (1) each of Moody's, S&P and Fitch; and (2) if any of Moody's, S&P or Fitch ceases to rate the Notes or fails to make a rating of the Notes publicly available for reasons beyond our control, a nationally recognized statistical rating organization within the meaning of Rule 15c3-1(c)(2)(vi)(F) under the Exchange Act selected by us (as certified by a resolution of our Board of Directors) as a replacement agency for Moody's, S&P or Fitch, or all of them, as the case may be.

Rating Event means the rating on the Notes is lowered by at least two of the three Rating Agencies and the Notes are rated below an Investment Grade Rating by at least two of the three Rating Agencies, in any case on any day during the period (which period will be extended so long as the rating of the Notes is under publicly announced consideration for a possible downgrade by any of the Rating Agencies) commencing 60 days prior to the first public notice of the occurrence of a Change of Control or our intention to effect a Change of Control and ending 60 days following consummation of such Change of Control.

S&P means Standard & Poor's Rating Services, a division of The McGraw-Hill Companies, Inc., and its successors.

Voting Stock means, with respect to any specified *person* (as that term is used in Section 13(d)(3) of the Exchange Act) as of any date, the capital stock of that person that is at the time entitled to vote generally in the election of the board of directors of that person.

Defeasance and Covenant Defeasance

In some circumstances, we may elect to discharge our obligations on the Notes through defeasance or covenant defeasance. See *Description of Debt Securities - Defeasance and Covenant Defeasance* in the accompanying prospectus for more information about how we may do this.

Book-Entry System

We will issue the Notes in the form of one or more fully registered global securities, as described in *Description of Debt Securities - Book-Entry Debt Securities* in the accompanying prospectus. We will deposit these global securities with, or on behalf of, The Depository Trust Company, New York, New York (*DTC*), and register these securities in

the name of DTC's nominee.

Investors may elect to hold interests in the Notes in global form through either DTC in the United States or Clearstream Banking, société anonyme (Clearstream, Luxembourg) or Euroclear Bank S.A./N.V, as operator of the Euroclear System (the Euroclear System), in Europe if they are participants in those systems, or indirectly through organizations which are participants in those systems. Clearstream, Luxembourg and the Euroclear System will hold interests on behalf of their participants through customers' securities accounts in

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Clearstream, Luxembourg's and the Euroclear System's names on the books of their respective depositaries, which in turn will hold those interests in customers' securities accounts in the depositaries' names on the books of DTC. Citibank, N.A. will act as depositary for Clearstream, Luxembourg and JP Morgan Chase Bank will act as depositary for the Euroclear System (in those capacities, the U.S. Depositaries).

DTC advises that it is a limited-purpose trust company organized under the New York Banking Law, a banking organization within the meaning of the New York Banking Law, a member of the Federal Reserve System, a clearing corporation within the meaning of the New York Uniform Commercial Code and a clearing agency registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds securities that its participants (the DTC Participants) deposit with DTC. DTC also facilitates the settlement among participants of securities transactions, including transfers and pledges, in deposited securities through electronic computerized book-entry changes in participants' accounts, thereby eliminating the need for physical movement of securities certificates. Direct participants include securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations. DTC is owned by a number of its direct participants and by the New York Stock Exchange, the American Stock Exchange, Inc., and the National Association of Securities Dealers, Inc. Access to DTC's system is also available to others, including securities brokers and dealers, banks and trust companies that clear transactions through or maintain a direct or indirect custodial relationship with a direct participant, either directly or indirectly. The rules applicable to DTC and its participants are on file with the SEC.

Clearstream, Luxembourg advises that it is organized under the laws of Luxembourg as a professional depositary. Clearstream, Luxembourg holds securities for its participating organizations (Clearstream Participants) and facilitates the clearance and settlement of securities transactions between Clearstream Participants through electronic book-entry changes in accounts of Clearstream Participants, thereby eliminating the need for physical movement of certificates. Clearstream, Luxembourg provides to Clearstream Participants, among other things, services for safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Clearstream, Luxembourg interfaces with domestic markets in several countries. As a professional depositary, Clearstream, Luxembourg is subject to regulation by the Luxembourg Commission for the Supervision of the Financial Sector (Commission de Surveillance du Secteur Financier). Clearstream Participants are recognized financial institutions around the world, including underwriters, securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations and may include the underwriters. Indirect access to Clearstream, Luxembourg is also available to others, such as banks, brokers, dealers and trust companies that clear through or maintain a custodial relationship with a Clearstream Participant, either directly or indirectly.

Distributions with respect to interests in the Notes held beneficially through Clearstream, Luxembourg will be credited to cash accounts of Clearstream Participants in accordance with its rules and procedures, to the extent received by the U.S. Depositary for Clearstream, Luxembourg.

The Euroclear System advises that it was created in 1968 to hold securities for participants of the Euroclear System (Euroclear Participants) and to clear and settle transactions between Euroclear Participants through simultaneous electronic book-entry delivery against payment, thereby eliminating the need for physical movement of certificates and any risk from lack of simultaneous transfers of securities and cash. The Euroclear System includes various other services, including securities lending and borrowing and interfaces with domestic markets in several countries. The Euroclear System is operated by Euroclear Bank S.A./N.V. (the Euroclear Operator). All operations are conducted by the Euroclear Operator, and all Euroclear securities clearance accounts and Euroclear System cash accounts are accounts with the Euroclear Operator. Euroclear Participants include banks (including central banks), securities brokers and dealers and other professional financial intermediaries and may include the underwriters. Indirect access to the Euroclear System is also available to other firms that clear through or maintain a custodial relationship with a Euroclear Participant, either directly or indirectly.

Securities clearance accounts and cash accounts with the Euroclear Operator are governed by the Terms and Conditions Governing Use of Euroclear and the related Operating Procedures of the Euroclear System, and applicable Belgian law (collectively, the Terms and Conditions). The Terms and Conditions govern

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transfers of securities and cash within the Euroclear System, withdrawals of securities and cash from the Euroclear System, and receipts of payments with respect to securities in the Euroclear System. All securities in the Euroclear System are held on a fungible basis without attribution of specific certificates to specific securities clearance accounts. The Euroclear Operator acts under the Terms and Conditions only on behalf of Euroclear Participants, and has no records of or relationship with persons holding through Euroclear Participants.

Distributions with respect to the Notes held beneficially through the Euroclear System will be credited to the cash accounts of Euroclear Participants in accordance with the Terms and Conditions, to the extent received by the U.S. Depositary for the Euroclear System.

We will issue the Notes in definitive certificated form if DTC notifies us that it is unwilling or unable to continue as depositary or DTC ceases to be a clearing agency registered under the Exchange Act and we do not appoint a successor depositary within 90 days. In addition, beneficial interests in a global security certificate may be exchanged for definitive Note certificates upon request by or on behalf of DTC in accordance with customary procedures following the request of a beneficial owner seeking to exercise or enforce its rights under those Notes. If we determine at any time that the Notes shall no longer be represented by global security certificates, we will inform DTC of our determination, and DTC will, in turn, notify participants of their right to withdraw their beneficial interests from the global security certificates. If those participants elect to withdraw their beneficial interests, we will issue certificates in definitive form in exchange for the beneficial interests in the global security certificates. Any global security certificate, or portion thereof, that is exchangeable pursuant to this paragraph will be exchangeable for Note certificates, as the case may be, registered in the names directed by DTC. We expect that these instructions will be based upon directions received by DTC from its participants with respect to ownership of beneficial interests in the global security certificates.

As long as DTC or its nominee is the registered owner of the global security certificates, DTC or its nominee, as the case may be, will be considered the sole owner and holder of the global security certificates and all Notes represented by these certificates for all purposes under the Notes and the Senior Indenture governing the Notes. Except in the limited circumstances referred to above, owners of beneficial interests in global security certificates:

will not be entitled to have the Notes represented by these global security certificates registered in their names, and

will not be considered to be owners or holders of the global security certificates or any Notes represented by these certificates for any purpose under the Notes or the junior subordinated indenture governing the Notes.

All payments on the Notes represented by the global security certificates and all transfers and deliveries of related Notes will be made to the depositary or its nominee, as the case may be, as the holder of the securities.

Ownership of beneficial interests in the global security certificates will be limited to participants or persons that may hold beneficial interests through institutions that have accounts with DTC or its nominee. Ownership of beneficial interests in global security certificates will be shown only on, and the transfer of those ownership interests will be effected only through, records maintained by DTC or its nominee, with respect to participants' interests, or any participant, with respect to interests of persons held by the participant on their behalf. Payments, transfers, deliveries, exchanges and other matters relating to beneficial interests in global security certificates may be subject to various policies and procedures adopted by DTC from time to time. Neither we nor the trustee will have any responsibility or liability for any aspect of DTC's or any participant's records relating to, or for payments made on account of, beneficial interests in global security certificates, or for maintaining, supervising or reviewing any of DTC's records or any participant's records relating to these beneficial ownership interests.

Although DTC has agreed to the foregoing procedures in order to facilitate transfers of interests in the global security certificates among participants, DTC is under no obligation to perform or continue to perform

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these procedures, and these procedures may be discontinued at any time. We will not have any responsibility for the performance by DTC or its direct participants or indirect participants under the rules and procedures governing DTC.

The information in this section concerning DTC, its book-entry system, Clearstream, Luxembourg and the Euroclear System has been obtained from sources that we believe to be reliable, but we have not attempted to verify the accuracy of this information.

Global Clearance and Settlement Procedures

Initial settlement for the Notes will be made in immediately available funds. Secondary market trading between DTC Participants will occur in the ordinary way in accordance with DTC rules and will be settled in immediately available funds using DTC's Same-Day Funds Settlement System. Secondary market trading among Clearstream Participants and/or Euroclear Participants will occur in the ordinary way in accordance with the applicable rules and operating procedures of Clearstream, Luxembourg and the Euroclear System, as applicable.

Cross-market transfers between persons holding directly or indirectly through DTC on the one hand, and directly or indirectly through Clearstream Participants or Euroclear Participants, on the other, will be effected through DTC in accordance with DTC rules on behalf of the relevant European international clearing system by its U.S. Depository; however, such cross-market transactions will require delivery of instructions to the relevant European international clearing system by the counterparty in that system in accordance with its rules and procedures and within its established deadlines (European time). The relevant European international clearing system will, if the transaction meets its settlement requirements, deliver instructions to its U.S. Depository to take action to effect final settlement on its behalf by delivering or receiving securities in DTC, and making or receiving payment in accordance with normal procedures for same-day funds settlement applicable to DTC. Clearstream Participants and Euroclear Participants may not deliver instructions directly to their respective U.S. Depositories.

Because of time-zone differences, credits of Notes received in Clearstream, Luxembourg or the Euroclear System as a result of a transaction with a DTC Participant will be made during subsequent securities settlement processing and dated the business day following the DTC settlement date. The credits or any transactions in the Notes settled during the processing will be reported to the relevant Euroclear Participant or Clearstream Participant on that business day. Cash received in Clearstream, Luxembourg or the Euroclear System as a result of sales of the Notes by or through a Clearstream Participant or a Euroclear Participant to a DTC Participant will be received with value on the DTC settlement date but will be available in the relevant Clearstream, Luxembourg or the Euroclear System cash account only as of the business day following settlement in DTC.

Although DTC, Clearstream, Luxembourg and the Euroclear System have agreed to the foregoing procedures in order to facilitate transfers of Notes among participants of DTC, Clearstream, Luxembourg and the Euroclear System, they are under no obligation to perform or continue to perform those procedures and those procedures may be discontinued or changed at any time.

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CERTAIN U.S. FEDERAL INCOME TAX CONSIDERATIONS TO NON-U.S. HOLDERS

Prospective investors should consult their professional advisors on the possible tax consequences of buying, holding or selling any Notes under the laws of their country of citizenship, residence or domicile. If you are a foreign person, please see the discussion in the accompanying prospectus under the heading **United States Federal Taxation Non-United States Holders** for a description of certain United States federal tax requirements and considerations for persons outside of the United States that invest in the Notes.

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Table of Contents**UNDERWRITING**

Banc of America Securities LLC, Goldman, Sachs & Co. and UBS Securities LLC are acting as joint book-running managers of the offering of the Notes and are acting as representatives of the underwriters named below.

Subject to the terms and conditions stated in the underwriting agreement, dated the date of this prospectus supplement, each underwriter named below has severally agreed to purchase, and we have agreed to sell to that underwriter, the principal amount of the Notes set forth opposite the underwriter's name.

Underwriter	Principal Amount of Notes
Banc of America Securities LLC	\$
Goldman, Sachs & Co.	
UBS Securities LLC	
Total	\$

The underwriting agreement provides that the obligations of the underwriters to purchase the Notes included in this offering are subject to approval of legal matters by counsel and to other conditions. The underwriters are obligated to purchase all the Notes if they purchase any of the Notes.

The underwriters propose to offer some of the Notes directly to the public at the public offering price set forth on the cover page of this prospectus supplement and some of the Notes to dealers at the public offering price less a concession not to exceed % of the principal amount of the Notes. The underwriters may allow, and dealers may reallocate, a concession not to exceed % of the principal amount of the Notes. If all the Notes are not sold at the initial offering price, the underwriters may change the offering price and the other selling terms. The offering of the Notes by the underwriters is subject to receipt and acceptance and subject to the underwriters' right to reject any order in whole or in part.

In connection with the offering, the representatives, on behalf of the underwriters, may purchase and sell Notes in the open market. These transactions may include over-allotment, syndicate covering transactions and stabilizing transactions. Over-allotment involves syndicate sales of Notes in excess of the principal amount of Notes to be purchased by the underwriters in the offering, which creates a syndicate short position. Syndicate covering transactions involve purchases of the Notes in the open market after the distribution has been completed in order to cover syndicate short positions. Stabilizing transactions consist of certain bids or purchases of Notes made for the purpose of preventing or retarding a decline in the market price of the Notes while the offering is in progress.

The underwriters also may impose a penalty bid. Penalty bids permit the underwriters to reclaim a selling concession from a syndicate member when the representatives, in covering syndicate short positions or making stabilizing

purchases, repurchase Notes originally sold by that syndicate member.

Any of these activities may have the effect of preventing or retarding a decline in the market price of the Notes. They may also cause the price of the Notes to be higher than the price that otherwise would exist in the open market in the absence of these transactions. The underwriters may conduct these transactions in the over-the-counter market or otherwise. If the underwriters commence any of these transactions, they may discontinue them at any time.

We estimate that our total expenses for this offering will be approximately \$350,000.

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The underwriters have performed commercial banking, investment banking and advisory services for us from time to time for which they have received customary fees and expenses. The underwriters may, from time to time, engage in transactions with and perform services for us in the ordinary course of their business. In addition, certain of the underwriters or their respective affiliates are dealers in our commercial paper program and are lenders under one or more of our credit facilities.

We have agreed to indemnify the underwriters against certain liabilities, including liabilities under the Securities Act of 1933, or to contribute to payments the underwriters may be required to make because of any of those liabilities.

Notice to Prospective Investors in the European Economic Area

In relation to each member state of the European Economic Area that has implemented the Prospectus Directive (each, a relevant member state), with effect from and including the date on which the Prospectus Directive is implemented in that relevant member state (the relevant implementation date), an offer of the Notes described in this prospectus supplement may not be made to the public in that relevant member state prior to the publication of a prospectus in relation to the Notes that has been approved by the competent authority in that relevant member state or, where appropriate, approved in another relevant member state and notified to the competent authority in that relevant member state, all in accordance with the Prospectus Directive, except that, with effect from and including the relevant implementation date, an offer of securities may be offered to the public in that relevant member state at any time:

to any legal entity that is authorized or regulated to operate in the financial markets or, if not so authorized or regulated, whose corporate purpose is solely to invest in securities or

to fewer than 100 natural or legal persons (other than qualified investors as defined in the Prospectus Directive) subject to obtaining the prior consent of the representatives for any such offer or

to any legal entity that has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet net worth of more than 43,000,000 and (3) an annual net turnover of more than 50,000,000, as shown in its last annual or consolidated accounts or

in any other circumstances that do not require the publication of a prospectus pursuant to Article 3 of the Prospectus Directive.

Each purchaser of Notes described in this prospectus supplement who is located within a relevant member state will be deemed to have represented, acknowledged and agreed that it is a qualified investor within the meaning of Article 2(1)(e) of the Prospectus Directive.

For purposes of this provision, the expression an offer to the public in any relevant member state means the communication in any form and by any means of sufficient information on the terms of the offer and the securities to be offered so as to enable an investor to decide to purchase or subscribe the securities, as the expression may be varied in that member state by any measure implementing the Prospectus Directive in that member state, and the expression Prospectus Directive means Directive 2003/71/EC and includes any relevant implementing measure in each relevant member state.

The sellers of the Notes have not authorized and do not authorize the making of any offer of the Notes through any financial intermediary on their behalf, other than offers made by the underwriters with a view to the final placement of the Notes as contemplated in this prospectus supplement. Accordingly, no purchaser of the Notes, other than the underwriters, is authorized to make any further offer of the Notes on behalf of the sellers or the underwriters.

Notice to Prospective Investors in the United Kingdom

Each representative represents and warrants that:

- (a) (i) it is a person whose ordinary activities involve it in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of its business and (ii) it has not offered or sold

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and will not offer or sell any Notes other than to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or as agent) for the purposes of their businesses or who it is reasonable to expect will acquire, hold, manage or dispose of investments (as principal or agent) for the purposes of their businesses where the issue of the Notes would otherwise constitute a contravention of Section 19 of the FSMA by the issuer;

(b) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of any Notes in circumstances in which Section 21(1) of the FSMA does not apply to the issuer;

(c) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the Notes in, from or otherwise involving the United Kingdom.

This prospectus supplement and the accompanying prospectus are only being distributed to, and are only directed at, persons in the United Kingdom that are qualified investors within the meaning of Article 2(1)(e) of the Prospectus Directive (Qualified Investors) that are also (i) investment professionals falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the Order) or (ii) high net worth entities, and other persons to whom it may lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as relevant persons). This prospectus supplement, the accompanying prospectus and their contents are confidential and should not be distributed, published or reproduced (in whole or in part) or disclosed by recipients to any other persons in the United Kingdom. Any person in the United Kingdom that is not a relevant person should not act or rely on this document or any of its contents.

UK Stabilisation

In connection with this offering, the representatives (or any person or persons acting on their behalves), may over-allot or effect transactions with a view to supporting the market price of the Notes at a level higher than that which might otherwise prevail for a limited period after the issue date. However, there may be no obligation on the representatives to do this. Such stabilising, if commenced, may be discontinued at any time, and must be brought to an end after a limited period.

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LEGAL OPINIONS

The validity of the Notes will be passed upon for our company by Mark Hennessey, Deputy General Counsel and Assistant Secretary and for the underwriters by Shearman & Sterling LLP, New York, New York. Mr. Hennessey is paid a salary by our company and participates in various employee benefit plans offered to certain employees of our company generally.

EXPERTS

Our consolidated financial statements appearing in our Annual Report on Form 10-K for the year ended December 31, 2008, and the effectiveness of our internal control over financial reporting as of December 31, 2008 have been audited by Ernst & Young LLP, independent registered public accounting firm, as set forth in their reports thereon, included therein, and incorporated herein by reference. Such consolidated financial statements are incorporated herein by reference in reliance upon such reports given on the authority of such firm as experts in accounting and auditing.

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Eaton Corporation

Senior Debt Securities
Subordinated Debt Securities
Preferred Shares
Common Shares
Warrants
Units

We may offer and sell, from time to time, in one or more offerings, senior or subordinated debt securities, preferred shares, common shares and warrants, as well as units that include any of these securities or securities of other entities. The debt securities, preferred shares and warrants may be convertible into or exercisable or exchangeable for common or preferred shares or other securities of the Company or debt or equity securities of one or more other entities. We may offer and sell these securities to or through one or more underwriters, dealers and agents, or directly to purchasers, on a continuous or delayed basis.

The specific terms of any securities to be offered will be described in a prospectus supplement or term sheet. You should read this prospectus and the accompanying prospectus supplement or term sheet carefully before you invest in our securities.

The common shares of the Company are listed on the NYSE and the Chicago Stock Exchange and trade under the ticker symbol ETN .

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.

The date of this prospectus is February 27, 2009.

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ABOUT THIS PROSPECTUS

The information contained in this prospectus is not complete and may be changed. You should rely only on the information provided in or incorporated by reference in this prospectus, any prospectus supplement or other offering materials. We have not authorized anyone else to provide you with different information. We are not making an offer of any securities in any jurisdiction where the offer is not permitted. You should not assume that the information in this prospectus, any prospectus supplement, other offering materials or any document incorporated by reference is accurate as of any date other than the date of the document in which such information is contained or such other date referred to in such document, regardless of the time of any sale or issuance of a security.

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission (the SEC) using a shelf registration process. This prospectus contains a general description of the securities we may offer. Each time we sell or issue securities, we will provide a prospectus supplement or term sheet that will contain specific information about the terms of that offering and the manner in which they may be offered. The prospectus supplement or term sheet may also add to, update or change information contained in this prospectus. If so, the prospectus supplement or term sheet should be read as superseding this prospectus. You should read both this prospectus and any prospectus supplement or term sheet, together with additional information described under the heading **Where You Can Find More Information** , before making an investment decision. As used in this prospectus, the terms **we**, **us** and **our** refer to Eaton Corporation.

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and special reports, proxy statements and other information with the SEC. You may read and copy any document we file at the SEC's public reference room at 100 F Street, N.E., Washington D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on its public reference room. Our SEC filings are also available to the public from the SEC's web site at <http://www.sec.gov>. Our common shares are listed on the New York Stock Exchange and the Chicago Stock Exchange and information about us also is available there.

This prospectus is part of a registration statement that we have filed with the SEC. The SEC allows us to incorporate by reference into this prospectus the information we file with it. This means that we can disclose important information to you by referring you to other documents separately filed with the SEC. The information incorporated by reference is considered to be part of this prospectus, unless and until that information is updated and superseded by the information contained in this prospectus or any information incorporated later. We incorporate by reference the document listed below and any future filings we make with the SEC under Sections 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), until our offering of securities has been completed.

Annual Report on Form 10-K for the year ended December 31, 2008.

Our filings with the SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, current reports on Form 8-K and amendments to those reports, are available free of charge on our website as soon as reasonably practicable after they are filed with, or furnished to, the SEC. Our internet website is located at <http://www.eaton.com>. The contents of the website are not incorporated by reference into this prospectus. You may also obtain a copy of these filings, at no cost, by writing to or telephoning us at the following address:

Eaton Corporation
Eaton Center
1111 Superior Avenue

Cleveland, Ohio 44114-2584
Attn: Shareholder Relations
(216) 523-5000

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THE COMPANY

We are a diversified power management company with 2008 sales of \$15.4 billion. We are a global technology leader in: electrical components and systems for power quality, distribution and control; hydraulics components, systems and services for industrial and mobile equipment; aerospace fuel, hydraulics and pneumatic systems for commercial and military use; and truck and automotive drivetrain and powertrain systems for performance, fuel economy and safety. We have approximately 75,000 employees and sells products to customers in more than 150 countries.

Our operations are categorized into the following five business segments: Electrical, Hydraulics, Aerospace, Truck and Automotive. Prior to January 1, 2008, we reported our businesses in four segments, with the current Hydraulics and Aerospace segments being part of one segment called Fluid Power.

Electrical

The Electrical segment is a global leader in electrical control, power distribution, uninterruptible power supply (UPS) systems and industrial automation products and services. Products include circuit breakers, switchgear, UPS systems, power distribution units, panelboards, loadcenters, motor controls, meters, sensors and relays. The principal markets for the Electrical segment are industrial, institutional, government, utility, commercial, residential, IT, mission critical and original equipment manufacturer customers. These products are used wherever there is a demand for electrical power in commercial buildings, data centers, residences, apartment and office buildings, hospitals and factories. These customers are generally concentrated in North America, Europe and Asia/Pacific; however, sales are made globally. Sales in the Electrical segment are made directly and indirectly through distributors, resellers, and manufacturers representatives to these customers.

Hydraulics

The Hydraulics segment is a worldwide leader in reliable, high-efficiency hydraulic components and systems for use in mobile and industrial markets. We offer a wide range of power products including pumps, motors, hydraulic power units; a broad range of controls and sensing products, including valves, cylinders and electronic controls; a full range of fluid conveyance products, including industrial and hydraulic hose, fittings, and assemblies, thermoplastic hose and tubing, couplings, connectors, and assembly equipment; filtration systems solutions; heavy-duty drum and disc brakes; and golf grips. The principal market segments for Hydraulics include oil and gas, renewable energy, marine, agriculture, construction, mining, forestry, utility, material handling, truck and bus, machine tool, molding, primary metals, power generation, and entertainment. Key manufacturers in these markets and other customers are located globally, and these products are sold and serviced through a variety of channels.

Aerospace

The Aerospace segment is a leading global supplier to the commercial and military aviation and aerospace industries. Products include hydraulic power generation systems for aerospace applications, including, pumps, motors, hydraulic power units, hose and fittings, electro-hydraulic pumps and power and load management systems; controls and sensing products, including valves, cylinders, electronic controls, electromechanical actuators, sensors, displays and panels, aircraft flap and slat systems and nose wheel steering systems; fluid conveyance products, including hose, thermoplastic tubing, fittings, adapters, couplings, sealing and ducting; and fuel systems, including fuel pumps, sensors, valves, adapters and regulators. The principal markets for the Aerospace segment are manufacturers of commercial and military aircraft and related after-market customers. These manufacturers and other customers operate globally, and these products are sold and serviced through a variety of channels.

Truck

The Truck segment is a leader in the design, manufacture and marketing of a complete line of powertrain systems and components for commercial vehicles. Products include transmissions, clutches and hybrid electric power systems. The principal markets for the Truck segment are original equipment manufacturers and after-

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market customers of heavy-, medium- and light-duty trucks and passenger cars. These manufacturers and other customers are located globally, and most sales of these products are made directly to these customers.

Automotive

The Automotive segment is a leading supplier of critical components that reduce emissions and fuel consumption and improve stability and performance of cars, light trucks and commercial vehicles. Products include superchargers, engine valves and valve actuation systems, cylinder heads, locking and limited slip differentials, transmission controls, engine controls, fuel vapor components, compressor control clutches for mobile refrigeration, fluid connectors and hoses for air conditioning and power steering, decorative spoilers, underhood plastic components, fluid conveyance products including, hose, thermoplastic tubing, fittings, adapters, couplings and sealing products to the global automotive industry. The principal markets for the Automotive segment are original equipment manufacturers and aftermarket customers of light-duty trucks and passenger cars. These manufacturers and other customers are located globally, and most sales of these products are made directly to these customers.

Our principal executive office is located at Eaton Center, 1111 Superior Avenue, Cleveland, Ohio 44114-2584, and our telephone number is (216) 523-5000.

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Except as may be described otherwise in a prospectus supplement or term sheet, we will use the net proceeds from the sale of the securities under this prospectus for general corporate purposes, which may include additions to working capital, acquisitions, or the retirement of existing indebtedness via repayment, redemption or exchange.

RATIO OF EARNINGS TO FIXED CHARGES

The following table shows our ratio of earnings to fixed charges for each of the five years in the period ended December 31, 2008.

	For The Years Ended December 31,				
	2008	2007	2006	2005	2004
Ratio of Earnings to Fixed Charges	5.26	5.16	6.02	7.04	6.78

For the purpose of computing the ratio of earnings to fixed charges, earnings consist of consolidated pretax income from continuing operations before adjustment for minority interests in consolidated subsidiaries and income (loss) of equity investees, plus (1) amortization of capitalized interest, (2) distributed income of equity investees and (3) fixed charges described below, excluding interest capitalized. Fixed charges consist of (1) interest expensed, (2) capitalized interest, (3) amortization of debt issue costs and (4) that portion of rent expense estimated to represent interest.

Because we have not had any preferred shares outstanding during the last five years and have, therefore, not paid any dividends on preferred shares, our ratio of earnings to combined fixed charges and preferred share dividends has been the same as the ratio of earnings to fixed charges for each of the above periods.

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DESCRIPTION OF DEBT SECURITIES

We may issue debt securities from time to time in one or more distinct series. This section summarizes the material terms of the debt securities that are common to all series. Most of the financial terms and other specific material terms of any series of debt securities that we offer will be described in a prospectus supplement or term sheet. Furthermore, since the terms of specific debt securities may differ from the general information we have provided below, you should rely on information in the prospectus supplement or term sheet that is inconsistent with the information below. As used in this section, we, us, our and our company refer to Eaton Corporation and not to its subsidiaries, unless the context otherwise requires.

The debt securities are governed by a document called an indenture. An indenture is a contract between us and a financial institution acting as Trustee on your behalf. The Trustee has two main roles. First, the Trustee can enforce your rights against us if we default. There are some limitations on the extent to which the Trustee acts on your behalf. Second, the Trustee performs certain administrative duties for us.

Senior securities will be issued under an indenture dated as of April 1, 1994, as supplemented from time to time (the Senior Indenture), which we entered into with Chemical Bank, as trustee (the Senior Trustee), and subordinated securities will be issued under a separate indenture (the Subordinated Indenture), which we will enter into with a trustee (the Subordinated Trustee) if we decide to issue any subordinated securities. The Bank of New York Mellon Trust Company N.A., as successor to JPMorgan Chase Bank, N.A. (formerly known as Chemical Bank), is acting as Senior Trustee. The term Trustee refers to either the Senior Trustee or the Subordinated Trustee, as appropriate. We will refer to the Senior Indenture and the Subordinated Indenture, as executed, together as the Indentures and each, as an Indenture. The Indentures are subject to and governed by the Trust Indenture Act of 1939, as amended (the Trust Indenture Act).

The Indentures and associated documents contain the full legal text of the matters described in this section. The Senior Indenture is filed as an exhibit to the registration statement to which this prospectus is a part. The Subordinated Indenture will be filed as an exhibit to a post-effective amendment to the registration statement at a later time if we decide to issue any subordinated securities.

Because this section is a summary of the material terms of the Indentures, it does not describe every aspect of the debt securities. This summary is qualified in its entirety by the provisions of the Indentures, including definitions of certain terms used in the Indentures. For example, in this section, we use capitalized words to signify terms that are specifically defined in the Indentures. Some of the definitions are repeated in this prospectus, but for the rest you will need to read the Indentures. We also include references in parentheses to certain sections of the Indentures or the Trust Indenture Act. Whenever we refer to particular sections or defined terms of the Indentures, those sections or defined terms are incorporated by reference in this prospectus or in the prospectus supplement or term sheet. Unless otherwise noted, the section numbers refer to the applicable section for both Indentures.

Provisions Applicable to Both the Senior and Subordinated Indentures

General

The debt securities will be our unsecured obligations. The senior securities will rank equally with all of our other unsecured and unsubordinated indebtedness. The subordinated securities will be subordinated in right of payment to the prior payment in full of our Senior Indebtedness as described below under Subordinated Indenture Provisions-Subordination.

Under the Indentures, we may issue any debt securities offered under this prospectus and the accompanying prospectus supplement or term sheet (offered debt securities) and any debt securities issuable upon the exercise of debt warrants or upon conversion or exchange of other offered securities (underlying debt securities), as well as other unsecured debt securities.

With respect to the offered debt securities and any underlying debt securities, you should read the prospectus supplement or term sheet for the following terms and other material terms, which will be

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established by authority of our Board of Directors or pursuant to an officers certificate or a supplement to an Indenture before the issuance of the debt securities:

the title of the debt securities and whether they will be senior securities or subordinated securities, including whether securities are convertible securities;

the total principal amount of the debt securities and any limit on the total principal amount of debt securities of each series;

the date or dates when the principal of the debt securities will be payable or how those dates will be determined or extended;

the interest rate or rates, which may be fixed or variable, that the debt securities will bear, if any, or how such rate or rates will be determined, the date or dates from which any interest will accrue, if any, or how such date or dates will be determined, the interest payment dates, the record dates for such payments, if any, or how such date or dates will be determined and the basis upon which interest will be calculated, if other than that of a 360-day year or twelve 30-day months;

whether the amount of payments of principal of (or premium, if any), or interest on, the debt securities will be determined with reference to an index, formula or other method (which could be based on one or more Currencies, commodities, equity indices or other indices) and how such amounts will be determined;

any optional redemption provisions;

any sinking fund or other provisions that would obligate us to repurchase or otherwise redeem the debt securities;

if other than U.S. dollars, the Currency or Currencies of the debt securities;

if other than denominations of \$1,000 in the case of Registered Securities, the denominations in which the offered debt securities will be issued;

if not the principal amount of the debt securities, the portion of the principal amount at which the debt securities will be issued and, if not the principal amount of the debt securities, the portion of the principal amount payable upon acceleration of the maturity of the debt securities or how that portion will be determined;

the form of the debt securities, if other than a registered global note, including whether the debt securities are to be issuable in permanent or temporary global form, as Registered Securities, Bearer Securities or both, any restrictions on the offer, sale or delivery of Bearer Securities, and the terms, if any, upon which you may exchange Bearer Securities for Registered Securities and vice versa (if permitted by applicable laws and regulations);

any modifications or additions to the provisions of Article Fourteen of the applicable Indenture described below under Defeasance and Covenant Defeasance if that Article is applicable to the debt securities;

any changes or additions to the Events of Default or our covenants with respect to the debt securities;

the place or places, if any, other than or in addition to The City of New York, of payment, transfer, conversion and/or exchange of the debt securities, and where notices or demands to or upon us in respect of the debt

securities may be served;

whether we or a holder may elect payment of the principal or interest in one or more Currencies other than that in which such debt securities are stated to be payable, and the period or periods within which, and the terms and conditions upon which, that election may be made, and the time and manner of determining the exchange rate between the Currency or Currencies in which they are stated to be payable and the Currency or Currencies in which they are to be so payable;

if other than the Trustee, the identity of each Security Registrar and/or Paying Agent;

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the designation of the Exchange Rate Agent, if applicable;

the Person to whom any interest on any Registered Security of the series will be payable, if other than the registered holder at the close of business on the record date, the manner in which, or the Person to whom, any interest on any Bearer Security of the series will be payable, if not upon presentation and surrender of the coupons relating to the Bearer Security as they mature, and the extent to which, or the manner in which, any interest payable on a temporary Global Security on an Interest Payment Date will be paid if not in the manner provided in the applicable Indenture;

whether and under what circumstances we will pay additional amounts as contemplated by Section 1005 of the applicable Indenture (Additional Amounts) in respect of any tax, assessment or governmental charge and, if so, whether we will have the option to redeem the debt securities rather than pay the Additional Amounts (and the terms of any such option);

any provisions granting special rights to the holders of the debt securities upon the occurrence of specified events;

in the case of subordinated securities, any terms modifying the subordination provisions;

in the case of convertible securities, any terms by which they may be convertible into common shares;

if we issue the debt securities in definitive form, the terms and conditions under which definitive securities will be issued;

if we issue the debt securities upon the exercise of warrants, the time, manner and place for them to be authenticated and delivered;

the manner for paying principal and interest and the manner for transferring the debt securities; and

any other terms of the debt securities that are consistent with the requirements of the Trust Indenture Act.

For purposes of this prospectus, any reference to the payment of principal of (or premium, if any), or interest on, or interest on debt securities will include Additional Amounts if required by the terms of the debt securities.

The Indentures do not limit the amount of debt securities that we are authorized to issue from time to time. (Section 301) When a single Trustee is acting for all debt securities issued under an Indenture, those Securities are called the Indenture Securities. Each Indenture also provides that there may be more than one Trustee thereunder, each for a series of Indenture Securities. See Resignation of Trustee of this prospectus. At a time when two or more Trustees are acting under either Indenture, each with respect to only certain series, the term Indenture Securities means the series of debt securities for which each respective Trustee is acting. If there is more than one Trustee under either Indenture, the powers and trust obligations of each Trustee will apply only to the Indenture Securities for which it is Trustee. If two or more Trustees are acting under either Indenture, then the Indenture Securities for which each Trustee is acting would be treated as if issued under separate indentures.

The Indentures do not contain any provisions that give you protection in the event we issue a large amount of debt or we are acquired by another entity.

We may issue Indenture Securities with terms different from those of Indenture Securities already issued. Without the consent of the holders thereof, we may reopen a previous issue of a series of Indenture Securities and issue additional Indenture Securities of that series unless the reopening was restricted when that series was created.

There is no requirement that we issue debt securities in the future under the Indentures, and we may use other indentures or documentation containing different provisions in connection with future issues of such other debt securities.

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We may issue the debt securities as original issue discount securities, which are debt securities, including any zero-coupon debt securities, that are issued and sold at a discount from their stated principal amount. Original issue discount securities provide that, upon acceleration of their maturity, an amount less than their principal amount will become due and payable. We will describe United States federal income tax consequences and other considerations applicable to original issue discount securities in any prospectus supplement or term sheet relating to them.

Unless otherwise specified in the applicable prospectus supplement or term sheet, the debt securities will be denominated in U.S. dollars and all payments on the debt securities will be made in U.S. dollars. If any series of debt securities is sold for, payable in or denominated in one or more foreign Currencies, we will specify applicable restrictions, elections, tax consequences, specific terms and other information in the applicable prospectus supplement or term sheet. For further information regarding foreign currency debt securities, see Foreign Currency Risk-Fluctuations and Controls below.

Payment of the purchase price of the debt securities must be made in immediately available funds.

As used in this prospectus, Business Day means any day, other than a Saturday or Sunday, that is neither a legal holiday nor a day on which commercial banks are authorized or required by law, regulation or executive order to close in The City of New York; *provided, however*, that, with respect to foreign currency debt securities, the day is also not a day on which commercial banks are authorized or required by law, regulation or executive order to close in the Principal Financial Center (as defined below) of the country issuing the specified currency (or, if the specified currency is the euro, the day is also a day on which the Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET) System is open); and *provided further* that, with respect to debt securities as to which LIBOR is an applicable interest rate basis, the day is also a London Business Day.

London Business Day means a day on which commercial banks are open for business (including dealings in the designated LIBOR Currency) in London.

Principal Financial Center means (i) the capital city of the country issuing the specified currency or (ii) the capital city of the country to which the designated LIBOR Currency relates, as applicable, except that the term Principal Financial Center means the following cities in the case of the following currencies:

Currency	Principal Financial Center
U.S. dollars	The City of New York
Australian dollars	Sydney
Canadian dollars	Toronto
New Zealand dollars	Auckland
South African rand	Johannesburg
Swiss francs	Zurich

and in the event the LIBOR Currency is euro, the Principal Financial Center is London.

LIBOR Currency means the currency specified in the applicable prospectus supplement or term sheet as to which LIBOR shall be calculated or, if no such currency is specified in the applicable prospectus supplement or term sheet, U.S. dollars.

The authorized denominations of debt securities denominated in U.S. dollars will be integral multiples of \$1,000. The authorized denominations of foreign currency debt securities will be set forth in the applicable prospectus supplement

or term sheet.

Optional Redemption, Repayment and Repurchase

The prospectus supplement or term sheet for a debt security will indicate whether we will have the option to redeem the debt security before the stated maturity and the price and date or dates on which redemption may occur. If we are allowed to redeem a debt security, we may exercise the option by notifying the Trustee and the paying agent at least 45 days prior to the redemption date. In the case we elect to redeem less than all

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of a series of debt securities, we may exercise the option by notifying the Trustee and the paying agent at least 60 days prior to the redemption date. At least 30 but not more than 60 days before the redemption date, the Trustee will mail notice or cause the paying agent to mail notice of redemption to the holders. If a debt security is only redeemed in part, we will issue a new debt security or debt securities for the unredeemed portion.

The prospectus supplement or term sheet relating to a debt security will also indicate whether you will have the option to elect repayment by us prior to the stated maturity and the price and the date or dates on which repayment may occur.

For a debt security to be repaid at your election, the paying agent must receive, at least 30 but not more than 45 days prior to an optional repayment date, if, in certificated form, such debt security with the form entitled "Option to Elect Repayment" on the reverse of the debt security duly completed. You may also send the paying agent a facsimile or letter from a member of a national securities exchange or the Financial Industry Regulatory Authority (FINRA) or a commercial bank or trust company in the United States describing the particulars of the repayment, including a guarantee that the debt security and the form entitled "Option to Elect Repayment" will be received by the paying agent no later than five Business Days after such facsimile or letter. If you present a debt security for repayment, such act will be irrevocable. You may exercise the repayment option for less than the entire principal of the debt security, provided the remaining principal outstanding is an authorized denomination. If you elect partial repayment, your debt security will be cancelled, and we will issue a new debt security or debt securities for the remaining amount.

The Depository Trust Company or its nominee will be the holder of each Global Security and will be the only party that can exercise a right of repayment. If you are a beneficial owner of a Global Security and you want to exercise your right of repayment, you must instruct your broker or indirect participant through which you hold your interest to notify The Depository Trust Company. You should consult your broker or such indirect participant to discuss the appropriate cut-off times and any other requirements for giving this instruction. The giving of any such instruction will be irrevocable.

Regardless of anything in this prospectus, if a debt security is an OID Note (as defined below) (other than an Indexed Note), the amount payable in the event of redemption or repayment prior to its stated maturity will be the amortized face amount on the redemption or repayment date, as the case may be. The amortized face amount of an OID Note will be equal to (i) the issue price specified in the applicable prospectus supplement or term sheet plus (ii) that portion of the difference between the issue price and the principal amount of the debt security that has accrued at the yield to maturity described in the prospectus supplement or term sheet (computed in accordance with generally accepted U.S. bond yield computation principles) by the redemption or repayment date. However, in no case will the amortized face amount of an OID Note exceed its principal amount.

Regardless of anything in this prospectus, if a debt security is an OID Note (as defined below) (other than an Indexed Note), the amount payable in the event of acceleration shall be the portion of principal amount specified in the terms of that series of notes to be due and payable immediately.

We may at any time purchase debt securities at any price in the open market or otherwise. We may hold, resell or surrender for cancellation any debt securities that we purchase.

Conversion and Exchange

If you may convert or exchange debt securities for other Securities, the prospectus supplement or term sheet will explain the terms and conditions of such conversion or exchange, including:

the conversion price or exchange ratio (or the calculation method);

the conversion or exchange period (or how such period will be determined);
if conversion or exchange will be mandatory, at your option or at our option;
provisions for adjustment of the conversion price or the exchange ratio; and

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provisions affecting conversion or exchange in the event of the redemption of the debt securities.

The terms may also include provisions under which the number or amount of other Securities to be received by the holders of such debt securities upon conversion or exchange would be calculated according to the market price of such other Securities as of a time stated in the prospectus supplement or term sheet.

Interest and Interest Rates

General

Each debt security will begin to accrue interest from the date it is originally issued. The related prospectus supplement or term sheet will specify each debt security as a Fixed Rate Note, a Floating Rate Note, an Amortizing Note or an Indexed Note and describe the method of determining the interest rate, including any spread and/or spread multiplier. For an Indexed Note, the related prospectus supplement or term sheet also will describe the method for the calculation and payment of principal and interest. The prospectus supplement or term sheet for a Floating Rate Note or Indexed Note may also specify a maximum and a minimum interest rate.

A debt security may be issued as a Fixed Rate Note or a Floating Rate Note or as a debt security that combines fixed and floating rate terms.

Interest rates offered with respect to debt securities may differ depending upon, among other things, the aggregate principal amount of debt securities purchased in any single transaction. Debt securities with similar variable terms but different interest rates, as well as debt securities with different variable terms, may be offered concurrently to different investors. Interest rates or formulas and other terms of debt securities are subject to change from time to time, but no such change will affect any debt security already issued or as to which an offer to purchase has been accepted.

Interest on the debt securities denominated in U.S. dollars will be paid by check mailed on an Interest Payment Date other than a Maturity Date (as defined below) to the persons entitled thereto to the addresses of such holders as they appear in the security register or, at our option, by wire transfer to a bank account maintained by the holder. The principal of, premium, if any, and interest on debt securities denominated in U.S. dollars, together with interest accrued and unpaid thereon, due on the Maturity Date will be paid in immediately available funds upon surrender of such debt securities at the corporate trust office of the Trustee in The City of New York, or, at our option, by wire transfer of immediately available funds to an account with a bank designated at least 15 calendar days prior to the Maturity Date by the applicable registered holder, *provided* the particular bank has appropriate facilities to receive these payments and the particular debt security is presented and surrendered at the office or agency maintained by us for this purpose in the Borough of Manhattan, The City of New York, in time for the Trustee to make these payments in accordance with its normal procedures.

Fixed Rate Notes

The prospectus supplement or term sheet for debt securities with a fixed interest rate (Fixed Rate Notes) will describe a fixed interest rate payable semiannually in arrears on dates specified in such prospectus supplement or term sheet (each, with respect to Fixed Rate Notes, an Interest Payment Date). Unless otherwise specified in a prospectus supplement or term sheet, interest on Fixed Rate Notes will be computed on the basis of a 360-day year of twelve 30-day months. If the stated maturity date, any redemption date or any repayment date (together referred to as the Maturity Date) or an Interest Payment Date for any Fixed Rate Note is not a Business Day, principal of, premium, if any, and interest on that debt security will be paid on the next Business Day, and no interest will accrue from and after the Maturity Date or Interest Payment Date. Interest on Fixed Rate Notes will be paid to holders of record as of each

Regular Record Date as determined in the applicable prospectus supplement or term sheet.

Each interest payment on a Fixed Rate Note will include interest accrued from, and including, the issue date or the last Interest Payment Date to which interest has been paid or duly provided for, as the case may be, to but excluding the applicable Interest Payment Date or the Maturity Date, as the case may be.

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Original Issue Discount Notes

We may issue original issue discount debt securities (including zero coupon debt securities) (*OID Notes*), which are debt securities issued at a discount from the principal amount payable on the Maturity Date. There may not be any periodic interest payments on *OID Notes*. For *OID Notes*, interest normally accrues during the life of the debt security and is paid on the Maturity Date. Upon a redemption, repayment or acceleration of the maturity of an *OID Note*, the amount payable will be determined as set forth under *Optional Redemption, Repayment and Repurchase* . This amount normally is less than the amount payable on the stated maturity date.

Amortizing Notes

We may issue amortizing debt securities, which are *Fixed Rate Notes* for which combined principal and interest payments are made in installments over the life of each debt security (*Amortizing Notes*). Payments on *Amortizing Notes* are applied first to interest due and then to the reduction of the unpaid principal amount. The related prospectus supplement or term sheet for an *Amortizing Note* will include a table setting forth repayment information.

Floating Rate Notes

Each debt security with a floating interest rate (a *Floating Rate Note*) will have an interest rate basis or formula. That basis or formula may be based on:

the CD Rate;

the Commercial Paper Rate;

LIBOR;

the Federal Funds Rate;

the Prime Rate;

the Treasury Rate;

the CMT Rate;

the Eleventh District Cost of Funds Rate; or

another negotiated interest rate basis or formula.

The prospectus supplement or term sheet will also indicate any spread and/or spread multiplier, which would be applied to the interest rate formula to determine the interest rate. Any *Floating Rate Note* may have a maximum or minimum interest rate limitation. In addition to any maximum interest rate limitation, the interest rate on the *Floating Rate Notes* will in no event be higher than the maximum rate permitted by New York law, as the same may be modified by United States law for general application.

We will appoint a calculation agent to calculate interest rates on the *Floating Rate Notes*. Unless we identify a different party in the prospectus supplement or term sheet, the paying agent will be the calculation agent for each debt security.

Unless otherwise specified in a prospectus supplement or term sheet, the Calculation Date, if applicable, relating to an Interest Determination Date will be the earlier of (i) the tenth calendar day after such Interest Determination Date or, if such day is not a Business Day, the next succeeding Business Day, or (ii) the Business Day immediately preceding the relevant Interest Payment Date or the Maturity Date, as the case may be.

Upon the request of the beneficial holder of any Floating Rate Note, the calculation agent will provide the interest rate then in effect and, if different, when available, the interest rate that will become effective on the next Interest Reset Date for the Floating Rate Note.

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Change of Interest Rate. The interest rate on each Floating Rate Note may be reset daily, weekly, monthly, quarterly, semiannually, annually or on some other specified basis (each, an Interest Reset Date). Unless otherwise specified in a prospectus supplement or term sheet, the Interest Reset Date will be:

for debt securities with interest that resets daily, each Business Day;

for debt securities (other than Treasury Rate Notes) with interest that resets weekly, Wednesday of each week;

for Treasury Rate Notes with interest that resets weekly, Tuesday of each week;

for debt securities with interest that resets monthly, the third Wednesday of each month;

for debt securities with interest that resets quarterly, the third Wednesday of March, June, September and December of each year;

for debt securities with interest that resets semiannually, the third Wednesday of each of the two months of each year indicated in the applicable prospectus supplement or term sheet; and

for debt securities with interest that resets annually, the third Wednesday of the month of each year indicated in the applicable prospectus supplement or term sheet.

The related prospectus supplement or term sheet will describe the initial interest rate or interest rate formula on each debt security. That rate is effective until the following Interest Reset Date. Thereafter, the interest rate will be the rate determined on each Interest Determination Date. Each time a new interest rate is determined, it becomes effective on the following Interest Reset Date. If any Interest Reset Date is not a Business Day, then the Interest Reset Date is postponed to the next Business Day, except, in the case of a LIBOR Note, if the next Business Day is in the next calendar month, the Interest Reset Date is the immediately preceding Business Day.

Date Interest Rate Is Determined. The Interest Determination Date for all CD and CMT Rate Notes is the second Business Day before the Interest Reset Date and for all LIBOR Notes will be the second London Business Day immediately preceding the applicable Interest Reset Date (unless the LIBOR Currency is Sterling, in which case the Interest Determination Date will be the Interest Reset Date).

The Interest Determination Date for Treasury Rate Notes will be the day of the week in which the Interest Reset Date falls on which Treasury bills of the Index Maturity are normally auctioned. Treasury bills are usually sold at auction on Monday of each week, unless that day is a legal holiday, in which case the auction is usually held on Tuesday. Sometimes, the auction is held on the preceding Friday. If an auction is held on the preceding Friday, that day will be the Interest Determination Date relating to the Interest Reset Date occurring in the next week.

The Interest Determination Date for all Commercial Paper, Federal Funds and Prime Rate Notes will be the first Business Day preceding the Interest Reset Date.

The Interest Determination Date for an Eleventh District Cost of Funds Rate Note is the last Business Day of the month immediately preceding the applicable Interest Reset Date in which the Federal Home Loan Bank of San Francisco published the applicable rate.

The Interest Determination Date relating to a Floating Rate Note with an interest rate that is determined by reference to two or more interest rate bases will be the most recent Business Day which is at least two Business Days before the applicable Interest Reset Date for each interest rate for the applicable Floating Rate Note on which each interest rate

basis is determinable.

Payment of Interest. Unless otherwise specified in a prospectus supplement or term sheet, interest is paid as follows:

for debt securities with interest that resets daily, weekly or monthly, on the third Wednesday of each month;

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for debt securities with interest payable quarterly, on the third Wednesday of March, June, September, and December of each year;

for debt securities with interest payable semiannually, on the third Wednesday of each of the two months specified in the applicable prospectus supplement or term sheet;

for debt securities with interest payable annually, on the third Wednesday of the month specified in the applicable prospectus supplement or term sheet (each of the above, with respect to Floating Rate Notes, an Interest Payment Date); and

at maturity, redemption or repayment.

Each interest payment on a Floating Rate Note will include interest accrued from, and including, the issue date or the last Interest Payment Date to which interest has been paid or duly provided for, as the case may be, to but excluding the applicable Interest Payment Date or the Maturity Date, as the case may be.

Interest on a Floating Rate Note will be payable beginning on the first Interest Payment Date after its issue date to holders of record at the close of business on each Regular Record Date, as determined in the applicable prospectus supplement or term sheet (whether or not a Business Day) next preceding the applicable Interest Payment Date, unless the issue date falls after a Regular Record Date and on or prior to the related Interest Payment Date, in which case payment will be made to holders of record at the close of business on the Regular Record Date next preceding the second Interest Payment Date following the issue date. If an Interest Payment Date (but not the Maturity Date) is not a Business Day then the Interest Payment Date will be postponed to the next Business Day. However, in the case of LIBOR Notes, if the next Business Day is in the next calendar month, the Interest Payment Date will be the immediately preceding Business Day. If the Maturity Date of any Floating Rate Note is not a Business Day, principal of, premium, if any, and interest on that debt security will be paid on the next Business Day, and no interest will accrue from and after the Maturity Date.

Accrued interest on a Floating Rate Note is calculated by multiplying the principal amount of a debt security by an accrued interest factor. The accrued interest factor is the sum of the interest factors calculated for each day in the period for which accrued interest is being calculated. The interest factor for each day is computed by dividing the interest rate in effect on that day by (1) the actual number of days in the year, in the case of Treasury Rate Notes or CMT Rate Notes, or (2) 360, in the case of other Floating Rate Notes. The interest factor for Floating Rate Notes for which the interest rate is calculated with reference to two or more interest rate bases will be calculated in each period in the same manner as if only one of the applicable interest rate bases applied. All percentages resulting from any calculation are rounded to the nearest one hundred-thousandth of a percentage point, with five one-millionths of a percentage point rounded upward. For example, 9.876545% (or .09876545) will be rounded to 9.87655% (or .0987655). Dollar amounts used in the calculation are rounded to the nearest cent (with one-half cent being rounded upward).

CD Rate Notes. The CD Rate for any Interest Determination Date is the rate on that date for negotiable U.S. dollar certificates of deposit having the Index Maturity described in the related prospectus supplement or term sheet, as published in H.15(519) prior to 3:00 P.M., New York City time, on the Calculation Date, for that Interest

Determination Date under the heading CDs (secondary market) . The Index Maturity is the period to maturity of the instrument or obligation with respect to which the related interest rate basis or formula will be calculated.

The following procedures will be followed if the CD Rate cannot be determined as described above:

If the above rate is not published in H.15(519) by 3:00 P.M., New York City time, on the Calculation Date, the CD Rate will be the rate on that Interest Determination Date for negotiable United States dollar certificates of deposit of the Index Maturity described in the prospectus supplement or term sheet as published in H.15 Daily Update, or such other recognized electronic source used for the purpose of displaying such rate, under the caption CDs (secondary market) .

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If that rate is not published in H.15(519), H.15 Daily Update or another recognized electronic source by 3:00 P.M., New York City time, on the Calculation Date, then the calculation agent will determine the CD Rate to be the average of the secondary market offered rates as of 10:00 A.M., New York City time, on that Interest Determination Date, quoted by three leading nonbank dealers of negotiable U.S. dollar certificates of deposit in New York City (which may include an agent or its affiliates) for negotiable U.S. dollar certificates of deposit of major United States money-center banks with a remaining maturity closest to the Index Maturity in an amount that is representative for a single transaction in the market at that time described in the prospectus supplement or term sheet. The calculation agent, after consultation with us, will select the three dealers referred to above.

If fewer than three dealers are quoting as mentioned above, the CD Rate will remain the CD Rate for the immediately preceding interest reset period, or, if there was no interest reset period, the rate of interest payable will be the initial interest rate.

H.15(519) means the weekly statistical release designated as such, or any successor publication, published by the Board of Governors of the Federal Reserve System.

H.15 Daily Update means the daily update of H.15(519), available through the web site of the Board of Governors of the Federal Reserve System at <http://www.federalreserve.gov/releases/h15/update>, or any successor site or publication.

Commercial Paper Rate Notes. The Commercial Paper Rate for any Interest Determination Date is the Money Market Yield of the rate on that date for commercial paper having the Index Maturity described in the related prospectus supplement or term sheet, as published in H.15(519) prior to 3:00 P.M., New York City time, on the Calculation Date for that Interest Determination Date under the heading Commercial Paper Nonfinancial .

The following procedures will be followed if the Commercial Paper Rate cannot be determined as described above:

If the above rate is not published in H.15(519) by 3:00 P.M., New York City time, on the Calculation Date, the Commercial Paper Rate will be the Money Market Yield of the rate on that Interest Determination Date for commercial paper having the Index Maturity described in the prospectus supplement or term sheet, as published in H.15 Daily Update, or such other recognized electronic source used for the purpose of displaying such rate, under the caption Commercial Paper Nonfinancial .

If that rate is not published in H.15(519), H.15 Daily Update or another recognized electronic source by 3:00 P.M., New York City time, on the Calculation Date, then the calculation agent will determine the Commercial Paper Rate to be the Money Market Yield of the average of the offered rates of three leading dealers of U.S. dollar commercial paper in New York City (which may include an agent or its affiliates) as of 11:00 A.M., New York City time, on that Interest Determination Date for commercial paper having the Index Maturity described in the prospectus supplement or term sheet placed for an industrial issuer whose bond rating is Aa , or the equivalent, from a nationally recognized statistical rating organization. The calculation agent, after consultation with us, will select the three dealers referred to above.

If fewer than three dealers selected by the calculation agent are quoting as mentioned above, the Commercial Paper Rate will remain the Commercial Paper Rate for the immediately preceding interest reset period, or, if there was no interest reset period, the rate of interest payable will be the initial interest rate.

Money Market Yield means a yield (expressed as a percentage) calculated in accordance with the following formula:

$$\text{Money Market Yield} = \frac{D \times 360}{360 - (D \times M)} \times 100$$

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where D refers to the applicable per annum rate for commercial paper quoted on a bank discount basis and expressed as a decimal, and M refers to the actual number of days in the reset period for which interest is being calculated.

LIBOR Notes. On each Interest Determination Date, the calculation agent will determine LIBOR as follows:

LIBOR will be the average of the offered rates calculated by the calculation agent, or the offered rate, if the Designated LIBOR Page by its terms provides only for a single rate, for deposits in the LIBOR Currency having the Index Maturity described in the related prospectus supplement or term sheet commencing on the applicable Interest Reset Date, as such rates appear on the Designated LIBOR Page as of 11:00 A.M., London time, on that Interest Determination Date, if at least two such offered rates appear on the Designated LIBOR Page.

On any Interest Determination Date on which fewer than two offered rates appear or no rate appears on the applicable Designated LIBOR Page, the calculation agent will determine LIBOR as follows:

LIBOR will be determined on the basis of the offered rates at which deposits in the LIBOR Currency having the Index Maturity described in the related prospectus supplement or term sheet on the Interest Determination Date and in a principal amount that is representative of a single transaction in that market at that time are offered by four major reference banks (which may include affiliates of the agent) in the London interbank market commencing on the applicable Interest Reset Date to prime banks in the London interbank market at approximately 11:00 A.M., London time, on that Interest Determination Date and in a principal amount that is representative for a single transaction in the LIBOR Currency in that market at that time. The calculation agent, after consultation with us, will select the four banks and request the principal London office of each of those banks to provide a quotation of its rate for deposits in the LIBOR Currency. If at least two quotations are provided, LIBOR for that Interest Determination Date will be the average of those quotations.

If fewer than two quotations are provided as mentioned above, LIBOR will be the rate calculated by the calculation agent as the average of the rates quoted by three major banks, which may include affiliates of the agent, in the Principal Financial Center at approximately 11:00 A.M., in the Principal Financial Center, on that Interest Determination Date for loans to leading European banks in the LIBOR Currency having the Index Maturity designated in the prospectus supplement or term sheet and in a principal amount that is representative for a single transaction in the LIBOR Currency in that market at that time. The calculation agent, after consultation with us, will select the three banks referred to above.

If fewer than three banks selected by the calculation agent are quoting as mentioned above, LIBOR will remain LIBOR for the immediately preceding interest reset period, or, if there was no interest reset period, the rate of interest payable will be the initial interest rate.

Designated LIBOR Page means the display on Reuters (or any successor service) on page LIBOR01 (or any other page as may replace such page on such service) for the purpose of displaying the London interbank rates of major banks for the LIBOR Currency.

Federal Funds Rate Notes. The Federal Funds Rate for any Interest Determination Date is the rate as of that date for U.S. dollar federal funds, as published in H.15(519) prior to 3:00 P.M., New York City time, on the Calculation Date for that Interest Determination Date under the heading Federal Funds (Effective), as such rate is displayed on Reuters (or any successor service) on page FEDFUNDS1 (or any other page as may replace such page on such service) (Reuters Page FEDFUNDS1).

The following procedures will be followed if the Federal Funds Rate cannot be determined as described above:

If the above rate is not published in H.15(519) by 3:00 P.M., New York City time, on the Calculation Date, the Federal Funds Rate will be the rate as of that Interest Determination Date for U.S. dollar

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Federal Funds, as published in H.15 Daily Update, or such other recognized electronic source used for the purpose of displaying such rate, under the caption Federal Funds (Effective) .

If that rate does not appear on Telerate Page 120 or is not yet published in H.15(519), H.15 Daily Update or another recognized electronic source by 3:00 P.M., New York City time, on the Calculation Date, then the calculation agent will determine the Federal Funds Rate to be the average of the rates for the last transaction in overnight U.S. dollar Federal Funds arranged by three leading brokers of United States dollar federal funds transactions in New York City as of 9:00 A.M., New York City time, which may include the agent or its affiliates, on the Business Day following that Interest Determination Date. The calculation agent, after consultation with us, will select the three brokers referred to above.

If fewer than three brokers selected by the calculation agent are quoting as mentioned above, the Federal Funds Rate will be the Federal Funds Rate for the immediately preceding interest reset period, or, if there was no interest reset period, the rate of interest payable will be the initial interest rate.

Prime Rate Notes. The Prime Rate for any Interest Determination Date is the rate on that date, as published in H.15(519) by 3:00 P.M., New York City time, on the Calculation Date for that Interest Determination Date under the heading Bank Prime Loan or, if not published by 3:00 P.M., New York City time, on the related Calculation Date, the rate on such Interest Determination Date as published in the H.15 Daily Update, or such other recognized electronic source used for the purpose of displaying such rate, under the caption Bank Prime Loan .

The following procedures will be followed if the Prime Rate cannot be determined as described above:

If the above rate is not published in H.15(519), H.15 Daily Update or another recognized electronic source by 3:00 P.M., New York City time, on the Calculation Date, the calculation agent will determine the Prime Rate to be the average of the rates of interest publicly announced by each bank that appears on the Reuters Page US PRIME 1, as defined below, as that bank's prime rate or base lending rate in effect as of 11:00 A.M., New York City time on that Interest Determination Date.

If fewer than four rates appear on the Reuters Page US PRIME 1 on the Interest Determination Date, then the Prime Rate will be the average of the prime rates or base lending rates quoted (on the basis of the actual number of days in the year divided by a 360-day year) as of the close of business on the Interest Determination Date by three major banks, which may include an agent or its affiliates, in The City of New York selected by the calculation agent, after consultation with us.

If the banks selected by the calculation agent are not quoting as mentioned above, the Prime Rate will remain the Prime Rate for the immediately preceding interest reset period, or, if there was no interest reset period, the rate of interest payable will be the initial interest rate.

Reuters Page US PRIME 1 means the display designated as page US PRIME 1 on Reuters (or any successor service or any other page as may replace such page on such service) for the purpose of displaying prime rates or base lending rates of major United States banks.

Treasury Rate Notes. The Treasury Rate for any Interest Determination Date is the rate set at the auction of direct obligations of the United States (Treasury bills) having the Index Maturity described in the related prospectus supplement or term sheet under the caption INVESTMENT RATE on the display on Reuters (or any successor service) on page USAUCTION10 (or any other page as may replace such page on such service) (Reuters Page USAUCTION10) or on page USAUCTION11 (or any other page as may replace such page on such service)

(Reuters Page USAUCTION11) by 3:00 P.M., New York City time, on the Calculation Date for that Interest Determination Date.

The following procedures will be followed if the Treasury Rate cannot be determined as described above:

if the rate is not so published by 3:00 P.M., New York City time, on the Calculation Date, the Treasury Rate will be the Bond equivalent yield of the auction rate for the applicable Treasury bills as published in H.15 Daily Update, or other recognized electronic source used for the purpose of displaying the applicable rate, under the caption U.S. Government Securities/Treasury Bills/Auction High , or

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if such rate is not so published in H.15 Daily Update by 3:00 P.M., New York City time, on the Calculation Date, the Treasury Rate will be the Bond equivalent yield of the auction rate of the applicable Treasury bills announced by the United States Department of the Treasury, or

if the rate referred to above is not yet published or announced by the United States Department of the Treasury by 3:00 P.M., New York City time, or if the auction is not held, the Treasury Rate will be the Bond equivalent yield of the auction rate on the applicable Interest Determination Date of Treasury bills having the Index Maturity specified in the applicable prospectus supplement or term sheet published in H.15(519) under the caption U.S. Government Securities/Treasury Bills/Secondary Market , or

if such rate is not so published by 3:00 P.M., New York City time, on the related Calculation Date, then the Treasury Rate will be the rate on the applicable Interest Determination Date of the applicable Treasury bills as published in the H.15 Daily Update, or other recognized electronic sources used for the purpose of displaying the applicable rate, under the caption U.S. Government Securities/Treasury Bills/Secondary Market , or

if such rate is not so published in H.15(519), H.15 Daily Update or another recognized electronic source by 3:00 P.M., New York City time, on the related Calculation Date, then the calculation agent will determine the Treasury Rate to be the Bond equivalent yield of the average of the secondary market bid rates, as of approximately 3:30 P.M., New York City time, on the applicable Interest Determination Date, of three primary United States government securities dealers (which may include the agent or its affiliates) selected by the calculation agent, after consultation with us, for the issue of Treasury bills with a remaining maturity closest to the Index Maturity specified in the applicable prospectus supplement or term sheet, or

if fewer than three dealers selected by the calculation agent are quoting as mentioned above, the Treasury Rate will remain the Treasury Rate for the immediately preceding interest reset period, or, if there was no interest reset period, the rate of interest payable will be the initial interest rate.

Bond equivalent yield means a yield calculated in accordance with the following formula and expressed as a percentage:

$$\text{Bond equivalent yield} = \frac{D \times N}{360 - (D \times M)} \times 100$$

where D refers to the applicable per annum rate for Treasury bills quoted on a bank discount basis and expressed as a decimal, N refers to the number of days in the year, either 365 or 366, as the case may be, and M refers to the actual number of days in the interest reset period for which interest is being calculated.

CMT Rate Notes. The CMT Rate for any Interest Determination Date is any of the following rates displayed on the Designated CMT Reuters Page, as defined below, under the caption ... Treasury Constant Maturities ... Federal Reserve Board Release H.15... Mondays Approximately 3:45 p.m., under the column for the Designated CMT Maturity Index, as defined below, for:

the rate on that Interest Determination Date, if the Designated CMT Reuters Page is FRBCMT; and

the week or the month, as applicable, ended immediately preceding the week in which the related Interest Determination Date occurs, if the Designated CMT Reuters Page is FEDCMT.

The following procedures will be followed if the CMT Rate cannot be determined as described above:

If the above rate is no longer displayed on the relevant page, or if not displayed by 3:00 p.m., New York City time, on the related calculation date, then the CMT Rate will be the Treasury Constant Maturities rate for the Designated CMT Maturity Index published in the relevant H.15(519).

If the above rate described in the first bullet point is no longer published, or if not published by 3:00 p.m., New York City time, on the related calculation date, then the CMT rate will be the Treasury Constant Maturities rate for the Designated CMT Maturity Index or other U.S. Treasury rate for the

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Designated CMT Maturity Index on the interest determination date for the related interest reset date as may then be published by either the Board of Governors of the Federal Reserve System or the United States Department of the Treasury that the calculation agent determines to be comparable to the rate formerly displayed on the Designated CMT Reuters Page and published in the relevant H.155(519);

If the information described in the second bullet point is not provided by 3:00 p.m., New York City time, on the related calculation date, then the calculation agent will determine the CMT Rate to be a yield to maturity based on the arithmetic mean of the secondary market closing offer side prices as of approximately 3:30 p.m., New York City time, on the Interest Determination Date, reported, according to their written records, by three leading primary U.S. government securities dealers, which we refer to as a reference dealer in The City of New York, which may include the agent or another affiliate of ours, selected by the calculation agent as described in the following sentence. The calculation agent will select five reference dealers, after consultation with us, and will eliminate the highest quotation, or in the event of equality, one of the highest, and the lowest quotation or, in the event of equality, one of the lowest, for the most recently issued direct noncallable fixed rate obligations of the United States, which are commonly referred to as Treasury notes, with an original maturity of approximately the Designated CMT Maturity Index, a remaining term to maturity of no more than 1 year shorter than that Designated CMT Maturity Index and in a principal amount that is representative for a single transaction in the securities in that market at that time. If two Treasury notes with an original maturity as described above have remaining terms to maturity equally close to the Designated CMT Maturity Index, the quotes for the Treasury note with the shorter remaining term to maturity will be used.

If the calculation agent cannot obtain three Treasury notes quotations as described in the immediately preceding paragraph, the calculation agent will determine the CMT Rate to be a yield to maturity based on the arithmetic mean of the secondary market offer side prices as of approximately 3:30 p.m., New York City time, on the Interest Determination Date of three reference dealers in The City of New York, selected using the same method described in the immediately preceding paragraph, for Treasury notes with an original maturity equal to the number of years closest to but not less than the Designated CMT Maturity Index and a remaining term to maturity closest to the Designated CMT Maturity Index and in a principal amount that is representative for a single transaction in the securities in that market at that time.

If three or four, and not five, of the reference dealers are quoting as described above, then the CMT Rate will be based on the arithmetic mean of the offer prices obtained and neither the highest nor the lowest of those quotes will be eliminated.

If fewer than three reference dealers selected by the calculation agent are quoting as described above, the CMT Rate for that Interest Determination Date will remain the CMT Rate for the immediately preceding interest reset period, or, if there was no interest reset period, the rate of interest payable will be the initial interest rate.

Designated CMT Reuters Page means the display on Reuters (or any successor service) on the page designated in the applicable prospectus supplement or term sheet (or any other page as may replace such page on such service) for the purpose of displaying Treasury Constant Maturities as reported in H.15(519). If not Reuters page is specified in the applicable prospectus supplement or term sheet, the Designated CMT Reuters Page will be FEDCMT, for the most recent week.

Designated CMT Maturity Index means the original period to maturity of the U.S. Treasury securities, which is either 1, 2, 3, 5, 7, 10, 20 or 30 years, as specified in the applicable prospectus supplement or term sheet, for which the CMT rate will be calculated. If no maturity is specified in the applicable prospectus supplement or term sheet, the Designated CMT Maturity Index will be two years.

Eleventh District Cost of Funds Rate Notes. The Eleventh District Cost of Funds Rate for any Interest Determination Date is the rate equal to the monthly weighted average cost of funds for the calendar month preceding the Interest Determination Date as displayed on Telerate Page 7058 (or any other page as

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may replace that specified page on that service) as of 11:00 A.M., San Francisco time, on the Calculation Date for that Interest Determination Date under the caption 11th District .

The following procedures will be used if the Eleventh District Cost of Funds Rate cannot be determined as described above:

If the rate is not displayed on the relevant page as of 11:00 A.M., San Francisco time, on the Calculation Date, then the Eleventh District Cost of Funds Rate will be the monthly weighted average cost of funds paid by member institutions of the Eleventh Federal Home Loan Bank District, as announced by the Federal Home Loan Bank of San Francisco, as the cost of funds for the calendar month preceding the date of announcement.

If no announcement was made relating to the calendar month preceding the Interest Determination Date, the Eleventh District Cost of Funds Rate will remain the Eleventh District Cost of Funds Rate for the immediately preceding interest reset period, or, if there was no interest reset period, the rate of interest payable will be the initial interest rate.

Indexed Notes

We may issue debt securities for which the amount of interest or principal that you will receive will not be known on your date of purchase. Interest or principal payments for these types of debt securities, which we call Indexed Notes , are determined by reference to securities, financial or non-financial indices, currencies, commodities, interest rates, or a composite or baskets of any or all of the above. Examples of indexed items that may be used include a published stock index, the common stock price of a publicly traded company, the value of the U.S. dollar versus the Japanese yen, or the price of a barrel of West Texas intermediate crude oil.

If you purchase an Indexed Note, you may receive a principal amount at maturity that is greater than or less than the Note s face amount, and an interest rate that is greater than or less than the interest rate that you would have earned if you had instead purchased a conventional debt security issued by us at the same time with the same maturity. The amount of interest and principal that you will receive will depend on the structure of the Indexed Note and the level of the specified indexed item throughout the term of the Indexed Note and at maturity. Specific information pertaining to the method of determining the interest payments and the principal amount will be described in the prospectus supplement or term sheet, as well as additional risk factors unique to the Indexed Note, certain historical information for the specified indexed item and certain additional United States federal tax considerations.

Renewable Notes

We may issue Renewable Notes (Renewable Notes) which are debt securities that will automatically renew at their stated maturity date unless the holder of a Renewable Note elects to terminate the automatic extension feature by giving notice in the manner described in the related prospectus supplement or term sheet. In addition, we may issue debt securities whose stated Maturity Date may be extended at the option of the holder for one or more periods, as more fully described in the prospectus supplement relating to such securities.

The holder of a Renewable Note must give notice of termination at least 15 but not more than 30 days prior to a Renewal Date.

The holder of a Renewable Note may terminate the automatic extension for less than all of its Renewable Notes only if the terms of the Renewable Note specifically permit partial termination. An election to terminate the automatic extension of any portion of the Renewable Note is not revocable and will be binding on the holder of the Renewable Note. If the holder elects to terminate the automatic extension of the maturity of the Note, the holder will become

entitled to the principal and interest accrued up to the Renewal Date. The related prospectus supplement or term sheet will identify a stated maturity date beyond which the Maturity Date cannot be renewed.

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If a Renewable Note is represented by a Global Security, The Depository Trust Company or its nominee will be the holder of the Note and therefore will be the only entity that can exercise a right to terminate the automatic extension of a Note. In order to ensure that The Depository Trust Company or its nominee will exercise a right to terminate the automatic extension provisions of a particular Renewable Note, the beneficial owner of the Note must instruct the broker or other Depository Trust Company participant through which it holds an interest in the Note to notify The Depository Trust Company of its desire to terminate the automatic extension of the Note. Different firms have different cut-off times for accepting instructions from their customers and, accordingly, each beneficial owner should consult the broker or other participant through whom it holds an interest in a Note to ascertain the cut-off time by which an instruction must be given for delivery of timely notice to The Depository Trust Company or its nominee.

Extendible Notes

We may issue debt securities whose stated Maturity Date may be extended at our option (an Extendible Note) for one or more whole-year periods (each, an Extension Period), up to but not beyond a stated maturity date described in the related prospectus supplement or term sheet.

We may exercise our option to extend the Extendible Note by notifying the applicable Trustee (or any duly appointed paying agent) at least 45 but not more than 60 days prior to the then effective Maturity Date. If we elect to extend the Extendible Note, the Trustee (or paying agent) will mail (at least 40 days prior to the Maturity Date) to the registered holder of the Extendible Note a notice (an Extension Notice) informing the holder of our election, the new Maturity Date and any updated terms. Upon the mailing of the Extension Notice, the maturity of that Extendible Note will be extended automatically as set forth in the Extension Notice.

However, we may, not later than 20 days prior to the Maturity Date of an Extendible Note (or, if that date is not a Business Day, prior to the next Business Day), at our option, establish a higher interest rate, in the case of a Fixed Rate Note, or a higher spread and/or spread multiplier, in the case of a Floating Rate Note, for the Extension Period by mailing or causing the applicable Trustee (or paying agent) to mail notice of such higher interest rate or higher spread and/or spread multiplier to the holder of the Note. The notice will be irrevocable.

If we elect to extend the maturity of an Extendible Note, the holder of the Note will have the option to instead elect repayment of the Note by us on the then effective Maturity Date. In order for an Extendible Note to be so repaid on the Maturity Date, we must receive, at least 15 days but not more than 30 days prior to the Maturity Date:

- (1) the Extendible Note with the form Option to Elect Repayment on the reverse of the Note duly completed; or
- (2) a facsimile transmission, telex or letter from a member of a national securities exchange or FINRA or a commercial bank or trust company in the United States setting forth the name of the holder of the Extendible Note, the principal amount of the Note, the principal amount of the Note to be repaid, the certificate number or a description of the tenor and terms of the Note, a statement that the option to elect repayment is being exercised thereby and a guarantee that the Note be repaid, together with the duly completed form entitled Option to Elect Repayment on the reverse of the Note, will be received by the applicable Trustee (or paying agent) not later than the fifth Business Day after the date of the facsimile transmission, telex or letter; provided, however, that the facsimile transmission, telex or letter will only be effective if the Note and form duly completed are received by the applicable Trustee (or paying agent) by that fifth Business Day. The option may be exercised by the holder of an Extendible Note for less than the aggregate principal amount of the Note then outstanding if the principal amount of the Note remaining outstanding after repayment is an authorized denomination.

If an Extendible Note is represented by a Global Security, The Depository Trust Company or its nominee will be the holder of that Note and therefore will be the only entity that can exercise a right to repayment. To ensure that The

Depository Trust Company or its nominee timely exercises a right to repayment with respect

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to a particular Extendible Note, the beneficial owner of that Note must instruct the broker or other participant through which it holds an interest in the Note to notify The Depository Trust Company of its desire to exercise a right of repayment. Different firms have different cut-off times for accepting instructions from their customers and, accordingly, each beneficial owner should consult the broker or other participant through which it holds an interest in an Extendible Note to determine the cut-off time by which an instruction must be given for timely notice to be delivered to The Depository Trust Company or its nominee.

Additional Mechanics

Form, Exchange and Transfer

We may issue debt securities as follows:

as Registered Securities;

as Bearer Securities (with interest coupons attached unless otherwise stated in the prospectus supplement or term sheet) (Section 201);

as both Registered Securities and Bearer Securities;

in denominations that are even multiples of \$1,000 for Registered Securities and even multiples of \$5,000 for Bearer Securities (Section 302); or

in global form. See Book-Entry Debt Securities.

You may have your Registered Securities separated into smaller denominations or combined into larger denominations, as long as the total principal amount is not changed. (Section 305) This is called an exchange. If provided in the prospectus supplement or term sheet, you may exchange your Bearer Securities with all unmatured coupons, except as provided below, and all matured coupons which are in default for Registered Securities of the same series as long as the total principal amount is not changed. Bearer Securities surrendered in exchange for Registered Securities between a Regular Record Date or a Special Record Date and the relevant interest payment dates will be surrendered without the coupon relating to such interest payment dates. Interest will not be payable in respect of the Registered Security issued in exchange for that Bearer Security, but will be payable only to the holder of such coupon when due in accordance with the terms of the applicable Indenture. Unless we specify otherwise in the prospectus supplement or term sheet, we will not issue Bearer Securities in exchange for Registered Securities. (Section 305)

You may transfer Registered Securities of a series and you may exchange debt securities of a series at the office of the Trustee. The Trustee will act as our agent for registering Registered Securities in the names of holders and transferring debt securities. We may designate someone else to perform this function. Whoever maintains the list of registered holders is called the Security Registrar. The Security Registrar also will perform transfers. (Section 305)

You will not be required to pay a service charge to transfer or exchange debt securities, but you may be required to pay for any tax or other governmental charge associated with the exchange or transfer. The transfer or exchange will be made only if the Security Registrar is satisfied with your proof of ownership. (Section 305)

If we designate additional transfer agents, we will name them in the accompanying prospectus supplement or term sheet. We may cancel the designation of any particular transfer agent. We may also approve a change in the office through which any transfer agent acts.

If we redeem less than all of the Securities of a redeemable series, we may block the transfer or exchange of Securities during the period beginning 15 days before the day we mail the notice of redemption or publish the notice (in the case of Bearer Securities) and ending on the day of that mailing or publication, as the case may be, in order to freeze the list of holders to prepare the mailing. We may also decline to register transfers or exchanges of debt securities selected for redemption, except that we will continue to permit transfers and exchanges of the unredeemed portion of any debt security being partially redeemed. (Section 305)

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If the offered debt securities are redeemable, we will describe the procedures for redemption in the accompanying prospectus supplement or term sheet.

In this Additional Mechanics section of this prospectus, you means direct holders and not indirect holders of debt securities.

Payment and Paying Agents

We will pay interest to you, if you are listed in the Trustee's records as the owner of your debt security at the close of business on a particular day in advance of each due date for interest on your debt security. Interest will be paid to you if you are listed as the owner even if you no longer own the debt security on the interest due date. That particular day is called the Regular Record Date and is defined in the prospectus supplement or term sheet. Persons who are listed in the Trustee's records as the owners of debt securities at the close of business on a particular day are referred to as holders. (Section 307) Holders buying and selling debt securities must work out between themselves the appropriate purchase price since we will pay all the interest for an interest period to the holders on the Regular Record Date. The most common manner is to adjust the sales price of the debt securities to prorate interest fairly between buyer and seller based on their respective ownership periods within the particular interest period.

We will deposit interest, principal and any other money due on the debt securities with the Paying Agent that we name in the prospectus supplement or term sheet.

If you plan to have a bank or brokerage firm hold your securities, you should ask them for information on how you will receive payments. (Section 305)

If we issue Bearer Securities, unless we provide otherwise in the prospectus supplement or term sheet, we will maintain an office or agency outside the United States for the payment of all amounts due on the Bearer Securities. If we list the debt securities on any stock exchange located outside the United States, we will maintain an office or agency for those debt securities in any city located outside the United States required by that stock exchange.

(Section 1002) We will specify the initial locations of such offices and agencies in the prospectus supplement or term sheet. Unless otherwise provided in the prospectus supplement or term sheet, we will make payment of interest on any Bearer Securities on or before Maturity only against surrender of coupons for such interest installments as they mature. (Section 1001) Unless otherwise provided in the prospectus supplement or term sheet, we will not make payment with respect to any Bearer Security at any of our offices or agencies in the United States or by check mailed to any address in the United States or by transfer to an account maintained with a bank located in the United States. Notwithstanding the foregoing, we will make payments of principal of (and premium, if any) and interest on Bearer Securities payable in U.S. dollars at the office of our Paying Agent in The City of New York if (but only if) payment of the full amount in U.S. dollars at all offices or agencies outside the United States is illegal or effectively precluded by exchange controls or other similar restrictions. (Section 1002)

We may from time to time designate additional offices or agencies, approve a change in the location of any office or agency and, except as provided above, rescind the designation of any office or agency. (Section 1002)

Events of Default

You will have special rights if an Event of Default occurs as to the debt securities of your series which is not cured, as described later in this subsection. (Section 501) Please refer to the prospectus supplement or term sheet for information about any changes to the Events of Default or our covenants that are described below, including any addition of a covenant or other provision providing event risk or similar protection.

What Is an Event of Default? The term *Event of Default* as to the debt securities of your series means any of the following:

we do not pay the principal of (or premium, if any) on a debt security of such series on its due date;

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we do not pay interest on a debt security of such series within 30 days of its due date;

we do not make or satisfy any sinking fund payment in respect of debt securities of such series within 30 days of its due date;

we remain in breach of a covenant in respect of debt securities of such series for 60 days after we receive a written notice of default stating we are in breach. The notice must be sent by either the Trustee or holders of 25% of the principal amount of debt securities of such series;

we file for bankruptcy, or certain other events in bankruptcy, insolvency or reorganization occur; or

there occurs any other Event of Default as to debt securities of the series described in the prospectus supplement or term sheet. (Section 501)

An Event of Default for a particular series of debt securities does not necessarily constitute an Event of Default for any other series of debt securities issued under an Indenture.

The Trustee may withhold notice to the holders of debt securities of a particular series of any default if it considers its withholding of notice to be in the interest of the holders of that series, except that the Trustee may not withhold notice if the default is in the payment of principal of (or premium, if any), or interest on, the debt securities. (Section 601)

Remedies if an Event of Default Occurs. If an Event of Default has occurred and we have not cured it, the Trustee or the holders of 25% in principal amount of the debt securities of the affected series may declare the entire principal amount of all the debt securities of that series to be due and immediately payable by notifying us (or the Trustee, if the holders give notice) in writing. This is called a declaration of acceleration of maturity. A declaration of acceleration of maturity may be canceled by the holders of at least a majority in principal amount of the debt securities of the affected series by notifying us (or the Trustee, if the holders give notice) in writing. (Section 502)

Except in cases of default, where the Trustee has some special duties, the Trustee is not required to take any action under the Indenture at the request of any holders unless the holders offer the Trustee reasonable protection from expenses and liability (called an indemnity). (Section 602 and Trust Indenture Act Section 315). If reasonable indemnity is provided, the holders of a majority in principal amount of the Outstanding debt securities of the relevant series may direct the time, method and place of conducting any lawsuit or other formal legal action seeking any remedy available to the Trustee. The Trustee may refuse to follow those directions in certain circumstances. (Section 512) No delay or omission in exercising any right or remedy will be treated as a waiver of that right, remedy or Event of Default. (Section 511)

Before you are allowed to bypass the Trustee and bring your own lawsuit or other formal legal action or take other steps to enforce your rights or protect your interest relating to the debt securities, the following must occur:

you must give the Trustee written notice that an Event of Default has occurred and remains uncured (Section 507);

the holders of 25% in principal amount of all of the debt securities of the relevant series must make a written request that the Trustee take action because of the default (Section 507) and must offer reasonable indemnity to the Trustee against the cost and other liabilities of taking that action (Section 602);

the Trustee must not have instituted a proceeding for 60 days after receipt of the above notice and offer of indemnity (Section 507); and

the holders of a majority in principal amount of the debt securities must not have given the Trustee a direction inconsistent with the above notice during such 60-day period. (Section 507).

However, you are entitled at any time to bring a lawsuit for the payment of money due on your debt securities on or after the due date. (Section 508)

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Holders of a majority in principal amount of the debt securities of the affected series may waive any past defaults other than the following:

the payment of principal of, any premium, interest or Additional Amounts on any debt security or related coupon; or

in respect of a covenant that under Article Ten of the applicable Indenture cannot be modified or amended without the consent of each holder. (Section 513)

If your securities are held for you by a bank or brokerage firm, you should consult them for information on how to give notice or direction to the Trustee or make a request of the Trustee and how to make or cancel a declaration of acceleration.

Each year, we will furnish the Trustee with a written statement of certain of our officers certifying that, to their knowledge, we are in compliance with the Indenture and the debt securities, or else specifying any default. (Section 1004)

Merger, Consolidation or Sale of Assets

Under the terms of the Indentures, we are generally permitted to consolidate or merge with another firm. We are also permitted to sell or transfer our assets substantially as an entirety to another firm. (Section 801) However, we may not take any of these actions unless all of the following conditions are met:

where we merge or consolidate out of existence or sell or transfer our assets substantially as an entirety, the resulting firm must agree to be legally responsible for all obligations under the debt securities and the applicable Indenture (Section 801);

the merger, consolidation or sale or transfer of assets substantially as an entirety must not cause a default on the debt securities. For purposes of this no-default test, a default would include an Event of Default that has occurred and not been cured, as described in this prospectus under **What Is an Event of Default?** (Section 801);

where we merge or consolidate out of existence or sell or transfer our assets substantially as an entirety, the resulting firm (if a corporation) must be a corporation organized under the laws of the United States or any state thereof or the District of Columbia (Section 801);

under the Senior Indenture, we may not merge, consolidate or sell or transfer our assets substantially as an entirety if, as a result, any of our property or assets or any property or assets of a Restricted Subsidiary (as defined) would become subject to any mortgage, lien or other encumbrance unless either:

the mortgage, lien or other encumbrance could be created pursuant to Section 1009 of such Indenture (see **-Senior Indenture Provisions-Limitation on Liens**) without equally and ratably securing the Indenture Securities or

the Indenture Securities are secured equally and ratably with or prior to the debt secured by the mortgage, lien or other encumbrance (Section 803);

we must deliver certain certificates and documents to the Trustee (Section 801); and

we must satisfy any other requirements specified in the prospectus supplement or term sheet.

Modification or Waiver

There are three types of changes that we can make to the Indentures and the debt securities.

Changes Requiring Your Approval. First, there are changes that cannot be made to your debt securities without your specific approval. (Section 902) Following is a list of those types of changes:

a change of the Stated Maturity of the principal of or interest on a debt security;

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a reduction of any amounts due on a debt security;

a reduction of the amount of principal payable upon acceleration of the Maturity of a Security following a default;

an adverse effect on any right of repayment at your option;

a change of the place (except as otherwise described in this prospectus) or Currency of payment on a debt security;

impairment of your right to sue for payment;

with respect to debt securities issued under the Subordinated Indenture, an adverse effect on the right to convert any debt securities as provided in Article 15 of the Subordinated Indenture;

a modification of the subordination provisions in the Subordinated Indenture in a manner that is adverse to you as a holder of the Subordinated Securities;

a reduction of the percentage of holders of debt securities whose consent is needed to modify or amend the Indenture;

a reduction of the percentage of holders of debt securities whose consent is needed to waive compliance with certain provisions of the Indenture or to waive certain defaults;

a modification of any other aspect of the provisions of the Indenture dealing with modification and waiver of past defaults (Section 513), the quorum or voting requirements of the debt securities (Section 1504 of the Senior Indenture and Section 1704 of the Subordinated Indenture) or provisions relating to the waiver of certain covenants (Section 1011 of the Senior Indenture and Section 1008 of the Subordinated Indenture), except to increase any percentage of consents required to amend an Indenture or for any waiver or to add certain provisions that cannot be modified without the approval of each holder under Section 902; or

a change of any of our obligations to pay Additional Amounts.

Changes Requiring a Majority Vote. The second type of change to the Indenture and the outstanding debt securities is the kind that requires a vote in favor by holders of Outstanding debt securities owning a majority of the principal amount of the particular series affected. Most changes fall into this category, except for clarifying changes and certain other changes that would not adversely affect holders of the Outstanding debt securities in any material respect. The same vote would be required for us to obtain a waiver of all or part of certain covenants in the applicable Indenture (Section 1011 of the Senior Indenture and Section 1008 of the Subordinated Indenture) or a waiver of a past default. However, we cannot obtain a waiver of a payment default or any other aspect of the Indentures or the Outstanding debt securities listed in the first category described above under **Changes Requiring Your Approval** unless we obtain your individual consent to the waiver. (Section 902)

Changes Not Requiring Approval. The third type of change does not require any vote by you as holders of Outstanding debt securities. This type is limited to clarifications and certain other changes that would not adversely affect holders of the Outstanding debt securities in any material respect. (Section 901)

Further Details Concerning Voting. When taking a vote, we will use the following rules to decide how much principal amount to attribute to a debt security:

for original issue discount securities, we will use the principal amount that would be due and payable on the voting date if the Maturity of the debt securities were accelerated to that date because of a default;

for debt securities whose principal amount is not known (for example, because it is based on an index), we will use a special rule for that debt security described in the prospectus supplement or term sheet; and

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for debt securities denominated in one or more foreign Currencies or Currency units, we will use the U.S. dollar equivalent.

Debt securities will not be considered Outstanding, and therefore not eligible to vote, if we have deposited or set aside in trust for you money for their payment or redemption. Debt securities will also not be eligible to vote if they have been fully defeased as described later under Defeasance and Covenant Defeasance. (Section 101)

We will generally be entitled to set any day as a record date for the purpose of determining the holders of debt securities that are entitled to vote or take other action under the applicable Indenture. If we set a record date for a vote or other action to be taken by holders of a particular series, that vote or action may be taken only by persons who are holders of debt securities of that series on the record date. (Section 104)

If your securities are held by a bank or brokerage firm, you should consult them for information on how approval may be granted or denied if we seek to change the applicable Indenture or the debt securities or request a waiver.

Each Indenture contains provisions for convening meetings of the holders of debt securities issued as Bearer Securities. (Section 1501 of the Senior Indenture and Section 1701 of the Subordinated Indenture) A meeting may be called at any time by the applicable Trustee, and also, upon request, by us or by the holders of at least 10% in principal amount of the Outstanding debt securities of that series, upon notice given as provided in the applicable Indenture. (Section 1502 of the Senior Indenture and Section 1702 of the Subordinated Indenture)

Except for any consent that must be given by the holder of each debt security affected thereby, as described above, the holders of a majority in principal amount of the Outstanding debt securities of a series may adopt any resolution presented at a meeting at which a quorum is present. However, any resolution with respect to any action which the Indenture expressly provides may be taken by a specified percentage less than a majority in principal amount of the Outstanding debt securities of a series may be adopted at a meeting at which a quorum is present by vote of that specified percentage. Any resolution passed or decision taken at any meeting of holders of debt securities of a series in accordance with the applicable Indenture will be binding on all holders of debt securities of that series and any related coupons. The quorum at any meeting called to adopt a resolution will be persons holding or representing a majority in principal amount of the Outstanding debt securities of a series, except that if any action is to be taken at such meeting which may be given by the holders of not less than a specified percentage in principal amount of the Outstanding debt securities of a series, the persons holding or representing such specified percentage in principal amount of the Outstanding debt securities of that series will constitute a quorum. (Section 1504 of the Senior Indenture and Section 1704 of the Subordinated Indenture)

Notwithstanding the above, if any action is to be taken at a meeting of holders of debt securities of a series that the applicable Indenture expressly provides may be taken by the holders of a specified percentage in principal amount of all Outstanding debt securities affected thereby or of the holders of such series and one or more additional series:

there will be no minimum quorum requirement for that meeting; and

the principal amount of the Outstanding debt securities of that series that vote in favor of such action will be taken into account in determining whether that action has been taken under such Indenture. (Section 1504 of the Senior Indenture and Section 1704 of the Subordinated Indenture)

Defeasance and Covenant Defeasance

The following discussion of defeasance and covenant defeasance will be applicable to your series of debt securities, unless we specify otherwise in the applicable prospectus supplement or term sheet. (Section 1401)

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Defeasance. If there is a change in U.S. federal tax law, as described below, we can legally release ourselves from all payment and other obligations on the debt securities (called *defeasance*) if we put in place the following other arrangements for you to be repaid:

We must deposit in trust for your benefit and the benefit of all other direct holders of the debt securities a combination of money and U.S. government or U.S. government agency obligations that will generate enough cash to make interest, principal and any other payments on the debt securities on their various due dates.

We must deliver to the Trustee a legal opinion confirming that there has been a change in current U.S. federal tax law or an Internal Revenue Service (the *IRS*) ruling that lets us make the above deposit without causing you to be taxed on the debt securities any differently than if we did not make the deposit and just repaid the debt securities ourselves. (Sections 1402 and 1404) Under current U.S. federal tax law, the deposit and our legal release from the debt securities would be treated as though we paid you your share of the cash and notes or bonds at the time the cash and notes or bonds are deposited in trust in exchange for your debt securities, and you would recognize gain or loss on the debt securities at the time of the deposit.

If we ever accomplish defeasance, as described above, you would have to rely solely on the trust deposit for repayment of the debt securities. You could not look to us for repayment in the event of any shortfall. Conversely, the trust deposit would most likely be protected from claims of our lenders and other creditors if we ever become bankrupt or insolvent. You would also be released from the subordination provisions on the subordinated debt securities described later under *Subordination* in this prospectus. If we accomplish a defeasance, we would retain only the obligations to register the transfer or exchange of the debt securities, to maintain an office or agency in respect of the debt securities and to hold monies for payment in trust.

Covenant Defeasance. Under current U.S. federal tax law, we can make the same type of deposit described above and be released from some of the restrictive covenants in the Indentures. These covenants relate to *Limitation on Liens* and *Limitation on Sale and Leaseback Transactions* described in Sections 1009 and 1010, respectively, of the Senior Indenture and are summarized in this prospectus. We can also be released from certain other covenants in the Indentures which may be specified in the prospectus supplement or term sheet if we make the same type of deposit described above. This is called *covenant defeasance*. In that event, you would lose the protection of those covenants but would gain the protection of having money and debt securities set aside in trust to repay the debt securities. You also would be released from the subordination provisions on the subordinated securities described under *Subordination* in this prospectus. In order to achieve covenant defeasance, we must do the following:

deposit in trust for your benefit and the benefit of all other direct holders of the debt securities a combination of money and U.S. government or U.S. government agency obligations that will generate enough cash to make interest, principal and any other payments on the debt securities on their various due dates; and

deliver to the Trustee a legal opinion of our counsel confirming that, under current U.S. federal income tax law, we may make the above deposit without causing you to be taxed on the debt securities any differently than if we did not make the deposit and just repaid the debt securities ourselves.

If we accomplish covenant defeasance, you can still look to us for repayment of the debt securities if there were a shortfall in the trust deposit or the Trustee were prevented from making payment. In fact, if one of the remaining Events of Default occurred, such as our bankruptcy, and the debt securities become immediately due and payable, there may be such a shortfall. Depending on the event causing the default, you may not be able to obtain payment of the shortfall.

Book-Entry Debt Securities

We may issue debt securities of a series in whole or in part in global form that we will deposit with, or on behalf of, a depository that we identify in a prospectus supplement or term sheet. Global securities may be issued in either registered or bearer form and in either temporary or permanent form (each, a Global

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Security). Global Securities will be registered in the name of a financial institution we select, and the debt securities included in the Global Securities may not be transferred to the name of any other direct holder unless the special circumstances described below occur. The financial institution that acts as the sole direct holder of the Global Security is called the Depository. Any person wishing to own a debt security must do so indirectly by virtue of an account with a broker, bank or other financial institution that, in turn, has an account with the Depository.

Special Investor Considerations for Global Securities. Our obligations, as well as the obligations of the Trustee and those of any third parties employed by us or the Trustee, run only to Persons who are registered as holders of debt securities. For example, once we make payment to the registered holder, we have no further responsibility for the payment even if that holder is legally required to pass the payment along to you but does not do so. As an indirect holder, your rights relating to a Global Security will be governed by the account rules of your financial institution and of the Depository, as well as general laws relating to debt securities transfers.

You should be aware that when we issue debt securities in the form of Global Securities:

you cannot get debt securities registered in your own name;

you cannot receive physical certificates for your interest in the debt securities;

you must look to your own bank or brokerage firm for payments on the debt securities and protection of your legal rights relating to the debt securities;

you may not be able to sell interests in the debt securities to some insurance companies and other institutions that are required by law to hold the physical certificates of debt securities that they own;

the Depository's policies will govern payments, transfers, exchanges and other matters relating to your interest in the Global Security. We and the Trustee have no responsibility for any aspect of the Depository's actions or for its records of ownership interests in the Global Security. We and the Trustee also do not supervise the Depository in any way; and

the Depository will usually require that interests in a Global Security be purchased or sold within its system using same-day funds.

Special Situations When Global Security Will Be Terminated. In a few special situations described below, a Global Security will terminate and interests in it will be exchanged for physical certificates representing debt securities. After that exchange, the choice of whether to hold debt securities directly or indirectly through an account at your bank or brokerage firm will be up to you. You must consult your own bank or broker to find out how to have interests in debt securities transferred to your own name, so that you will hold them directly.

The special situations for termination of a Global Security are:

when the Depository notifies us that it is unwilling, unable or no longer qualified to continue as Depository (unless a replacement Depository is named); when an Event of Default on the debt securities has occurred and has not been cured; and

when and if we decide to terminate a Global Security, subject to the procedures of the Depository.

The prospectus supplement or term sheet may list situations for terminating a Global Security that would apply only to the particular series of debt securities covered by the prospectus supplement or term sheet. When a Global Security

terminates, the Depositary (and neither we nor the Trustee) is responsible for deciding the names of the institutions that will be the initial direct holders. (Section 302) Unless otherwise provided in the prospectus supplement or term sheet, debt securities that are represented by a Global Security will be issued in denominations of \$1,000 and any integral multiple thereof and will be issued in registered form only, without coupons.

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Resignation of Trustee

Each Trustee may resign or be removed with respect to one or more series of Indenture Securities, and a successor Trustee may be appointed to act with respect to such series. (Section 608) In the event that two or more persons are acting as Trustee with respect to different series of Indenture Securities under one of the Indentures, each such Trustee will be a Trustee of a trust separate and apart from the trust administered by any other such Trustee (Section 609), and any action described herein to be taken by the Trustee may then be taken by each such Trustee with respect to, and only with respect to, the one or more series of Indenture Securities for which it is Trustee.

Senior Indenture Provisions

Limitation on Sale and Leaseback Transactions

Under the terms of the Senior Indenture, we will not, and will not permit any Restricted Subsidiary (as defined) to, sell or transfer any manufacturing plant owned by us or any Restricted Subsidiary with the intention of taking back a lease on such property unless:

the sale or transfer of property is made within 120 days after the later of the date of

the acquisition of such property,

the completion of construction of such property, or

the commencement of full operation thereof;

such lease has a term, including permitted extensions and renewals, of not more than three years, and it is intended that the use by us or the Restricted Subsidiary of the manufacturing plant covered by such lease will be discontinued on or before the expiration of such term;

the amount that we realize from such sale or transfer, together with the value (as defined) of then outstanding Sale and Leaseback Transactions not otherwise permitted by the Senior Indenture and the outstanding aggregate principal amount of mortgage, pledge or lien indebtedness not otherwise permitted by the Senior Indenture, will not exceed 10% of our Consolidated Net Tangible Assets (as defined); or

we cause an amount equal to the value (as defined) of the manufacturing plant to be sold or transferred and leased to be applied to the retirement (other than any mandatory retirement) within 120 days of the effective date of such Sale and Leaseback Transaction of either the Indenture Securities or other funded indebtedness which is equal in rank to the Indenture Securities, or both. (Section 1010 of the Senior Indenture)

These provisions are intended to preserve our assets and to limit our ability to incur leases which effectively constitute indebtedness.

Limitation on Liens

Under the terms of the Senior Indenture, with certain exceptions, we will not, directly or indirectly, and we will not permit any Restricted Subsidiary to, create or assume any mortgage, pledge or other lien of or upon any of our or their assets unless all of the outstanding Indenture Securities of each series are secured by such mortgage, pledge or lien equally and ratably with any and all other obligations and indebtedness thereby secured for so long as any such other obligations and indebtedness will be so secured. Among the exceptions are:

the creation of any mortgage or other lien on any of our property or property of any Restricted Subsidiary to secure indebtedness incurred prior to, at the time of, or within 120 days after the later of, the acquisition, the completion of construction or the commencement of full operation of such property; and

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mortgages or liens on any property that we or any Restricted Subsidiary acquire after the date of the Senior Indenture existing at the time of such acquisition; provided that we incur the secured indebtedness for the purpose of financing all or any part of the acquisition or construction of any such property.

In addition, we or any Restricted Subsidiary may create or assume any mortgage, pledge or other lien not otherwise permitted by the Senior Indenture for the purpose of securing indebtedness or other obligations so long as the aggregate of all such indebtedness and other obligations then outstanding, together with the value of all outstanding Sale and Leaseback Transactions not otherwise permitted, will not exceed 10% of Consolidated Net Tangible Assets. (Section 1009 of the Senior Indenture)

Definitions

The Senior Indenture defines the term **Consolidated Net Tangible Assets** as our total assets and those of our consolidated subsidiaries, including the investment in (at equity) and the net amount of advances to and accounts receivable from corporations which are not consolidated subsidiaries, less the following:

our current liabilities and those of our consolidated subsidiaries, including an amount equal to indebtedness required to be redeemed by reason of any sinking fund payment due in 12 months or less from the date as of which current liabilities are to be determined;

all of our other liabilities and those of our consolidated subsidiaries other than Funded Debt (as defined), deferred income taxes and liabilities for employee post-retirement health plans recognized in accordance with Statement of Financial Accounting Standards No. 106;

all of our and our consolidated subsidiaries' depreciation and valuation reserves and all other reserves (except for reserves for contingencies which have not been allocated to any particular purpose);

the book amount of all our and our consolidated subsidiaries' segregated intangible assets, including, but without limitation, such items as goodwill, trademarks, trade names, patents and unamortized debt discount and expense, less unamortized debt premium; and

appropriate adjustments on account of minority interests of other persons holding stock in subsidiaries.

Consolidated Net Tangible Assets is to be determined on a consolidated basis in accordance with generally accepted accounting principles and as provided in the Senior Indenture. (Section 101 of the Senior Indenture)

The Senior Indenture defines the term **Restricted Subsidiary** as any of our subsidiaries except:

any subsidiary substantially all the assets of which are located, or substantially all of the business of which is carried on, outside of the United States and Canada, or any subsidiary substantially all the assets of which consist of stock or other securities of such subsidiary;

any subsidiary principally engaged in the business of financing notes and accounts receivable and any subsidiary substantially all the assets of which consist of stock or other securities of such subsidiary; or

any subsidiary acquired or organized after the date of the Indenture, unless our Board of Directors has designated it as a Restricted Subsidiary and such designation will not result in the breach of any covenant or agreement in the Senior Indenture. (Section 101 of the Senior Indenture)

The Senior Indenture defines the term **Funded Debt** as indebtedness for borrowed money owed or guaranteed by us or any of our consolidated subsidiaries, and any other indebtedness which under generally accepted accounting principles would appear as debt on the balance sheet of such corporation, which matures by its terms more than twelve months from the date as of which Funded Debt is to be determined or is extendible or renewable at the option of the obligor to a date more than twelve months from the date as of which Funded Debt is to be determined. (Section 101 of the Senior Indenture)

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For purposes of Limitation on Liens and Limitation on Sale and Leaseback Transactions, the Senior Indenture defines the term "value" with respect to a manufacturing plant as the amount equal to the greater of:

the net proceeds of the sale or transfer of such manufacturing plant; or

the fair value of such manufacturing plant at the time of entering into such Sale and Leaseback Transaction, as determined by our Board of Directors.

This amount is divided first by the number of full years of the term of the lease and then multiplied by the number of full years of such term remaining at the time of determination, without regard to renewal or extension options contained in such lease. (Section 1010 of the Senior Indenture)

Subordinated Indenture Provisions

Subordination

Article 16 of the Subordinated Indenture provides that the payment of principal of (and premium, if any), and interest on, subordinated securities will be subordinated in right of payment to the prior payment in full of Senior Indebtedness. We may make no payment with respect to subordinated securities while a default exists with respect to our Senior Indebtedness.

The Subordinated Indenture defines "Senior Indebtedness" as:

indebtedness of our company, whether outstanding on the date of the Subordinated Indenture or thereafter created, incurred, assumed or guaranteed for money borrowed from banks or other lending institutions and any other indebtedness or obligations of our company evidenced by a bond, debenture, note or other similar instrument, including without limitation, overdrafts, letters of credit issued for our account and commercial paper;

any other indebtedness that constitutes purchase money indebtedness for payment of which we are directly or contingently liable (excluding trade accounts payable);

any direct or contingent indebtedness or obligation represented by guarantees or instruments having a similar effect that we enter into (whether prior to the date of the Subordinated Indenture or thereafter) with reference to lease or purchase money obligations of a subsidiary or affiliate of our company or any other corporation in which we hold or have an option to purchase 50% or more of the outstanding capital stock; and

renewals, extensions and refundings of any indebtedness described in the three bullet points above, unless in any case the terms of the instrument creating or evidencing such indebtedness provide that the indebtedness is on a parity with or is junior to the Subordinated Indebtedness.

Any indebtedness that becomes indebtedness of our company by operation of merger, consolidation or other acquisition will constitute Senior Indebtedness if that indebtedness would have been Senior Indebtedness had it been issued by us. By reason of this subordination, in the event that we become insolvent, holders of our Senior Indebtedness may receive more, ratably, and holders of Subordinated Indebtedness may receive less, ratably, than our other creditors. The Subordinated Indenture does not limit our ability to issue Senior Indebtedness.

If this prospectus is being delivered in connection with a series of subordinated debt, the accompanying prospectus supplement or term sheet or the information incorporated by reference will set forth the approximate amount of Senior

Indebtedness outstanding as of a recent date.

The Trustees Under the Indentures

The Bank of New York Mellon Trust Company N.A., as successor to JPMorgan Chase Bank, N.A. (formerly known as Chemical Bank), is the Trustee under the Senior Indenture. We may appoint The Bank of New York Mellon Trust Company N.A. as trustee under the Subordinated Indenture. The Bank of New York Mellon Trust Company N.A. is among the banks with which we maintain ordinary banking relationships.

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In the event that a default occurs under either Indenture, unless the default is cured or waived within 90 days, the provisions of the Trust Indenture Act require that, if The Bank of New York Mellon Trust Company N.A. is Subordinated Trustee, it must resign as Trustee under either the Subordinated Indenture or the Senior Indenture. In such circumstance, we expect that The Bank of New York Mellon Trust Company N.A. would resign as Trustee under the Subordinated Indenture.

Foreign Currency Risks Fluctuations and Controls

Debt securities denominated or payable in foreign currencies may entail significant risks. For example, the value of the currencies, in comparison to U.S. dollars, may decline, or foreign governments may impose or modify controls regarding the payment of foreign currency obligations. These events may cause the value of debt securities denominated or payable in those foreign currencies to fall substantially. These risks will vary depending upon the foreign currency or currencies involved and will be more fully described in the applicable prospectus supplement or term sheet.

SPECIAL PROVISIONS RELATING TO FOREIGN CURRENCY NOTES

General

Unless otherwise indicated in the applicable prospectus supplement or term sheet, debt securities will be denominated in U.S. dollars, payments of principal of, premium, if any, and interest on debt securities will be made in U.S. dollars and payment of the purchase price of debt securities must be made in immediately available funds. If any debt securities (Foreign Currency Notes) are to be denominated or payable in a currency (a specified currency) other than U.S. dollars, the following provisions will apply in addition to, and to the extent inconsistent therewith will replace, the description of general terms and provisions of debt securities set forth in this prospectus and elsewhere in the accompanying prospectus supplement or term sheet.

A prospectus supplement or term sheet with respect to any Foreign Currency Note (which may include information with respect to applicable current foreign exchange controls) is a part of this prospectus. Any information concerning exchange rates is furnished as a matter of information only and should not be regarded as indicative of the range of or trends in fluctuations in currency exchange rates that may occur in the future.

Currencies

We may offer Foreign Currency Notes denominated and/or payable in a specified currency or specified currencies. Unless otherwise indicated in the applicable prospectus supplement or term sheet, purchasers are required to pay for Foreign Currency Notes in the specified currency. At the present time, there are limited facilities in the United States for conversion of U.S. dollars into specified currencies and vice versa, and banks may elect not to offer non-U.S. dollar checking or savings account facilities in the United States. However, if requested on or prior to the fifth Business Day preceding the date of delivery of the Foreign Currency Notes, or by such other day as determined by the agent who presents such offer to purchase Foreign Currency Notes to us, such agent may be prepared to arrange for the conversion of U.S. dollars into the specified currency set forth in the applicable prospectus supplement or term sheet to enable the purchasers to pay for the Foreign Currency Notes. Each such conversion will be made by the agents on such terms and subject to such conditions, limitations and charges as the agents may from time to time establish in accordance with their regular foreign exchange practices. All costs of exchange will be borne by the purchasers of the Foreign Currency Notes.

Information about the specified currency in which a particular Foreign Currency Note is denominated and/or payable, including historical exchange rates and a description of the currency and any exchange controls, will be set forth in the

applicable prospectus supplement or term sheet.

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Payment of Principal and Interest

The principal of, premium, if any, and interest on Foreign Currency Notes is payable by us in the specified currency. Currently, banks do not generally offer non-U.S. dollar-denominated account facilities in their offices in the United States, although they are permitted to do so. Accordingly, a holder of Foreign Currency Notes will be paid in U.S. dollars converted from the specified currency unless the holder is entitled to elect, and does elect, to be paid in the specified currency, or as otherwise specified in the applicable prospectus supplement or term sheet.

Any U.S. dollar amount to be received by a holder of a Foreign Currency Note will be based on the highest bid quotation in The City of New York received by an agent for us specified in the applicable prospectus supplement or term sheet (the Exchange Rate Agent) at approximately 11:00 A.M., New York City time, on the second Business Day preceding the applicable payment date from three recognized foreign exchange dealers (one of whom may be the Exchange Rate Agent) selected by the Exchange Rate Agent and approved by us for the purchase by the quoting dealer of the specified currency for U.S. dollars for settlement on the payment date in the aggregate amount of the specified currency payable to all holders of Foreign Currency Notes scheduled to receive U.S. dollar payments and at which the applicable dealer commits to execute a contract. If three bid quotations are not available, payments will be made in the specified currency. All currency exchange costs will be borne by the holder of the Foreign Currency Note by deductions from such payments.

Unless otherwise indicated in the applicable prospectus supplement or term sheet, a holder of Foreign Currency Notes may elect to receive payment of the principal of, and premium, if any, and interest on the Foreign Currency Notes in the specified currency by transmitting a written request for such payment to the corporate trust office of the Trustee in The City of New York on or prior to the regular record date or at least 15 calendar days prior to Maturity Date, as the case may be. This request may be in writing (mailed or hand delivered) or sent by cable, telex or other form of facsimile transmission. A holder of a Foreign Currency Note may elect to receive payment in the specified currency for all principal, premium, if any, and interest payments and need not file a separate election for each payment. This election will remain in effect until revoked by written notice to the Trustee, but written notice of any revocation must be received by the Trustee on or prior to the regular record date or at least fifteen calendar days prior to the Maturity Date, as the case may be. Holders of Foreign Currency Notes whose Notes are to be held in the name of a broker or nominee should contact their brokers or nominees to determine whether and how an election to receive payments in the specified currency may be made.

Unless otherwise specified in the applicable prospectus supplement or term sheet, if the specified currency is other than U.S. dollars, a beneficial owner of the related global security who elects to receive payments of principal, premium, if any, and/or interest, if any, in the specified currency must notify its participant through which it owns its beneficial interest on or prior to the applicable record date or at least fifteen calendar days prior to the Maturity Date, as the case may be, of such beneficial owner's election. The participant must notify the depository of such election on or prior to the third Business Day after such record date or at least 12 calendar days prior to the Maturity Date, as the case may be, and the depository will notify the Trustee of such election on or prior to the fifth Business Day after such record date or at least ten calendar days prior to the Maturity Date, as the case may be. If complete instructions are received by the participant from the beneficial owner and forwarded by the participant to the depository, and by the depository to the Trustee, on or prior to such dates, then the beneficial owner will receive payments in the specified currency.

Principal and interest on Foreign Currency Notes paid in U.S. dollars will be paid in the manner specified in this prospectus and the accompanying prospectus supplement or term sheet with respect to debt securities denominated in U.S. dollars. See Description of Debt Securities General. Interest on Foreign Currency Notes paid in the specified currency will be paid by check mailed on an Interest Payment Date other than a Maturity Date to the persons entitled thereto to the addresses of such holders as they appear in the security register or, at our option, by wire transfer to a

bank account maintained by the holder in the country of the specified currency. The principal of, premium, if any, and interest on Foreign Currency Notes, together with interest accrued and unpaid thereon, due on the Maturity Date will be paid, in the specified currency in

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immediately available funds upon surrender of such Notes at the corporate trust office of the Trustee in The City of New York, or, at our option, by wire transfer to such bank account of immediately available funds to an account with a bank designated at least 15 calendar days prior to the Maturity Date by the applicable registered holder, provided the particular bank has appropriate facilities to make these payments and the particular Foreign Currency Note is presented and surrendered at the office or agency maintained by us for this purpose in the Borough of Manhattan, The City of New York, in time for the Trustee to make these payments in accordance with its normal procedures.

Payment Currency

If a specified currency is not available for the payment of principal, premium, if any, or interest with respect to a Foreign Currency Note due to the imposition of exchange controls or other circumstances beyond our control, we will be entitled to satisfy our obligations to holders of Foreign Currency Notes by making such payment in U.S. dollars on the basis of the noon buying rate in The City of New York for cable transfers of the specified currency as certified for customs purposes (or, if not so certified, as otherwise determined) by the Federal Reserve Bank of New York (the Market Exchange Rate) as computed by the Exchange Rate Agent on the second Business Day prior to such payment or, if not then available, on the basis of the most recently available Market Exchange Rate or as otherwise indicated in an applicable prospectus supplement or term sheet. Any payment made under these circumstances in U.S. dollars where the required payment is in a specified currency will not constitute a default under the indenture with respect to the debt securities.

All determinations referred to above made by the Exchange Rate Agent will be at its sole discretion and will, in the absence of manifest error, be conclusive for all purposes and binding on the holders of the Foreign Currency Notes.

AS INDICATED ABOVE, AN INVESTMENT IN FOREIGN CURRENCY NOTES OR CURRENCY INDEXED NOTES INVOLVES SUBSTANTIAL RISKS, AND THE EXTENT AND NATURE OF SUCH RISKS CHANGE CONTINUOUSLY. AS WITH ANY INVESTMENT IN A SECURITY, PROSPECTIVE PURCHASERS SHOULD CONSULT THEIR OWN FINANCIAL AND LEGAL ADVISORS AS TO THE RISKS ENTAILED IN AN INVESTMENT IN FOREIGN CURRENCY NOTES OR CURRENCY INDEXED NOTES. SUCH NOTES ARE NOT AN APPROPRIATE INVESTMENT FOR PROSPECTIVE PURCHASERS WHO ARE UNSOPHISTICATED WITH RESPECT TO FOREIGN CURRENCY MATTERS.

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DESCRIPTION OF WARRANTS

The following is a general description of the terms of the warrants we may issue from time to time. This description is subject to the detailed provisions of a warrant agreement to be entered into between us and a warrant agent we select at the time of issue and the description in the prospectus supplement relating to the applicable series of warrants.

We may issue (either separately or together with other offered securities) warrants to purchase underlying debt securities, preferred shares, common shares or any combination thereof issued by us (offered warrants). Such warrants may be issued independently or together with any such securities and may be attached or separate from the securities. We may issue the warrants under separate warrant agreements (each a warrant agreement) to be entered into between us and a bank or trust company, as warrant agent (the warrant agent), identified in the prospectus supplement. The warrant agent will act solely as our agent and will not assume any obligation or relationship of agency for or with holders of beneficial owners of warrants.

Because this section is a summary, it does not describe every aspect of the warrants and any of the warrant agreements. We urge you to read any applicable warrant agreement because it, and not this description, defines your rights as a holder of our warrants. We will file any executed warrant agreement with the SEC. See Where You Can Find More Information for information on how to obtain a copy of the warrant agreement.

General

You should read the prospectus supplement for the material terms of the offered warrants, including the following:

The title and aggregate number of the warrants.

The title, rank, aggregate principal amount and terms of the underlying debt securities, preferred shares or common shares purchasable upon exercise of the warrants.

The principal amount of underlying debt securities, preferred shares or common shares that may be purchased upon exercise of each warrant, and the price or the manner of determining the price at which this principal amount may be purchased upon exercise.

The currency or currencies, including composite currencies, in which the price of such warrants may be payable.

The price at which and the currencies, including composite currencies, in which the securities purchasable upon exercise of such warrants shall commence and the date on which such right will expire.

If applicable, the minimum or maximum amount of such warrants which may be exercised at any one time.

If applicable, the title, rank, aggregate principal amount and terms of the securities with which such warrants are issued and the number of such warrants issued with each such security.

If applicable, the date on and after which such warrants and related securities will be separately transferable.

Any optional redemption terms.

Whether certificates evidencing the warrants will be issued in registered or bearer form and, if registered, where they may be transferred and exchanged.

Any other material terms of the warrants.

The prospectus supplement will also contain a discussion of the United States federal income tax considerations relevant to the offering.

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Warrant certificates will be exchangeable for new warrant certificates of different denominations. No service charge will be imposed for any permitted transfer or exchange of warrant certificates, but we may require payment of any tax or other governmental charge payable in connection therewith. Warrants may be exercised and exchanged and warrants in registered form may be presented for registration of transfer at the corporate trust office of the warrant agent or any other office indicated in the prospectus supplement or term sheet.

Exercise of Warrants

Each offered warrant will entitle the holder thereof to purchase the amount of underlying debt securities, preferred shares, common shares or any combination thereof at the exercise price set forth in, or calculable from, the prospectus supplement relating to the offered warrants. After the close of business on the expiration date, unexercised warrants will be void.

Warrants may be exercised by payment to the warrant agent of the applicable exercise price and by delivery to the warrant agent of the related warrant certificate, properly completed. Warrants will be deemed to have been exercised upon receipt of the exercise price and the warrant certificate or certificates. Upon receipt of this payment and the properly completed warrant certificates, we will, as soon as practicable, deliver the amount of underlying debt securities, preferred shares, common shares or any combination thereof purchased upon exercise.

If fewer than all of the warrants represented by any warrant certificate are exercised, a new warrant certificate will be issued for the unexercised warrants. The holder of a warrant will be required to pay any tax or other governmental charge that may be imposed in connection with any transfer involved in the issuance of underlying debt securities preferred shares, common shares or other combination thereof purchased upon exercise.

Amendments and Supplements to Warrant Agreement

We and the warrant agent may amend or supplement the warrant agreement for a series of warrants without the consent of the holders of the warrants issued thereunder to effect changes that are not inconsistent with the provisions of the warrants and that do not materially and adversely affect the interests of the holders of the warrants.

No Rights as Holders of Underlying Debt Securities, Preferred Shares or Common Shares

Before the warrants are exercised, holders of the warrants are not entitled to payments of principal of, premium, if any, or interest on the related underlying debt securities and dividends on the preferred shares, common shares or any combination thereof, as applicable, or to exercise any rights whatsoever as holders of the underlying debt securities, preferred shares or common shares.

DESCRIPTION OF PREFERRED SHARES

The following description sets forth the general terms and provisions of the preferred shares. If we offer preferred shares, we will describe the specific designation and rights in a prospectus supplement or term sheet, and we will file a description with the SEC.

General

Our Board of Directors is authorized without further shareholder action to issue one or more series of up to 14,106,394 preferred shares. The Board of Directors can also determine the number of shares, dividend rates, dividend payment dates and dates from which dividends will be cumulative, redemption rights or prices, sinking fund provisions, liquidation prices, conversion rights and restrictions on the issuance of shares of the same series or any

other class or series. As of the date of this prospectus, no preferred shares are issued or outstanding.

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The preferred shares will have the dividend, liquidation, redemption, voting rights and conversion rights set forth below unless otherwise provided in the prospectus supplement or term sheet relating to a particular series of offered preferred shares.

We will set forth the following terms of the offered preferred shares in the prospectus supplement or term sheet:

the title and stated value of the offered preferred shares, the liquidation preference per share and the number of shares offered;

the price at which we will issue the offered preferred shares;

the dividend rates and dates on which dividends will be payable, as well as the dates from which dividends will commence to cumulate or the method(s) of calculation thereof;

the period or periods within which, the price or prices at which, and the terms and conditions upon which the offered preferred shares may be redeemed, in whole or in part, at our option, if we are to have that option;

our obligation, if any, to redeem or purchase the offered preferred shares pursuant to any sinking fund or analogous provisions or at the option of a holder thereof, and the period or periods within which, the price or prices at which, and the terms and conditions upon which the offered preferred shares will be redeemed or purchased in whole or in part pursuant to such obligation;

any rights on the part of the holder to convert the offered preferred shares into our common shares;

any additional dividend, liquidation, redemption, sinking fund, voting and other rights, preferences, privileges, limitations and restrictions;

the terms of any debt warrants that we will offer together with or separately from the offered preferred shares;

the national securities exchanges, if any, upon which the offered preferred shares will be listed;

the procedures for any auction or remarketing, if any, of the offered preferred shares; and

any other terms of the offered preferred shares.

The preferred shares will be fully paid and nonassessable, and for each share issued, a sum equal to the stated value will be credited to our preferred stock account.

We are subject to certain provisions of Ohio law, each of which may have the effect of delaying, deferring or preventing a change in control of our company. See Description of Common Shares-Certain Ohio Statutes.

Dividends

As a holder of offered preferred shares, you will be entitled to receive cash dividends, when and as declared by the Board of Directors out of our assets legally available for payment, at such rate and on such quarterly dates as will be set forth in the applicable prospectus supplement or term sheet. Each dividend will be payable to holders of record as they appear on our stock books on the record dates fixed by the Board of Directors. Dividends will be cumulative from and after the date set forth in the applicable prospectus supplement or term sheet.

If we have not paid or declared and set apart for payment full cumulative dividends on any preferred shares for any dividend period or we are in default with respect to the redemption of preferred shares or any sinking fund for any preferred shares, we may not do the following:

declare any dividends (except a dividend payable in shares ranking senior to the preferred shares) on, or make any distribution (except as aforesaid) on, the common shares or any of our other shares; or

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make any payment on account of the purchase, redemption or other retirement of our common shares or any of our other shares except out of the proceeds of the sale of common shares or any other shares ranking junior to the preferred shares.

If dividends on preferred shares are in arrears, and there will be outstanding shares of any other series of preferred shares ranking on a parity as to dividends with the preferred shares, we, in making any dividend payment on account of such arrears, are required to make payments ratably upon all outstanding preferred shares and such other series of preferred shares in proportion to the respective amounts of dividends in arrears on such preferred shares and shares of such other series.

Liquidation Rights

In the event of any voluntary or involuntary liquidation, dissolution or winding up of our company, the holders of the offered preferred shares will be entitled to receive liquidating distributions in the amount set forth in the applicable prospectus supplement or term sheet plus all accrued and unpaid dividends. This distribution will be made out of our assets available for distribution to shareholders and will be made before any distribution is made to holders of our common shares. If, upon any voluntary or involuntary liquidation, dissolution or winding up of our company, the amounts payable with respect to the preferred shares and any of our other shares ranking on a parity with the preferred shares are not paid in full, the holders of those shares will share ratably in any such distribution of our assets in proportion to the full respective preferential amounts to which they are entitled. After payment of the full amount of the liquidating distribution to which they are entitled, the holders of preferred shares will not be entitled to any further participation in any distribution of our assets. A consolidation or merger of our company with or into any other corporation or corporations or a sale of all or substantially all of our assets will not be deemed to be a liquidation, dissolution or winding up of our company.

Redemption

The offered preferred shares will be redeemable in whole or in part at our option, at the times and at the redemption prices that we set forth in the applicable prospectus supplement or term sheet.

We may not redeem less than all the outstanding shares of any series of preferred shares unless full cumulative dividends have been paid or declared and set apart for payment upon all outstanding shares of such series of preferred shares for all past dividend periods. In addition, all of our matured obligations with respect to all sinking funds, retirement funds or purchase funds for all series of preferred shares then outstanding must have been met.

Voting Rights

The holders of the offered preferred shares are entitled to one vote per share on all matters presented to our shareholders.

If the equivalent of six quarterly dividends payable on any series of preferred shares are in default, whether or not declared or consecutive, the holders of all outstanding series of preferred shares, voting as a single class without regard to series, will be entitled to elect two directors until all dividends in default have been paid or declared and set apart for payment. The holders of preferred shares will not have or exercise such special class voting rights except at meetings of the shareholders for the election of directors at which the holders of not less than a majority of the outstanding preferred shares of all series are present in person or by proxy.

The affirmative vote of the holders of at least two-thirds of the outstanding preferred shares, voting as a single class without regard to series, will be required for any amendment of our Amended Articles of Incorporation or Amended Regulations that will adversely affect the preferences, rights or voting powers of the preferred shares. If not all series of preferred shares would be affected as to their preferences, rights or voting powers, only the consent of holders of at least two-thirds of the shares of each series that would be affected, voting separately as a class, will be required. A two-thirds vote is also required to issue any class of

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stock that will have preference as to dividends or distribution of assets over any outstanding series of preferred shares.

The affirmative vote of the holders of a majority of the outstanding preferred shares will be necessary to increase the authorized number of preferred shares or to authorize any shares ranking on a parity with the preferred shares. The Regulations may be amended to increase the number of directors, without the vote of the holders of outstanding preferred shares.

Conversion Rights

We will state in the prospectus supplement or term sheet for any series of offered preferred shares whether shares in that series are convertible into common shares. Unless otherwise provided in the applicable prospectus supplement or term sheet, if a series of preferred shares is convertible into common shares, holders of convertible preferred shares of that series will have the right, at their option and at any time, to convert any of those convertible preferred shares in accordance with their terms. However, if that series of convertible preferred shares is called for redemption, the conversion rights pertaining to such series will terminate at the close of business on the date before the redemption date.

Unless we specify otherwise in the applicable prospectus supplement or term sheet, the conversion rate is subject to adjustment in certain events, including the following:

- the issuance of common shares or capital shares of any other class as a dividend or distribution on the common shares;

- subdivisions and combinations of the common shares;

- the issuance of certain rights or warrants to all holders of common shares entitling those holders to subscribe for or purchase common shares, or securities convertible into common shares, within the period specified in the prospectus supplement or term sheet at less than the current market price as defined in the Certificate of Designations for such series of convertible preferred shares; and

- the distribution of evidences of indebtedness or assets or rights or warrants to all holders of common shares (excluding cash dividends, distributions, rights or warrants, referred to above).

No adjustments in the conversion rate will be made as a result of regular quarterly or other periodic or recurrent cash dividends or distributions or for cash dividends or distributions to the extent paid from retained earnings. No adjustment in the conversion price will be required unless such adjustment would require a change of at least 1% in the conversion price then in effect or a period of three years will have elapsed from the date of occurrence of any event requiring any such adjustment; provided that any adjustment that would otherwise be required to be made will be carried forward and taken into account in any subsequent adjustment. We reserve the right to make such increases in the conversion rate in addition to those required in the foregoing provisions as we, in our discretion, determine to be advisable in order that certain stock-related distributions or subdivisions of the common shares hereafter made by us to our shareholders will not be taxable. Except as stated above, the conversion rate will not be adjusted for the issuance of common shares or any securities convertible into or exchangeable for common shares, or securities carrying the right to purchase any of the foregoing.

In the case of:

- any reclassification or change of the common shares,

a consolidation or merger involving our company, or

a sale or conveyance to another corporation of the property and assets of our company as an entirety or substantially as an entirety,

as a result of which holders of common shares will be entitled to receive stock, securities, or other property or assets, including cash, with respect to or in exchange for such common shares, the holders of the convertible preferred shares then outstanding will be entitled thereafter to convert those convertible preferred shares into

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the kind and amount of shares and other securities or property which they would have received upon such reclassification, change, consolidation, merger, combination, sale or conveyance had those convertible preferred shares been converted into common shares immediately prior to the reclassification, change, consolidation, merger, combination, sale or conveyance.

DESCRIPTION OF COMMON SHARES

The following is a summary of the material provisions concerning the common shares contained in our Amended Articles of Incorporation (Articles) and our Amended Regulations (Regulations), as affected by debt agreements. Reference is made to such Articles and Regulations, which we have filed with the SEC. See Where You Can Find More Information in this prospectus for information on how to obtain a copy of the Articles and Regulations. Our common shares are listed on the New York Stock Exchange and the Chicago Stock Exchange.

Authorized Number

The Articles authorize the issuance of up to 500,000,000 common shares. Common shares issued and outstanding totaled 165.2 million as of January 31, 2009. The outstanding common shares are fully paid and non-assessable, and shareholders are not subject to any liability for calls and assessments. The Articles also authorize the issuance of up to 14,106,394 preferred shares. Currently, there are no preferred shares issued and outstanding.

Dividends

Holders of common shares may receive dividends that our Board of Directors declares.

Voting Rights

Each common share entitles the holder to one vote. Directors are elected by cumulative voting, which means that each common share entitles the holder to the number of votes equal to the number of directors to be elected. All votes in respect of such common share may be cast for one or more of the directors to be elected. Cumulative voting may have the effect of increasing minority shareholders' representation on the Board of Directors.

The Articles provide that action may be taken by the vote of the holders of shares entitling them to exercise a majority of the voting power of the Company, except in each case as is otherwise provided in the Articles or Regulations. The Articles and Regulations provide for a voting proportion, which is different from that provided by statutory law, in order for shareholders to take action in certain circumstances, including the following:

- (1) two-thirds vote required to fix or change the number of directors;
- (2) two-thirds vote required for removal of directors;
- (3) fifty percent of the outstanding shares required to call a special meeting of shareholders;
- (4) two-thirds vote required to amend the Regulations without a meeting;
- (5) two-thirds vote required to amend the provisions described in items (1) and (4) above and this provision, unless such action is recommended by two-thirds of the members of the Board of Directors;
- (6) two-thirds vote required to approve certain transactions, such as the sale, exchange, lease, transfer or other disposition by the Company of all, or substantially all, of its assets or business, or the consolidation of the Company or

its merger into another corporation, or certain other mergers and majority share acquisitions; and

(7) two-thirds vote required to amend the provisions described in item (6) above, or this provision.

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The requirement of a two-thirds vote in certain circumstances may have the effect of delaying, deferring or preventing a change in control of our Company.

Liquidation Rights

In the event of any voluntary or involuntary liquidation, dissolution or winding up of our company, after the payment or provision for payment of our debts and other liabilities and the preferential amounts to which holders of our preferred shares are entitled, if any such preferred shares are then outstanding, the holders of the common shares are entitled to share pro rata in our assets remaining for distribution to shareholders.

Miscellaneous Rights, Listing and Transfer Agents

Our common shares have no preemptive or conversion rights and there are no redemption or sinking fund provisions applicable thereto.

Our outstanding common shares are listed on the New York Stock Exchange. The Bank of New York Mellon Corporation is the transfer agent and registrar for our common shares.

Classification of Board of Directors

Our Board of Directors is divided into three approximately equal classes, having staggered terms of office of three years each. The effect of a classified board of directors, where cumulative voting is in effect, is to require the votes of more shares to elect one or more members of the Board of Directors than would be required if the Board of Directors were not classified. Additionally, the effect of a classified board of directors may be to make it more difficult to acquire control of our company.

Certain Ohio Statutes

Various laws may affect the legal or practical ability of shareholders to dispose of shares of our company. Such laws include the Ohio statutory provisions described below.

Chapter 1704 of the Ohio Revised Code prohibits an interested shareholder (defined as a beneficial owner, directly or indirectly, of ten percent (10%) or more of the voting power of any issuing public Ohio corporation) or any affiliate or associate of an interested shareholder (as defined in Section 1704.01 of the Ohio Revised Code) from engaging in certain transactions with the corporation during the three-year period after the interested shareholder's share acquisition date.

The prohibited transactions include mergers, consolidations, majority share acquisitions, certain asset sales, loans, certain sales of shares, dissolution, and certain reclassifications, recapitalizations, or other transactions that would increase the proportion of shares held by the interested shareholder.

After expiration of the three-year period, the corporation may participate in such a transaction with an interested shareholder only if, among other things:

the transaction receives the approval of the holders of two-thirds of all the voting shares and the approval of the holders of a majority of the disinterested voting shares (shares not held by the interested shareholder); or

the transaction meets certain criteria designed to ensure that the remaining shareholders receive fair consideration for their shares.

The prohibitions do not apply if, before the interested shareholder becomes an interested shareholder, the board of directors of the corporation approves either the interested shareholder's acquisition of shares or the otherwise prohibited transaction. The restrictions also do not apply if a person inadvertently becomes an interested shareholder or was an interested shareholder prior to the adoption of the statute on April 11, 1990, unless, subject to certain exceptions, the interested shareholder increases his, her or its proportionate share interest on or after April 11, 1990.

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Pursuant to Ohio Revised Code Section 1707.043, a public corporation formed in Ohio may recover profits that a shareholder makes from the sale of the corporation's securities within eighteen (18) months after making a proposal to acquire control or publicly disclosing the possibility of a proposal to acquire control. The corporation may not, however, recover from a person who proves in a court of competent jurisdiction either of the following:

that his, her or its sole purpose in making the proposal was to succeed in acquiring control of the corporation and there were reasonable grounds to believe that such person would acquire control of the corporation; or

such person's purpose was not to increase any profit or decrease any loss in the stock, and the proposal did not have a material effect on the market price or trading volume of the stock.

Also, before the corporation may obtain any recovery, the aggregate amount of the profit realized by such person must exceed \$250,000. Any shareholder may bring an action on behalf of the corporation if a corporation fails or refuses to bring an action to recover these profits within sixty (60) days of a written request. The party bringing such an action may recover attorneys' fees if the court having jurisdiction over such action orders recovery of any profits.

Control Share Acquisition Act

We are also subject to Ohio's Control Share Acquisition Act (Ohio Revised Code 1701.831). The Control Share Acquisition Act provides that, with certain exceptions, a person may acquire beneficial ownership of shares in certain ranges (one-fifth or more but less than one-third, one-third or more but less than a majority, or a majority or more) of the voting power of the outstanding shares of an Ohio corporation meeting certain criteria, which our company meets, only if such person has submitted an acquiring person statement and the proposed acquisition has been approved by the vote of a majority of the shares of the corporation represented at a special meeting called for such purpose and by a majority of such shares of the corporation excluding interested shares, as defined in Section 1701.01 of the Ohio Revised Code.

UNITED STATES FEDERAL TAXATION

The following summary describes, subject to the limitations set forth below, the material U.S. federal income tax considerations relevant to the purchase, ownership and disposition of debt securities and equity securities described in this prospectus. Except where noted, this discussion addresses only debt securities and equity securities purchased by investors at original issue for their issue price and held as capital assets and does not address certain types of securities described in this prospectus as further explained below. The applicable prospectus supplement or term sheet will contain a discussion of any special U.S. federal income tax considerations in respect of those types of securities.

This discussion is based on the Internal Revenue Code of 1986, as amended (the Code), Treasury Regulations (including proposed Regulations and temporary Regulations) promulgated thereunder, the IRS rulings, official pronouncements and judicial decisions, all as in effect on the date of this prospectus and all of which are subject to change, possibly with retroactive effect, or to different interpretations. The discussion below does not address all of the U.S. federal income tax consequences that may be applicable to a holder of a security nor does this discussion describe certain tax consequences that may be relevant to certain types of holders subject to special treatment under U.S. federal income tax law, such as individual retirement and other tax-deferred accounts, dealers in securities or currencies, financial institutions, partnerships, life insurance companies, tax-exempt organizations, persons holding a debt security as a hedge or hedged against currency risk, as a position in a straddle for tax purposes, as part of a synthetic security or other integrated investment comprised of a debt security or equity security and one or more other investments, United States persons (as defined below) whose functional currency is other than the U.S. dollar, or to certain U.S. expatriates. This discussion applies only to debt securities issued in registered form, and except where noted, this discussion does not describe tax consequences to subsequent purchases of debt securities or equity

securities.

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The U.S. federal income tax consequences of purchasing, holding or disposing of a particular security will depend, in part, on the particular terms of such security as set forth in the applicable prospectus supplement or term sheet. The U.S. federal income tax consequences of purchasing, holding or disposing of certain Floating Rate Notes, Foreign Currency Notes (other than Single Foreign Currency Notes, as defined below), Amortizing Notes, Bearer Securities, Floating Rate/Fixed Rate Notes, Indexed Notes, Renewable Notes, Extendible Notes, Notes (as defined below) paired with warrants, common shares, preferred shares, warrants, units and convertible securities referred to in this prospectus will be set out in the applicable prospectus supplement or term sheet. Persons considering the purchase of one or more securities should consult their independent tax advisors concerning the application of U.S. federal income tax law to their particular situations, as well as any tax consequences arising under the law of any state, local or foreign tax jurisdiction, and about any potential tax law changes and the effects applicable to them.

For purposes of the following discussion, **United States person** means an individual who is a citizen or resident of the United States, an estate subject to U.S. federal income taxation without regard to the source of its income, a corporation or other business entity treated as a corporation for U.S. federal income tax purposes created or organized in or under the laws of the United States, any state thereof or the District of Columbia, or a trust if a valid election to be treated as a United States person, as defined in the Code, is in effect with respect to such trust or both:

a court within the United States is able to exercise primary supervision over the administration of the trust, and one or more United States persons have the authority to control all substantial decisions of the trust.

If a partnership (including for this purpose any entity treated as a partnership for U.S. federal income tax purposes) is a beneficial owner of the security, the treatment of a partner in the partnership will generally depend upon the status of the partner and upon the activities of the partnership. A holder of security that is a partnership and partners in such partnership should consult their independent tax advisors.

United States Holders

The following discussion pertains only to a holder that is a beneficial owner of a debt security (a **Note**) or an equity security described in this prospectus and that is a United States person (a **U.S. holder**).

Payments of Interest on Notes

Except as discussed below under **OID Notes** and **Short-Term Notes**, payment of interest on a **Note** will be taxable to a U.S. holder as ordinary interest income at the time it is accrued or received in accordance with the holder's method of tax accounting. Special rules relating to **OID Notes**, **Notes** with floating interest rates, **Notes** denominated in a foreign currency or containing certain other provisions are described below.

OID Notes

The following summary is a general description of U.S. federal income tax consequences to holders of **Notes** issued with original issue discount (**OID Notes**) and is based on the provisions of the Code and on certain Treasury Regulations promulgated thereunder relating to original issue discount (the **OID Regulations**).

For U.S. federal income tax purposes, **original issue discount** is the excess of the stated redemption price at maturity of an **OID Note** over its issue price, if such excess is greater than or equal to a *de minimis* amount (generally 1/4 of 1% of the **OID Note**'s stated redemption price at maturity multiplied by the number of complete years to maturity from its issue date). The issue price of **OID Notes** that are issued for cash will be equal to the first price at which a substantial amount of such **Notes** is sold for money. For this purpose, sales to bond houses, brokers or similar persons or

organizations acting in the capacity of underwriters, placement agents or wholesalers are ignored. The stated redemption price at maturity of an OID Note is the sum of all payments provided by the OID Note, other than payments of qualified stated interest. Under the OID Regulations, qualified stated interest includes stated interest that is unconditionally payable in cash or

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property (other than debt instruments of the issuer) at least annually at a single fixed rate (with certain exceptions for lower rates paid during some periods) or certain variable rates as described below. Interest is payable at a single fixed rate only if the rate appropriately takes into account the length of the interval between payments. Except as described below with respect to Short-Term Notes, a holder of an OID Note will be required to include original issue discount in ordinary income as it accrues before the receipt of any cash attributable to such income, regardless of such holder's regular method of accounting for U.S. federal income tax purposes. Special rules for certain floating rate Notes are described below under Variable Rate Notes. A holder of an OID Note with *de minimis* original issue discount will include any *de minimis* original issue discount in income, as capital gain, on a pro rata basis as principal payments are made on such Note.

The amount of original issue discount includible in income by the initial holder of an OID Note is the sum of the daily portions of original issue discount with respect to such Note for each day during the taxable year on which such holder held such Note (accrued original issue discount). Generally, the daily portion of the original issue discount is determined by allocating to each day in any accrual period a ratable portion of the original issue discount allocable to such accrual period. Under the OID Regulations, the accrual periods for an OID Note may be selected by each holder, may be of any length, and may vary in length over the term of an OID Note, provided that each accrual period is no longer than one year and each scheduled payment of principal or interest occurs either on the first day or final day of an accrual period. The amount of original issue discount allocable to each accrual period is equal to the excess, if any, of:

the product of an OID Note's adjusted issue price at the beginning of such accrual period and its yield to maturity (determined on the basis of compounding at the close of each accrual period and adjusted for the length of such accrual period) over

the amount of qualified stated interest, if any, payable on such OID Note and allocable to such accrual period.

The adjusted issue price of an OID Note at the beginning of any accrual period generally is the sum of the issue price (including accrued interest, if any) of an OID Note plus the accrued original issue discount allocable to all prior accrual periods, reduced by any prior payment on the OID Note other than a payment of qualified stated interest. As a result of this constant yield method of including original issue discount income, a holder of an OID Note generally will have to include in income increasingly greater amounts of original issue discount in successive accrual periods.

If a holder's tax basis in an OID Note immediately after purchase exceeds the adjusted issue price of the OID Note (the amount of such excess is considered acquisition premium) but is not greater than the stated redemption price at maturity of such OID Note, the amount includible in income in each taxable year as original issue discount is reduced (but not below zero) by that portion of the acquisition premium properly allocable to such year.

If a holder purchases an OID Note for an amount in excess of the stated redemption price at maturity, the holder does not include any original issue discount in income and generally may be subject to the bond premium rules discussed below. See Amortizable Bond Premium. If a holder has a tax basis in an OID Note that is less than the adjusted issue price of such Note, the difference may be subject to the market discount provisions discussed below. See Market Discount.

Variable Rate Notes

In general, under Treasury Regulations, stated interest on certain floating rate Notes that qualify as Variable Rate Notes will be taxable to a U.S. holder when accrued or received in accordance with the U.S. holder's method of tax accounting. For this purpose, a Variable Rate Note is a Note that

(1) has an issue price that does not exceed the total noncontingent principal payments by more than the lesser of:

(a) the product of:

the total noncontingent principal payments;

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the number of complete years to maturity from the issue date; and

0.015; or

(b) 15 percent of the total noncontingent principal payments; and

(2) does not provide for stated interest other than stated interest compounded or paid at least annually at:

(a) one or more qualified floating rates ;

(b) a single fixed rate and one or more qualified floating rates;

(c) a single objective rate ; or

(d) a single fixed rate and a single objective rate that is a qualified inverse floating rate.

A qualified floating rate or objective rate in effect at any time during the term of the instrument must be set at a current value of that rate. A current value of a rate is the value of the rate on any day that is no earlier than three months prior to the first day on which that value is in effect and no later than one year following that first day.

A variable rate is a qualified floating rate if

(1) variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the Note is denominated; or

(2) it is equal to the product of such a rate and either:

(a) a fixed multiple that is greater than 0.65 but not more than 1.35; or

(b) a fixed multiple greater than 0.65 but not more than 1.35, increased or decreased by a fixed rate.

If a Note provides for two or more qualified floating rates that:

have values within 0.25 percentage points of each other on the issue date; or

can reasonably be expected to have approximately the same values throughout the term of the Note,

the qualified floating rates together constitute a single qualified floating rate. A rate is not a qualified floating rate, however, if the rate is subject to certain restrictions (including caps, floors, governors, or other similar restrictions) unless such restrictions are fixed throughout the term of the Note or are not reasonably expected to significantly affect the yield on the Note.

An objective rate is a rate, other than a qualified floating rate, that is determined using a single, fixed formula and that is based on objective financial or economic information. A rate will not qualify as an objective rate if it is based on information that is within the control of the issuer (or a related party) or that is unique to the circumstances of the issuer (or a related party), such as dividends, profits, or the value of the issuer's stock (although a rate does not fail to be an objective rate merely because it is based on the credit quality of the issuer). A variable rate is not an objective rate if it is reasonably expected that the average value of the rate during the first half of the Note's term will be either

significantly less than or significantly greater than the average value of the rate during the final half of the Note's term. An objective rate is a qualified inverse floating rate if:

the rate is equal to a fixed rate minus a qualified floating rate; and

the variations in the rate can reasonably be expected to inversely reflect contemporaneous variations in the qualified floating rate.

If interest on a Note is stated at a fixed rate for an initial period of one year or less followed by either a qualified floating rate or an objective rate for a subsequent period, and:

the fixed rate and the qualified floating rate or objective rate have values on the issue date of the Note that do not differ by more than 0.25 percentage points; or

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the value of the qualified floating rate or objective rate on the issue date is intended to approximate the fixed rate,

then the fixed rate and the qualified floating rate or the objective rate constitute a single qualified floating rate or objective rate.

Under these rules relating to variable rate debt instruments, CD Rate Notes, Commercial Paper Rate Notes, LIBOR Notes, Federal Funds Rate Notes, Prime Rate Notes, Treasury Rate Notes, CMT Rate Notes and Eleventh District Cost of Funds Rate Notes generally will be treated as Variable Rate Notes.

In general, if a Variable Rate Note provides for stated interest at a single qualified floating rate or objective rate and the interest is unconditionally payable in cash at least annually, all stated interest on the Variable Rate Note is qualified stated interest. The amount of original issue discount, if any, is determined by using, in the case of a qualified floating rate or qualified inverse floating rate, the value as of the issue date of the qualified floating rate or qualified inverse floating rate, or, in the case of any other objective rate, a fixed rate that reflects the yield reasonably expected for the Variable Rate Note. The qualified stated interest allocable to an accrual period is increased (or decreased) if the interest actually paid during an accrual period exceeds (or is less than) the interest assumed to be paid during the accrual period, as described in the previous sentence.

If a Variable Rate Note does not provide for stated interest at a single qualified floating rate or a single objective rate, or at a single fixed rate (other than at a single fixed rate for an initial period), the amount of interest and original issue discount accruals on the Variable Rate Note are generally determined by:

determining a fixed rate substitute for each variable rate provided under the Variable Rate Note (generally the value of each variable rate as of the issue date or, in the case of an objective rate that is not a qualified inverse floating rate, a rate that reflects the reasonably expected yield on the Variable Rate Note);

constructing the equivalent fixed rate debt instrument (using the fixed rate substitute described above);

determining the amount of qualified stated interest and original issue discount with respect to the equivalent fixed rate debt instrument; and

making the appropriate adjustments for actual variable rates during the applicable accrual period.

If a Variable Rate Note provides for stated interest, either at one or more qualified floating rates or at a qualified inverse floating rate, and in addition provides for stated interest at a single fixed rate (other than at a single fixed rate for an initial period), the amount of interest and original issue discount accruals are determined as in the immediately preceding paragraph with the modification that the Variable Rate Note is treated, for purposes of the first three steps of the determination, as if it provided for a qualified floating rate (or a qualified inverse floating rate, as the case may be) rather than the fixed rate. The qualified floating rate (or qualified inverse floating rate) replacing the fixed rate must be such that the fair market value of the Variable Rate Note, as of the issue date, would be approximately the same as the fair market value of an otherwise identical debt instrument that provides for the qualified floating rate (or qualified inverse floating rate) rather than the fixed rate.

Single Foreign Currency Notes

The following summary relates to Notes (*Single Foreign Currency Notes*) on which all payments that a holder is entitled to receive are denominated in or determined by reference to the value of a single Foreign Currency. Foreign

Currency means a currency or currency unit, other than a hyperinflationary currency as defined in the Code, or the U.S. dollar.

The amount required to be included in income by a cash basis holder upon receipt of an interest payment (representing a payment of qualified stated interest) denominated in or determined with reference to a single Foreign Currency, will be the U.S. dollar value of the amount paid (determined on the basis of the spot rate on the date such payment is received), regardless of whether the payment is in fact converted into U.S. dollars. No exchange gain or loss will be recognized with respect to the receipt of such payment.

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Except in the case of a Spot Rate Convention Election (as defined below), a holder of a Single Foreign Currency Note who uses the accrual method of accounting or is otherwise required to accrue interest income prior to receipt will be required to include in income for each taxable year the U.S. dollar value of the interest that has accrued during such year, determined by translating such interest at the average rate of exchange for the period or periods during which such interest has accrued. The average rate of exchange for an interest accrual period (or partial period) is the simple average of the spot exchange rates for each business day of such period (or such other average exchange rate that is reasonably derived and consistently applied by the holder). Upon receipt of an interest payment (including a payment attributable to accrued but unpaid interest upon the sale or exchange of a Single Foreign Currency Note), such holder will recognize ordinary gain or loss in an amount equal to the difference between the U.S. dollar value of the Foreign Currency received (determined on the basis of the spot rate on the date such payment is received) or, in the case of interest received in U.S. dollars rather than in Foreign Currency, the amount so received and the U.S. dollar value of the interest income that such holder has previously included in income with respect to such payment. Any such gain or loss generally will not be treated as interest income or expense, except to the extent provided by administrative pronouncements of the IRS.

A holder may elect (a Spot Rate Convention Election) to translate accrued interest into U.S. dollars at the spot rate on the last day of an accrual period for the interest, or, in the case of an accrual period that spans two taxable years, at the spot rate on the last day of the taxable year. Additionally, if a payment of interest is received within five business days of the last day of the accrual period, an electing holder may instead translate such accrued interest into U.S. dollars at the spot rate on the day of receipt. Any such election will apply to all debt instruments held by the United States person at the beginning of the first taxable year to which the election applies or thereafter acquired by the United States person and cannot be revoked without the consent of the IRS.

For purposes of this discussion, the spot rate generally means a rate that reflects a fair market rate of exchange available to the public for currency under a spot contract in a free market and involving representative amounts. A spot contract is a contract to buy or sell a currency on the nearest conventional settlement date, generally two business days following the date of the execution of the contract. If such a spot rate cannot be demonstrated, the IRS has the authority to determine the spot rate.

Original issue discount on a Single Foreign Currency Note that is also an OID Note will be determined for any accrual period in the applicable Foreign Currency and then translated into U.S. dollars in the same manner as interest income accrued by a holder on the accrual basis, including the application of a Spot Rate Convention Election. Likewise, upon receipt of payment attributable to original issue discount (whether in connection with a payment of interest or the sale, exchange or retirement of an OID Note), a holder will recognize exchange gain or loss to the extent of the difference between such holder's basis in the accrued original issue discount (determined in the same manner as for accrued interest) and the U.S. dollar value of such payment (determined by translating any Foreign Currency received at the spot rate on the date of payment). Generally, any such exchange gain or loss will be ordinary income or loss and will not be treated as interest income or expense, except to the extent provided in administrative pronouncements of the IRS. For this purpose, all payments on a Note will be viewed first as the payment of qualified stated interest (determined under the original issue discount rules), second as the payment of previously accrued original issue discount (to the extent thereof), with payments considered made for the earliest accrual periods first, and thereafter as the payment of principal.

Treasury Regulations issued under the Code meant to require the reporting of certain tax shelter transactions could be interpreted to cover transactions generally not regarded as tax shelters, including certain foreign currency transactions. Under the Treasury Regulations, certain transactions are required to be reported to the IRS, including, in certain circumstances, a sale, exchange, retirement or other taxable disposition of a foreign currency debt security to the extent that such sale, exchange, retirement or other taxable disposition results in a tax loss in excess of a threshold amount. If you are considering the purchase of a foreign currency debt security, you should consult with your

independent tax advisors to determine the tax return and disclosure obligations, if any, with respect to an investment in the debt securities, including any requirement to file IRS Form 8886 (Reportable Transaction Disclosure Statement).

Table of Contents***Short-Term Notes***

In general, an individual or other cash method holder of a Note that matures one year or less from the date of its original issuance (a Short-Term Note) is not required to accrue original issue discount on such Note unless it has elected to do so. For purposes of determining whether a Note is a Short-Term Note, the Note matures on the last possible date it could be outstanding under its terms. Holders who report income for U.S. federal income tax purposes under the accrual method, however, and certain other holders, including banks, dealers in securities and electing holders, are required to accrue original issue discount (unless the holder elects to accrue acquisition discount in lieu of original issue discount) and stated interest (if any) on such Note. Acquisition discount is the excess of the remaining stated redemption price at maturity of the Short-Term Note over the holder's tax basis in the Short-Term Note at the time of the acquisition. In the case of a holder who is not required, and does not elect, to accrue original issue discount or acquisition discount on a Short-Term Note, any gain realized on the sale, exchange or retirement of such Short-Term Note will be ordinary income to the extent of the original issue discount accrued through the date of such sale, exchange or retirement. Such a holder will be required to defer, until such Short-Term Note is sold or otherwise disposed of, the deduction of a portion of the interest expense on any indebtedness incurred or continued to purchase or carry such Short-Term Note. Original issue discount or acquisition discount on a Short-Term Note accrues on a straight-line basis unless an election is made to use the constant yield method (based on daily compounding).

In the case of a Short-Term Note that is also a Single Foreign Currency Note, the amount of original issue discount or acquisition discount subject to current accrual and the amount of any exchange gain or loss on a sale, exchange or retirement are determined under the same rules that apply to accrued interest on a Single Foreign Currency Note held by a holder on the accrual basis. A holder which is not required to, and which does not elect to, accrue original issue discount, or acquisition discount, will determine exchange gain or loss with respect to accrued original issue (or acquisition) discount on a sale, exchange, retirement or on maturity of a Short-Term Note in the same manner that a cash basis holder would account for interest income on a Single Foreign Currency Note.

The market discount rules will not apply to a Short-Term Note.

Market Discount

If a holder purchases a Note (other than an OID Note or a Short-Term Note) for an amount that is less than its stated redemption price at maturity, or purchases an OID Note for less than its revised issue price (as defined under the Code) as of the purchase date, the amount of the difference will be treated as market discount unless such difference is less than a specified *de minimis* amount. Under the market discount rules of the Code, a holder will be required to treat any partial principal payment on (or, in the case of an OID Note, any payment that does not constitute qualified stated interest), or any gain realized on the sale, exchange or retirement of, a Note as ordinary interest income to the extent of the market discount which has not previously been included in income and is treated as having accrued on such Note at the time of such payment or disposition. Further, a disposition of a Note by gift (and in certain other circumstances) could result in the recognition of market discount income, computed as if such Note had been sold at its then fair market value. In addition, a holder who purchases a Note with market discount may be required to defer the deduction of all, or a portion, of the interest paid or accrued on any indebtedness incurred or maintained to purchase or carry such Note until the maturity of the Note, or its earlier disposition in a taxable transaction.

Market discount is considered to accrue ratably during the period from the date of acquisition to the stated maturity date of a Note, unless the holder elects to accrue market discount under the rules applicable to original issue discount. A holder may elect to include market discount in income (generally as ordinary income) currently as it accrues, in which case the rules described above regarding the deferral of interest deductions and ordinary income treatment upon disposition or partial principal payment will not apply. Such election will apply to all debt instruments acquired by the holder on or after the first day of the first taxable year to which such election applies and may be revoked only with

the consent of the IRS.

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With respect to a Single Foreign Currency Note, market discount is determined in the applicable Foreign Currency. In the case of a holder who does not elect current inclusion, accrued market discount is translated into U.S. dollars at the spot rate on the date of disposition. No part of such accrued market discount is treated as exchange gain or loss. In the case of a holder who elects current inclusion, the amount currently includible in income for a taxable year is the U.S. dollar value of the market discount that has accrued during such year, determined by translating such market discount at the average rate of exchange for the period or periods during which it accrued. Such an electing holder will recognize exchange gain or loss with respect to accrued market discount under the same rules that apply to accrued interest on a Single Foreign Currency Note received by a holder on the accrual basis.

Amortizable Bond Premium

Generally, if a holder's tax basis in a Note held as a capital asset exceeds the stated redemption price at maturity of such Note, such excess may constitute amortizable bond premium that the holder may elect to amortize as an offset to interest income on the Note under the constant interest rate method over the period from the holder's acquisition date to the Note's stated maturity date. Any such election will apply to all debt instruments held by and acquired by the holder on or after the first day of the first taxable year to which such election applies and may be revoked only with the consent of the IRS. Under certain circumstances, amortizable bond premium may be determined by reference to an early call date. Special rules apply with respect to Single Foreign Currency Notes. If a holder elects to amortize the premium, the holder will be required to reduce such holder's tax basis in the Note by the amount of the premium amortized during the holding period. If a holder does not elect to amortize premium, the amount of premium will be included in such holder's tax basis in the Note. Therefore, if a holder does not elect to amortize premium and holds the Note to maturity, such holder generally will be required to treat the premium as capital loss when the Note matures.

Constant Yield Election

Under the OID Regulations, a holder of a Note may elect to include in income all interest that accrues on such Note using the constant yield method (a "constant yield election"). For this purpose, interest includes stated interest, acquisition discount, original issue discount, *de minimis* original issue discount, market discount, *de minimis* market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium. Special rules apply to constant yield elections made with respect to Notes issued with amortizable bond premium or market discount, including that a holder would be deemed, by virtue of making such constant yield election, to have made an election to amortize bond premium or accrue market discount, as separately described above. Once made with respect to a Note, the constant yield election cannot be revoked without the consent of the IRS. Holders considering a constant yield election should consult their independent tax advisors.

Purchase, Sale, Exchange or Retirement of Notes

A holder's tax basis in a Note generally will be the U.S. dollar cost of the Note to such holder (which, in the case of a Note purchased with Foreign Currency, will be determined by translating the purchase price at the spot rate on the date of purchase or, in the case of a Note that is traded on an established securities market as defined in applicable Treasury Regulations, on the settlement date if the holder is a cash basis taxpayer or an accrual basis taxpayer that so elects), increased by any original issue discount, market discount or acquisition discount previously included in the holder's gross income (as described below), and reduced by any amortized bond premium, taken into account by the holder and any principal payments and payments of stated interest that are not payments of qualified stated interest received by the holder.

Upon the sale, exchange or retirement of a Note, a holder generally will recognize gain or loss equal to the difference between the amount realized on the sale, exchange or retirement (or the U.S. dollar value of the amount realized in a Foreign Currency at the spot rate on the date of the sale, exchange or retirement or, in the case of a Note that is traded

on an established securities market as defined in applicable Treasury Regulations, on the settlement date if the holder is a cash basis taxpayer or an accrual basis taxpayer that so

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elects), except to the extent such amount is attributable to accrued but unpaid interest, and the holder's tax basis in the Note. Except with respect to:

gains or losses attributable to changes in exchange rates (as described in the next paragraph);

gains attributable to market discount; and

gains on the disposition of a Short-Term Note;

gain or loss so recognized will be capital gain or loss and will be long-term capital gain or loss, if, at the time of the sale, exchange or retirement, the Note was held for more than one year. Under current law, long-term capital gains of individuals are, under certain circumstances, taxed at lower rates than items of ordinary income. The deductibility of capital losses is subject to limitations.

Gain or loss recognized by a holder on the sale, exchange or retirement of a Single Foreign Currency Note that is attributable to changes in exchange rates will be treated as ordinary income or loss and generally will not be treated as interest income or expense except to the extent provided by administrative pronouncements of the IRS. Gain or loss attributable to changes in exchange rates is recognized on the sale, exchange or retirement of a Single Foreign Currency Note only to the extent of the total gain or loss recognized on such sale, exchange or retirement.

Exchange of Foreign Currency

A U.S. holder's tax basis in Foreign Currency purchased by the holder generally will be the U.S. dollar value thereof at the spot rate on the date such Foreign Currency is purchased. A holder's tax basis in Foreign Currency received as interest on, or on the sale, exchange or retirement of, a Single Foreign Currency Note will be the U.S. dollar value thereof at the spot rate at the time such Foreign Currency is received. The amount of gain or loss recognized by a holder on a sale, exchange or other disposition of Foreign Currency will be equal to the difference between:

the amount of U.S. dollars, the U.S. dollar value at the spot rate of the Foreign Currency, or the fair market value in U.S. dollars of the property received by the holder in the sale, exchange or other disposition; and

the holder's tax basis in the Foreign Currency.

Accordingly, a holder that purchases a Note with Foreign Currency will recognize gain or loss in an amount equal to the difference, if any, between such holder's tax basis in the Foreign Currency and the U.S. dollar value at the spot rate of the Foreign Currency on the date of purchase. Generally, any such gain or loss will be ordinary income or loss and will not be treated as interest income or expense, except to the extent provided by administrative pronouncements of the IRS.

Subsequent Interest Periods and Extension of Maturity

If so specified in the prospectus supplement or term sheet relating to a Note, we may have the option:

to reset the interest rate, in the case of a Fixed Rate Note, or to reset the spread, the spread multiplier or other formulas by which the interest rate basis is adjusted, in the case of a Floating Rate Note;
and/or

to extend the maturity of such Note.

See Description of Debt Securities Interest and Interest Rates and Description of Debt Securities Extendible Notes. The treatment of a holder of Notes with respect to which such an option has been exercised who does not elect to have us repay such Notes will depend on the terms established for such Notes by us pursuant to the exercise of such option (the revised terms). Depending on the particular circumstances, such holder may be treated as having surrendered such Notes for new Notes with the revised terms in either a taxable exchange or a recapitalization qualifying for nonrecognition of gain or loss.

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Notes Subject to Contingencies Including Optional Redemption

In general, the following rules apply if a Note provides for an alternative payment schedule applicable upon the occurrence of a contingency or contingencies and the timing and amounts of the payments that comprise each payment schedule are known as of the issue date, and one of such payment schedules is more likely than not to occur or the Note provides us or the holder with an unconditional option or options exercisable on one or more dates during the term of the Note. If based on all the facts and circumstances as of the issue date a single payment schedule for a debt instrument, including the stated payment schedule, is significantly more likely than not to occur, then, in general, the yield and maturity of the Note are computed based on this payment schedule.

Notwithstanding the general rules for determining yield and maturity in the case of Notes subject to contingencies, if we have or the holder has an unconditional option or options that, if exercised, would require payments to be made on the Notes under an alternative payment schedule or schedules, then (i) in the case of an option or options exercisable by us, we will be deemed to exercise or not exercise an option or combination of options in the manner that minimizes the yield on the Note and (ii) in the case of an option or options of the holder, the holder will be deemed to exercise or not exercise an option or combination of options in the manner that maximizes the yield on the Note. For purposes of those calculations, the yield on the Note is determined by using any date on which the Note may be redeemed or repurchased as the stated maturity date and the amount payable on such date in accordance with the terms of the Note as the principal amount at maturity.

If a contingency (including the exercise of an option) actually occurs or does not occur contrary to an assumption made according to the above rules (a change in circumstances) then, except to the extent that a portion of the Note is repaid as a result of a change in circumstances and solely for purposes of the accrual of original issue discount, the Note is treated as retired and then reissued on the date of the change in circumstances for an amount equal to the Note's adjusted issue price on that date.

In addition, the OID Regulations contain other rules for projecting payments and determining the timing, character and amount of income, gain and loss to holders of debt instruments not described above that provide for contingent payments, including certain Notes (other than Variable Rate Notes) that provide for floating or contingent interest. Potential investors in Notes with contingent payment features should review the applicable prospectus supplement or term sheet for a discussion of their U.S. federal income tax treatment.

Common Shares

In general, if distributions are made on our common shares to a U.S. holder, these distributions will be included in income of that U.S. holder as dividends to the extent of our current or accumulated earnings and profits, as determined under U.S. federal income tax principles. Distributions in excess of our current and accumulated earnings and profits will be treated as a nontaxable return of capital that reduce a U.S. holder's adjusted tax basis in the common shares and thereafter as capital gain. Subject to certain limitations and requirements, dividend income received by U.S. holders that are corporations will be eligible for a dividends received deduction and there may be reduced rate provisions in effect for dividends received by U.S. holders that are individuals.

A U.S. holder will recognize gain or loss upon the sale, exchange, or other taxable disposition of our common shares in an amount equal to the difference between (1) the amount of cash and the fair market value of any other property received in exchange for such common shares and (2) the U.S. holder's tax basis in the common shares. Generally, any such gain or loss will be capital gain or loss, and will be long-term capital gain or loss if, at the time of such disposition, the U.S. holder has held the common shares for more than one year. Long-term capital gain recognized by a non-corporate U.S. holder generally is subject to U.S. federal income tax at a reduced rate. The deductibility of capital losses is subject to limitations.

The U.S. federal income tax consequences of the purchase, ownership or disposition of our equity securities (other than our common shares) will depend on various factors, including their terms, conversion or exchange features, issue price and redemption provisions. U.S. holders should review the applicable prospectus

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supplement or term sheet for a discussion of the U.S. federal income tax treatment to U.S. holders of any such equity securities.

Non-United States Holders

The following discussion applies only to a holder that is a beneficial owner of a Note or our common shares described in this prospectus and that is not a United States person (a non-U.S. holder). Special U.S. federal income tax rules may apply to certain non-U.S. holders, such as controlled foreign corporations, passive foreign investment companies, certain U.S. expatriates, and foreign persons eligible for benefits under an income tax treaty with the United States.

Interest and OID on Notes

Subject to the discussion of backup withholding below, payments of principal and interest (including original issue discount) by us or our agent (in its capacity as such) to any non-U.S. holder not engaged in a trade or business in the United States will generally not be subject to U.S. federal withholding tax under the portfolio interest exception, *provided that*, in the case of interest (including original issue discount):

(1) such holder does not actually or constructively own 10% or more of the total combined voting power of all classes of our stock entitled to vote;

(2) such holder is not a controlled foreign corporation for United States tax purposes that is related to us through stock ownership;

(3) such holder is not a bank receiving interest described in Code Section 881(c)(3)(A); and

(4) neither we nor our agent has actual knowledge or reason to know that such holder is a United States person, and either:

(a) the beneficial owner of the Note certifies to us or our agent, under penalties of perjury, that such owner is not a United States person and provides its name and address (which certification can be made on IRS Form W-8BEN or a suitable substitute); or

(b) a securities clearing organization, bank or other financial institution that holds customers' securities in the ordinary course of its trade or business (a financial institution) certifies to us or our agent, under penalties of perjury (which certification can be made on IRS Form W-8IMY or a suitable substitute), that it is a qualified intermediary and that the certification described in clause (4)(a) above has been received from the beneficial owner by it or by another financial institution acting for the beneficial owner.

In the case of Notes held by a foreign partnership or foreign trust:

the certification described in clause (4)(a) above must be provided by the partners or beneficiaries rather than by the foreign partnership or foreign trust; and

the partnership or trust must provide certain information, including a United States taxpayer identification number (which certification can be made on IRS Form W-8IMY or a suitable substitute) and such other information as may be required if such foreign partnership (or foreign trust) is a withholding foreign partnership (or withholding foreign trust) that has entered into a qualified intermediary or similar agreement with the IRS.

A look-through rule would apply in the case of tiered partnerships.

If a non-U.S. holder of a Note fails to satisfy the requirements of the portfolio interest exception described above, payments of interest (including original issue discount) made to such holder generally will be subject to a 30% withholding tax (or such lower rate as may be provided by an applicable income tax treaty between the United States and a foreign country) unless another exemption applies and such holder complies with IRS certification requirements. In general, the exemption or reduced rate pursuant to an income tax treaty applies only if the non-U.S. holder provides a properly completed IRS Form W-8BEN or other documentation

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as may be prescribed by the IRS claiming benefits under an applicable income tax treaty. Any prospective investor who cannot satisfy the portfolio interest requirements described above should consult its independent tax advisor prior to making an investment in the Notes. In addition, an exemption from U.S. withholding tax is available for interest on a Note held by a non-U.S. holder not engaged in a trade or business in the United States if the Note matures not later than 183 days after the date of its original issue. Moreover, if a change in circumstances makes information set forth on IRS Form W-8 incorrect, then the non-U.S. holder must provide new documentation generally within thirty days.

If a non-U.S. holder of a Note is engaged in a trade or business in the United States and interest (including original issue discount) on the Note is effectively connected with the conduct of such trade or business, such holder, although exempt from U.S. federal withholding tax (by reason of the delivery of a properly completed IRS Form W-8ECI or a suitable substitute), will be subject to U.S. federal income tax on such interest (including original issue discount) in the same manner as if the non-U.S. holder were a United States person. In addition, if such holder is a foreign corporation, it may be subject to a branch profits tax equal to 30% of its effectively connected earnings and profits, as defined in the Code, for the taxable year, subject to adjustments, unless reduced under an applicable income tax treaty.

Dividends

In general, dividends paid to a non-U.S. holder in respect of common shares will be subject to U.S. withholding tax at a 30% rate. However, dividends that are effectively connected with the conduct of a trade or business within the United States by the non-U.S. holder are not subject to withholding tax so long as a properly completed IRS Form W-8ECI is provided by the non-U.S. holder. Rather, dividends so connected will be subject to U.S. federal income tax in the same manner as if the non-U.S. holder was a U.S. person and, if received by a non-U.S. holder that is a corporation, would also be subject to an additional branch profits tax at a 30% rate unless reduced under an applicable income tax treaty.

The 30% withholding rate may be reduced if the non-U.S. holder is eligible for the benefits of an income tax treaty that provides for a lower rate. Generally, to claim the benefits of an income tax treaty, a non-U.S. holder of our common shares will be required to provide a properly executed IRS Form W-8BEN and satisfy applicable certification and other requirements. A non-U.S. holder of our common shares that is eligible for a reduced rate of U.S. withholding tax under an income tax treaty may obtain a refund or credit of any excess amounts withheld by filing an appropriate claim for a refund with the IRS. A non-U.S. holder should consult its independent tax advisor as to its entitlement to benefits under a relevant income tax treaty.

Sale or Exchange

Subject to the discussion of backup withholding below, any capital gain realized upon the sale, exchange or retirement of a Note or common shares by a non-U.S. holder will not be subject to U.S. federal income or withholding taxes unless:

such gain is effectively connected with a United States trade or business of the holder; or

in the case of an individual, such holder is present in the United States for 183 days or more in the taxable year of the retirement or disposition and certain other conditions are met, or

in certain circumstances involving the sale of our common shares, we have been or are a U.S. real property holding company within the meaning of the Code. We have not been, and do not expect to become, a U.S. real property holding company.

Notes held by a non-U.S. holder who is an individual, who at the time of death is neither a citizen nor a resident of the United States for U.S. federal estate tax purposes, will not be subject to U.S. federal estate tax, *provided* that the income from the Notes was not or would not have been effectively connected with a U.S. trade or business of such individual and that such individual qualified for the exemption from U.S. federal withholding tax (without regard to the certification requirements) that is described above. Common shares so held, however, will be included in the gross estate of such non-U.S. holder for U.S. federal estate tax purposes, unless an applicable estate tax treaty or exemption provides otherwise.

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Backup Withholding and Information Reporting

In general, information reporting to U.S. tax authorities generally will apply to payments of principal and interest and dividends, and the proceeds of a sale of securities to a U.S. holder unless such U.S. holder is an exempt recipient (such as a corporation). Backup withholding tax will apply to such payments if such U.S. holder fails to provide its taxpayer identification number or certification of exempt status or fails to report in full dividend and interest income. A non-U.S. holder in general will not be subject to backup withholding and information reporting with respect to interest or dividend payments provided that we do not have actual knowledge or reason to know that such non-U.S. holder is a U.S. person and such non-U.S. holder has provided the IRS certification statement (on IRS Form W-8BEN or other applicable form) described above under Non-United States Holders . In addition, a non-U.S. holder will not be subject to backup withholding or information reporting with respect to the proceeds of a sale of securities within the United States or conducted through certain U.S.-related financial intermediaries, if the payor receives the IRS certification statement described above and does not have actual knowledge or reason to know that such non-U.S. holder is a U.S. person, as defined under the Code, or otherwise establishes an exemption. However, we may be required to report annually to U.S. tax authorities and to non-U.S. holders the amount of, and the tax withheld, if any, with respect to, any interest or dividends paid, regardless of whether any tax was actually withheld. Copies of these information returns may also be made available under the provisions of a specific treaty or agreement to the tax authorities of the country in which the non-U.S. holder resides. Any amounts withheld under the backup withholding rules will be allowed as a refund or a credit against a non-U.S. holder's U.S. federal income tax liability provided any required information is furnished timely to the IRS.

THE PRECEDING IS A DISCUSSION OF THE MATERIAL U.S. FEDERAL INCOME TAX CONSEQUENCES OF THE PURCHASE, OWNERSHIP AND DISPOSITION OF THE SECURITIES BUT MAY NOT BE APPLICABLE DEPENDING UPON YOUR PARTICULAR TAX SITUATION. YOU ARE URGED TO CONSULT YOUR INDEPENDENT TAX ADVISOR WITH RESPECT TO THE TAX CONSEQUENCES TO YOU OF THE PURCHASE, OWNERSHIP AND DISPOSITION OF THE SECURITIES, INCLUDING THE TAX CONSEQUENCES UNDER STATE, LOCAL, FOREIGN AND OTHER TAX LAWS AND THE POSSIBLE EFFECTS OF CHANGES IN FEDERAL OR OTHER TAX LAWS.

PLAN OF DISTRIBUTION

We may sell the offered securities as follows:

through agents;

to or through underwriters; or

directly to other purchasers.

We will identify any underwriters or agents and describe their compensation in a prospectus supplement.

We, directly or through agents, may sell, and the underwriters may resell, the offered securities in one or more transactions, including negotiated transactions. These transactions may be:

at a fixed public offering price or prices, which may be changed;

at market prices prevailing at the time of sale;

at prices related to such prevailing market prices; or

at negotiated prices.

In connection with the sale of offered securities, the underwriters or agents may receive compensation from us or from purchasers of the offered securities for whom they may act as agents. The underwriters may sell offered securities to or through dealers, who may also receive compensation from purchasers of the offered securities for whom they may act as agents. Compensation may be in the form of discounts, concessions or commissions. Underwriters, dealers and agents that participate in the distribution of the offered securities may

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be underwriters as defined in the Securities Act of 1933, and any discounts or commissions received by them from us and any profit on the resale of the offered securities by them may be treated as underwriting discounts and commissions under the Securities Act of 1933.

We will indemnify the underwriters and agents against certain civil liabilities, including liabilities under the Securities Act of 1933.

Underwriters, dealers and agents may engage in transactions with, or perform services for, us or our affiliates in the ordinary course of their business.

If we indicate in the prospectus supplement or term sheet relating to a particular series or issue of offered securities, we will authorize underwriters, dealers or agents to solicit offers by certain institutions to purchase such offered securities from us pursuant to delayed delivery contracts providing for payment and delivery at a future date. Such contracts will be subject only to those conditions that we specify in the prospectus supplement or term sheet, and we will specify in the prospectus supplement or term sheet the commission payable for solicitation of such contracts.

LEGAL OPINIONS

The validity of the offered securities will be passed upon for us by Mark McGuire, our General Counsel, and for any underwriters, dealers or agents by Shearman & Sterling LLP, 599 Lexington Avenue, New York, New York 10022. Mr. McGuire is paid a salary by our company and participates in various employee benefit plans offered by us, including equity based plans.

EXPERTS

The consolidated financial statements of Eaton Corporation appearing in Eaton Corporation's Annual Report on Form 10-K for the year ended December 31, 2008, and the effectiveness of Eaton Corporation's internal control over financial reporting as of December 31, 2008 have been audited by Ernst & Young LLP, independent registered public accounting firm, as set forth in their reports thereon, included therein, and incorporated herein by reference. Such consolidated financial statements are incorporated herein by reference in reliance upon such reports given on the authority of such firm as experts in accounting and auditing.

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Eaton Corporation

% Notes due 2014

PROSPECTUS SUPPLEMENT

March , 2009

Joint Book-Running Managers

**Banc of America Securities LLC
Goldman, Sachs & Co.
UBS Investment Bank**

renal immunopathology at Scripps Research Foundation. Since 1977 he has been a member of the Division of Nephrology at UCSD. He directed the dialysis unit and clinical nephrology program at UCSD for 19 years, and has directed the therapeutic apheresis program for the last 22 years. At different times he has served the UCSD Medical School as Assistant Dean for Clinical Affairs, Chief of Staff of the Hospital, and Chairman of the UCSD Medical Group. Special interests include immunological diseases, glomerular diseases, transplantation medicine, apheresis medicine, hemodialysis technology, innovative extracorporeal blood circuits, and general clinical nephrology. He practices, publishes and teaches in these areas, including authoring chapters in standard textbooks such as "Rheumatology" and "Clinical Dialysis".

Sepsis and Inflammation Advisory Board

Irshad H. Chaudry, Ph.D.

Dr. Chaudry is the Editor-in-Chief of the journal SHOCK®, a leading research publication that reviews novel therapeutic advances to address shock, trauma, sepsis, inflammation, ischemia, and related pathobiological states, with particular emphasis on the biologic mechanisms that determine the response to such injury. Dr. Chaudry received a B.S. as well as a M.S. with honors from Sind University, and a Ph.D. from Monash University, Australia. After his postdoctoral training at Toronto University, Canada, he was appointed Instructor and subsequently an Assistant Professor at the Jewish Hospital and Washington University School of Medicine. He then moved to Yale University as an Associate Professor and subsequently became a Professor. He moved to Michigan State University in

1986 as Professor and Director of Research and in 1996 became the Director of the Center for Surgical Research at Brown University. In 2000, he became the Director of the Center for Surgical Research at the University of Alabama at Birmingham, and the Vice Chairman of the Department of Surgery. He has over 500 publications to his credit and is a recipient of the NIH MERIT award.

Larry D. Cowgill, D.V.M., Ph.D.

Dr. Cowgill received his DVM degree from the University of California at Davis and completed his internship and residency training at the University of Pennsylvania. He was a National Institutes of Health Special Research Fellow at the Renal and Electrolyte Section of the University of Pennsylvania School of Medicine and earned a PhD in Comparative Medical Sciences. He is Board Certified in Small Animal Internal Medicine and is Associate Dean for Southern California Clinical Programs, Co-Director of the UC Veterinary Medical Center-San Diego (UCVMC-SD), and Professor in the Department of Medicine and Epidemiology. He oversees the Clinical Nephrology programs and the Companion Animal Hemodialysis Units at the Veterinary Medical Teaching Hospital at Davis and the UCVMC-SD. Dr. Cowgill has more than 35 years of experience in veterinary internal medicine, nephrology, and teaching and has trained many of the leading veterinary nephrologists throughout the world. He is a pioneer in the application of hemodialysis in companion and remains a leading authority in the development of blood purification therapies for renal diseases in animals and people.

Charles J. Fisher, Jr., M.D.

Dr. Fisher, founder and CEO of Margaux Biologics, Inc., is a physician scientist with a distinguished career in both academia and industry spanning over 30 years. Prior to joining industry, Dr. Fisher served as Professor and Head of Critical Care Medicine at The Cleveland Clinic Foundation, and has held professor, division chief and director positions at the University of California at Davis Medical Center, Case Western Reserve University and The Cleveland Clinic Foundation. His research in sepsis, host defense and endothelial dysfunction led to his assisting in the founding of Incyte, and his later recruitment to Eli Lilly & Co, where he led the Xigris (activated Protein C) Global Product Team and successfully registered the first drug approved for the treatment of sepsis. He was recruited to Abbott Laboratories as Vice President for Global Pharmaceutical Development and, among other accomplishments, led the registration of Humira (first fully humanized anti-TNF mab). Other medical firsts include his contributions to the development of, and later approval of, sTNF:fc (Enbrel, 1st soluble anti-TNF tx) and IL-1ra (Kinneret, 1st anti-IL-1 tx). Dr. Fisher has numerous patents and publications to his credit. Prior to founding Margaux Biologics, he was Chief Medical Officer and Executive Vice President of Cardiome Pharma Corp. where he led the team that invented, developed, registered and sold to Merck (\$800M) vernakalant, a novel, first in class, multi-ion channel drug for atrial fibrillation (Brinavess).

Additionally, Dr. Fisher is a decorated, multi tour combat veteran, with extensive military experience in special operations. He is a Life Member of the Special Operations Medical Association, has served as a member of the Defense Science Research Council and on Defense Advanced Research Projects Agency panels, including one focused on universal host defense. His unique background of direct patient care, basic and clinical research, on the ground combat experience, and leadership at all levels, has led to an exemplary track record of building teams, delivering results, medical firsts and saving lives.

Geert Schmid-Schonbein, Ph.D.

Dr. Schmid-Schonbein is Distinguished Professor of Bioengineering, Adjunct Professor in Medicine at the University of California, San Diego (UCSD) and director of the UCSD Microcirculation Laboratory where he and his team are studying organ injury mechanisms, apoptosis in hypertension, and triggers for inflammation in the blood circulation. Dr. Schmid-Schonbein earned his Ph.D. in bioengineering from UCSD in 1976. After a three-year post-doctoral fellowship at Columbia University, he returned to UCSD in 1979 as an assistant professor. Some of Dr. Schmid-Schonbein's early research discoveries involved the behavior of infection-fighting white blood cells. Using engineering techniques, he made the first determination of the force with which white blood cells adhere to the walls of blood vessels as part of the initial process of inflammation. Later, Dr. Schmid-Schonbein concluded that the survival of an acutely ill patient can hinge on the degree to which white blood cells are activated. Recently his group discovered a mechanism that leads to activation of white blood cells, which is due to digestive enzymes and may cause cardiovascular disease. Among his many distinctions, Dr. Schmid-Schonbein is a member of the National Academy of Engineering and a fellow of the American Heart Association. He is a founding fellow of the American Institute for Medical and Biological Engineering, and winner of the Melville Medal from the American Society of Mechanical Engineering.

Cancer Advisory Board

Dr. Radvanyi received his Ph.D. in clinical biochemistry from the University of Toronto. His main research area is tumor immunology studying immune regulation in cancer and identifying new antigens as targets for anti-cancer T-cell therapy. After completing postdoctoral work in Toronto and at Harvard University in Boston at the Joslin Diabetes Center, Dr. Radvanyi joined the Immunology Group at Sanofi-Pasteur in Toronto in 2000 as a Senior Scientist where he helped lead an antigen discovery program that led to the discovery of a group of over-expressed breast cancer-specific genes that are candidates for antigen-specific vaccines against breast cancer. In 2005, Dr. Radvanyi joined the faculty of the University of Texas, MD Anderson Cancer Center, where he also holds the additional appointment as Associate Professor, Department of Breast Medical Oncology, Division of Cancer Medicine.

Involvement in Legal Proceedings

To the best of our knowledge, during the past ten years, none of the following occurred with respect to a present or former director or executive officer of our company: (1) any bankruptcy petition filed by or against such person or any business of which such person was a general partner or executive officer either at the time of the bankruptcy or within two years prior to that time; (2) any conviction in a criminal proceeding or being subject to a pending criminal proceeding (excluding traffic violations and other minor offenses); (3) being subject to any order, judgment or decree, not subsequently reversed, suspended or vacated, of any court of any competent jurisdiction, permanently or temporarily enjoining, barring, suspending or otherwise limiting his involvement in any type of business, securities or

banking activities; (4) being found by a court of competent jurisdiction (in a civil action), the Securities and Exchange Commission or the Commodities Futures Trading Commission to have violated a federal or state securities or commodities law, and the judgment has not been reversed, suspended or vacated; and (5) being the subject of, or a party to, any federal or state judicial or administrative order, judgment, decree or finding, not subsequently reversed, suspended or vacated, relating to an alleged violation of any federal or state securities or commodities law or regulation, law or regulation respecting financial institutions or insurance companies or law or regulation prohibiting mail or wire fraud or fraud in connection with any business entity; or (6) being the subject of, or a party to, any sanction or order, not subsequently reversed, suspended or vacated, of any self-regulatory organization (as defined in Section 3(a)(26) of the Securities Exchange Act of 1934, as amended), any registered entity (as defined in Section 1(a)(29) of the Commodity Exchange Act), or any equivalent exchange, association, entity or organization that has disciplinary authority over its members or associated persons.

EXECUTIVE COMPENSATION

The following executive compensation disclosure reflects all compensation awarded to, earned by or paid to the executive officers below for the fiscal years ended March 31, 2014 and March 31, 2013. The following table summarizes all compensation for fiscal years 2014 and 2013 received by our Chief Executive Officer, and our three most highly compensated executive officers who earned more than \$100,000 in fiscal year 2014.

SUMMARY COMPENSATION TABLE FOR 2014 AND 2013 FISCAL YEARS

NAMED EXECUTIVE OFFICER AND PRINCIPAL POSITION	YEAR	SALARY (\$)	BONUS (\$)	STOCK AWARDS (\$)(5)	OPTION AWARDS (\$)(5)	NON- EQUITY INCENTIVE COMPEN- SATION (\$)	NON- QUALIFIED DEFERRED COMPEN- SATION EARNINGS (\$)	ALL OTHER COMP. (\$)	TOTAL
James A. Joyce (1) CHIEF EXECUTIVE OFFICER	2014	\$330,000	\$70,000	\$ -	\$180,000	\$ -	\$ -	\$ -	\$580,000
	2013	\$325,000	\$12,500	\$ -	\$ -	\$ -	\$ -	\$ -	\$337,500
Richard H. Tullis, PhD (2) VICE PRESIDENT AND CHIEF SCIENCE OFFICER	2014	\$195,000	\$--	\$ -	\$45,000	\$ -	\$ -	\$ -	\$240,000
	2013	\$195,000	\$10,000	\$ -	\$ -	\$ -	\$ -	\$ -	\$205,000
James B. Frakes (3) CHIEF FINANCIAL OFFICER AND SVP-FINANCE	2014	\$180,000	\$3,000	\$ -	\$45,000	\$ -	\$ -	\$ -	\$228,000
	2013	\$180,000	\$7,500	\$ -	\$ -	\$ -	\$ -	\$ -	\$187,500
Rodney S. Kenley (4) PRESIDENT	2014	\$240,000	\$--	\$ -	\$45,000	\$ -	\$ -	\$ -	\$285,000
	2013	\$240,000	\$10,000	\$ -	\$ -	\$ -	\$ -	\$ -	\$250,000

(1) The aggregate number of stock awards and stock option awards issued to Mr. Joyce and outstanding as of March 31, 2014 is 3,400,000 (see share restricted stock grant below) and 14,088,243, respectively. Mr. Joyce received a \$5,000 salary increase from \$325,000 to \$330,000 effective July 1, 2013. In June, 2014, Mr. Joyce received a \$20,000 salary increase from \$330,000 to \$350,000.

Mr. Joyce was granted 4,000,000 shares of restricted common stock, at a price per share of \$0.24, which vested in equal installments over a thirty-six month period that commenced on June 30, 2010. Mr. Joyce has accepted all 4,000,000 shares of the grant and all such shares have vested. Of these shares, Mr. Joyce currently owns 3,400,000 shares.

(2) The aggregate number of stock awards and stock option awards issued to Dr. Tullis and outstanding as of March 31, 2014 is zero and 3,117,175, respectively.

(3) Mr. Frakes was appointed as Chief Financial Officer on September 27, 2010 after previously serving as Senior Vice President-Finance on a part-time basis. The aggregate number of stock awards and stock option awards outstanding as of March 31, 2014 is zero and 1,000,000, respectively. In June 2014, Mr. Frakes received a \$30,000 salary increase from \$180,000 to \$210,000.

(4) Mr. Kenley was appointed President on October 27, 2011. The aggregate number of stock awards and stock option awards issued to Mr. Kenley and outstanding as of March 31, 2014 is zero and 1,500,000, respectively. In June, 2014, Mr. Kenley received a \$20,000 salary increase from \$240,000 to \$260,000.

(5) See note 6 to our financial statements for the years ended March 31, 2014 and 2013 regarding the assumptions made in valuing the stock/option awards in the above table.

Employment Agreements

We entered into an employment agreement with Mr. Joyce effective April 1, 1999. Effective June 1, 2001, Mr. Joyce was appointed President and Chief Executive Officer and his base annual salary was increased from \$120,000 to \$180,000. Effective January 1, 2005, Mr. Joyce's salary was increased from \$180,000 to \$205,000 per year. Under the terms of the agreement, his employment continues at a salary of \$205,000 per year for successive one-year periods, unless given notice of termination 60 days prior to the anniversary of his employment agreement. Effective April 1, 2006, Mr. Joyce's salary was increased from \$205,000 to \$240,000. His salary was subsequently increased to \$265,000 per year and effective May 1, 2008, his salary was increased from \$265,000 to \$290,000 per year. Effective April 1, 2010, his salary was increased from \$290,000 to \$325,000 per year. Effective July 2013, his salary was increased from \$325,000 to \$330,000 per year. In June 2014, his salary was increased from \$330,000 to \$350,000 per year.

During the fiscal year ended March 31, 2014, Mr. Joyce earned a bonus of \$50,000 from us that was paid to him in April 2014 and bonuses of \$20,000 from Exosome Sciences, Inc. All of those bonuses were based upon targets established by our compensation committee.

We entered into an employment agreement with Dr. Tullis effective January 10, 2000. Effective June 1, 2001, Dr. Tullis was appointed our Chief Science Officer. His compensation under the agreement was modified in June 2001 from \$80,000 to \$150,000 per year. Effective January 1, 2005, Dr. Tullis' salary was increased from \$150,000 to \$165,000 per year. Under the terms of the agreement, his employment continues at a salary of \$165,000 per year for successive one-year periods, unless given notice of termination 60 days prior to the anniversary of his employment agreement. Dr. Tullis was granted 250,000 stock options to purchase our common stock in connection the completing certain milestones, such as the initiation and completion of certain clinical trials, the submission of proposals to the U.S. Food and Drug Administration and the filing of a patent application. Effective April 1, 2006, Dr. Tullis' salary was increased to \$180,000 per year. Effective April 1, 2010, his salary was increased from \$180,000 to \$195,000 per year.

Both Mr. Joyce's and Dr. Tullis' agreements provide for medical insurance and disability benefits, one year of severance pay if their employment is terminated by us without cause or due to change in our control before the expiration of their agreements, and allow for bonus compensation and stock option grants as determined by our Board of Directors. Both agreements also contain restrictive covenants preventing competition with us and the use of confidential business information, except in connection with the performance of their duties for us, for a period of two years following the termination of their employment with us.

On September 27, 2010, Mr. Frakes was appointed our Chief Financial Officer. We have not entered into a written employment agreement with Mr. Frakes. As Chief Financial Officer, Mr. Frakes receives an annual salary of \$180,000 and medical insurance benefits. In June 2014, his salary was increased from \$180,000 to \$210,000 per year. During the fiscal year ended March 31, 2014, Mr. Frakes earned a bonus of \$3,000 from Exosome Sciences, Inc. based upon targets established by our compensation committee.

Mr. Kenley was appointed our President on October 27, 2010. Pursuant to a written offer of employment executed by us and Mr. Kenley, he receives an annual salary of \$240,000 and medical insurance benefits. In June 2014, his salary was increased from \$240,000 to \$260,000 per year.

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Outstanding Equity Awards at 2014 Fiscal Year-End

The following table sets forth certain information concerning stock option awards granted to our named executive officers.

OUTSTANDING EQUITY AWARDS AT 2014 FISCAL YEAR END

NAME	OPTIONS AWARDS			EQUITY INCENTIVE PLAN AWARDS NUMBER OF SECURITIES UNDERLYING UNEXERCISED UNEARNED OPTIONS UNEXERCISABLE (#)	OPTION EXERCISE PRICE (\$)	DATE OF OPTION EXPIRATION
	NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS EXERCISABLE (#)	NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS (#)				
James A. Joyce	1,115,550(1)	–	–	–	\$0.38	02/23/15
	557,775(1)	–	–	–	\$0.38	02/23/15
	557,775(1)	–	–	–	\$0.38	02/23/15
	2,857,143(1)	–	–	–	\$0.21	12/18/15
	2,500,000(2)	–	–	–	\$0.36	09/21/17
	2,000,000(3)	–	–	–	\$0.25	02/21/19
	2,500,000(4)	--	–	–	\$0.25	09/27/20
–(5)	2,000,000	–	–	\$0.10	07/01/23	
Richard H. Tullis	433,588(6)	–	–	–	\$0.38	02/23/15
	433,587(6)	–	–	–	\$0.38	02/23/15
	750,000(7)	–	–	–	\$0.41	06/14/18
	1,000,000(8)	–	–	–	\$0.25	09/27/20
	–(5)	500,000	–	–	\$0.10	07/01/23
James B. Frakes	500,000(9)	–	–	–	\$0.25	09/27/20
	–(5)	500,000	–	–	\$0.10	07/01/23
Rodney S. Kenley	854,157(10)	145,843	–	–	\$0.25	10/27/20
	–(5)	500,000	–	–	\$0.10	7/01/23

Note: We have omitted the stock awards columns of the above table because we have no disclosure applicable to those columns.

(1) This option was fully vested as of March 31, 2010 and as a result of the Option Suspension Agreement, the expiration date was extended by 100 days. Subsequent to March 31, 2010, the expiration date of this option was extended to February 23, 2015 (see Item 13 to the Financial Statements).

(2) The option vested 1,000,000 shares at grant, with 500,000 shares vesting each annual anniversary date through June 13, 2010 and as a result of the Option Suspension Agreement, the expiration date was extended by 100 days.

(3) The option vested 1,000,000 at grant, with 500,000 shares vesting on December 31, 2009 and December 31, 2010 and as a result of the Option Suspension Agreement, the expiration date was extended by 100 days.

(4) The option vested 1,000,000 at grant, with 500,000 vesting on each anniversary date through September 27, 2013.

(5) This option vests ratably on July 1, 2014, July 1, 2015 and July 1, 2016.

(6) This option was fully vested as of March 31, 2010. Subsequent to March 31, 2010, the expiration date of this option was extended to February 23, 2015 (see Item 13 to the Financial Statements).

(7) This option was fully vested as of December 15, 2011.

(8) The option was fully vested as of September 27, 2011.

(9) The option was fully vested as of September 27, 2011.

(10) The option vested 250,000 on October 27, 2011 and the remaining 750,000 vests over the 36 months following that date.

We have omitted the stock awards columns of the above table because we have no disclosure applicable to those columns.

Director Compensation for 2014 Fiscal Year

The following director compensation disclosure reflects all compensation awarded to, earned by or paid to the directors below for the fiscal year ended March 31, 2014.

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	Fees Earned or Paid in Cash (\$)	Stock Awards (\$)	Option Awards (\$)	Non-Equity Incentive Plan Compensation (\$)	Nonqualified Deferred Compensation Earnings (\$)	All Other Compensation (\$)	Total (\$)
James A. Joyce (1)	\$-	-	\$-	-	-	-	\$-
Richard H. Tullis (2)	\$-	-	\$-	-	-	-	\$-
Rodney S. Kenley (3)	\$-	-	\$-	-	-	-	\$-
Edward G. Broenniman (4)	\$15,000	-	\$93,902	-	-	-	\$108,902
Franklyn S. Barry, Jr. (5)	\$15,500	-	\$93,902	-	-	-	\$109,402
Chetan S. Shah, MD (6)	\$14,000	-	\$82,725	-	-	-	\$96,725
Phillip A. Ward (7)	\$11,000	-	\$40,244	-	-	-	\$51,244
Thomas V. Wornham (8)	\$10,000	-	\$40,244	-	-	-	\$50,244

(1) All compensation received by Mr. Joyce in fiscal year 2014 is disclosed in the Summary Compensation Table above. Mr. Joyce received no compensation as a director in fiscal year 2014.

(2) All compensation received by Dr. Tullis in fiscal year 2014 is disclosed in the Summary Compensation Table above. Dr. Tullis received no compensation as a director in fiscal year 2014.

(3) All compensation received by Mr. Kenley in fiscal year 2014 is disclosed in the Summary Compensation Table above. Mr. Kenley received no compensation as a director in fiscal year 2014.

(4) The aggregate number of stock awards and options awards issued and outstanding as of March 31, 2014 are 0 and 2,296,080. Mr. Broenniman received a stock option grant of 426,829 shares on March 14, 2014 for his service as an outside director and also received a stock option grant of 460,526 shares on July 24, 2012 for his service as an outside director. The 2014 option vested all 426,829 shares at grant and the 2012 option vested 198,026 at grant, with 262,500 vesting in the June 2013 quarter.

(5) The aggregate number of stock awards and options awards issued and outstanding as of March 31, 2014 are 0 and 2,151,905. Mr. Barry received a stock option grant of 426,829 shares on March 14, 2014 for his service as an outside director and also received a stock option grant of 460,526 shares on July 24, 2012 for his service as an outside director. The 2014 option vested all 426,829 shares at grant and the 2012 option vested 198,026 at grant, with 262,500 vesting in the June 2013 quarter.

(6) The aggregate number of stock awards and options awards issued and outstanding as of March 31, 2014 are 0 and 376,024. Dr. Shah received a stock option grant of 376,024 shares on July 24, 2012 for his service as an outside director. The 2014 option vested all 376,024 shares at grant.

(7) The aggregate number of stock awards and options awards issued and outstanding as of March 31, 2014 are 0 and 555,953. Mr. Ward received a stock option grant of 182,927 shares on March 14, 2014 for his service as an outside director and also received a stock option grant of 373,026 shares on July 24, 2012 for his service as an outside director. The 2014 option vested all 182,927 shares at grant and the 2012 option vested 198,026 at grant, with 175,000 vesting in the June 2013 quarter. Mr. Ward resigned from his position as one of our directors on January 9, 2014.

(8) The aggregate number of stock awards and options awards issued and outstanding as of March 31, 2014 are 0 and 373,026. Mr. Wornham received a stock option grant of 182,927 shares on March 14, 2014 for his service as an outside director and also received a stock option grant of 373,026 shares on July 24, 2012 for his service as an outside director. The 2014 option vested all 182,927 shares at grant and the 2012 option vested 198,026 at grant, with 175,000 vesting in the June 2013 quarter. Mr. Wornham exercised the 2014 stock option in full prior to March 31, 2014. Mr. Wornham resigned from his position as one of our directors on January 9, 2014.

Directors Compensation Program

We maintain a board compensation program, in which only non-employee directors may participate. Please see the “Equity Compensation Plans” section of this prospectus for more information on the program.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth information as of December 31, 2014, with respect to the ownership of our common stock, by (i) each person known by us to be the beneficial owner of more than five percent (5%) of the outstanding shares of each class of our capital stock, (ii) each of our directors and director nominees (if any), (iii) each of our named executive officers and (iv) all of our executive officers and directors as a group. The term "executive officer" is defined as the President/Chief Executive Officer, Secretary, Chief Financial Officer/Treasurer, any vice-president in charge of a principal business function (such as administration or finance), or any other person who performs similar policy making functions for us. We believe that each individual or entity named has sole investment and voting power with respect to shares of common stock indicated as beneficially owned by them, subject to community property laws where applicable, excepted where otherwise noted:

TITLE OF CLASS	NAME AND ADDRESS	AMOUNT AND NATURE OF BENEFICIAL OWNERSHIP (1)(2)	PERCENT OF BENEFICIAL OWNERSHIP
Common Stock	James A. Joyce, Chief Executive Officer and Director 9635 Granite Ridge Drive, Suite 100 San Diego, CA 92123	16,888,243 shares (3)	5.0%
Common Stock	Richard H. Tullis, PhD, Chief Scientific Officer and Director 9635 Granite Ridge Drive, Suite 100 San Diego, CA 92123	3,277,592 shares (4)	1.0%
Common Stock	Rodney S. Kenley, President and Director 9635 Granite Ridge Drive, Suite 100 San Diego, CA 92123	1,228,333 shares (5)	*
Common Stock	James B. Frakes, Chief Financial Officer 9635 Granite Ridge Drive, Suite 100 San Diego, CA 92123	718,333 shares (6)	*
Common Stock	Franklyn S. Barry, Jr., Director 9635 Granite Ridge Drive, Suite 100 San Diego, CA 92123	2,257,998 shares (7)	*
Common Stock	Edward G. Broenniman, Director 9635 Granite Ridge Drive, Suite 100 San Diego, CA 92123	2,578,254 shares (8)	*
Common Stock	Chetan Shah, MD, Director (11) 9635 Granite Ridge Drive, Suite 100 San Diego, CA 92123	19,207,084 shares (9)	5.8%
Common Stock	Ellen R Weiner Family Revocable Trust (11) 10645 N. Tatum Blvd., Suite 200-166 Phoenix, AZ 85028	40,510,230 shares (10)	11.8%
Common Stock	Estate of Allen S. Bird 9960 West Cheyenne Avenue, Suite 110 Las Vegas, NV 89129	14,730,620 shares (10)	4.4%
		46,155,837 shares	13.0%

All Current Directors and Executive Officers as a
Common Stock Group (7 members)

* Less than 1%

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(1) Based on 327,739,188 shares of common stock outstanding on our transfer records as of December 31, 2014.

(2) Calculated pursuant to Rule 13d-3(d)(1) of the Securities Exchange Act of 1934, as amended. Under Rule 13d-3(d)(1), shares not outstanding that are subject to options, warrants, rights or conversion privileges exercisable by a person within 60 days are deemed outstanding for the purpose of calculating the number and percentage owned by such person but not deemed outstanding for the purpose of calculating the percentage owned by each other person listed. Except where otherwise noted, we believe that each individual or entity named has sole investment and voting power with respect to the shares of common stock indicated as beneficially owned by such person, subject to community property laws, where applicable.

(3) Includes 2,231,100 stock options exercisable at \$0.38 per-share, 2,857,143 stock options exercisable at \$0.21 per share, 2,500,000 stock options exercisable at \$0.36 per share, 4,500,000 stock options exercisable at \$0.25 per share, 500,000 stock options exercisable at \$0.10 per share and 500,000 stock options exercisable at \$0.19 per share.

(4) Includes 867,175 stock options exercisable at \$0.38 per share, 750,000 stock options exercisable at \$0.41 per share, 1,000,000 stock options exercisable at \$0.25 per share 125,000 stock options exercisable at \$0.10 per share and 16,667 stock options exercisable at \$0.19 per share.

(5) Includes 1,000,000 stock options exercisable at \$0.25 per share, 125,000 stock options exercisable at \$0.10 per share and 83,333 stock options exercisable at \$0.19 per share.

(6) Includes 500,000 stock options exercisable at \$0.25 per share, 125,000 stock options exercisable at \$0.10 per share and 83,333 stock options exercisable at \$0.19 per share.

(7) Includes 264,550 stock options exercisable at \$0.38 per share, 500,000 stock options exercisable at \$0.41 per share, 500,000 stock options exercisable at \$0.25 per share. 460,526 stock options exercisable at \$0.076 per share and 426,829 stock options exercisable at \$0.082 per share.

(8) Includes 308,725 stock options exercisable at \$0.38 per share, 500,000 stock options exercisable at \$0.41 per share, 600,000 stock options exercisable at \$0.25 per share, 460,526 stock options exercisable at \$0.076 per share and 426,829 stock options exercisable at \$0.082 per share.

(9) Includes warrants to purchase 5,465,983 shares of common stock at exercise prices ranging from \$0.093 per share to \$0.132 per share and 376,024 stock options exercisable at \$0.082 per share.

(10) Includes common stock issuable upon exercise of warrants held by the Ellen R. Weiner Family Revocable Trust and common stock issuable upon exercise of warrants held by the Estate of Allan S. Bird. The trust owns 15,976,643 warrants to purchase common shares at prices ranging from \$0.042 to \$0.108 per share. The estate owns 5,154,916 warrants to purchase common shares at prices ranging from \$0.042 to \$0.108 per share. Mr. Bird was Ms. Weiner's father-in-law. The Ellen R. Weiner Family Trust disclaims any beneficial ownership of the estate's warrants and underlying common stock. The Estate of Mr. Bird disclaims any beneficial ownership of the trust's warrants and underlying common stock.

(11) More-than-5% stockholder.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The following describes all transactions since April 1, 2012, and all proposed transactions, in which we were or are to be a participant and the amount involved exceeds the lesser of \$120,000 or one percent of the average of our total assets at year-end for the last two completed fiscal years, and in which any related person had or will have a direct or indirect material interest.

On June 26, 2012, prior to joining our Board of Directors, Mr. Thomas Wornham, now one of our former directors, purchased \$10,000 of units, with each unit consisting of (i) one share of common stock at a price per share of \$0.072 and (ii) a warrant to purchase such number of shares of common stock as shall equal (a) fifty percent of the subscription amount divided by (b) \$0.072 at an exercise price of \$0.107 per share.

On July 24, 2012, our Board of Directors granted, to our four outside directors, ten year options to acquire an aggregate of 1,667,105 shares of our common stock, all with an exercise price of \$0.076 per share.

Between March 2012 and June 2013, Dr. Chetan Shah, one of our directors, participated in several private equity placements with us under which he invested an aggregate amount of \$625,556 and in return received 8.5 million restricted shares of our common stock and seven year warrants to purchase 4,250,000 shares of our common stock.

In June 2013, we borrowed \$80,000 at a 10% interest rate from Mr. Phillip Ward, one of our former directors. We repaid that loan and paid accrued interest of \$133 to Mr. Ward in June 2013.

In July 2013, we borrowed \$400,000 from Mr. Ward and Dr. Shah under 90-day notes bearing 10% interest. If we did not pay back those loans by October 9, 2013, then the notes would bear interest at a penalty rate of 12% and the noteholders would have the right at their discretion (i) to convert their principal and accrued interest into shares of common stock at \$0.088 per share and (ii) receive warrants to purchase common stock equal to 50% of the principal converted under the notes, with an exercise price of \$0.132 per share. We subsequently repaid Mr. Ward's note in cash. That repayment extinguished all potential common stock and warrant issuance provisions of Mr. Ward's note. On July 24, 2014, we issued to Dr. Shah an aggregate of 2,503,966 shares of restricted common stock and a seven-year warrant to issue up to 1,251,983 shares of common stock at an exercise price of \$0.132 per share upon the conversion of an aggregate of \$220,349 of unpaid principal and accrued interest due under his note. The amount converted represented the entire amount outstanding under Dr. Shah's note.

On March 14, 2014, our Board of Directors granted to our three outside directors ten-year options to acquire an aggregate of 1,595,536 shares of our common stock at an exercise price of \$0.082 per share.

On June 6, 2014, our Board of Directors granted to our directors and our Chief Financial Officer ten-year options to acquire an aggregate of 2,602,633 shares of our common stock at an exercise price of \$0.19 per share.

In July 2014, Exosome Sciences, Inc. paid a bonus of \$15,000 to Mr. Joyce.

In October 2014, Exosome Sciences, Inc. paid bonuses of \$15,000 to Mr. Joyce and \$1,500 to Mr. Frakes.

On October 20, 2014, we issued to Dr. Shah 2,111,111 shares of common stock and three-year warrants to acquire up to 2,111,111 shares of common stock with exercise prices ranging from \$0.093 to \$0.11 per share. The common stock and warrants were issued to Dr. Shah upon his cash exercise, for an aggregate of \$214,000, of previously issued warrants for 2,111,111 shares held by him.

On October 21, 2014 and November 7, 2014, we paid Mr. Franklyn Barry and Mr. Edward Broenniman, two of our outside directors, an aggregate of \$10,944 and \$10,063, respectively, for accrued Board of Directors fees and expenses reimbursable to them. On November 7, 2014, we paid Dr. Tullis \$5,000 for accrued expenses reimbursable to him.

In December 2014, we paid bonuses of \$25,000 to Mr. Joyce, \$15,000 to Mr. Kenley, \$15,000 to Mr. Frakes and \$5,000 to Dr. Tullis.

On December 22, 2014, Exosome Sciences, Inc. paid Mr. Joyce a bonus of \$15,000.

Director Independence

Each of Mr. Barry, Mr. Broenniman and Dr. Shah is an independent director as that term is defined by NASDAQ Stock Market Rule 5605(a)(2). We currently have a compensation and audit committee. Of the members of our Board of Directors, each of Mr. Barry, Mr. Broenniman and Dr. Shah meets the NASDAQ Stock Market's independence standards for members of such committees.

DESCRIPTION OF SECURITIES

General

Our authorized capital consists of 500,000,000 shares of common stock, par value \$0.001 per share. As of December 31, 2014, there were issued and outstanding 327,739,188 shares of common stock.

Common Shares

The holders of our common stock are entitled to one vote (or consent) per share on all matters to be voted on by the stockholders. Holders of common stock are entitled to receive ratably such dividends as may be declared by the Board out of funds legally available therefore. If we liquidate, dissolve or wind up, holders of common stock are entitled to share ratably in all assets remaining after payment of all debts and other liabilities. Holders of common stock have no preemptive, conversion or subscription rights. There are no redemption or sinking fund provisions applicable to the common stock. All outstanding shares of common stock are, and all shares of common stock to be outstanding upon completion of this offering will be, validly issued, fully paid and nonassessable.

Except as otherwise required by Nevada law, all stockholder action is taken by the vote of a majority of common stock voting as a single class present at a meeting of stockholders at which a quorum consisting of a majority of the outstanding shares of common stock is present in person or proxy.

Options and Warrants Convertible into Common Shares

As of December 31, 2014, there were outstanding common share purchase options entitling the holders to purchase 28,956,038 common shares at a weighted average exercise price of \$0.26 per share and warrants entitling the holders to purchase up to 71,794,602 common shares at a weighted average exercise price of \$0.14 per share.

LEGAL MATTERS

The validity of the shares of common stock offered by this prospectus has been passed upon by Raines Feldman LLP. Jennifer A. Post, a partner of the firm, owns approximately 800,000 shares of our common stock.

EXPERTS

The financial statements included in this prospectus as of March 31, 2014 and March 31, 2013 and for each of the years then ended have been audited by Squar, Milner, Peterson, Miranda & Williamson, LLP. Such financial statements have been so included in reliance on the report of such firm, appearing elsewhere herein, given upon their authority as experts in accounting and auditing.

WHERE YOU CAN FIND MORE INFORMATION

We are a reporting company under the Securities Exchange Act of 1934, as amended, and we file annual, quarterly and current reports and other information with the Securities and Exchange Commission. The public may read and copy any materials that we file with the Securities and Exchange Commission at its Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the Securities and Exchange Commission at 1-800-SEC-0330. The Securities and Exchange Commission maintains an Internet site at <http://www.sec.gov> that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the Securities and Exchange Commission.

Our website address is www.aethlonmedical.com. Our website and the information contained on our website are not incorporated into this prospectus or the registration statement of which it forms a part.

DISCLOSURE OF COMMISSION POSITION ON INDEMNIFICATION FOR SECURITIES ACT LIABILITIES

Nevada Law.

We are incorporated in Nevada. Subsection 1 of Section 78.7502 of the Nevada Revised Statutes empowers a corporation to indemnify any person who was or is a party or is threatened to be made a party to any threatened,

pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that he is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by him in connection with such action, suit or proceeding if he is not liable pursuant to Section 78.138 of the Nevada Revised Statutes or if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful. Subsection 7 of Section 78.138 provides that, with certain exceptions, a director or officer is not individually liable to the corporation or its stockholders or creditors for any damages as a result of any act or failure to act in his capacity as a director or officer unless it is proven that (i) his act or failure to act constituted a breach of his fiduciary duties as a director or officer, and (ii) his breach of those duties involved intentional misconduct, fraud or a knowing violation of the law.

Subsection 2 of Section 78.7502 empowers a corporation to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that such person acted in any of the capacities set forth above against expenses, including amounts paid in settlement and attorneys' fees actually and reasonably incurred by him in connection with the defense or settlement of such action or suit if he acted under similar standards, except that no indemnification may be made in respect of any claim, issue or matter as to which such person shall have been adjudged by a court of competent jurisdiction to be liable to the corporation or for amounts paid in settlement to the corporation, unless and only to the extent that the court in which such action or suit was brought or other court of competent jurisdiction determines that, in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses as the court deems proper.

Section 78.7502 further provides that to the extent a director or officer of a corporation has been successful in the defense of any action, suit or proceeding referred to in subsections (1) and (2) thereof, or in the defense of any claim, issue or matter therein, he shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by him in connection therewith. Subsection 3 of Section 78.751 of the Nevada Revised Statutes provides that the indemnification provided for by Section 78.7502 shall not be deemed exclusive or exclude any other rights to which the indemnified party may be entitled (except that indemnification will generally not be available to a person if a final adjudication establishes that his acts or omissions involved intentional misconduct, fraud or a knowing violation of the law and were material to the cause of action) and that the indemnification shall continue as to directors, officers, employees or agents who have ceased to hold such positions, and to their heirs, executors and administrators. Section 78.752 empowers the corporation to purchase and maintain insurance on behalf of a director, officer, employee or agent of the corporation against any liability asserted against him or incurred by him in any such capacity or arising out of his status as such whether or not the corporation would have the power to indemnify him against such liabilities under Section 78.7502.

By-Laws.

Our by-laws provide for the elimination of the personal liability of our officers, directors, corporate employees and agents to the fullest extent permitted by the provisions of the Nevada Law. Under such provisions, we shall indemnify a director or officer (and may indemnify a corporate employee or agent) who in his capacity as such is made, or threatened to be made, party to any suit or proceeding, if it is determined that such person acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of our company and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful.

Liability Insurance.

We maintain directors' and officers' liability insurance covering our directors and officers against expenses and liabilities arising from certain actions to which they may become subject by reason of having served in such role, including insurance for claims against these persons brought under securities laws. Such insurance is subject to the coverage amounts, exceptions, deductibles and other conditions set forth in the policy as in effect at the time of a

claim, if any. There is no assurance that we will maintain liability insurance for our directors and officers.

Public Policy Limitations.

Insofar as indemnification for liabilities arising under the Securities Act of 1933, as amended, may be permitted to our directors, officers and controlling persons pursuant to the foregoing provisions, or otherwise, we have been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Securities Act of 1933, as amended, and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by us of expenses incurred or paid by one of our directors, officers or controlling persons in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, we will, unless in the opinion of our counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by us is against public policy as expressed in the Securities Act of 1933, as amended, and will be governed by the final adjudication of such issue.

AETHLON MEDICAL, INC. AND SUBSIDIARY

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders

Aethlon Medical, Inc. and Subsidiary

We have audited the accompanying consolidated balance sheets of Aethlon Medical, Inc. and Subsidiary (the "Company") as of March 31, 2014 and 2013 and the related consolidated statements of operations, deficit and cash flows for each of the years in the two-year period ended March 31, 2014. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Aethlon Medical, Inc. and Subsidiary as of March 31, 2014 and 2013 and the consolidated results of their operations and cash flows for each of the years in the two-year period ended March 31, 2014 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1, the accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company has incurred continuing losses from operations and at March 31, 2014 is in default on certain debt agreements, has negative working capital of approximately \$14,169,000 and an accumulated deficit of approximately \$74,833,000. A significant amount of additional capital will be necessary to advance the development of the Company's products to the point at which they may become commercially viable. These conditions, among others, raise substantial doubt about the Company's ability to continue as a going concern. Management's plans regarding these matters are also described in Note 1. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Subsequent to March 31, 2014, as more fully discussed in Note 16, the Company entered into amended debt agreements with certain creditors which resulted in conversion of debt into common stock and the elimination of warrant and convertible debt price protection features. As a result, derivative liabilities of approximately \$10,679,000 were reclassified to equity and certain debt holders converted their debt and accrued interest into equity in the approximate amount of \$1,235,000. Due to the significance of such subsequent events, the Company has included an unaudited pro forma balance sheet as of March 31, 2014 alongside its consolidated balance sheets to present the effect of these subsequent events as if they had occurred on March 31, 2014.

/s/ SQUAR, MILNER, PETERSON, MIRANDA & WILLIAMSON, LLP

NEWPORT BEACH, CALIFORNIA

JULY 14, 2014

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AETHLON MEDICAL, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

	March 31, 2014	March 31, 2013	Pro Forma March 31, 2014 (Note 16) (unaudited)
ASSETS			
CURRENT ASSETS			
Cash	\$1,250,279	\$125,274	\$1,250,279
Accounts receivable	95,177	208,781	95,177
Deferred financing costs	83,191	863	83,191
Prepaid expenses	50,699	29,602	50,699
TOTAL CURRENT ASSETS	1,479,346	364,520	1,479,346
NON-CURRENT ASSETS			
Property and equipment, net	84,279	145	84,279
Patents, net	112,489	121,653	112,489
Deposits	18,988	10,376	18,988
TOTAL NON-CURRENT ASSETS	215,756	132,174	215,756
TOTAL ASSETS	\$1,695,102	\$496,694	\$1,695,102
LIABILITIES AND DEFICIT			
CURRENT LIABILITIES			
Accounts payable	\$517,651	\$822,832	\$517,651
Due to related parties	839,070	736,070	839,070
Notes payable	390,000	321,381	390,000
Convertible notes payable, current portion	1,367,655	2,367,631	482,655
Derivative liabilities	10,679,067	3,588,239	–
Other current liabilities	1,855,374	1,804,985	1,280,124
TOTAL CURRENT LIABILITIES	15,648,817	9,641,138	3,509,500
NONCURRENT LIABILITIES			
Convertible notes payable, noncurrent portion	776,451	–	1,001,451
TOTAL NONCURRENT LIABILITIES	776,451	–	1,001,451
TOTAL LIABILITIES	16,425,268	9,641,138	4,510,951
COMMITMENTS AND CONTINGENCIES (Note 13)			
STOCKHOLDERS' DEFICIT			

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Common stock, \$0.001 par value, 500,000,000 and 250,000,000 shares authorized at March 31, 2014 and 2013, respectively; 224,973,980 and 173,674,201 issued and outstanding at March 31, 2014 and 2013, respectively	224,984	173,685	250,994
Additional paid-in capital	59,659,137	52,157,196	74,116,754
Accumulated deficit	(74,832,557)	(61,475,325)	(77,401,867)
TOTAL AETHLON MEDICAL, INC STOCKHOLDERS' DEFICIT	(14,948,436)	(9,144,444)	(3,034,119)
NONCONTROLLING INTERESTS	218,270	–	218,270
TOTAL DEFICIT	(14,730,166)	(9,144,444)	(2,815,849)
TOTAL LIABILITIES AND DEFICIT	\$1,695,102	\$496,694	\$1,695,102

See accompanying notes to the consolidated financial statements.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED MARCH 31, 2014 AND 2013

	Years Ended March 31,	
	2014	2013
REVENUES:		
Government contract revenue	\$1,623,769	\$1,230,004
Total revenues	1,623,769	1,230,004
OPERATING EXPENSES		
Professional fees	1,521,397	1,892,270
Payroll and related	2,227,194	2,166,989
General and administrative	931,106	746,099
	4,679,697	4,805,358
OPERATING LOSS	(3,055,928)	(3,575,354)
OTHER (INCOME) EXPENSE		
Loss on debt conversion	40,257	139,839
Change in fair value of derivative liabilities	8,547,015	44,705
Loss on litigation settlement	583,601	—
Other expenses	(75,060)	(172)
Interest and other debt expenses	1,287,221	1,132,314
	10,383,034	1,316,686
NET LOSS BEFORE NONCONTROLLING INTERESTS	(13,438,962)	(4,892,040)
LOSS ATTRIBUTABLE TO NONCONTROLLING INTERESTS	(81,730)	—
LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS	\$(13,357,232)	\$(4,892,040)
Basic and diluted net loss per share available to common stockholders	\$(0.07)	\$(0.03)
Weighted average number of common shares outstanding - basic and diluted	194,058,972	149,223,601

See accompanying notes to the consolidated financial statements.

AETHLON MEDICAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF DEFICIT

FOR THE YEARS ENDED MARCH 31, 2014 AND 2013

	ATTRIBUTABLE TO AETHLON MEDICAL, INC.				NON- CONTROLLING INTERESTS	TOTAL DEFICIT
	COMMON STOCK SHARES	AMOUNT	ADDITIONAL PAID IN CAPITAL	ACCUMULATED DEFICIT		
BALANCE - MARCH 31, 2012	117,515,892	\$ 117,518	\$ 47,170,146	\$ (56,583,285)	\$ -	\$(9,295,621)
Issuance of common stock for cash	29,724,545	29,726	2,080,108	-	-	2,109,834
Issuances of common stock upon conversions of notes payable	21,941,154	21,941	1,673,118	-	-	1,695,059
Issuance of common stock for services	2,896,181	2,896	256,139	-	-	259,035
Patent license fees paid with issuance of common stock	246,429	246	17,004	-	-	17,250
Reclassification of derivative liability into equity	-	-	45,081	-	-	45,081
Issuance of common stock for interest	116,000	120	11,726	-	-	11,846
Loss on debt conversion	1,234,000	1,238	138,601	-	-	139,839
Stock-based compensation expense	-	-	765,273	-	-	765,273
Net loss	-	-	-	(4,892,040)	-	(4,892,040)
BALANCE - MARCH 31, 2013	173,674,201	\$ 173,685	\$ 52,157,196	\$ (61,475,325)	\$ -	\$(9,144,444)

See accompanying notes to the consolidated financial statements.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF DEFICIT

FOR THE YEARS ENDED MARCH 31, 2014 AND 2013

	ATTRIBUTABLE TO AETHLON MEDICAL, INC.				NON- CONTROLLING INTERESTS	TOTAL DEFICIT
	COMMON STOCK SHARES	AMOUNT	ADDITIONAL PAID IN CAPITAL	ACCUMULATED DEFICIT		
BALANCE - MARCH 31, 2013	173,674,201	\$ 173,685	\$ 52,157,196	\$ (61,475,325)	\$ -	\$ (9,144,444)
Issuances of common stock upon conversions of notes payable	10,574,024	10,572	716,204	-	-	726,776
Issuance of common stock for cash - Aethlon	16,872,739	16,873	1,660,159	-	-	1,677,032
Issuance of common stock for cash - ESI	-	-	1,200,000	-	300,000	1,500,000
Issuance of common stock for services	3,071,150	3,071	389,022	-	-	392,093
Issuance of common stock under convertible debt restructuring	4,507,105	4,507	851,842	-	-	856,349
Issuance of common stock under stock option exercises for accrued expenses	158,536	159	12,841	-	-	13,000
Reclassification of derivative liability into equity	-	-	1,456,187	-	-	1,456,187
Issuance of common stock under cashless warrant exercises	12,716,225	12,717	(12,717)	-	-	-
Shares issued under restricted stock grant	3,400,000	3,400	(3,400)	-	-	-

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Issuance of common stock on litigation settlement	–	–	583,601	–	–	583,601
Loss on debt conversion	–	–	40,256	–	–	40,256
Stock-based compensation expense	–	–	607,946	–	–	607,946
Net loss	–	–	–	(13,357,232)	(81,730)	(13,438,962)
BALANCE - MARCH 31, 2014	224,973,980	\$ 224,984	\$ 59,659,137	\$ (74,832,557)	\$ 218,270	\$(14,730,166)

See accompanying notes to the consolidated financial statements.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED MARCH 31, 2014 AND 2013

	2014	2013
Cash flows from operating activities:		
Net loss	\$(13,438,962)	\$(4,892,040)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	21,087	10,484
Debt restructuring cost	856,349	139,839
Non-cash interest expense	-	11,846
Loss on litigation settlement	583,601	-
Change in estimated fair value of derivative liabilities	8,547,015	44,705
Loss on debt conversion	40,256	-
Fair market value of equity instruments issued for services	392,093	259,035
Stock based compensation	607,946	765,273
Patent license fees paid with issuance of common stock	-	17,250
Amortization of debt discount and deferred financing costs	5,147	594,358
Changes in operating assets and liabilities:		
Accounts receivable	113,604	191,333
Prepaid expenses	(21,097)	1,850
Other assets	(8,612)	-
Accounts payable and other current liabilities	46,602	751,210
Due to related parties	116,000	6,000
Net cash used in operating activities	(2,138,971)	(2,098,857)
Cash flows from investing activities:		
Purchases of property and equipment	(96,056)	-
Net cash used in investing activities	(96,056)	-

See accompanying notes to the consolidated financial statements.

AETHLON MEDICAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED MARCH 31, 2014 AND 2013

	2014	2013
Cash flows from financing activities:		
Principal repayments of notes payable	(217,000)	(29,610)
Proceeds from the issuance of notes payable	400,000	-
Net proceeds from the issuance of common stock	3,177,032	2,109,834
Net cash provided by financing activities	3,360,032	2,080,224
Net increase (decrease) in cash	1,125,005	(18,633)
Cash at beginning of year	125,274	143,907
Cash at end of year	\$1,250,279	\$125,274
Supplemental disclosure of cash flow information - Cash paid during the year for:		
Interest	\$13,950	\$2,821
Income taxes	\$-	\$-
Supplement information for non-cash investing and financing activities:		
Conversion of debt, accrued liabilities and accrued interest to common stock	\$726,776	\$1,695,059
Reclassification of accounts payable to convertible notes payable	\$47,000	\$-
Reclassification of accrued interest to convertible notes payable	\$20,027	\$-
Recording deferred financing costs associated with notes payable and convertible notes payable	\$83,191	\$7,500
Reclassification of warrant derivative liability into equity	\$1,456,187	\$45,081
Issuance of shares under cashless warrant exercises	\$12,717	\$-
Exercise of stock option for accrued expenses	\$13,000	\$-
Reclassification of note payable to convertible notes payable	\$-	\$75,000
Stock issued under restricted stock grant	\$3,400	\$-

See accompanying notes to the consolidated financial statements.

AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION

Aethlon Medical, Inc. and subsidiary ("Aethlon", the "Company", "we" or "us") is a medical device company focused on creating innovative devices that address unmet medical needs in cancer, infectious disease and other life-threatening conditions. At the core of our developments is the Aethlon ADAPT™ (Adaptive Dialysis-Like Affinity Platform Technology) system, a medical device platform that converges single or multiple affinity drug agents with advanced plasma membrane technology to create therapeutic filtration devices that selectively remove harmful particles from the entire circulatory system without loss of essential blood components. On June 25, 2013, the United States Food and Drug Administration (FDA) approved an Investigational Device Exemption (IDE) that allows us to initiate human feasibility studies of the Aethlon Hemopurifier® in the United States. Under the feasibility study protocol, we will enroll ten end-stage renal disease patients who are infected with the Hepatitis C virus (HCV) to demonstrate the safety of Hemopurifier therapy. Successful completion of this study will allow us the opportunity to initiate pivotal studies that are required for market clearance to treat HCV and other disease conditions in the United States.

Successful outcomes of human trials will also be required by the regulatory agencies of certain foreign countries where we intend to sell this device. Some of our patents may expire before FDA approval or approval in a foreign country, if any, is obtained. However, we believe that certain patent applications and/or other patents issued more recently will help protect the proprietary nature of the Hemopurifier(R) treatment technology.

In October 2013, our subsidiary, Exosome Sciences, Inc. ("ESI"), commenced operations with a focus on advancing exosome-based strategies to diagnose and monitor the progression of cancer, infectious disease and other life-threatening conditions.

Our common stock is quoted on the OTCQB marketplace administered by the OTC Markets Group under the symbol "AEMD."

UNAUDITED PRO FORMA BALANCE SHEET INFORMATION

During June and July 2014, we entered into agreements with two existing convertible note holders to convert one note into common stock and to extend the second note and to restructure warrants related to the original note issuances removing certain price protection features from such warrants. The transaction resulted in not only the conversion of debt to equity but also the reclassification of such warrants from derivative liabilities to equity. As further explained in Note 16, we have presented an unaudited March 31, 2014 pro forma balance sheet to reflect such transactions as if they had occurred on March 31, 2014.

PRINCIPLES OF CONSOLIDATION

The accompanying consolidated financial statements include the accounts of Aethlon Medical, Inc. and its majority-owned and controlled subsidiary, ESI. All significant intercompany balances and transactions have been eliminated in consolidation. The Company classifies the noncontrolling interests in ESI as part of consolidated net loss in the fiscal year ended March 31, 2014 and includes the accumulated amount of noncontrolling interests as part of stockholders' equity. For the fiscal year ended March 31, 2013, ESI was a wholly-owned subsidiary. During the fiscal year ended March 31, 2014, Aethlon Medical, Inc. reduced its ownership percentage to 80% by ESI's issuance of 300,000 shares of ESI common stock in exchange for cash of \$1,500,000.

The losses at ESI during the fiscal year ended March 31, 2014 reduced the noncontrolling interests on our consolidated balance sheet by \$81,730 from \$300,000 to \$218,270 at March 31, 2014.

GOING CONCERN

The accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern, which contemplates, among other things, the realization of assets and satisfaction of liabilities in the ordinary course of business. We have incurred continuing losses from operations and at March 31, 2014 are in default on certain debt agreements, have negative working capital of approximately \$14,169,000, and an accumulated deficit of approximately \$74,833,000. These factors, among other matters, raise substantial doubt about our ability to continue as a going concern. A significant amount of additional capital will be necessary to advance the development of our products to the point at which they may become commercially viable. We intend to fund operations, working capital and other cash requirements for the fiscal year ending March 31, 2015 through debt and/or equity financing arrangements as well as through revenues and related cash receipts under our government contracts (see Note 11).

We are currently addressing our liquidity issue by seeking additional investment capital through private placements of common stock and debt and by applying for additional grants issued by government agencies in the United States. We believe that our cash on hand and funds expected to be received from additional private investment will be sufficient

to meet our liquidity needs for fiscal 2015. However, no assurance can be given that we will receive any funds in addition to the funds we have received to date.

The successful outcome of future activities cannot be determined at this time and there is no assurance that, if achieved, we will have sufficient funds to execute our intended business plan or generate positive operating results.

Subsequent to March 31, 2014, we completed several significant transactions related to our convertible notes (see Note 16).

The consolidated financial statements do not include any adjustments related to this uncertainty and as to the recoverability and classification of asset carrying amounts or the amount and classification of liabilities that might result should the Company be unable to continue as a going concern.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

RISKS AND UNCERTAINTIES

We operate in an industry that is subject to intense competition, government regulation and rapid technological change. Our operations are subject to significant risk and uncertainties including financial, operational, technological, regulatory, and including the potential risk of business failure.

USE OF ESTIMATES

We prepare our consolidated financial statements in conformity with GAAP, which requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and reported amounts of revenues and expenses during the reporting periods. Significant estimates made by management include, among others, realization of long-lived assets, valuation of derivative liabilities, estimating fair value associated with debt and equity transactions and valuation of deferred tax assets. Actual results could differ from those estimates.

CASH AND CASH EQUIVALENTS

Accounting standards define "cash and cash equivalents" as any short-term, highly liquid investment that is both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. For the purpose of financial statement presentation, we consider all highly liquid investment instruments with original maturities of three months or less when purchased, or any investment redeemable without penalty or loss of interest to be cash equivalents. As of March 31, 2014 and 2013, we had no assets that were classified as cash equivalents.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amount of our cash, accounts receivable, accounts payable, and other current liabilities approximates their estimated fair values due to the short-term maturities of those financial instruments. The carrying amount of the notes payable approximates their fair value due to the short maturity of the notes and since the interest rates approximate current market interest rates for similar instruments. Derivative liabilities recorded in connection with warrants and embedded conversion features of certain convertible notes payable are reported at their estimated fair value, with changes in fair value being reported in results of operations (see Note 10).

Management has concluded that it is not practical to determine the estimated fair value of amounts due to related parties because the transactions cannot be assumed to have been consummated at arm's length, the terms are not deemed to be market terms, there are no quoted values available for these instruments, and an independent valuation would not be practicable due to the lack of data regarding similar instruments, if any, and the associated potential costs.

Other than our derivative liabilities, we do not have any assets or liabilities that are measured at fair value on a recurring basis and, during the years ended March 31, 2014 and 2013, did not have any assets or liabilities that were measured at fair value on a nonrecurring basis except as described in Note 10 under derivative liabilities.

CONCENTRATIONS OF CREDIT RISKS

Cash is maintained at two financial institutions in checking accounts and related cash management accounts. Accounts at these institutions are secured by the Federal Deposit Insurance Corporation ("FDIC") up to \$250,000. Our March 31, 2014 cash balances were approximately \$1,000,000 over such insured amount. We do not believe that the Company is exposed to any significant risk with respect to its cash.

All of our accounts receivable at March 31, 2014 and 2013 and all of our revenue in the fiscal years ended March 31, 2014 and 2013 were directly from the U.S. Department of Defense or from a subcontract under Battelle, which is a prime contractor with the U.S. Department of Defense.

PROPERTY AND EQUIPMENT

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets, which range from two to five years. Repairs and maintenance are charged to expense as incurred while improvements are capitalized. Upon the sale or retirement of property and equipment, the accounts are relieved of the cost and the related accumulated depreciation with any gain or loss included in the consolidated statements of operations.

INCOME TAXES

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to the difference between the consolidated financial statements and their respective tax basis. Deferred income taxes reflect the net tax effects of (a) temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts reported for income tax purposes, and (b) tax credit carryforwards. We record a valuation allowance for deferred tax assets when, based on our best estimate of taxable income (if any) in the foreseeable future, it is more likely than not that some portion of the deferred tax assets may not be realized.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

LONG-LIVED ASSETS

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. If the cost basis of a long-lived asset is greater than the projected future undiscounted net cash flows from such asset, an impairment loss is recognized. We believe no impairment charges were necessary during the fiscal years ended March 31, 2014 and 2013.

LOSS PER SHARE

Basic loss per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period of computation. Diluted loss per share is computed similar to basic loss per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if potential common shares had been issued, if such additional common shares were dilutive. Since we had net losses for all periods presented, basic and diluted loss per share are the same, and additional potential common shares have been excluded as their effect would be antidilutive.

As of March 31, 2014 and 2013, a total of 143,074,602 and 142,701,202 potential common shares, consisting of shares underlying outstanding stock options, warrants and convertible notes payable were excluded as their inclusion would be antidilutive.

SEGMENTS

Historically, we operated in one segment that was based on our development of therapeutic devices. However in the December 2013 quarter, we initiated the operations of ESI to develop diagnostic tests. As a result, we now operate in two segments, Aethlon for therapeutic applications and ESI for diagnostic applications (See Note 14).

DEFERRED FINANCING COSTS

Costs related to the issuance of debt are capitalized and amortized to interest expense over the life of the related debt using the effective interest method. We recorded amortization expense related to our deferred offering costs of \$863 and \$127,200 during the fiscal years ended March 31, 2014 and 2013, respectively.

REVENUE RECOGNITION

DARPA Contract -- With respect to revenue recognition, we entered into a government contract with DARPA and have recognized revenue of \$1,466,482 and \$1,230,004 under that contract during the fiscal years ended March 31, 2014 and 2013, respectively. We adopted the Milestone method of revenue recognition for the DARPA contract under ASC 605-28 "Revenue Recognition – Milestone Method" and we believe we meet the requirements under ASC 605-28 for reporting contract revenue under the Milestone Method for the fiscal years ended March 31, 2014 and 2013.

In order to account for this contract, we identify the deliverables included within the contract and evaluate which deliverables represent separate units of accounting based on if certain criteria are met, including whether the delivered element has standalone value to the collaborator. The consideration received is allocated among the separate units of accounting, and the applicable revenue recognition criteria are applied to each of the separate units.

A milestone is an event having all of the following characteristics:

- (1) There is substantive uncertainty at the date the arrangement is entered into that the event will be achieved. A vendor's assessment that it expects to achieve a milestone does not necessarily mean that there is not substantive uncertainty associated with achieving the milestone.
- (2) The event can only be achieved based in whole or in part on either: (a) the vendor's performance; or (b) a specific outcome resulting from the vendor's performance.
- (3) If achieved, the event would result in additional payments being due to the vendor.

AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

A milestone does not include events for which the occurrence is either: (a) contingent solely upon the passage of time; or (b) the result of a counterparty's performance.

The policy for recognizing deliverable consideration contingent upon achievement of a milestone must be applied consistently to similar deliverables.

The assessment of whether a milestone is substantive is performed at the inception of the arrangement. The consideration earned from the achievement of a milestone must meet all of the following for the milestone to be considered substantive:

(1) The consideration is commensurate with either: (a) the vendor's performance to achieve the milestone; or (b) the enhancement of the value of the delivered item or items as a result of a specific outcome resulting from the vendor's performance to achieve the milestone;

(2) The consideration relates solely to past performance; and

(3) The consideration is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

A milestone is not considered substantive if any portion of the associated milestone consideration relates to the remaining deliverables in the unit of accounting (i.e., it does not relate solely to past performance). To recognize the milestone consideration in its entirety as revenue in the period in which the milestone is achieved, the milestone must be substantive in its entirety. Milestone consideration cannot be bifurcated into substantive and nonsubstantive components. In addition, if a portion of the consideration earned from achieving a milestone may be refunded or adjusted based on future performance, the related milestone is not considered substantive.

See Note 11 for the additional disclosure information required under ASC 605-28.

Battelle Subcontract -- We entered into a subcontract agreement with Battelle Memorial Institute (“Battelle”) in March 2013. Battelle was chosen by DARPA to be the prime contractor on the systems integration portion of the original DARPA contract and we are one of several subcontractors on that systems integration project. The Battelle subcontract is cost-reimbursable under a time and materials basis. We began generating revenues under the subcontract during the three months ended September 30, 2013 and for the fiscal year 2014 recorded revenue of \$157,287.

Our revenue under this contract is a function of cost reimbursement plus an overhead mark-up for hours devoted to the project by specific employees (with specific hourly rates for those employees). Battelle engages us as needed. Each payment requires approval by the program manager at Battelle.

STOCK-BASED COMPENSATION

Employee stock options and rights to purchase shares under stock participation plans are accounted for under the fair value method. Accordingly, share-based compensation is measured when all granting activities have been completed, generally the grant date, based on the fair value of the award. The exercise price of options is generally equal to the market price of the Company's common stock (defined as the closing price as quoted on the OTCBB on the date of grant). Compensation cost recognized by the Company includes (a) compensation cost for all equity incentive awards granted prior to April 1, 2006, but not yet vested, based on the grant-date fair value estimated in accordance with the original provisions of the then current accounting standards, and (b) compensation cost for all equity incentive awards granted subsequent to April 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of subsequent accounting standards. We use a Binomial Lattice option pricing model for estimating fair value of options granted (see Note 6).

The following table summarizes share-based compensation expenses relating to shares and options granted and the effect on loss per common share during the years ended March 31, 2014 and 2013:

	March 31, 2014	March 31, 2013
Vesting of Stock Options	\$541,588	\$355,578
Incremental fair value of option Modifications	1,914	23,028
Vesting Expense Associated with CEO Restricted Stock Grant	64,444	386,667
Total Stock-Based Compensation Expense	\$607,946	\$765,273
Basic and diluted loss per common share	\$(0.00)	\$(0.01)

AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

We account for transactions involving services provided by third parties where we issue equity instruments as part of the total consideration using the fair value of the consideration received (i.e. the value of the goods or services) or the fair value of the equity instruments issued, whichever is more reliably measurable. In transactions, when the value of the goods and/or services are not readily determinable and (1) the fair value of the equity instruments is more reliably measurable and (2) the counterparty receives equity instruments in full or partial settlement of the transactions, we use the following methodology:

a) For transactions where goods have already been delivered or services rendered, the equity instruments are issued on or about the date the performance is complete (and valued on the date of issuance).

b) For transactions where the instruments are issued on a fully vested, non-forfeitable basis, the equity instruments are valued on or about the date of the contract.

c) For any transactions not meeting the criteria in (a) or (b) above, we re-measure the consideration at each reporting date based on its then current stock value.

We review share-based compensation on a quarterly basis for changes to the estimate of expected award forfeitures based on actual forfeiture experience. The effect of adjusting the forfeiture rate for all expense amortization after March 31, 2006 is recognized in the period the forfeiture estimate is changed. The effect of forfeiture adjustments for the fiscal year ended March 31, 2014 was insignificant.

PATENTS

Patents include both foreign and domestic patents. There were several patents pending at March 31, 2014. We capitalize the cost of patents and patents pending, some of which were acquired, and amortize such costs over the shorter of the remaining legal life or their estimated economic life, upon issuance of the patent. The unamortized costs of patents and patents pending are subject to our review for impairment under our long-lived asset policy above.

STOCK PURCHASE WARRANTS

We grant warrants in connection with the issuance of convertible notes payable and the issuance of common stock for cash. When such warrants are classified as equity and issued in connection with debt, we measure the relative estimated fair value of such warrants and record it as a discount from the face amount of the convertible notes payable. Such discounts are amortized to interest expense over the term of the notes using the effective interest method. Warrants issued in connection with common stock for cash, if classified as equity, are considered issued in connection with equity transactions and the warrant fair value is recorded to additional paid-in-capital. Lastly, warrants not meeting equity classification are recorded as derivative instruments.

DERIVATIVE INSTRUMENTS

We evaluate free-standing derivative instruments (or embedded derivatives) to properly classify such instruments within equity or as liabilities in our financial statements. Our policy is to settle instruments indexed to our common shares on a first-in-first-out basis.

The classification of a derivative instrument is reassessed at each reporting date. If the classification changes as a result of events during a reporting period, the instrument is reclassified as of the date of the event that caused the reclassification. There is no limit on the number of times a contract may be reclassified.

Instruments classified as derivative liabilities are remeasured each reporting period (or upon reclassification) and the change in fair value is recorded on our consolidated statement of operations in other (income) expense.

BENEFICIAL CONVERSION FEATURE OF CONVERTIBLE NOTES PAYABLE

The convertible feature of certain notes payable provides for a rate of conversion that is below market value. Such feature is normally characterized as a "Beneficial Conversion Feature" ("BCF"). We measure the estimated fair value of the BCF in circumstances in which the conversion feature is not required to be separated from the host instrument and accounted for separately, and record that value in the consolidated financial statements as a discount from the face amount of the notes. Such discounts are amortized to interest expense over the term of the notes.

AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

REGISTRATION PAYMENT ARRANGEMENTS

We account for contingent obligations to make future payments or otherwise transfer consideration under a registration payment arrangement separately from any related financing transaction agreements, and any such contingent obligations are recognized only when it is determined that it is probable that the Company will become obligated for future payments and the amount, or range of amounts, of such future payments can be reasonably estimated.

RESEARCH AND DEVELOPMENT EXPENSES

Our research and development costs are expensed as incurred. We incurred approximately \$1,509,000 and \$1,440,000 of research and development expenses for the years ended March 31, 2014 and 2013, respectively, which are included in various operating expenses in the accompanying consolidated statements of operations.

OFF-BALANCE SHEET ARRANGEMENTS

We have not entered into any off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our consolidated financial statements.

SIGNIFICANT RECENT ACCOUNTING PRONOUNCEMENTS

Management is evaluating significant recent accounting pronouncements that are not yet effective for the Company, including the new accounting standard on revenue recognition, ASU 2014-09 (Topic 606), and has not yet concluded whether any such pronouncements will have a significant effect on the Company's future consolidated financial statements.

2. PROPERTY AND EQUIPMENT

Property and equipment, net, consist of the following:

	March 31, 2014	March 31, 2013
Furniture and office equipment, at cost	\$385,088	\$289,031
Accumulated depreciation	(300,809)	(288,886)
	\$84,279	\$145

Depreciation expense for the years ended March 31, 2014 and 2013 approximated \$12,000 and \$1,000, respectively.

3. PATENTS

Patents consist of the following:

	March 31, 2014	March 31, 2013
Patents	\$157,442	\$157,442
Patents pending and trademarks	54,203	54,203
Accumulated amortization	(99,156)	(89,992)
	\$112,489	\$121,653

Amortization expense for patents for the years ended March 31, 2014 and 2013 approximated \$9,000. Future amortization expense on patents is estimated to be approximately \$9,000 per year based on the estimated life of the patents. The weighted average remaining life of our patents is approximately 6.5 years.

AETHLON MEDICAL, INC. AND SUBSIDIARY**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2014 AND 2013****4. NOTES PAYABLE**

Notes payable consist of the following:

	March 31, 2014		March 31, 2013	
	Principal Balance	Accrued Interest	Principal Balance	Accrued Interest
12% Notes payable, past due	\$185,000	\$353,813	\$185,000	\$326,062
10% Note payable, past due	5,000	6,375	5,000	5,875
Directors' Note(s)	200,000	14,516	–	–
Tonaquint Note	–	–	131,381	1,629
Total	\$390,000	\$374,704	\$321,381	\$333,566

During the fiscal year ended March 31, 2014, we recorded interest expense of \$59,901 related to the contractual interest rates of our notes payable.

12% NOTES

From August 1999 through May 2005, we entered into various borrowing arrangements for the issuance of notes payable from private placement offerings (the "12% Notes"). On April 21, 2010, a holder of \$100,000 of the 12% Notes converted his principal balance and \$71,758 of accrued interest into 687,033 shares of common stock at an agreed conversion price of \$0.25 per share. At March 31, 2014, the 12% Notes were past due, in default, and bearing interest at the default rate of 15%.

10% NOTES

At March 31, 2014, one 10% Note in the amount of \$5,000, which is past due and in default, remained outstanding and it bears interest at the default rate of 15%.

Management's plans to satisfy the remaining outstanding balance on these 12% and 10% Notes include converting the notes to common stock at market value or repayment with available funds.

TONAQUINT NOTE

On June 28, 2011, in conjunction with our satisfying all balances owed under a convertible note, we entered into a Termination Agreement with Tonaquint, Inc. under which both parties agreed that in consideration of the termination of a warrant, the waiving of all fees, penalties, the creation of the selling program and other factors, we agreed to issue an unsecured non-convertible promissory note (the "New Note") in the principal amount of \$360,186, which provides for annual interest at a rate of 6%, payable monthly in either cash or our stock, at our option. The New Note originally had a maturity date of April 30, 2012. We subsequently extended the note initially to July 31, 2012 and then to July 31, 2013 and subsequently to August 31, 2013. We also recorded into principal \$12,500 of the lender's legal fees related to documentation of the extension agreement.

During the fiscal year ended March 31, 2014, we issued 1,540,426 shares of common stock to convert \$136,060 of principal and accrued interest (see Note 6). As a result of those conversions, the Tonaquint Note was paid off in full during the September 2013 quarter. We recorded a loss on conversion of \$40,256 on those conversions during the fiscal year ended March 31, 2014.

The following table shows the conversions into principal of the Tonaquint Note by fiscal year:

Initial principal balance	\$360,186
Lender's legal fees	12,500
Conversions during the fiscal year ended March 31, 2013	(241,305)
Conversions during the fiscal year ended March 31, 2014	(131,381)
Balance as of March 31, 2014	\$-

AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

DIRECTORS' NOTES

In July 2013, we borrowed \$400,000 from two of our directors under two 90 day notes for \$200,000 each bearing 10% interest (the "Notes"). At the discretion of the holders, if not paid off by October 9, 2013, the noteholders were entitled to (i) convert their principal and accrued interest into shares of common stock at \$0.088 per share (the "Conversion Price") and (ii) receive warrants to purchase common stock equal to 50% of the principal converted under the Notes, with an exercise price of \$0.132 per share. Additionally, there was a provision for a penalty interest rate of 12%.

That potential conversion price and warrant exercise price were based on the same pricing mechanism that we have used in prior equity unit financings since March 2012 (see Note 6) which are based on 80% of the then current market price of our common stock and with the warrant exercise price based on 120% of the same then current market price. We initially reserved 6,931,818 shares of common stock to support the conversion of the Notes and accrued interest in full as well as the exercise of the warrants in full (should such conversion and/or issuance occur).

During the fiscal year ended March 31, 2014, the principal of \$200,000 and accrued interest of \$9,367 were paid on one of the notes, which extinguished all potential common stock and warrant issuance provisions related to that Note.

The holder of the second Note agreed to extend the expiration date of his Note to July 31, 2014.

5. CONVERTIBLE NOTES PAYABLE

Convertible Notes Payable consisted of the following at March 31, 2014:

	Principal	Unamortized Discount	Net Amount	Accrued Interest
Convertible Notes Payable – Current Portion:				

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Amended and Restated Series A 12% Convertible Notes, past due	\$885,000	\$	–	\$885,000	\$575,250
2008 10% Convertible Notes, past due	25,000	–	–	25,000	19,167
October & November 2009 10% Convertible Notes	50,000	–	–	50,000	26,097
April 2010 10% Convertible Note	75,000	–	–	75,000	31,438
July and August 2011 10% Convertible Notes, past due	257,655	–	–	257,655	90,256
Law Firm Note	75,000	–	–	75,000	7,604
Total – Convertible Notes Payable – Current Portion	1,367,655	–	–	1,367,655	749,812
Convertible Notes Payable – Non-Current Portion:					
September 2010 12% Convertible Notes	317,072	–	–	317,072	35,034
April 2011 12% Convertible Notes	448,448	–	–	448,448	12,117
September 2011 12% Convertible Notes	10,931	–	–	10,931	--
Total – Convertible Notes Payable – Non-Current Portion	776,451	–	–	776,451	47,151
Total Convertible Notes Payable	\$2,144,106	\$	–	\$2,144,106	\$796,963

There were no discounts remaining on any of our Convertible Notes Payable as of March 31, 2014.

During the fiscal year ended March 31, 2014, we recorded interest expense of \$354,949 related to the contractual interest rates of our convertible notes and interest expense of \$4,284 related to the amortization of debt discounts on the convertible notes for a total of \$359,233.

AETHLON MEDICAL, INC. AND SUBSIDIARY**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2014 AND 2013**

Convertible Notes Payable consisted of the following at March 31, 2013:

	Principal	Unamortized Discount	Net Amount	Accrued Interest
Amended and Restated Series A 12% Convertible Notes, past due	\$885,000	\$ –	\$885,000	\$398,250
2008 10% Convertible Notes, past due	25,000	–	25,000	15,417
December 2006 10% Convertible Notes, past due	17,000	–	17,000	15,888
October & November 2009 10% Convertible Notes	50,000	(389)	49,611	20,000
April 2010 10% Convertible Note	75,000	(3,895)	71,105	23,938
September 2010 10% Convertible Notes, past due	308,100	–	308,100	52,393
April 2011 10% Convertible Notes, past due	400,400	–	400,400	100,100
July and August 2011 10% Convertible Notes, \$257,656 past due	357,655	–	357,655	68,704
September 2011 Convertible Notes, past due	178,760	–	178,760	–
Law Firm Note	75,000	–	75,000	3,854
Total – Convertible Notes Payable	\$2,371,915	\$ (4,284)	\$2,367,631	\$698,544

During the fiscal year ended March 31, 2013, we recorded interest expense of \$459,199 related to the contractual interest rates of our convertible notes and interest expense of \$467,158 related to the amortization of debt discounts on the convertible notes for a total of \$926,357.

AMENDED AND RESTATED SERIES A 12% CONVERTIBLE NOTES

In June 2010, we entered into Amended and Restated Series A 12% Convertible Promissory Notes (the "Amended and Restated Notes") with the holders of certain promissory notes previously issued by the Company, extending the due date to December 31, 2010 on the aggregate principal balance of \$900,000. During the fiscal year ended March 31, 2013, the holders of \$15,000 of the Notes converted their principal and related accrued interest into common stock. The balance remaining at March 31, 2014 and 2013 was \$885,000 and is past due as of March 31, 2014. Such notes bear a default annual interest rate of 20%.

Subsequent to year end on June 24, 2014, we entered into an agreement with the Ellen R. Weiner Family Revocable Trust (the "Trust"), a holder of a Series A 12% Convertible Note (the "Note"), whereby the Trust converted a past due combined principal and interest balance of \$1,003,200 (principal of \$660,000 and interest of \$343,200) into restricted common stock.

Additionally, the Trust agreed to waive anti-dilution price protection underlying warrants previously issued to the Trust. Under its agreement, the Trust converted the entire \$1,003,200 past due principal and interest balance on the Note

In exchange for the Trust's conversion in full of the Note and accrued interest and for the waivers of anti-dilution price protection in previously issued warrants, we (1) issued five-year warrants to acquire up to 6,809,524 shares of our common stock at an exercise price of \$.042 per share and up to 397,222 shares of our common stock at an exercise price of \$.108 per share (collectively, the "Conversion Securities"); (2) issued 75,000 restricted shares of common stock as a service fee; (3) changed the exercise price of all of the previously issued warrants to the Trust to \$.042 per share; and (4) extended the expiration date of all of the previously issued warrants to the Trust to July 1, 2018.

We continue to hold discussions with the holder of the remaining note in this grouping regarding either an extension to the note or a conversion of the note but there can be no assurance that we will be able to do so on terms that we deem acceptable or at all. We are recording interest at the default rate of 20% on the remaining note.

DECEMBER 2006 10% CONVERTIBLE NOTES

In January 2014, we paid off the remaining balance of the December 2006 10% Convertible Notes and the related accrued interest balance with a cash payment of \$35,055. Such payment represented the sum of the \$17,000 in principal balance and \$18,055 in accrued interest.

2008 10% CONVERTIBLE NOTES

One 2008 10% Convertible Note in the amount of \$25,000 which matured in January 2010 remained outstanding and past due at March 31, 2014. Such note is convertible into our common stock at \$0.50 per share. We are recording interest at the default rate of 15%.

OCTOBER & NOVEMBER 2009 10% CONVERTIBLE NOTES

In October and November 2009, we raised \$430,000 from the sale to accredited investors of 10% convertible notes ("October & November 2009 10% Convertible Notes"). The October & November 2009 10% Convertible Notes matured at various dates between April 2011 and May 2011 and are convertible into our common stock at a fixed conversion price of \$0.25 per share. The investors also received matching three year warrants to purchase unregistered shares of our common stock at an exercise price of \$0.25 per share. We measured the fair value of the warrants and the beneficial conversion feature of the notes and recorded a 100% discount against the principal of the notes. Such discount was fully amortized at March 31, 2014.

In July 2012, we issued 461,409 shares of common stock and 230,705 warrants to purchase common stock to the holder of a \$25,000 note in this grouping in exchange for the conversion of such note and related accrued interest of \$8,000 (for a total of \$33,000). The warrants expired in 2012 and are exercisable at \$0.107 per share (see Note 6). We recorded a loss on conversion of \$45,796.

The following table shows the conversions into principal of the October and November 2009 Convertible Notes by fiscal year:

Activity in October & November 2009 10% Convertible Notes	
Initial principal balance	\$450,250
Conversions during the fiscal year ended March 31, 2010	(70,000)
Conversions during the fiscal year ended March 31, 2011	(175,000)
Conversions during the fiscal year ended March 31, 2012	(130,250)
Conversions during the fiscal year ended March 31, 2013	(25,000)
Conversions during the fiscal year ended March 31, 2014	--
Balance as of March 31, 2014	\$50,000

On March 31, 2012, we agreed to extend the expiration date and to change the exercise price of certain warrants of one of the note holders by two years in exchange for the extension of \$50,000 of the October & November 2009 10%

Convertible Notes and the \$75,000 April 2010 10% Convertible Note (see below) by that same two year period. We recorded a charge of \$77,265 relating to this modification.

In September 2013, we agreed to extend the expiration date of certain warrants of one of the note holders by two years in exchange for the extension of \$50,000 of the October & November 2009 10% Convertible Notes and the \$75,000 April 2010 10% Convertible Note (see below) by that same two year period. Management assessed the change in the value of the notes and related warrants before and after that extension and determined that the change in value related to the change in terms was not significant.

APRIL 2010 10% CONVERTIBLE NOTE

In April 2010, we raised \$75,000 from the sale to an accredited investor of a 10% convertible note. The convertible note was originally scheduled to mature in October 2011 and is convertible into our common stock at a fixed conversion price of \$0.25 per share prior to maturity. The investor also received three year warrants to purchase 300,000 unregistered shares of our common stock at a price of \$0.25 per share.

We measured the fair value of the warrants and the beneficial conversion feature of the notes and recorded a 100% discount against the principal of the notes. We amortized this discount using the effective interest method over the term of the note. As of March 31, 2014, there have not been any conversions of the April 2010 10% Convertible Note.

On March 31, 2012, we agreed to extend the expiration date and to change the exercise price of certain warrants of the note holder by two years in exchange for his extension of \$50,000 of the October & November 2009 10% Convertible Notes and the \$75,000 April 2010 10% Convertible Note by that same two year period.

In September 2013, we agreed to extend the expiration date of certain warrants of one of the note holders by two years in exchange for the extension of \$50,000 of the October & November 2009 10% Convertible Notes and the \$75,000 April 2010 10% Convertible Note (see below) by that same two year period. Management assessed the change in the value of the notes and related warrants before and after that extension and determined that the change in value related to the change in terms was not significant.

SEPTEMBER 2010 10% CONVERTIBLE NOTES

On September 3, 2010, we entered into a Subscription Agreement with three accredited investors (the “Purchasers”) providing for the issuance and sale of convertible promissory notes and corresponding warrants in the aggregate principal amount of \$1,430,000. The initial closing under the Subscription Agreement resulted in the issuance and sale of (i) convertible promissory notes in the aggregate principal amount of \$743,600, (ii) five-year warrants to purchase an aggregate of 3,718,000 shares of our common stock at an exercise price of \$0.31125 per share, and (iii) five-year warrants to purchase an aggregate of 3,718,000 shares of our common stock at an exercise price of \$0.43575 per share. The convertible promissory notes bear interest compounded monthly at the annual rate of ten percent (10%) and mature on April 1, 2016 (see below). The aggregate gross cash proceeds were \$650,000, the balance of the principal amount representing a due diligence fee and an original issuance discount. The convertible promissory notes are convertible at the option of the holders into shares of our common stock at a price per share equal to eighty percent (80%) of the average of the three lowest closing bid prices of the common stock as reported by Bloomberg L.P. for the principal market on which the common stock trades or is quoted for the ten (10) trading days preceding the proposed conversion date. Subject to adjustment as described in the notes, the conversion price may not be more than \$0.30 nor less than \$0.20. There are no registration requirements with respect to the shares of common stock underlying the notes or the warrants.

On March 31, 2014, we entered into separate Amendments to Convertible Notes and Warrants (collectively, the “Amendments”) with three accredited investors (collectively, the “Investors”) who own certain convertible promissory notes (collectively, the “Notes”) and warrants (collectively, the “Warrants”) previously issued by us on various dates between December 5, 2007 and September 23, 2011, including the September 2010 Convertible Notes.

Prior to the Amendments, the Notes were past maturity and were in default, resulting in the accrual of interest at the applicable default interest rate. The Amendments extended the maturity date of each of the Notes to April 1, 2016, which permits us to classify them as long-term liabilities. As a result of the Amendments, the Notes are no longer in default and the non-default interest rate for all of the Notes was set at 12% per annum, which represents a reduction from the default interest rates of fifteen percent at which interest had been accruing. By entering into the Amendments, we also agreed to increase the currently outstanding principal amount of the Notes by 12% from a total of \$693,260 to a total of \$776,451.

During the period from October 2011 to February 2014, the Investors had converted, at conversion prices between \$.0546 and \$.07 per share, portions of principal and interest outstanding under the Notes and certain other convertible promissory notes previously issued to them by us. Certain antidilution provisions applicable to such notes should have resulted in such conversions being effected at a conversion price of \$.042 per share. Accordingly, pursuant to the Amendments, we issued to the investors an aggregate of 4,507,105 shares of the Company’s Common Stock, which represents the additional shares of Common Stock that would have been issued to the Investors had such conversions been effected at \$.042 per share.

The Amendments also provide that if all of our currently outstanding promissory notes and warrants that contain antidilution adjustment provisions (other than the Investors' Notes and Warrants) are amended to remove, or the holders thereof waive, such provisions, then any similar antidilution provisions in the Investors' Notes and Warrants will automatically be deemed removed. In addition, for so long as the Investors' Notes and Warrants are outstanding, we will not be permitted to issue any common stock or common stock equivalents (or modify, with equivalent effect, any outstanding common stock or common stock equivalents) at a lower price than the then-current conversion price of the Notes and exercise price of the Warrants (with certain issuances to be excepted from this general provision). If our other note and warrant holders agree to waive the antidilution provisions of their securities on the same basis as agreed to by the Investors, then we will no longer be required to report a derivative liability in its financial statements with the accompanying quarterly adjustments to its financial statements and will transfer the amount shown as a derivative liability to equity.

The Amendments also set the conversion price of the Notes, as well as the exercise price at which shares of our common stock can be purchased under the Warrants, at \$.042 per share. By virtue of the Amendments, the expiration dates of the Warrants also were extended from dates between September 3, 2015 and September 23, 2016 to January 1, 2017.

The following table shows the activity in the September 2010 10% Convertible Notes by fiscal year:

Activity in the September 2010 10% Convertible Notes	
Initial principal balance	\$743,600
Conversions during the fiscal year ended March 31, 2012	(405,500)
Conversions during the fiscal year ended March 31, 2013	(30,000)
Conversions during the fiscal year ended March 31, 2014	(25,000)
Increase in principal balance due to 12% extension fee	33,972
Balance as of March 31, 2014	\$317,072

APRIL 2011 10% CONVERTIBLE NOTES

In April 2011, we entered into a Subscription Agreement with two accredited investors (the “Purchasers”) providing for the issuance and sale of convertible promissory notes and corresponding warrants in the aggregate principal amount of \$385,000. The closing under the Subscription Agreement resulted in the issuance and sale by us of (i) convertible promissory notes in the aggregate principal amount of \$385,000, (ii) five-year warrants to purchase an aggregate of 4,004,000 shares of our common stock at an exercise price of \$0.125 per share, and (iii) five-year warrants to purchase an aggregate of 4,004,000 shares of our common stock at an exercise price of \$0.175 per share. The convertible promissory notes bear interest compounded monthly at the annual rate of 10% and mature on April 1, 2016 (see below). The aggregate gross cash proceeds to us were \$350,000, the balance of the principal amount representing a due diligence fee and an original issuance discount. The convertible promissory notes are convertible at the option of the holders into shares of our common stock at a price per share equal to eighty percent (80%) of the average of the three lowest closing bid prices of the common stock as reported by Bloomberg L.P. for the principal market on which the common stock trades or is quoted for the ten (10) trading days preceding the proposed conversion date. Subject to adjustment as described in the notes, the conversion price may not be more than \$0.20 nor less than \$0.10. There are no registration requirements with respect to the shares of common stock underlying the notes or the warrants.

In addition, we issued (i) five-year warrants to purchase an aggregate of 812,500 shares of our common stock at an exercise price of \$0.125 per share, and (ii) five-year warrants to purchase an aggregate of 812,500 shares of our common stock at an exercise price of \$0.175 per share to the Purchasers. These warrants were issued as an antidilution adjustment under certain common stock purchase warrants held by the Purchasers that were acquired from us in September 2010.

On March 31, 2014, we entered into separate Amendments to Convertible Notes and Warrants (collectively, the “Amendments”) with three accredited investors (collectively, the “Investors”) who own certain convertible promissory notes (collectively, the “Notes”) and warrants (collectively, the “Warrants”) previously issued by us on various dates between December 5, 2007 and September 23, 2011, including the April 2011 Convertible Notes.

Prior to the Amendments, the Notes were past maturity and were in default, resulting in the accrual of interest at the applicable default interest rate. The Amendments extended the maturity date of each of the Notes to April 1, 2016, which permits us to classify them as long-term liabilities. As a result of the Amendments, the Notes are no longer in default and the non-default interest rate for all of the Notes was set at 12% per annum, which represents a reduction from the default interest rates of 15% at which interest had been accruing. By entering into the Amendments, we also agreed to increase the currently outstanding principal amount of the Notes by 12% from a total of \$693,260 to a total of \$776,451.

During the period from October 2011 to February 2014, the Investors had converted, at conversion prices between \$.0546 and \$.07 per share, portions of principal and interest outstanding under the Notes and certain other convertible promissory notes previously issued to them by us. Certain antidilution provisions applicable to such notes should have resulted in such conversions being effected at a conversion price of \$.042 per share. Accordingly, pursuant to the Amendments, we issued to the investors an aggregate of 4,507,105 shares of the Company's Common Stock, which represents the additional shares of Common Stock that would have been issued to the Investors had such conversions been effected at \$.042 per share.

The Amendments also provide that if all of our currently outstanding promissory notes and warrants that contain antidilution adjustment provisions (other than the Investors' Notes and Warrants) are amended to remove, or the holders thereof waive, such provisions, then any similar antidilution provisions in the Investors' Notes and Warrants will automatically be deemed removed. In addition, for so long as the Investors' Notes and Warrants are outstanding, we will not be permitted to issue any common stock or common stock equivalents (or modify, with equivalent effect, any outstanding common stock or common stock equivalents) at a lower price than the then-current conversion price of the Notes and exercise price of the Warrants (with certain issuances to be excepted from this general provision).

The Amendments also set the conversion price of the Notes, as well as the exercise price at which shares of our common stock can be purchased under the Warrants, at \$.042 per share. By virtue of the Amendments, the expiration dates of the Warrants also were extended from dates between September 3, 2015 and September 23, 2016 to January 1, 2017.

As of March 31, 2014, there have not been any conversions of the April 2011 10% Convertible Notes and the 12% extension fee noted above increased the principal balance by \$48,048 to a principal balance of \$448,448.

JULY & AUGUST 2011 10% CONVERTIBLE NOTES

During the three months ended September 30, 2011, we raised \$357,656 in 10% convertible notes. Those notes had a fixed conversion price of \$0.09 per share and carried an interest rate of 10%. The convertible notes matured in July and August 2012. We also issued those investors five year warrants to purchase 3,973,957 shares of common stock at \$0.125 per share.

We measured the fair value of the warrants and the beneficial conversion feature of the notes and recorded a \$257,926 discount against the principal of the notes. We amortized this discount using the effective interest method over the term of the note.

Effective March 31, 2014, the holders of the three notes totaling \$100,000 converted all of their principal and accrued interest into 1,438,700 shares of our common stock at the contractual conversion price of \$0.09 per share.

At March 31, 2014, the remaining outstanding principal balance was \$257,655, all of which was in default. We are recording interest at the default interest rate of 15%.

SEPTEMBER 2011 CONVERTIBLE NOTES

In September 2011, we issued \$253,760 of convertible notes, convertible at \$0.07 per share. Such notes originally matured in September 2012.

On March 31, 2014, we entered into separate Amendments to Convertible Notes and Warrants (collectively, the "Amendments") with three accredited investors (collectively, the "Investors") who own certain convertible promissory notes (collectively, the "Notes") and warrants (collectively, the "Warrants") previously issued by us on various dates between December 5, 2007 and September 23, 2011, including the September 2011 Convertible Notes.

Prior to the Amendments, the Notes were past maturity and were in default, resulting in the accrual of interest at the applicable default interest rate. The Amendments extended the maturity date of each of the Notes to April 1, 2016, which permits us to classify them as long-term liabilities. As a result of the Amendments, the Notes are no longer in default and the non-default interest rate for all of the Notes was set at 12% per annum, which represents a reduction from the default interest rates of 15% at which interest had been accruing. By entering into the Amendments, we also agreed to increase the currently outstanding principal amount of the Notes by 12%, which in the case of the September 2011 Notes, they increased from \$9,760 to \$10,931.

During the period from October 2011 to February 2014, the Investors had converted, at conversion prices between \$.0546 and \$.07 per share, portions of principal and interest outstanding under the Notes and certain other convertible promissory notes previously issued to them by us. Certain antidilution provisions applicable to such notes should have resulted in such conversions being effected at a conversion price of \$.042 per share. Accordingly, pursuant to the Amendments, we issued to the investors an aggregate of 4,507,105 shares of the Company's Common Stock, which represents the additional shares of Common Stock that would have been issued to the Investors had such conversions

been effected at \$.042 per share.

The Amendments also provide that if all of our currently outstanding promissory notes and warrants that contain antidilution adjustment provisions (other than the Investors' Notes and Warrants) are amended to remove, or the holders thereof waive, such provisions, then any similar antidilution provisions in the Investors' Notes and Warrants will automatically be deemed removed. In addition, for so long as the Investors' Notes and Warrants are outstanding, we will not be permitted to issue any common stock or common stock equivalents (or modify, with equivalent effect, any outstanding common stock or common stock equivalents) at a lower price than the then-current conversion price of the Notes and exercise price of the Warrants (with certain issuances to be excepted from this general provision). If our other note and warrant holders agree to waive the antidilution provisions of their securities on the same basis as agreed to by the Investors, then we will no longer be required to report a derivative liability in its financial statements with the accompanying quarterly adjustments to its financial statements and will transfer the amount shown as a derivative liability to equity.

The Amendments also set the conversion price of the Notes, as well as the exercise price at which shares of our common stock can be purchased under the Warrants, at \$.042 per share. By virtue of the Amendments, the expiration dates of the Warrants also were extended to January 1, 2017.

The following table shows the conversions into principal of the September 2011 Convertible Notes by fiscal year:

Activity in the September 2011 Convertible Notes	
Initial principal balance	\$253,760
Conversions during the fiscal year ended March 31, 2012	(15,000)
Conversions during the fiscal year ended March 31, 2013	(60,000)
Conversions during the fiscal year ended March 31, 2014	(169,000)
Increase in principal balance due to extension fee	1,171
Balance as of March 31, 2014	\$10,931

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LAW FIRM NOTE NUMBER 1

On March 22, 2012, we entered into a Promissory Note with our corporate law firm for the amount of \$75,000, which represented the majority of the amount we owed to that firm at that time. The Promissory Note originally had a maturity date of December 31, 2012 and bears interest at 5% per annum. The note is convertible at the option of the holder into shares of our common stock at a 10% discount to the market price of the common stock on the date prior to conversion with a floor price on such conversions of \$0.08 per share. The holder subsequently agreed to extend the Maturity Date of the Note first to October 1, 2013, then to September 30, 2013, and now the expiration date of this note is again extended to October 1, 2014. As of March 31, 2014, there have not been any conversions of the Law Firm Note.

LAW FIRM NOTE NUMBER 2

On June 4, 2013, we entered into a Promissory Note with our corporate law firm for the amount of \$47,000, which represented approximately 50% of the amount we owed to that firm for services in 2012. The Promissory Note had a maturity date of October 1, 2014 and bore interest at 5% per annum. The note was convertible at the option of the holder into shares of our common stock at a 10% discount to the market price of the common stock on the date prior to conversion with a floor price on such conversions of \$0.07 per share.

Effective March 31, 2014, our law firm converted this note and all related accrued interest into 302,043 shares of our common stock at a conversion price of \$0.16 per share.

6. EQUITY TRANSACTIONS

COMMON STOCK AND WARRANTS

Aethlon Medical, Inc. Equity Transactions in the Fiscal Year Ended March 31, 2014

Common Stock Issuances in the Fiscal Year Ended March 31, 2014:

In June 2013, we completed a unit subscription agreement with three accredited investors pursuant to which we issued 1,580,248 shares of our common stock and 790,124 warrants to purchase our common stock for net cash proceeds of \$128,000. Such warrants have an exercise price of \$0.121 per share.

In June 2013, we issued to our CEO the remaining 3,400,000 shares under his restricted share grant, all of which were vested.

During the three months ended June 30, 2013, we issued 3,675,278 shares of restricted common stock to the holders of three notes issued by the Company in exchange for the partial conversion of principal and interest in an aggregate amount of \$246,500 at an average conversion price of \$0.07 per share.

During the three months ended June 30, 2013, we issued 222,734 shares of common stock pursuant to our S-8 registration statement covering our Amended 2010 Stock Plan at an average price of \$0.10 per share in payment for legal services valued at \$21,750 based on the value of the services provided.

In August 2013, we completed a unit subscription agreement with four accredited investors (the "Purchasers") pursuant to which we issued 900,901 shares of our common stock and 450,451 warrants to purchase our common stock in exchange for net cash proceeds of \$100,000. Such warrants have an exercise price of \$0.167 per share.

During the three months ended September 30, 2013, we issued 933,522 shares of common stock pursuant to our S-8 registration statement covering our Amended 2010 Stock Plan at an average price of \$0.14 per share in payment for legal and scientific consulting services valued at \$127,593 based on the value of the services provided.

During the three months ended September 30, 2013, we issued 1,168,343 shares of restricted common stock at an average price of \$0.10 per share in payment for investor relations and public relations services valued at \$115,000 based on the value of the services provided.

During the three months ended September 30 2013, we issued 2,795,367 shares of restricted common stock to the holders of four notes issued by the Company in exchange for the partial or full conversion of principal and interest in an aggregate amount of \$173,960 at an average conversion price of \$0.06 per share.

During the three months ended December 31, 2013, we entered into a unit purchase agreement and subscription agreements with 32 accredited investors pursuant to which we issued 14,367,200 shares of our common stock and warrants to purchase our common stock for gross cash proceeds of \$1,795,900. Such warrants have an exercise price of \$0.22 per share. A FINRA registered broker-dealer was engaged as placement agent in connection with the above

Unit Purchase Agreement. We paid the placement agent an aggregate cash fee in the amount of \$270,508 and will issue the placement agent or its designees warrants to purchase an aggregate of 2,155,080 shares of our common stock. We also paid \$78,360 in other costs and fees, including legal fees, blue sky fees and escrow costs. The net proceeds that we received totaled \$1,447,032.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

During the three months ended December 31 2013, we issued 1,465,200 shares of restricted common stock to the holders of two notes issued by us in exchange for the partial or full conversion of accrued interest in an aggregate amount of \$80,000 at an average conversion price of \$0.05 per share.

During the three months ended March 31 2014, we issued 2,638,179 shares of restricted common stock to the holders of five notes issued by us in exchange for the partial or full conversion of accrued interest in an aggregate amount of \$226,316 at an average conversion price of \$0.09 per share.

During the three months ended March 31, 2014, we issued 346,770 shares of common stock pursuant to our S-8 registration statement covering our Amended 2010 Stock Plan at an average price of \$0.19 per share in payment for legal services valued at \$65,250 based on the value of the services provided.

During the three months ended March 31, 2014, we issued 399,781 shares of restricted common stock at an average price of \$0.16 per share in payment for investor relations and public relations services valued at \$62,500 based on the value of the services provided.

On March 31, 2014, we entered into extension agreements with three noteholders (see Note 5). In conjunction with the extension agreements, we agreed to issue to the noteholders an aggregate 4,507,105 shares of restricted common stock as a result of the noteholders invoking the antidilution protection on their notes.

In March 2014, a former director exercised 182,927 in vested stock options through the contribution of \$2,000 in cash and \$13,000 in accrued expenses owed to him based on the exercise price of \$0.082 per share.

During the fiscal year ended March 31, 2014, we issued 12,716,225 shares of restricted common stock in connection with cashless warrant exercises discussed elsewhere in this footnote.

Exosome Sciences, Inc. Equity Transactions in the Fiscal Year Ended March 31, 2014

On November 21, 2013, ESI, prior to the transaction described herein, a wholly owned diagnostic subsidiary of ours, entered into a stock purchase agreement with twelve accredited investors pursuant to which such investors purchased an aggregate of 220,000 shares of ESI's common stock at a purchase price of \$5.00 per share, for an aggregate purchase price of \$1,100,000 in cash.

On December 13, 2013, ESI entered into a second stock purchase agreement with three accredited investors, pursuant to which such investors purchased an aggregate of 80,000 shares of ESI's common stock at a purchase price of \$5.00 per share, for an aggregate purchase price of \$400,000 in cash.

The aggregate gross proceeds received by ESI under these two transactions above were \$1,500,000. As a result of these transactions the Company's percentage ownership of the outstanding common stock of ESI was reduced from 100% to 80%.

One of the investors was Dr. Chetan Shah, a director of the Company. Dr. Shah purchased 70,000 ESI shares for an aggregate purchase price of \$350,000.

Common Stock Issuances in the Fiscal Year Ended March 31, 2013:

During the fiscal year ended March 31, 2013, we issued 22,829,754 shares of restricted common stock to holders of notes issued by the Company in exchange for the partial or full conversion of principal and interest of several notes payable in an aggregate amount of \$1,707,052 at an average conversion price of \$0.07 per share based upon the conversion formulae in the respective notes.

During the fiscal year ended March 31, 2013, we issued 1,932,808 restricted shares of common stock to service providers for investor relations, corporate communications and business development services valued at \$170,849 based upon the fair value of the shares issued. The average issuance price on the restricted share issuances was approximately \$0.09 per share.

During the fiscal year ended March 31, 2013, we issued 963,373 shares of common stock pursuant to our S-8 registration statement covering our Amended 2010 Stock Plan at an average price of \$0.09 per share in payment for scientific consulting services valued at \$88,186 based on the value of the services provided.

AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

On April 5, 2012, we completed a unit subscription agreement with one accredited investor (the “Purchaser”) pursuant to which we issued 2,500,000 shares of our common stock and 1,250,000 warrants to purchase our common stock for net cash proceeds of \$200,000. Such warrants have an exercise price of \$0.125 per share.

On June 19, 2012, we completed a unit subscription agreement whereby we issued 8,222,222 shares of our common stock and 4,111,111 warrants to purchase our common stock at an exercise price of \$0.108 per share in exchange for net cash proceeds of \$592,000.

On June 26, 2012, we completed a unit subscription agreement whereby we issued 139,821 shares of our common stock and 69,911 warrants to purchase our common stock at an exercise price of \$0.107 per share in exchange for net cash proceeds of \$10,000.

In July 2012, we issued 461,409 shares of common stock to the holder of a \$25,000 October & November 2009 10% Convertible Note (See Note 5) in exchange for the value of the principal and related accrued interest of \$8,000 under the same terms that we used to sell units consisting of one share of common stock and one-half of a stock purchase warrant on June 29, 2012 (See Note 6). As part of that structure, the noteholder also received seven year warrants to purchase 230,705 shares of our common stock at an exercise price of \$0.107 per share.

On August 29, 2012, we completed a unit subscription agreement with seven accredited investors pursuant to which we issued 3,387,500 shares of our common stock and 1,693,750 warrants to purchase our common stock in exchange for net cash proceeds of \$271,000. Such warrants have an exercise price of \$0.12 per share.

Between October 2012 and December 2012, we completed several unit subscription agreements with several accredited investors pursuant to which we issued 7,878,580 shares of our common stock and 3,939,292 warrants to purchase our common stock for net cash proceeds of \$498,000. Such warrants have an exercise price based upon 120% of the average of the closing prices of our common stock for the five-day period immediately preceding the respective investment transaction date.

In January 2013, we issued 246,429 shares of restricted common stock to the owner of a patent as a patent license payment valued at \$17,250.

Between January 2013 and March 2013, we completed several unit subscription agreements with several accredited investors pursuant to which we issued 7,596,423 shares of our common stock and 3,798,219 warrants to purchase our common stock for net cash proceeds of \$538,834. Such warrants have an exercise price based upon 120% of the average of the closing prices of our common stock for the five-day period immediately preceding the respective investment transaction date.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

A summary of the aggregate warrant activity for the years ended March 31, 2014 and 2013 is presented below:

	Year Ended March 31,		2013	
	2014	Weighted Average Exercise Price	Warrants	Weighted Average Exercise Price
Outstanding, beginning of year	75,647,294	\$ 0.11	59,807,849	\$ 0.14
Granted	14,530,519	\$ 0.18	16,710,445	\$ 0.11
Exercised	(12,716,225)	\$ 0.08	—	\$ —
Cancelled/Forfeited	(6,752,113)	\$ 0.11	(871,000)	\$ 0.25
Outstanding, end of year	70,709,475	\$ 0.10	75,647,294	\$ 0.11
Exercisable, end of year	70,709,475	\$ 0.10	75,647,294	\$ 0.11
Weighted average estimated fair value of warrants granted		\$ 0.09		\$ 0.07

The following outlines the significant weighted average assumptions used to estimate the fair value of warrants granted utilizing the Binomial Lattice option pricing model:

	Year Ended March 31,	
	2014	2013
Risk free interest rate	1.3%-2.04%	0.86%-1.56%
Average expected life	5 to 7 years	5 to 7 years
Expected volatility	91.2% - 98.5%	90.3% - 94.3%
Expected dividends	None	None

The detail of the warrants outstanding and exercisable as of March 31, 2014 is as follows:

Range of Exercise Prices	Warrants Outstanding		Warrants Exercisable	
	Number	Weighted Average	Number	Weighted Average
	Outstanding		Outstanding	

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	Remaining	Exercise		Exercise	
		Price		Price	
	Life				
	(Years)				
\$0.10 or Below	37,094,795	2.42	\$ 0.05	37,094,795	\$ 0.05
\$0.11 - \$0.19	21,876,000	4.74	\$ 0.13	21,876,000	\$ 0.13
\$0.20 - \$0.25	11,738,680	5.05	\$ 0.21	11,738,680	\$ 0.21
	70,709,475			70,709,475	

STOCK OPTIONS:

2000 STOCK OPTION PLAN

Our 2000 Stock Option Plan (the "Plan"), adopted by us in August 2000, provides for the grant of incentive stock options ("ISOs") to our full-time employees (who may also be directors) and nonstatutory stock options ("NSOs") to non-employee directors, consultants, customers, vendors or providers of significant services. The exercise price of any ISO may not be less than the fair market value of our common stock on the date of grant or, in the case of an optionee who owns more than 10% of the total combined voting power of all classes of our outstanding common stock, not be less than 110% of the fair market value on the date of grant. The exercise price, in the case of any NSO, must not be less than 75% of the fair market value of our common stock on the date of grant. The amount reserved under the Plan is 500,000 options.

At March 31, 2012, all of the grants previously made under the Plan had expired and 10,000 restricted shares had been issued under the 2000 Stock Option Plan, with 490,000 available for future issuance.

2003 CONSULTANT STOCK PLAN

Our 2003 Consultant Stock Plan, as amended from time to time (the "Stock Plan"), adopted by us in August 2003, advances our interests by helping us obtain and retain the services of persons providing consulting services upon whose judgment, initiative, efforts and/or services we are substantially dependent, by offering to or providing those persons with incentives or inducements affording such persons an opportunity to become owners of our common stock. Over several years, we issued 7,500,000 shares under the Stock Plan and discontinued using the Stock Plan in October 2012.

2010 STOCK INCENTIVE PLAN

In August 2010, we adopted the 2010 Stock Incentive Plan (the "Incentive Plan"), which provides incentives to attract, retain and motivate employees and directors whose present and potential contributions are important to the success of the Company by offering them an opportunity to participate in our future performance through awards of options, the right to purchase common stock, stock bonuses and stock appreciation rights and other awards. A total of 3,500,000 common shares were initially reserved for issuance under the Incentive Plan.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

In August 2010, we filed a registration statement on Form S-8 for the purpose of registering 3,500,000 common shares issuable under the Incentive Plan under the Securities Act of 1933 and in July 2012, we filed a registration statement on Form S-8 for the purpose of registering an additional 5,000,000 common shares issuable under the Incentive Plan under the Securities Act of 1933.

In May 2013, we issued to a scientific advisory board member and a scientific consultant a three year option to purchase 125,000 shares of our common stock at a price of \$0.11 per share.

At March 31, 2014, we had 2,445,626 shares available under the Incentive Plan.

2012 DIRECTORS COMPENSATION PROGRAM

In July 2012, our Board of Directors approved a new Board Compensation Program (the “New Program”), which modifies and supersedes the 2005 Directors Compensation Program (the “2005 Program”) that was previously in effect. Under the New Program, in which only non-employee Directors may participate, an eligible Director will receive a grant of \$35,000 worth of ten year options to acquire shares of our common stock, with such grant being valued at the exercise price based on the average of the closing bid prices of our common stock for the five trading days preceding the first day of the fiscal year. In addition, under the New Program, eligible Directors will receive cash compensation equal to \$500 for each committee meeting attended and \$1,000 for each formal Board meeting attended.

In the fiscal year ended March 31, 2013, our Board of Directors granted under the New Program, to our four outside directors, ten year options to acquire an aggregate of 1,667,105 shares of our common stock, all with an exercise price of \$0.076 per share.

In the fiscal year ended March 31, 2014, our Board of Directors granted under the New Program, to our five outside directors, ten year options to acquire an aggregate of 1,595,536 shares of our common stock, all with an exercise price of \$0.082 per share.

At March 31, 2014 under the 2005 Program, we had issued 1,337,825 options to outside directors and 3,965,450 options to employee-directors. Of such amounts, 514,550 outside directors' options had been forfeited, 250,000 outside directors' options had been exercised, and 3,671,550 options remained outstanding.

On June 6, 2014, our Board of Directors approved certain changes to the New Program. Under the modified New Program, a new eligible Director will receive an initial grant of \$50,000 worth of options to acquire shares of our common stock, with such grant being valued at the exercise price based on the average of the closing bid prices of our common stock for the five trading days preceding the first day of the fiscal year. These options will have a term of ten years and will vest 1/3 upon grant and 1/3 upon each of the first two anniversaries of the date of grant. In addition, at the beginning of each fiscal year, each existing Director eligible to participate in the modified New Program also will receive a grant of \$35,000 worth of options valued at the exercise price based on the average of the closing bid prices of our common stock for the five trading days preceding the first day of the fiscal year. Such options will vest on the first anniversary of the date of grant. In lieu of per meeting fees, under the modified New Program eligible Directors will receive an annual Board cash retainer fee of \$30,000. The modified New Program also provides for the following annual cash retainer fees: Audit Committee Chair - \$5,000, Compensation Committee chair - \$5,000, Audit Committee member - \$4,000, Compensation Committee member - \$4,000, and Lead independent director - \$15,000.

STAND-ALONE GRANTS

From time to time our Board of Directors grants restricted stock or common share purchase options or warrants to selected directors, officers, employees and consultants as equity compensation to such persons on a stand-alone basis outside of any of our formal stock plans. The terms of these grants are individually negotiated.

On June 8, 2009, our board of directors approved the grant to Mr. Joyce of 4,000,000 shares of restricted common stock at a price per share of \$0.24, the vesting and issuance of which occurred in equal installments over a thirty-six-month period that commenced on June 30, 2010. Mr. Joyce may, from time to time, defer acceptance of the shares. However, all shares must be issued and accepted by Mr. Joyce by the expiration of the thirty-six-month vesting period. Mr. Joyce has accepted all 4,000,000 shares of the grant. However, the 600,000 shares previously accepted by Mr. Joyce were pledged as collateral for a loan and have been retained and/or sold by the lender and are no longer owned by Mr. Joyce.

In July 2013, our compensation committee and Board of Directors approved the issuance of four stock option grants to four of our executives. The options carried an exercise price of \$0.10 per share, have a ten year life and vest over the following schedule: 25% on July 1, 2014, 25% on July 1, 2015, 25% on July 1, 2016 and 25% on July 1, 2017. The numbers of shares underlying each of the stock option grants were as follows: 2,000,000 shares to our chief executive officer and 500,000 shares each to our president, chief science officer and chief financial officer.

AETHLON MEDICAL, INC. AND SUBSIDIARY**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2014 AND 2013**

During the three months ended March 31, 2014, a former director exercised 182,927 in vested stock options through the contribution of \$2,000 in cash and \$13,000 in accrued expenses owed to him based on the exercise price of \$0.082 per share.

As of March 31, 2014, we have issued 22,568,158 options (of which 3,368,942 have been exercised or cancelled) and authorized the issuance of 4,000,000 shares of restricted stock outside of the 2005 Directors Compensation Plan, the 2012 Directors Compensation Plan, the 2000 Stock Option Plan, the 2003 Consultant Stock Plan and the 2010 Incentive Stock Plan.

In the fiscal year ended March 31, 2014, our Board of Directors granted, to our five outside directors, ten year options to acquire an aggregate of 1,595,536 shares of our common stock, all with an exercise price of \$0.082 per share.

The following is a summary of the stock options outstanding at March 31, 2014 and 2013 and the changes during the years then ended:

	Year Ended March 31,			
	2014		2013	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding, beginning of year	21,095,798	\$ 0.28	19,428,693	\$ 0.31
Granted	5,220,536	\$ 0.09	1,667,105	\$ 0.08
Exercised	182,927	\$ 0.08	—	\$ —
Cancelled/Forfeited	—	\$ —	—	\$ —
Outstanding, end of year	26,133,407	\$ 0.25	21,095,798	\$ 0.28
Exercisable, end of year	22,487,563	\$ 0.27	19,141,625	\$ 0.29
Weighted average estimated fair value of options granted		\$ 0.13		\$ 0.08

The following outlines the significant weighted average assumptions used to estimate the fair value with respect to stock options utilizing the Binomial Lattice option pricing model for the years ended March 31, 2014 and March 31,

2013:

	Year Ended March 31,	
	2014	2013
Risk free interest rate	0.38% to 2.65%	1.44%
Average expected life	3 to 10 years	10 years
Expected volatility	91.05% to 102.67%	117.53%
Expected dividends	None	None

The detail of the options outstanding and exercisable as of March 31, 2014 is as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number Outstanding	Weighted Average Exercise Price
\$0.08 - \$0.11	6,704,714	9.68 years	\$ 0.09	3,204,714	\$ 0.08
\$0.21 - \$0.25	11,207,143	4.28 years	\$ 0.24	11,061,299	\$ 0.24
\$0.36 - \$0.41	8,221,550	2.68 years	\$ 0.38	8,221,550	\$ 0.38
	26,133,407			22,487,563	

We recorded stock-based compensation expense related to share issuances and to options granted totaling \$607,946 and \$765,273 for the fiscal years ended March 31, 2014 and 2013, respectively. These expenses were recorded as stock compensation included in payroll and related expenses in the accompanying consolidated statement of operations for the years ended March 31, 2014 and 2013.

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AETHLON MEDICAL, INC. AND SUBSIDIARY**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2014 AND 2013**

Our total stock-based compensation for fiscal years ended March 31, 2014 and 2013 included the following:

	March 31, 2014	March 31, 2013
Vesting of restricted stock grant	\$64,444	\$386,668
Incremental fair value of option modifications	1,914	23,027
Vesting of stock options	541,588	355,578
Total Stock-Based Compensation	\$607,946	\$765,273

As of March 31, 2014, we had \$270,952 of remaining unrecognized stock option expense, which is expected to be recognized over a weighted average remaining vesting period of 2.07 years.

On March 31, 2014, our stock options had a negative intrinsic value since the closing price on that date of \$0.17 per share was below the weighted average exercise price of our stock options.

7. RELATED PARTY TRANSACTIONS**DUE TO RELATED PARTIES**

Certain of our officers and other related parties have advanced us funds, agreed to defer compensation and/or paid expenses on our behalf to cover working capital deficiencies. These unsecured and non-interest-bearing liabilities have been included as due to related parties in the accompanying consolidated balance sheets.

Other related party transactions are disclosed elsewhere in these notes to consolidated financial statements.

8. OTHER CURRENT LIABILITIES

Other current liabilities were comprised of the following items:

	March 31, 2014	March 31, 2013
Accrued interest	\$1,165,335	\$1,032,110
Accrued legal fees	179,465	179,465
Accrued liquidated damages	362,800	437,800
Other accrued liabilities	147,774	155,610
Total other current liabilities	\$1,855,374	\$1,804,985

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AETHLON MEDICAL, INC. AND SUBSIDIARY**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2014 AND 2013****9. INCOME TAXES**

For the years ended March 31, 2014 and 2013, we had no income tax expense due to our net operating losses and 100% deferred tax asset valuation allowance.

At March 31, 2014 and 2013, we had net deferred tax assets as detailed below. These deferred tax assets are primarily composed of capitalized research and development costs and tax net operating loss carryforwards. Due to uncertainties surrounding our ability to generate future taxable income to realize these assets, a 100% valuation has been established to offset the net deferred tax assets.

Significant components of our net deferred tax assets at March 31, 2014 and 2013 are shown below:

	YEAR ENDED MARCH 31,	
	2014	2013
Deferred tax assets:		
Capitalized research and development	\$3,442,000	\$3,442,000
Net operating loss carryforwards	15,193,000	14,793,000
Total deferred tax assets	18,635,000	18,235,000
Total deferred tax liabilities	—	—
Net deferred tax assets	18,635,000	18,235,000
Valuation allowance for deferred tax assets	(18,635,000)	(18,235,000)
Net deferred tax assets	\$—	\$—

At March 31, 2014, we had tax net operating loss carryforwards for federal and state purposes approximating \$39 million and \$30 million, which begin to expire in the year 2020.

The provision for income taxes on earnings subject to income taxes differs from the statutory federal rate for the years ended March 31, 2014 and 2013 due to the following:

	2014	2013
Income taxes (benefit) at federal statutory rate of 34%	\$(4,541,000)	\$(1,663,000)
State income tax, net of federal benefit	(156,000)	(285,000)
Tax effect on non-deductible expenses and credits	4,297,000	215,000
Change in valuation allowance ¹	400,000	1,733,000
	\$-	\$-

Pursuant to Internal Revenue Code Sections 382, use of our tax net operating loss carryforwards may be limited.

ASC 740, "Income Taxes", clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements, and prescribes recognition thresholds and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under ASC 740, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, ASC 740 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Our practice is to recognize interest and/or penalties related to income tax matters in income tax expense. During the years ended March 31, 2014 and 2013, we did not recognize any interest or penalties relating to tax matters.

At and for the years ended March 31, 2014 and 2013, management does not believe the Company has any uncertain tax positions. Accordingly, there are no unrecognized tax benefits at March 31, 2014 or March 31, 2013.

Our tax returns for the years 2010 and forward are subject to examination by the Internal Revenue Service and 2009 and forward by the California Franchise Tax Board. We are currently not under examination by any taxing authorities.

AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

10. FAIR VALUE MEASUREMENTS

We follow FASB ASC 820, "FAIR VALUE MEASUREMENTS AND DISCLOSURES" ("ASC 820") in connection with financial assets and liabilities measured at fair value on a recurring basis subsequent to initial recognition.

ASC 820 requires that assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

Level 1: Quoted market prices in active markets for identical assets or liabilities.

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3: Unobservable inputs that are not corroborated by market data.

The hierarchy noted above requires us to minimize the use of unobservable inputs and to use observable market data, if available, when determining fair value.

The fair value of our recorded derivative liabilities is determined based on unobservable inputs that are not corroborated by market data, which is a Level 3 classification. We record derivative liabilities on our balance sheet at fair value with changes in fair value recorded in our consolidated statements of operations. Our fair value measurements at the reporting date were as follows:

At March 31, 2014:

Description	Quoted Prices in	Active Markets for Identical Assets	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Level 1)			
Derivative Liabilities	\$ -	\$ -	\$ -	\$ 10,679,067
Total Assets	\$ -	\$ -	\$ -	\$ 10,679,067

At March 31, 2013:

Description	Quoted Prices in	Active Markets for Identical Assets	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Level 1)			
Derivative Liabilities	\$ -	\$ -	\$ -	\$ 3,588,239
Total Assets	\$ -	\$ -	\$ -	\$ 3,588,239

The following outlines the significant weighted average assumptions used to estimate the fair value information presented for the fiscal years ended March 31, 2014 and 2013, in connection with our April 2011 convertible note, July & August 2011 10% convertible notes and the September 2011 convertible note offerings and with respect to warrant and embedded conversion option derivative instruments utilizing the Binomial Lattice option pricing model:

Fiscal Year Ended March 31, 2014

Risk free interest rate	0.02% - 0.79%
Average expected life	0.25 – 2.8 years
Expected volatility	58.0% - 103.1%
Expected dividends	None

Fiscal Year Ended March 31, 2013

Risk free interest rate	0.05% - 1.56%
Average expected life	0.25 – 3.6 years

Expected volatility 76.0% - 107.1%
 Expected dividends None

The table below sets forth a summary of changes in the fair value of our Level 3 financial instruments for the year ended March 31, 2014:

	April 1, 2013	Recorded New Derivative Liabilities	Change in estimated fair value recognized in results of operations	Reclassification of Derivative Liability to Paid in capital	March 31, 2014
Derivative liabilities	\$3,588,239	\$ -	\$5,729,780	\$ 1,361,048	\$10,679,067

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AETHLON MEDICAL, INC. AND SUBSIDIARY**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2014 AND 2013**

The table below sets forth a summary of changes in the fair value of our Level 3 financial instruments for the year ended March 31, 2013:

	April 1,	Recorded New Derivative Liabilities	Change in estimated fair value recognized in results of operations	Reclassification of Derivative Liability to Paid in capital	March 31, 2013
Derivative liabilities	\$3,588,615	\$ —	\$ (44,705)	\$ 44,329	\$3,588,239

11. DARPA CONTRACT AND RELATED REVENUE RECOGNITION

As discussed in Note 1, we entered into a contract with the DARPA on September 30, 2011. Under the DARPA award, we have been engaged to develop a therapeutic device to reduce the incidence of sepsis, a fatal bloodstream infection that often results in the death of combat-injured soldiers. The award from DARPA was a fixed-price contract with potential total payments to us of \$6,794,389 over the course of five years. Fixed price contracts require the achievement of multiple, incremental milestones to receive the full award during each year of the contract. Under the terms of the contract, we will perform certain incremental work towards the achievement of specific milestones against which we will invoice the government for fixed payment amounts.

Originally, only the base year (year one contract) was effective for the parties, however, DARPA subsequently exercised the option on the second and third years of the contract. DARPA has the option to enter into the contract for years four and five. The milestones are comprised of planning, engineering and clinical targets, the achievement of which in some cases will require the participation and contribution of third party participants under the contract. There can be no assurance that we alone, or with third party participants, will meet such milestones to the satisfaction of the government and in compliance with the terms of the contract or that we will be paid the full amount of the contract revenues during any year of the contract term. We commenced work under the contract in October 2011.

Due to budget restrictions within the Department of Defense, on February 10, 2014, DARPA reduced the scope of our contract in years three through five of the contract. The reduction in scope focused our research on exosomes, viruses and blood processing instrumentation. This scope reduction will reduce the possible payments under the contract by \$858,491 over years three through five. We recently completed a rebudgeting of the expected costs on the remaining years of the DARPA contract based on the reduced milestones and have concluded that the reductions in our costs due to the scaled back level of work will almost entirely offset the anticipated revenue levels based on current assumptions.

Fiscal Year Ended March 31, 2014

As a result of achieving eight milestones in the fiscal year ended March 31, 2014, we reported \$1,466,482 in contract revenue for that fiscal year. The details of the eight milestones achieved during the fiscal year ended March 31, 2014 were as follows:

Milestone 2.3.2.2 – Formulate initial design work based on work from the previous phase. Begin to build and test selected instrument design and tubing sets. The milestone payment was \$195,581. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we were able to formulate the initial design work and to build and test selected instrument design and tubing sets as part of our submission for approval. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone 2.3.2.2 – Write and test software and conduct ergonomic research. Begin discussions with the systems integrator. The milestone payment was \$195,581. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We obtained wrote and tested software and conducted ergonomic research and began discussions with the systems integrator. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone 2.3.3.2 – Cartridge construction with optimized affinity matrix design for each potential target. Complete the capture agent screening. The milestone payment was \$208,781. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We completed the cartridge construction with optimized affinity matrix design for each potential target and completed the capture agent screening. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

Milestone M5 – Target capture > 90% in 24 hours for at least three targets in blood or blood components. The milestone payment was \$208,781. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we were able to capture > 90% in 24 hours for at least three of the agreed targets in blood or blood components. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone M3 – Conduct a series of experiments aimed at characterizing the contribution of several alternate fluidic designs and methods of perfusing plasma filters and affinity columns in the performance of affinity plasmapheresis. The milestone payment was \$195,576. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we had conducted the relevant series of experiments. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone 2.4.2.1 – Evaluate contribution of manufacturing process variables to binding capacity of affinity resin. The milestone payment was \$197,362. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we had evaluated the contribution of manufacturing process variables to binding capacity of affinity resin. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone 2.4.1.1 – Design and fabricate optimized configuration(s) of hemopurification device(s) that contain(s) a combination of hemofilters, plasma filters and affinity columns. The milestone payment was \$186,164. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we had designed and fabricated optimized configuration of hemopurification devices. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone 2.4.2.3 – Perform biocompatibility tests for the combination ADAPT device to confirm the combination cartridge does not present additional risk. The milestone payment was \$78,641. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we had performed biocompatibility tests for the combination ADAPT device to confirm the combination cartridge does not present additional risk. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Fiscal Year Ended March 31, 2013

As a result of achieving six milestones in the fiscal year ended March 31, 2013, we reported \$1,230,004 in contract revenue for that fiscal year. The details of the six milestones achieved during the fiscal year ended March 31, 2013 were as follows:

Milestone 2.2.2.3 – Perform preliminary quantitative real time PCR to measure viral load, and specific DNA or RNA targets. The milestone payment was \$216,747. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we were able to measure viral load of one or more targets as part of our submission for approval. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone 2.2.1.4 – Obtain all necessary IRB documentation and obtain both institutional and Government approval in accordance with IRB documentation submission guidance prior to conducting human or animal testing. The milestone payment was \$183,367. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We obtained all of the required documentation from both institutional and Government authorities. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone M2 – Target capture > 50% in 24 hours for at least one target in blood or blood components. The milestone payment was \$216,747. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we were able to capture > 50% in 24 hours of one of the agreed targets in blood or blood components. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone 2.3.3.1 – Build the ADAPT capture cartridges with the identified affinity agents. Measure the rate of capture of the specific targets from in ex vivo recirculation experiments from cell culture and blood. The milestone payment was \$208,781. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we were able build the ADAPT capture cartridges with the identified affinity agents and to measure the rate of capture of the specific targets from in ex vivo recirculation experiments from cell culture and blood. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

Milestone 2.3.2.1 – Demonstrate the effectiveness of the prototype device in vivo in animals preventing platelet activation or clotting in at least a 2 hour blood pumping experiment at 75 mL/min blood flow. The milestone payment amount was \$195,581. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. The prototype device was successfully used in vivo in animals preventing platelet activation or clotting in at least a 2 hour blood pumping experiment at 75 mL/min blood flow. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone M4 – Target capture > 50% in 24 hours for at least 5 targets in blood or blood components. The milestone payment was \$208,781. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we were able to capture > 50% in 24 hours for at least 5 of the agreed targets in blood or blood components. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

12. SIGNIFICANT FOURTH QUARTER ADJUSTMENTS

During the fourth quarter of the fiscal years ended March 31, 2014 and 2013, we did not deem any unusual or infrequently occurring items or adjustments to be material to our fourth quarter results.

13. COMMITMENTS AND CONTINGENCIES

EMPLOYMENT CONTRACTS

We entered into an employment agreement with our Chairman of the Board (“Chairman”) effective April 1, 1999. The agreement, which is cancelable by either party upon sixty days’ notice, will be in effect until the Chairman retires or ceases to be employed by us. Under the terms of the agreement, if the Chairman is terminated he may become eligible to receive a salary continuation payment in the amount of at least twelve months' base salary, which was increased to \$350,000 per year in June 2014.

We entered into an employment agreement with Dr. Tullis ("Tullis") effective January 10, 2000 as our Chief Science Officer ("CSO"). Under the terms of the agreement, if Tullis is terminated he may become eligible to receive a salary continuation payment in the amount of twelve months base salary, which is \$195,000 per year.

LEASE COMMITMENTS

We currently rent approximately 2,300 square feet of executive office space at 8910 University Center Lane, Suite 660, San Diego, CA 92122 at the rate of \$6,475 per month on a four year lease that expires in September 2014. We also rent approximately 1,700 square feet of laboratory space at 11585 Sorrento Valley Road, Suite 109, San Diego, California 92121 at the rate of \$2,917 per month on a two year lease that expires in October 2014. We are currently searching for new space in the greater San Diego area.

Our Exosome Sciences, Inc. subsidiary rents approximately 2,055 square feet of office and laboratory space at 11 Deer Park Drive, South Brunswick, NJ at the rate of \$3,425 per month on a one year lease that expires in October 2014. Our current plans are to renew the lease prior to expiration.

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AETHLON MEDICAL, INC. AND SUBSIDIARY**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2014 AND 2013**

Rent expense approximated \$163,000 and \$123,000 for the fiscal years ended March 31, 2014 and 2013, respectively. As of March 31, 2014, commitments under the lease agreements are as follows:

8910 University Center Lane, Suite 660, San Diego, CA 92122 office lease	2015 \$43,795
11585 Sorrento Valley Road, Suite 109, San Diego, California 92121 office lease	22,755
11 Deer Park Drive, South Brunswick, NJ	23,975
Total Lease Commitments	\$90,525

LEGAL MATTERS

From time to time, claims are made against us in the ordinary course of business, which could result in litigation. Claims and associated litigation are subject to inherent uncertainties and unfavorable outcomes could occur, such as monetary damages, fines, penalties or injunctions prohibiting us from selling one or more products or engaging in other activities.

The occurrence of an unfavorable outcome in any specific period could have a material adverse effect on our results of operations for that period or future periods. Other than as mentioned here, we are not presently a party to any pending or threatened legal proceedings.

On February 24, 2014, we entered into a Settlement Agreement and General Release (the "Settlement Agreement") with Gemini Master Fund, Ltd., a Cayman Islands company ("Gemini"), which, among other things, resulted in the dismissal with prejudice of the complaint filed by Gemini against us on July 5, 2012 in the Supreme Court of the State of New York, County of New York, entitled Gemini Master Fund Ltd. v. Aethlon Medical, Inc., Index No. 652358/2012 (the "Complaint").

In the Complaint, Gemini sought relief both in the form of money damages and delivery of shares of our common stock. The Complaint alleged, among other things, that we were in default of a convertible promissory note ("Convertible Note") originally issued to Gemini on February 12, 2010 by failing to pay the Convertible Note in full and by failing to honor certain requests by Gemini to convert the principal and interest under the Convertible Note into shares of our common stock. The Complaint also alleged that we failed to issue shares upon the presentation of exercise notices under warrants originally issued to Gemini in 2009 and 2010 (respectively, the "2009 Warrant" and the "2010 Warrant").

In the Complaint, Gemini alleged it was entitled to 22,389,382 shares of common stock upon conversion of the balance of the Convertible Note and Gemini alleged that it was entitled to receive 30,370,814 shares of common stock pursuant to the 2009 Warrant and the 2010 Warrant, for a combined sum of 52,760,196 common shares.

In response, we provided documentation that the Convertible Note had been paid in full in cash and accepted by Gemini prior to the filing of the Complaint. In addition, we had maintained on our books the total number of shares required to be issued under the 2009 Warrant, the 2010 Warrant and the 2008 Warrant (defined below) combined was 6,359,999 shares.

The Settlement Agreement required us to issue a total of 7,522,854 shares of common stock into an escrow and those shares were to be released to Gemini ratably over a ten-month period. The shares were issued upon partial exercise of the 2009 Warrant and 2010 Warrant as well as under a third warrant, issued by us to Gemini in 2008 (the "2008 Warrant"). No shares were issued as consideration for the alleged default under the Convertible Note or in consideration of the releases granted in the Settlement Agreement. In addition, our insurance company paid Gemini \$150,000 in cash. Upon the completion of the share issuances, the 2008 Warrant, the 2009 Warrant and the 2010 Warrants were canceled. In addition, under the Settlement Agreement, the Convertible Note (and any other agreement to pay Gemini or issue stock or anything else of value to Gemini) was extinguished and fully satisfied.

As we previously had 6,359,999 shares of common stock reserved for issuance under the three Warrants described above, the settlement increased our fully diluted shares outstanding by 1,162,855 shares.

Following the performance of the settlement terms described above, a Stipulation of Dismissal was filed with the Court, permanently terminating the litigation. The Settlement Agreement also provided for mutual and full releases of all other claims between Gemini and us.

The Company accrued an estimate of \$1,000,000 for such matter at December 31, 2013 and expensed such amount during the quarter ended December 31, 2013. Upon final settlement, management determined that the expense was approximately \$583,000. Accordingly, during the fourth quarter of the year ended March 31, 2014, the Company recorded a credit to expense of approximately \$417,000 related to this matter.

AETHLON MEDICAL, INC. AND SUBSIDIARY**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2014 AND 2013**

14. SEGMENTS

We operate our businesses principally through two reportable segments: Aethlon, which represents our therapeutic business activities, and ESI, which represents our diagnostic business activities. Our reportable segments have been determined based on the nature of the potential products being developed. ESI did not have any operations in the fiscal year ended March 31, 2013.

Aethlon's revenue is generated primarily from government contracts to date and ESI does not yet have any revenues. We have not included any allocation of corporate overhead to the ESI segment.

The following tables set forth certain information regarding our segments and other operations that conforms to the consolidated balance sheet and statement of operations presented in this Report:

	Fiscal Years Ended March	
	31,	
	2014	2013
Revenues:		
Aethlon	\$1,623,769	\$1,230,004
ESI	—	—
Total Revenues	\$1,623,769	\$1,230,004
Operating Losses:		
Aethlon	\$(2,651,863)	\$(3,575,354)
ESI	(404,065)	—
Total Operating Loss	\$(3,055,928)	\$(3,575,354)
Net Losses:		
Aethlon	\$(13,357,232)	\$(4,892,040)
ESI	(81,730)	—
Net Loss Before Non-Controlling Interests	\$(13,438,962)	\$(4,892,040)

Cash:

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Aethlon	\$208,259	\$125,274
ESI	1,042,020	–
Total Cash	\$1,250,279	\$125,274
Total Assets:		
Aethlon	\$597,026	\$496,694
ESI	1,098,076	–
Total Assets	\$1,695,102	\$496,694
Capital Expenditures:		
Aethlon	\$37,313	\$–
ESI	58,743	–
Capital Expenditures	\$96,056	\$–
Depreciation and Amortization:		
Aethlon	\$11,549	\$10,484
ESI	9,538	–
Total Depreciation and Amortization	\$21,087	\$10,484
Interest Expense:		
Aethlon	\$1,282,638	\$1,132,314
ESI	4,583	–
Total Interest Expense	\$1,287,221	\$1,132,314

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AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

15. SUBSEQUENT EVENTS (UNAUDITED)

Management has evaluated events subsequent to March 31, 2014 through the date that the accompanying condensed consolidated financial statements were filed with the Securities and Exchange Commission for transactions and other events which may require adjustment of and/or disclosure in such financial statements.

Government Contracts

Subsequent to March 31, 2014, we billed \$197,362 under our DARPA contract and billed \$62,696 under the Battelle subcontract and we collected \$135,376 under both contracts.

Common Stock Issuances

Subsequent to March 31, 2014, we issued 219,127 shares of common stock pursuant to our S-8 registration statement covering our Amended 2010 Stock Plan at an average price of \$0.17 per share in payment for internal controls, legal and scientific consulting services valued at \$38,268 based on the value of the services provided.

Subsequent to March 31, 2014, we completed unit subscription agreements with seven accredited investors (the "Purchasers") pursuant to which the Purchasers purchased an aggregate of \$320,800 of restricted common stock at an average price of \$0.15 per share. The common stock purchase price under the subscription agreement was determined to be 80% of the average closing price of our common stock for the five-day period immediately preceding the date of each subscription agreement, resulting in the issuance of 2,192,444 shares of common stock.

Each Purchaser also received one common stock purchase warrant for each two shares of common stock purchased under his subscription agreement. The warrant exercise price was calculated based upon 120% of the average of the closing prices of our common stock for the five-day period immediately preceding the parties entering into their

subscription agreement.

Stock Option Grants

On June 6, 2014, our Board of Directors approved the following grants of options to certain officers and directors of the Company:

To Mr. James A. Joyce, an option to acquire an aggregate of 1,500,000 shares of our common stock at an exercise price of \$0.19 per share, the closing price of our common stock on the date of grant. The option vested as to 500,000 shares on the grant date and will vest as to an additional 500,000 shares on each of the first two anniversaries of the grant date. Unless earlier exercised or terminated, the option will expire June 6, 2024.

To Mr. Rodney S. Kenley, an option to acquire an aggregate of 250,000 shares of our common stock at an exercise price of \$0.19 per share, the closing price of our common stock on the date of grant. The option vested as to 83,333 shares on the grant date and will vest as to an additional 83,333 shares on the first anniversary of the grant date and 83,334 shares on the second anniversary of the grant date. Unless earlier exercised or terminated, the option will expire June 6, 2024.

To Mr. James B. Frakes, an option to acquire an aggregate of 250,000 shares of our common stock at an exercise price of \$0.19 per share, the closing price of our common stock on the date of grant. The option vested as to 83,333 shares on the grant date and will vest as to an additional 83,333 shares on the first anniversary of the grant date and 83,334 shares on the second anniversary of the grant date. Unless earlier exercised or terminated, the option will expire June 6, 2024.

Changes to 2012 Board Compensation Program

In July 2012, the Board approved a Board Compensation Program (the “2012 Program”), which modified and superseded the 2005 Directors Compensation Program that had been in effect previously. On June 6, 2014, the Board approved certain changes to the 2012 Program. Under the modified 2012 Program, in which only non-employee Directors may participate, a new eligible Director will receive an initial grant of \$50,000 worth of options to acquire shares of common stock, with such grant being valued at the exercise price based on the average of the closing bid prices of our common stock for the five trading days preceding the first day of the fiscal year. These options will have a term of ten years and will vest 1/3 upon grant and 1/3 upon each of the first two anniversaries of the date of grant.

At the beginning of each fiscal year, each existing Director eligible to participate in the 2012 Program also will receive a grant of \$35,000 worth of options valued at the exercise price based on the average of the closing bid prices of the Common Stock for the five trading days preceding the first day of the fiscal year. Such options will vest on the first anniversary of the date of grant. In lieu of per meeting fees, under the 2012 Program eligible Directors will

receive an annual Board retainer fee of \$30,000. The modified 2012 Program also provides for the following annual retainer fees: Audit Committee Chair - \$5,000, Compensation Committee chair - \$5,000, Audit Committee member - \$4,000, Compensation Committee member - \$4,000 and Lead independent director - \$15,000.

All of the foregoing actions - the changes in base salaries, the option grants and the changes to the Directors Compensation Program discussed herein - were approved and recommended by the Company's Compensation Committee prior to approval by the Board.

Convertible Notes Payable – See Note 16 below

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AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014 AND 2013

NOTE 16 – PRO FORMA BALANCE SHEET (UNAUDITED)

Management has presented unaudited pro forma balance sheet information as if the subsequent events discussed below had occurred on March 31, 2014. Such pro forma information is subject to future adjustment as management determines the final accounting for such transactions.

Weiner Note Conversion

On June 24, 2014, we entered into an agreement with the Ellen R. Weiner Family Revocable Trust (the “Trust”), a holder of a Series A 12% Convertible Note (the “Note”) (see Note 5), which previously was classified as being in default. As per the agreement, the Trust converted a past due combined principal and interest balance of \$1,003,200 into restricted common stock.

Additionally, the Trust agreed to waive anti-dilution price protection underlying warrants previously issued to the Trust. On June 26, 2014, three other parties who held similar warrants also agreed to waive their anti-dilution price protection. As a result of the debt conversion and elimination of warrant anti-dilution price protection, \$3.7 million of our previously classified derivative liability will convert into equity based on the fair value of securities on our fiscal year-end date of March 31, 2014.

As a result of the note conversion and derivative liability reclassification into equity, our balance sheet equity will increase by approximately \$4.7 million.

Under its agreement, the Trust converted the entire \$1,003,200 past due principal and interest balance on the Note, which previously was in default, into an aggregate of 23,318,254 restricted shares of our common stock and five-year warrants to acquire up to 6,809,524 shares of our common stock at an exercise price of \$.042 per share and up to 397,222 shares of our common stock at an exercise price of \$.108 per share (collectively, the “Conversion Securities”).

In exchange for the Trust's conversion in full of the Note and accrued interest and for the waivers of anti-dilution price protection in the previously issued warrants, in addition to the Conversion Securities, we issued to the Trust 75,000 restricted shares of common stock as a service fee, changed the exercise price of all of the previously issued warrants to \$.042 per share and extended the expiration date of all of the previously issued warrants to July 1, 2018.

Bird Estate Extension

On July 8, 2014, we entered into a restructuring agreement (the "Agreement") with the Estate of Allan Bird (the "Estate"), a holder of a Series A 12% Convertible Note (the "Note"), which previously was classified as being in default. In the Agreement, the Estate agreed to extend the expiration date of the Note to April 1, 2016, to convert approximately \$116,970 of accrued interest to equity, and to waive anti-dilution price protection underlying the Note and warrants previously issued to the Estate.

As a result of the waiver of all anti-dilution price protection by the Estate, we will reclassify to equity \$1,238,292 from derivative liability.

Also, the execution of the Agreement results in the waiver of anti-dilution price protection under agreements with three other note and warrant holders, which will cause an additional \$5,724,761 of derivative liability to be reclassified from liability to equity.

In addition, as a result of a note conversion and waiver of anti-dilution price protection previously reported on Form 8-K on June 30, 2014, a combined \$4,719,214 of principal, accrued interest and derivative liability has been reclassified into equity.

Based on the Agreement, the elimination of antidilution provisions and the note and accrued interest conversions, all previously reported derivative liabilities will be reclassified into equity.

Under the Agreement, the Estate converted the entire \$116,970 past due interest balance on the Note, which previously was in default, into an aggregate of 2,591,846 restricted shares of our common stock. The Estate received five-year warrants to acquire up to 2,321,429 shares of our common stock at an exercise price of \$.042 per share (which exercise price was the result of certain contractual price adjustments previously made during 2011). Based on our common stock prices during a period of negotiation with the Estate including during calendar year 2013, the Estate also received five-year warrants to acquire up to 135,417 shares of our common stock at an exercise price of \$.108 (collectively known as the "Conversion Securities").

In exchange for the Estate's extension of the Note, conversion of accrued interest and for the waivers of anti-dilution price protection in the previously issued warrants, in addition to the Conversion Securities, we also issued to the Estate 25,000 restricted shares of common stock as a service fee and extended the expiration date of all of the previously issued warrants to July 1, 2018.

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AETHLON MEDICAL, INC. AND SUBSIDIARY**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2014 AND 2013**

Pro Forma References

The unaudited pro forma balance sheet information as of March 31, 2014 assumes (1) conversion of one of the Amended and Restated Series A 12% Convertible Notes (the Trust Note) in the principal amount of \$660,000 as well as \$343,200 of related accrued interest into 23.3 million shares of common stock, (2) the extension of the other Amended and Restated Series A 12% Convertible Note (the Estate Note) and conversion of \$116,970 of related accrued interest into 2.6 million shares of common stock, (3) reduction of accrued interest balance by \$85,800 for the Trust Note and by \$29,280 for the Estate Note, (4) the waiver of price antidilution protection on certain warrants in exchange for an extension on those warrants with a corresponding fair value change based on June 24, 2014 inputs of \$96,469 for the Trust warrant extension and based on July 8, 2014 inputs of \$29,679 for the Estate warrants, (5) the reclassification of \$10,679,067 of our derivative liability into paid in capital based upon the fair value of those derivatives at March 31, 2014, (6) calculation of a loss on the payment of shares and warrants as part of the conversion of accrued interest with an estimated fair value of \$1,876,421 to the Trust and \$665,571 to the Estate, and (7) the payment of 75,000 restricted shares of common stock to the Trust as a fee, valued at \$12,000 and the payment of 25,000 restricted shares of common stock, valued at \$4,250.

The following unaudited pro forma information has been prepared as though these subsequent event transactions had occurred on March 31, 2014. The pro forma references refer to the above paragraph.

	Aethlon Medical, Inc. Consolidated		Pro Forma Consolidated
	Balance Sheet March 31, 2014	Pro Forma Adjustments Amount Reference	Balance Sheet March 31, 2014
ASSETS			
CURRENT ASSETS			
Cash	\$ 1,250,279	\$—	\$ 1,250,279
Accounts receivable	95,177	—	95,177
Deferred financing costs	83,191	—	83,191
Prepaid expenses	50,699	—	50,699

TOTAL CURRENT ASSETS	1,479,346	–		1,479,346
NON-CURRENT ASSETS				
Property and equipment, net	84,279	–		84,279
Patents, net	112,489	–		112,489
Deposits	18,988	–		18,988
TOTAL NONCURRENT ASSETS	215,756	–		215,756
TOTAL ASSETS	\$ 1,695,102	\$–		\$ 1,695,102
LIABILITIES AND DEFICIT				
CURRENT LIABILITIES				
Accounts payable	\$ 517,651	\$–		\$ 517,651
Due to related parties	839,070			839,070
Notes payable, net	390,000			390,000
Convertible notes payable, current portion	1,367,655	(885,000)	(1) & (2)	482,655
Derivative liabilities	10,679,067	(10,679,067)	(5)	–
Other current liabilities	1,855,374	(575,250)	(1), (2) & (3)	1,280,124
TOTAL CURRENT LIABILITIES	15,648,817	(12,139,317)		3,509,500
NONCURRENT LIABILITIES				
Convertible notes payable, non-current portion	776,451	225,000	(2)	1,001,451
TOTAL NONCURRENT LIABILITIES	776,451	225,000		1,001,451
TOTAL LIABILITIES	16,425,268	(11,914,317)		4,510,951
COMMITMENTS AND CONTINGENCIES				
STOCKHOLDERS' DEFICIT				
Common stock	224,984	26,010	(1), (5), (6) & (7)	250,994
Additional paid in capital	59,659,137	14,457,617	(1), (4), (5), (6) & (7)	74,116,754
Accumulated deficit	(74,832,557)	(2,569,310)	(2), (3), (4), (5), (6) & (7)	(77,401,867)
TOTAL AETHLON MEDICAL, INC. STOCKHOLDERS' DEFICIT	(14,948,436)	11,914,317		(3,034,119)
Noncontrolling interests	218,270	–		218,270
TOTAL DEFICIT	(14,730,166)	11,914,317		(2,815,849)
TOTAL LIABILITIES AND DEFICIT	\$ 1,695,102	\$–		\$ 1,695,102

AETHLON MEDICAL, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2014 (Unaudited)	March 31, 2014
ASSETS		
Current assets		
Cash	\$526,187	\$1,250,279
Accounts receivable	258,672	95,177
Deferred financing costs	66,189	83,191
Prepaid expenses and other current assets	41,141	50,699
Total current assets	892,189	1,479,346
Property and equipment, net	70,185	84,279
Patents and patents pending, net	107,907	112,489
Deposits	18,988	18,988
Total assets	\$1,089,269	\$1,695,102
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities		
Accounts payable	\$609,153	\$517,651
Due to related parties	888,778	839,070
Notes payable	190,000	390,000
Convertible notes payable, current portion	483,421	1,367,655
Derivative liabilities	–	10,679,067
Other current liabilities	1,216,604	1,855,374
Total current liabilities	3,387,956	15,648,817
Noncurrent liabilities		
Convertible notes payable, noncurrent portion	990,520	776,451
Total noncurrent liabilities	990,520	776,451
Total liabilities	4,378,476	16,425,268
Commitments and Contingencies (Note 13)		
Stockholders' Deficit		
Common stock, par value \$0.001 per share; 500,000,000 shares authorized as of September 30, 2014 and March 31, 2014; 262,713,781 and 224,973,980 shares issued and outstanding as of September 30, 2014 and March 31, 2014, respectively	262,712	224,984

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Additional paid-in capital	75,654,853	59,659,137
Accumulated deficit	(79,335,907)	(74,832,557)
Total Aethlon Medical, Inc. stockholders' deficit before noncontrolling interests	(3,418,342)	(14,948,436)
Noncontrolling interests	129,135	218,270
Total deficit	(3,289,207)	(14,730,166)
Total liabilities and deficit	\$ 1,089,269	\$ 1,695,102

See accompanying notes.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

For the Three and Six Month Periods Ended September 30, 2014 and 2013

(Unaudited)

	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Six Months Ended September 30, 2014	Six Months Ended September 30, 2013
REVENUES				
Government contract revenue	\$479,075	\$644,887	\$530,371	\$840,483
OPERATING EXPENSES				
Professional fees	308,821	327,511	710,434	651,581
Payroll and related expenses	544,354	404,849	1,165,040	863,480
General and administrative	227,092	142,323	428,097	339,014
Total operating expenses	1,080,267	874,683	2,303,571	1,854,075
OPERATING LOSS	(601,192)	(229,796)	(1,773,200)	(1,013,592)
OTHER EXPENSE				
Loss on debt conversion	65,493	17,467	2,531,123	40,256
(Gain)/loss on change in fair value of derivative liability	–	2,992,002	–	2,382,877
Interest and other debt expenses	78,145	110,405	144,799	216,443
Loss on extension of warrants	143,363	–	143,363	–
Total other expense	287,001	3,119,874	2,819,285	2,639,576
NET LOSS BEFORE NONCONTROLLING INTERESTS	(888,193)	(3,349,670)	(4,592,485)	(3,653,168)
LOSS ATTRIBUTABLE TO NONCONTROLLING INTERESTS	(40,784)	–	(89,135)	–
NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS	\$(847,409)	\$(3,349,670)	\$(4,503,350)	\$(3,653,168)
BASIC AND DILUTED LOSS PER COMMON SHARE	\$(0.00)	\$(0.02)	\$(0.02)	\$(0.02)

WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING – BASIC AND DILUTED	259,369,911	187,643,582	243,494,916	182,004,220
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See accompanying notes.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Six Months Ended September 30, 2014 and 2013

(Unaudited)

	Six Months Ended September 30, 2014	Six Months Ended September 30, 2013
Cash flows from operating activities:		
Net loss	\$(4,592,485)	\$(3,653,168)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	18,676	4,727
Stock based compensation	260,680	190,601
Fair market value of common stock, warrants and options issued for services	162,358	264,343
Change in fair value of derivative liabilities	–	2,382,877
Loss on extension of warrants	143,363	–
Loss on debt conversion	2,531,123	40,256
Amortization of debt discount and deferred financing costs	21,502	4,578
Changes in operating assets and liabilities:		
Accounts receivable	(162,495)	(11,404)
Prepaid expenses and other current assets	9,558	(25,202)
Accounts payable and other current liabilities	163,646	(33,170)
Due to related parties	49,708	91,042
Net cash used in operating activities	(1,394,366)	(744,520)
Cash flows from financing activities:		
Proceeds from the issuance of notes payable	–	400,000
Proceeds from the issuance of common stock	670,274	228,000
Net cash provided by financing activities	670,274	628,000
Net decrease in cash	(724,092)	(116,520)
Cash at beginning of period	1,250,279	125,274
Cash at end of period	\$526,187	\$8,754

See accompanying notes.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

For the Six Months Ended September 30, 2014 and 2013

(Unaudited)

	Six Months Ended September 30, 2014	Six Months Ended September 30, 2013
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	\$-	\$-
Supplemental disclosures of non-cash investing and financing activities:		
Debt and accrued interest converted to common stock	\$ 1,007,631	\$ 420,460
Reclassification of warrant derivative liability into equity	\$ 10,679,067	\$ 106,501
Reclassification of accounts payable to convertible notes payable	\$-	\$ 47,000
Deferred financing costs recorded in connection with debt amendment	\$ 5,000	\$-
Reclassification of accrued interest to convertible notes payable	\$ 25,766	\$ 20,027

See accompanying notes.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

September 30, 2014

1. NATURE OF BUSINESS AND BASIS OF PRESENTATION

ORGANIZATION

Aethlon Medical, Inc. and subsidiary ("Aethlon", the "Company", "we" or "us") is a medical device company focused on creating innovative devices that address unmet medical needs in cancer, infectious disease and other life-threatening conditions. At the core of our developments is the Aethlon ADAPT™ (Adaptive Dialysis-Like Affinity Platform Technology) system, a medical device platform that converges single or multiple affinity drug agents with advanced plasma membrane technology to create therapeutic filtration devices that selectively remove harmful particles from the entire circulatory system without loss of essential blood components. On June 25, 2013, the United States Food and Drug Administration (FDA) approved an Investigational Device Exemption (IDE) that allows us to initiate human feasibility studies of the Aethlon Hemopurifier® in the United States. Under the feasibility study protocol, we will enroll ten end-stage renal disease patients who are infected with the Hepatitis C virus (HCV) to demonstrate the safety of Hemopurifier therapy. Successful completion of this study will allow us the opportunity to initiate pivotal studies that are required for market clearance to treat HCV and other disease conditions in the United States.

Successful outcomes of human trials will also be required by the regulatory agencies of certain foreign countries where we intend to sell this device. Some of our patents may expire before FDA approval or approval in a foreign country, if any, is obtained. However, we believe that certain patent applications and/or other patents issued more recently will help protect the proprietary nature of the Hemopurifier(R) treatment technology.

In October 2013, our subsidiary, Exosome Sciences, Inc. ("ESI"), commenced operations with a focus on advancing exosome-based strategies to diagnose and monitor the progression of cancer, infectious disease and other life-threatening conditions.

Our common stock is quoted on the OTCQB marketplace administered by the OTC Markets Group under the symbol "AEMD."

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with Generally Accepted Accounting Principles in the United States of America (“GAAP”) for interim financial information and with the instructions to Form 10-Q and applicable sections of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments necessary to make the financial statements not misleading have been included. The condensed consolidated balance sheet as of March 31, 2014 was derived from our audited financial statements. Operating results for the six months ended September 30, 2014 are not necessarily indicative of the results that may be expected for the year ending March 31, 2015. For further information, refer to our Annual Report on Form 10-K for the year ended March 31, 2014, which includes audited financial statements and footnotes as of March 31, 2014 and 2013 and for the years then ended.

NOTE 2. LIQUIDITY

The accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern, which contemplates, among other things, the realization of assets and satisfaction of liabilities in the ordinary course of business. We have incurred continuing losses from operations and at September 30, 2014 are in default on certain debt agreements, have negative working capital of approximately \$2,496,000, and have an accumulated deficit of approximately \$79,336,000. These factors, among other matters, raise substantial doubt about our ability to continue as a going concern. A significant amount of additional capital will be necessary to advance the development of our products to the point at which they may become commercially viable. We intend to fund operations, working capital and other cash requirements for the fiscal year ending March 31, 2015 through debt and/or equity financing arrangements as well as through revenues and related cash receipts under our government contracts (see Note 12).

During the six months ended September 30, 2014, we converted a past due convertible note in the amount of \$660,000 and related accrued interest into equity and also restructured and extended a formerly past due convertible note in the amount of \$225,000. We also eliminated the antidilution price protection on all the remaining outstanding notes and warrants which held such price protection. The combination of all of those actions allowed us to reclassify our derivative liability in the amount of \$10,679,067 into equity.

We are currently addressing our liquidity issue by seeking additional investment capital through private placements of common stock and debt and by applying for additional grants issued by government agencies in the United States. We believe that our cash on hand and funds expected to be received from additional private investments will be sufficient to meet our liquidity needs for fiscal 2015. However, no assurance can be given that we will receive any funds in the form of revenues or in connection with capital raising activities in addition to the funds we have already received.

The successful outcome of future contract-based and fundraising activities cannot be determined at this time and there is no assurance that, even if achieved, we will have sufficient funds to execute our intended business plan or generate positive operating results.

The consolidated financial statements do not include any adjustments related to this uncertainty and as to the recoverability and classification of asset carrying amounts or the amount and classification of liabilities that might result should the Company be unable to continue as a going concern.

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The summary of our significant accounting policies presented below is designed to assist the reader in understanding our condensed consolidated financial statements. Such financial statements and related notes are the representations of our management, who are responsible for their integrity and objectivity. These accounting policies conform to GAAP in all material respects, and have been consistently applied in preparing the accompanying condensed consolidated financial statements.

PRINCIPLES OF CONSOLIDATION

The accompanying condensed consolidated financial statements include the accounts of Aethlon Medical, Inc. and its majority-owned and controlled subsidiary, ESI. All significant intercompany balances and transactions have been eliminated in consolidation. The Company classifies the noncontrolling interests in ESI as part of consolidated net loss in the six months ended September 30, 2014 and includes the accumulated amount of noncontrolling interests as part of stockholders' equity. During the fiscal year ended March 31, 2014, ESI raised capital in the amount of \$1,500,000 in exchange for the issuance of 300,000 shares of ESI common stock to ESI's investors, representing 20% of ESI's issued and outstanding capital stock. As a result, Aethlon Medical, Inc.'s ownership of ESI was reduced to 80%. If a further change in Aethlon Medical Inc.'s ownership of ESI results in loss of control and deconsolidation, any retained ownership interest will be remeasured with the gain or loss reported in our statement of operations.

The losses at ESI during the six months ended September 30, 2014 reduced the noncontrolling interests on our consolidated balance sheet by \$89,135 from \$218,270 at March 31, 2014 to \$129,135 at September 30, 2014.

USE OF ESTIMATES

We prepare our condensed consolidated financial statements in conformity with GAAP, which requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and reported amounts of revenues and expenses during the reporting periods. Significant estimates made by management include, among others, realization of long-lived assets, estimating fair value associated with debt and equity transactions and valuation of deferred tax assets. Actual results could differ from those estimates.

CASH AND CASH EQUIVALENTS

Accounting standards define "cash and cash equivalents" as any short-term, highly liquid investment that is both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. For the purpose of financial statement presentation, we consider all highly liquid investment instruments with original maturities of three months or less when purchased, or any investment redeemable without penalty or loss of interest to be cash equivalents. As of September 30, 2014 and March 31, 2014, we had no assets that were classified as cash equivalents.

CONCENTRATIONS OF CREDIT RISKS

Cash is maintained at two financial institutions in checking accounts and related cash management accounts. Accounts at these institutions are secured by the Federal Deposit Insurance Corporation ("FDIC") up to \$250,000. Our September 30, 2014 cash balances were approximately \$276,000 over such insured amount. We do not believe that the Company is exposed to any significant risk with respect to its cash.

All of our accounts receivable at September 30, 2014 and March 31, 2014 and all of our revenue in the six month periods ended September 30, 2014 and 2013 were directly from the U.S. Department of Defense or from a subcontract under Battelle (defined herein), which is a prime contractor with the U.S. Department of Defense, and as such no allowance for uncollectable accounts receivable is deemed necessary at September 30, 2014 or March 31, 2014.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amount of our cash, accounts receivable, accounts payable, and other current liabilities approximate their estimated fair values due to the short-term maturities of those financial instruments. The carrying amount of the notes payable approximates their fair value due to the short maturity of the notes and since the interest rate approximates current market interest rates for similar instruments.

Management has concluded that it is not practical to determine the estimated fair value of amounts due to related parties because the transactions cannot be assumed to have been consummated at arm's length, the terms are not deemed to be market terms, there are no quoted values available for these instruments, and an independent valuation would not be practicable due to the lack of data regarding similar instruments, if any, and the associated potential costs.

See Note 9 with respect to derivative liabilities.

PROPERTY AND EQUIPMENT

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets, which range from two to five years. Repairs and maintenance are charged to expense as incurred while improvements are capitalized. Upon the sale or retirement of property and equipment, the accounts are relieved of the cost and the related accumulated depreciation with any gain or loss included in the consolidated statements of operations.

INCOME TAXES

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to the difference between the consolidated financial statements and their respective tax basis. Deferred income taxes reflect the net tax effects of (a) temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts reported for income tax purposes, and (b) tax credit carryforwards. We record a valuation allowance for deferred tax assets when, based on our best estimate of taxable income (if any) in the foreseeable future, it is more likely than not that some portion of the deferred tax assets may not be realized.

IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. If the cost basis of a long-lived asset is greater than the projected future undiscounted net cash flows from such asset, an impairment loss is recognized. We believe no impairment charges were necessary during the three and six month periods ended September 30, 2014 and 2013.

LOSS PER COMMON SHARE

Basic loss per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period of computation. Diluted loss per share is computed similar to basic loss per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if potential common shares had been issued, if such additional common shares were dilutive. Since we had net losses for all periods presented, basic and diluted loss per share are the same, and additional potential common shares have been excluded as their effect would be antidilutive.

As of September 30, 2014 and 2013, a total of 139,672,815 and 137,935,529 potential common shares, consisting of shares underlying outstanding stock options, warrants and convertible notes payable were excluded as their inclusion would be antidilutive.

SEGMENTS

Historically, we operated in one segment that was based on our development of therapeutic devices. However in the December 2013 quarter, we initiated the operations of ESI to develop diagnostic tests. As a result, we now operate in two segments, Aethlon for therapeutic applications and ESI for diagnostic applications (See Note 14).

DEFERRED FINANCING COSTS

Costs related to the issuance of debt are capitalized and amortized to interest expense over the life of the related debt using the effective interest method. We recorded amortization expense related to our deferred offering costs of \$21,502 and \$863 during the six month periods ended September 30, 2014 and 2013, respectively.

REVENUE RECOGNITION

DARPA Contract -- With respect to revenue recognition, we entered into a government contract with DARPA and have recognized revenue under such contract. We adopted the Milestone method of revenue recognition for the DARPA contract under ASC 605-28 "Revenue Recognition – Milestone Method" and we believe we meet the requirements under ASC 605-28 for reporting contract revenue under the Milestone Method.

In order to account for this contract, we identify the deliverables included within the contract and evaluate which deliverables represent separate units of accounting based on if certain criteria are met, including whether the delivered element has standalone value to the collaborator. The consideration received is allocated among the separate units of accounting, and the applicable revenue recognition criteria are applied to each of the separate units.

A milestone is an event having all of the following characteristics:

(1) There is substantive uncertainty at the date the arrangement is entered into that the event will be achieved. A vendor's assessment that it expects to achieve a milestone does not necessarily mean that there is not substantive uncertainty associated with achieving the milestone.

(2) The event can only be achieved based in whole or in part on either: (a) the vendor's performance; or (b) a specific outcome resulting from the vendor's performance.

(3) If achieved, the event would result in additional payments being due to the vendor.

A milestone does not include events for which the occurrence is either: (a) contingent solely upon the passage of time; or (b) the result of a counterparty's performance.

The policy for recognizing deliverable consideration contingent upon achievement of a milestone must be applied consistently to similar deliverables.

The assessment of whether a milestone is substantive is performed at the inception of the arrangement. The consideration earned from the achievement of a milestone must meet all of the following for the milestone to be considered substantive:

(1) The consideration is commensurate with either: (a) the vendor's performance to achieve the milestone; or (b) the enhancement of the value of the delivered item or items as a result of a specific outcome resulting from the vendor's performance to achieve the milestone;

(2) The consideration relates solely to past performance; and

(3) The consideration is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

A milestone is not considered substantive if any portion of the associated milestone consideration relates to the remaining deliverables in the unit of accounting (i.e., it does not relate solely to past performance). To recognize the milestone consideration in its entirety as revenue in the period in which the milestone is achieved, the milestone must be substantive in its entirety. Milestone consideration cannot be bifurcated into substantive and non-substantive components. In addition, if a portion of the consideration earned from achieving a milestone may be refunded or adjusted based on future performance, the related milestone is not considered substantive.

See Note 12 for the additional disclosure information required under ASC 605-28.

Battelle Subcontract -- We entered into a subcontract agreement with Battelle Memorial Institute ("Battelle") in March 2013. Battelle was chosen by DARPA to be the prime contractor on the systems integration portion of the original DARPA contract and we are one of several subcontractors on that systems integration project. The Battelle subcontract is cost-reimbursable under a time and materials basis. We began generating revenues under the subcontract during the six months ended September 30, 2013.

Our revenue under this contract is a function of cost reimbursement plus an overhead mark-up for hours devoted to the project by specific employees (with specific hourly rates for those employees). Battelle engages us as needed. Each payment requires approval by the program manager at Battelle.

STOCK-BASED COMPENSATION

Employee stock options and rights to purchase shares under stock participation plans are accounted for under the fair value method. Accordingly, share-based compensation is measured when all granting activities have been completed, generally the grant date, based on the fair value of the award. The exercise price of options is generally equal to the market price of the Company's common stock (defined as the closing price as quoted on the OTCBB on the date of grant). Compensation cost recognized by the Company includes (a) compensation cost for all equity incentive awards granted prior to April 1, 2006, but not yet vested, based on the grant-date fair value estimated in accordance with the original provisions of the then current accounting standards, and (b) compensation cost for all equity incentive awards granted subsequent to April 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of subsequent accounting standards. We use a Binomial Lattice option pricing model for estimating fair value of options granted (see Note 10).

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The following table summarizes share-based compensation expenses relating to shares and options granted and the effect on loss per common share during the six month periods ended September 30, 2014 and 2013:

	Six Months Ended September 30, 2014	Six Months Ended September 30, 2013
Vesting of Stock Options	\$260,680	\$124,243
Incremental fair value of option Modifications	–	1,914
Vesting Expense Associated with CEO Restricted Stock Grant	–	64,444
Total Stock-Based Compensation Expense	\$260,680	\$190,601
Weighted average number of common shares outstanding – basic and diluted	243,494,916	182,004,220
Basic and diluted loss per common share	\$(0.00) \$(0.00

We account for transactions involving services provided by third parties where we issue equity instruments as part of the total consideration using the fair value of the consideration received (i.e. the value of the goods or services) or the fair value of the equity instruments issued, whichever is more reliably measurable. In transactions, when the value of the goods and/or services are not readily determinable and (1) the fair value of the equity instruments is more reliably measurable and (2) the counterparty receives equity instruments in full or partial settlement of the transactions, we use the following methodology:

- For transactions where goods have already been delivered or services rendered, the equity instruments are issued on or about the date the performance is complete (and valued on the date of issuance).
- For transactions where the instruments are issued on a fully vested, non-forfeitable basis, the equity instruments are valued on or about the date of the contract.
- For any transactions not meeting the criteria in (a) or (b) above, we re-measure the consideration at each reporting date based on its then current stock value.

We review share-based compensation on a quarterly basis for changes to the estimate of expected award forfeitures based on actual forfeiture experience. The effect of adjusting the forfeiture rate for all expense amortization after March 31, 2006 is recognized in the period the forfeiture estimate is changed. The effect of forfeiture adjustments for the six months ended September 30, 2014 was insignificant.

PATENTS

Patents include both foreign and domestic patents. There were several patents pending at September 30, 2014. We capitalize the cost of patents and patents pending, some of which were acquired, and amortize such costs over the shorter of the remaining legal life or their estimated economic life, upon issuance of the patent. The unamortized costs of patents and patents pending are subject to our review for impairment under our long-lived asset policy above.

STOCK PURCHASE WARRANTS

We grant warrants in connection with the issuance of convertible notes payable and the issuance of common stock for cash. When such warrants are classified as equity and issued in connection with debt, we measure the relative estimated fair value of such warrants and record it as a discount from the face amount of the convertible notes payable. Such discounts are amortized to interest expense over the term of the notes using the effective interest method. Warrants issued in connection with common stock for cash, if classified as equity, are considered issued in connection with equity transactions and the warrant fair value is recorded to additional paid-in-capital. Lastly, warrants not meeting equity classification are recorded as derivative instruments.

DERIVATIVE INSTRUMENTS

We evaluate free-standing derivative instruments (or embedded derivatives) to properly classify such instruments within equity or as liabilities in our financial statements. Our policy is to settle instruments indexed to our common shares on a first-in-first-out basis.

The classification of a derivative instrument is reassessed at each reporting date. If the classification changes as a result of events during a reporting period, the instrument is reclassified as of the date of the event that caused the reclassification. There is no limit on the number of times a contract may be reclassified.

Instruments classified as derivative liabilities are remeasured each reporting period (or upon reclassification) and the change in fair value is recorded on our consolidated statement of operations in other (income) expense.

BENEFICIAL CONVERSION FEATURE OF CONVERTIBLE NOTES PAYABLE

The convertible feature of certain notes payable provides for a rate of conversion that is below market value. Such feature is normally characterized as a "Beneficial Conversion Feature" ("BCF"). We measure the estimated fair value of the BCF in circumstances in which the conversion feature is not required to be separated from the host instrument and accounted for separately, and record that value in the consolidated financial statements as a discount from the face amount of the notes. Such discounts are amortized to interest expense over the term of the notes.

REGISTRATION PAYMENT ARRANGEMENTS

We account for contingent obligations to make future payments or otherwise transfer consideration under a registration payment arrangement separately from any related financing transaction agreements, and any such contingent obligations are recognized only when it is determined that it is probable we will become obligated for future payments and the amount, or range of amounts, of such future payments can be reasonably estimated.

RESEARCH AND DEVELOPMENT EXPENSES

We incurred research and development expenses during the three and six month periods ended September 30, 2014 and 2013, which are included in various operating expense line items in the accompanying condensed consolidated statements of operations. Our research and development expenses in those periods were as follows:

	September 30, 2014	September 30, 2013
Three months ended	\$ 250,388	\$ 293,580
Six months ended	\$ 637,723	\$ 626,638

OFF-BALANCE SHEET ARRANGEMENTS

We have not entered into any off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our consolidated financial statements.

SIGNIFICANT RECENT ACCOUNTING PRONOUNCEMENTS

Management is evaluating significant recent accounting pronouncements that are not yet effective for the Company, including the new accounting standard on revenue recognition, ASU 2014-09 (Topic 606), and has not yet concluded whether any such pronouncements will have a significant effect on the Company's future consolidated financial statements.

NOTE 4. NOTES PAYABLE

Notes payable consist of the following:

	September 30, 2014		March 31, 2014	
	Principal Balance	Accrued Interest	Principal Balance	Accrued Interest
12% Notes payable, past due	\$ 185,000	\$ 367,687	\$ 185,000	\$ 353,813
10% Note payable, past due	5,000	6,625	5,000	6,375
Directors' Note(s)	–	–	200,000	14,516
Total	\$ 190,000	\$ 374,312	\$ 390,000	\$ 374,704

During the six months ended September 30, 2014, we recorded interest expense of \$19,959 related to the contractual interest rates of our notes payable.

12% NOTES

From August 1999 through May 2005, we entered into various borrowing arrangements for the issuance of notes payable from private placement offerings (the "12% Notes"). On April 21, 2010, a holder of \$100,000 of the 12% Notes converted the principal balance and \$71,758 of accrued interest into 687,033 shares of common stock at an agreed conversion price of \$0.25 per share. At September 30, 2014, the 12% Notes in the principal amount of \$185,000 were past due, in default, and bearing interest at the default rate of 15%.

10% NOTES

At September 30, 2014, one 10% Note in the amount of \$5,000 is past due and in default, remains outstanding and bears interest at the default rate of 15%.

Management's plans to satisfy the remaining outstanding balance on these 12% and 10% Notes include converting the notes to common stock at market value or repayment when funds are available.

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DIRECTORS' NOTES

In July 2013, we borrowed \$400,000 from two of our directors under two 90 day notes for \$200,000 each bearing 10% interest (the "Notes"). At the discretion of the holders, if not paid off by October 9, 2013, the noteholders were entitled to (i) convert the principal and accrued interest under the Notes into shares of common stock at \$0.088 per share (the "Conversion Price") and (ii) receive warrants to purchase common stock equal to 50% of the principal converted under the Notes, with an exercise price of \$0.132 per share. Additionally, there was a provision for a penalty interest rate of 12%.

That potential conversion price and warrant exercise price were based on the same pricing mechanism that we have used in prior equity unit financings since March 2012 (see Note 6) which are based on 80% of the then current market price of our common stock and with the warrant exercise price based on 120% of the same then current market price. We initially reserved 6,931,818 shares of common stock to support the conversion of the Notes and accrued interest in full as well as the exercise of the warrants in full (should such conversion and/or issuance occur).

During the fiscal year ended March 31, 2014, the principal of \$200,000 and accrued interest of \$9,367 were paid on one of the Notes, which extinguished all potential common stock and warrant issuance provisions related to that Note.

During the six months ended September 30, 2014, the holder of the second Note converted the principal of \$200,000 and accrued interest of \$20,349 into 2,503,966 shares of our common stock per the conversion formula of the Note (see Note 6).

5. CONVERTIBLE NOTES PAYABLE

Convertible Notes Payable consisted of the following at September 30, 2014:

	Principal	Unamortized Discount	Net Amount	Accrued Interest
Convertible Notes Payable – Current Portion:				
October & November 2009 10% Convertible Notes	\$ 50,000	\$ –	\$ 50,000	\$ 28,598
April 2010 10% Convertible Note	75,000	–	75,000	35,188
July and August 2011 10% Convertible Notes, past due	283,421	–	283,421	96,728
Law Firm Note	75,000	–	75,000	9,479
Total – Convertible Notes Payable – Current Portion	483,422	–	483,422	169,993

Convertible Notes Payable – Non-Current Portion:

Amended and Restated Series A 12% Convertible Notes	225,000	–	225,000	9,000
September 2010 12% Convertible Notes	317,072	–	317,072	9,513
April 2011 12% Convertible Notes	448,448	–	448,448	13,454
Total – Convertible Notes Payable – Non-Current Portion	990,520	–	990,520	31,967
Total Convertible Notes Payable	\$1,473,941	\$ –	\$1,473,941	\$201,960

There were no discounts remaining on any of our Convertible Notes Payable as of September 30, 2014.

During the six months ended September 30, 2014, we recorded interest expense of \$97,362 related to the contractual interest rates of our convertible notes and interest expense of \$21,502 related to the amortization of deferred financing costs related to the convertible notes for a total interest related to convertible notes of \$118,864.

Convertible Notes Payable consisted of the following at March 31, 2014:

	Principal	Unamortized Discount	Net Amount	Accrued Interest
Convertible Notes Payable – Current Portion:				
Amended and Restated Series A 12% Convertible Notes, past due	\$885,000	\$ –	\$885,000	\$575,250
2008 10% Convertible Notes, past due	25,000	–	25,000	19,167
October & November 2009 10% Convertible Notes	50,000	–	50,000	26,097
April 2010 10% Convertible Note	75,000	–	75,000	31,438
July and August 2011 10% Convertible Notes, past due	257,655	–	257,655	90,256
Law Firm Note	75,000	–	75,000	7,604
Total – Convertible Notes Payable – Current Portion	1,367,655	–	1,367,655	749,812
Convertible Notes Payable – Non-Current Portion:				
September 2010 12% Convertible Notes	317,072	–	317,072	35,034
April 2011 12% Convertible Notes	448,448	–	448,448	12,117
September 2011 12% Convertible Notes	10,931	–	10,931	–
Total – Convertible Notes Payable – Non-Current Portion	776,451	–	776,451	47,151
Total Convertible Notes Payable	\$2,144,106	\$ –	\$2,144,106	\$796,963

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There were no discounts remaining on any of our Convertible Notes Payable as of March 31, 2014.

AMENDED AND RESTATED SERIES A 12% CONVERTIBLE NOTES

In June 2010, we entered into Amended and Restated Series A 12% Convertible Promissory Notes (the "Amended and Restated Notes") with the holders of certain promissory notes previously issued by us, extending the due date to December 31, 2010 on the aggregate principal balance of \$900,000. During the fiscal year ended March 31, 2013, the holders of \$15,000 of the Notes converted their principal and related accrued interest into common stock. The balance remaining at March 31, 2014 was \$885,000 and past due.

Weiner Note Conversion

On June 24, 2014, we entered into an agreement with the Ellen R. Weiner Family Revocable Trust (the "Trust"), a holder of a Series A 12% Convertible Note (the "Note"), which previously was classified as being in default. As per the agreement, the Trust converted past due principal of \$660,000 and accrued interest balance of \$343,200 into restricted common stock.

Additionally, the Trust agreed to waive anti-dilution price protection underlying warrants previously issued to the Trust. On June 26, 2014, three other parties who held similar warrants also agreed to waive their anti-dilution price protection.

Under its agreement, the Trust converted the entire \$1,003,200 past due principal and interest balance on the Note, which previously was in default, into an aggregate of 23,318,254 restricted shares of our common stock and five-year warrants to acquire up to 6,809,524 shares of our common stock at an exercise price of \$.042 per share (which exercise price was the result of certain contractual price adjustments previously made during 2011) and up to 397,222 shares of our common stock at an exercise price of \$.108 per share (collectively, the "Conversion Securities"). Based on the fair value of the warrants and shares issued to the Trust for the accrued interest, we recorded a loss on settlement of notes of \$1,791,421.

In exchange for the Trust's conversion in full of the Note and accrued interest and for the waivers of anti-dilution price protection in the previously issued warrants, in addition to the Conversion Securities, we issued to the Trust 75,000 restricted shares of common stock as a service fee, changed the exercise price of all of the previously issued warrants to \$.042 per share and extended the expiration date of all of the previously issued warrants to July 1, 2018. We valued the 75,000 share service fee at \$12,000 based on our closing price on the date of the agreement and recorded that

value as interest expense during the June 2014 period.

Bird Estate Extension

On July 8, 2014, we executed a written restructuring agreement (the “Agreement”) with the Estate of Allan Bird (the “Estate”), a holder of a Series A 12% Convertible Note (the “Note”), which previously was classified as being in default. Since the negotiations for the Agreement were completed in the month of June, we recorded the impact of the Agreement as of June 30, 2014. In the Agreement, the Estate agreed to extend the expiration date of the Note to April 1, 2016, to convert approximately \$116,970 of accrued interest to equity, and to waive anti-dilution price protection underlying the Note and warrants previously issued to the Estate.

Under the Agreement, the Estate converted the entire \$116,970 past due interest balance on the Note, which previously was in default, into an aggregate of 2,591,846 restricted shares of our common stock. The Estate received five-year warrants to acquire up to 2,321,429 shares of our common stock at an exercise price of \$.042 per share (which exercise price was the result of certain contractual price adjustments previously made during 2011). Based on our common stock prices during a period of negotiation with the Estate including during calendar year 2013, the Estate also received five-year warrants to acquire up to 135,417 shares of our common stock at an exercise price of \$.108 (collectively known as the “Conversion Securities”). Based on the fair value of the warrants and shares issued to the Estate for the accrued interest, we recorded a loss on settlement of notes of \$663,209.

In exchange for the Estate’s extension of the Note, conversion of accrued interest and for the waivers of anti-dilution price protection in the previously issued warrants, in addition to the Conversion Securities, we also issued to the Estate 25,000 restricted shares of common stock as an extension fee and extended the expiration date of all of the previously issued warrants to July 1, 2018. We valued the 25,000 share extension fee at \$4,500 based on our closing price and recorded that value as a deferred financing cost, which we will amortize over the extended two year life of the note.

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2008 10% CONVERTIBLE NOTES

On September 17, 2014, we issued to the holder of the remaining 2008 10% Convertible Note units consisting of an aggregate of 478,188 shares of restricted common stock and unit warrants to acquire up to an aggregate of 239,094 shares of common stock at an exercise price of \$0.096 per share (see Note 6). The units were issued to the Note holder upon the conversion of an aggregate of \$45,906 of unpaid principal and accrued interest due under the Note, which represented the entire amount outstanding under the Note and the Note was retired. We recorded a loss on debt conversion of \$65,493 on this transaction.

OCTOBER & NOVEMBER 2009 10% CONVERTIBLE NOTES

In October and November 2009, we raised \$430,000 from the sale to accredited investors of 10% convertible notes ("October & November 2009 10% Convertible Notes"). The October & November 2009 10% Convertible Notes matured at various dates between April 2011 and May 2011 and are convertible into our common stock at a fixed conversion price of \$0.25 per share. The investors also received matching three year warrants to purchase unregistered shares of our common stock at an exercise price of \$0.25 per share. We measured the fair value of the warrants and the beneficial conversion feature of the Notes and recorded a 100% discount against the principal of the notes. Such discount was fully amortized at March 31, 2014.

In July 2012, we issued 461,409 shares of common stock and 230,705 warrants to purchase common stock to the holder of a \$25,000 note in this grouping in exchange for the conversion of such note and related accrued interest of \$8,000 (for a total of \$33,000). The warrants expired in 2012 and are exercisable at \$0.107 per share (see Note 6). We recorded a loss on conversion of \$45,796.

The following table shows the conversions into principal of the October and November 2009 10% Convertible Notes by fiscal year:

Activity in October & November 2009 10% Convertible Notes	
Initial principal balance	\$450,250
Conversions during the fiscal year ended March 31, 2010	(70,000)
Conversions during the fiscal year ended March 31, 2011	(175,000)
Conversions during the fiscal year ended March 31, 2012	(130,250)
Conversions during the fiscal year ended March 31, 2013	(25,000)
Conversions during the fiscal year ended March 31, 2014	–
Conversions during the six months ended September 30, 2014	–
Balance as of September 30, 2014	\$50,000

On March 31, 2012, we agreed to extend the expiration date and to change the exercise price of certain warrants of one of the note holders by two years in exchange for the extension of \$50,000 of the October & November 2009 10% Convertible Notes and the \$75,000 April 2010 10% Convertible Note (see below) by that same two year period. We recorded a charge of \$77,265 relating to this modification.

In September 2013, we agreed to extend the expiration date of certain warrants of one of the note holders by two years in exchange for the extension of \$50,000 of the October & November 2009 10% Convertible Notes and the \$75,000 April 2010 10% Convertible Note (see below) by that same two year period. Management assessed the change in the value of the notes and related warrants before and after that extension and determined that the change in value related to the change in terms was not significant.

Subsequent to September 30, 2014, we issued to the holder of the remaining October & November 2009 10% Convertible Note and the April 2010 10% Convertible Note units consisting of an aggregate of 1,835,798 shares of common stock and unit warrants to acquire up to an aggregate of 1,837,798 shares of common stock at an exercise price of \$0.103 per share. The units were issued to the note holder upon the conversion of an aggregate of \$189,087 of unpaid principal and accrued interest due under two promissory notes (the remaining October & November 2009 10% Convertible Note and the April 2010 10% Convertible Note). The amounts converted represented the entire principal and interest outstanding under the notes and the notes held by that holder were retired (see Note 15).

APRIL 2010 10% CONVERTIBLE NOTE

In April 2010, we raised \$75,000 from the sale to an accredited investor of a 10% convertible note. The convertible note was originally scheduled to mature in October 2011 and is convertible into our common stock at a fixed conversion price of \$0.25 per share prior to maturity. The investor also received three year warrants to purchase 300,000 unregistered shares of our common stock at a price of \$0.25 per share.

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We measured the fair value of the warrants and the beneficial conversion feature of the notes and recorded a 100% discount against the principal of the notes. We amortized this discount using the effective interest method over the term of the note. As of September 30, 2014, there have not been any conversions of the April 2010 10% Convertible Note.

On March 31, 2012, we agreed to extend the expiration date and to change the exercise price of certain warrants of the note holder by two years in exchange for his extension of \$50,000 of the October & November 2009 10% Convertible Notes and the \$75,000 April 2010 10% Convertible Note by that same two year period.

In September 2013, we agreed to extend the expiration date of certain warrants of one of the note holders by two years in exchange for the extension of \$50,000 of the October & November 2009 10% Convertible Notes and the \$75,000 April 2010 10% Convertible Note (see below) by that same two year period. Management assessed the change in the value of the notes and related warrants before and after that extension and determined that the change in value related to the change in terms was not significant.

Subsequent to September 30, 2014, we issued to the holder of the remaining October & November 2009 10% Convertible Note and the April 2010 10% Convertible Note units consisting of an aggregate of 1,835,798 shares of common stock and unit warrants to acquire up to an aggregate of 1,837,798 shares of common stock at an exercise price of \$0.103 per share. The units were issued to the note holder upon the conversion of an aggregate of \$189,087 of unpaid principal and accrued interest due under two promissory notes (the remaining October & November 2009 10% Convertible Note and the April 2010 10% Convertible Note). The amounts converted represented the entire principal and interest outstanding under the notes and the notes held by that holder were retired (see Note 15).

SEPTEMBER 2010 10% CONVERTIBLE NOTES

On September 3, 2010, we entered into a Subscription Agreement with three accredited investors (the “Purchasers”) providing for the issuance and sale of convertible promissory notes and corresponding warrants in the aggregate principal amount of \$1,430,000. The initial closing under the Subscription Agreement resulted in the issuance and sale of (i) convertible promissory notes in the aggregate principal amount of \$743,600, (ii) five-year warrants to purchase an aggregate of 3,718,000 shares of our common stock at an exercise price of \$0.31125 per share, and (iii) five-year warrants to purchase an aggregate of 3,718,000 shares of our common stock at an exercise price of \$0.43575 per share. The convertible promissory notes bear interest compounded monthly at the annual rate of ten percent (10%) and mature on April 1, 2016 (see below). The aggregate gross cash proceeds were \$650,000, the balance of the principal amount representing a due diligence fee and an original issuance discount. The convertible promissory notes are convertible at the option of the holders into shares of our common stock at a price per share equal to eighty percent (80%) of the average of the three lowest closing bid prices of the common stock as reported by Bloomberg L.P. for the principal market on which the common stock trades or is quoted for the ten (10) trading days preceding the proposed conversion date. Subject to adjustment as described in the notes, the conversion price may not

be more than \$0.30 nor less than \$0.20. There are no registration requirements with respect to the shares of common stock underlying the notes or the warrants.

On March 31, 2014, we entered into separate Amendments to Convertible Notes and Warrants (collectively, the “Amendments”) with three accredited investors (collectively, the “Investors”) who own certain convertible promissory notes (collectively, the “Notes”) and warrants (collectively, the “Warrants”) previously issued by us on various dates between December 5, 2007 and September 23, 2011, including the September 2010 Convertible Notes.

Prior to the Amendments, the Notes were past maturity and were in default, resulting in the accrual of interest at the applicable default interest rate. The Amendments extended the maturity date of each of the Notes to April 1, 2016, which permits us to classify them as long-term liabilities. As a result of the Amendments, the Notes are no longer in default and the non-default interest rate for all of the Notes was set at 12% per annum, which represents a reduction from the default interest rates of fifteen percent at which interest had been accruing. By entering into the Amendments, we also agreed to increase the currently outstanding principal amount of the Notes by 12% from a total of \$693,260 to a total of \$776,451.

During the period from October 2011 to February 2014, the Investors had converted, at conversion prices between \$.0546 and \$.07 per share, portions of principal and interest outstanding under the Notes and certain other convertible promissory notes previously issued to them by us. Certain antidilution provisions applicable to such notes should have resulted in such conversions being effected at a conversion price of \$.042 per share. Accordingly, pursuant to the Amendments, we issued to the investors an aggregate of 4,507,105 shares of the Company’s Common Stock, which represents the additional shares of Common Stock that would have been issued to the Investors had such conversions been effected at \$.042 per share.

The Amendments also set the conversion price of the Notes, as well as the exercise price at which shares of our common stock can be purchased under the Warrants, at \$.042 per share. By virtue of the Amendments, the expiration dates of the Warrants also were extended from dates between September 3, 2015 and September 23, 2016 to January 1, 2017.

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The following table shows the activity in the September 2010 10% Convertible Notes by fiscal year:

Activity in the September 2010 10% Convertible Notes	
Initial principal balance	\$743,600
Conversions during the fiscal year ended March 31, 2012	(405,500)
Conversions during the fiscal year ended March 31, 2013	(30,000)
Conversions during the fiscal year ended March 31, 2014	(25,000)
Increase in principal balance due to 12% extension fee	33,972
Conversions during the six months ended September 30, 2014	–
Balance as of September 30, 2014	\$317,072

APRIL 2011 10% CONVERTIBLE NOTES

In April 2011, we entered into a Subscription Agreement with two accredited investors (the “Purchasers”) providing for the issuance and sale of convertible promissory notes and corresponding warrants in the aggregate principal amount of \$385,000. The closing under the Subscription Agreement resulted in the issuance and sale by us of (i) convertible promissory notes in the aggregate principal amount of \$385,000, (ii) five-year warrants to purchase an aggregate of 4,004,000 shares of our common stock at an exercise price of \$0.125 per share, and (iii) five-year warrants to purchase an aggregate of 4,004,000 shares of our common stock at an exercise price of \$0.175 per share. The convertible promissory notes bear interest compounded monthly at the annual rate of 10% and mature on April 1, 2016 (see below). The aggregate gross cash proceeds to us were \$350,000, the balance of the principal amount representing a due diligence fee and an original issuance discount. The convertible promissory notes are convertible at the option of the holders into shares of our common stock at a price per share equal to eighty percent (80%) of the average of the three lowest closing bid prices of the common stock as reported by Bloomberg L.P. for the principal market on which the common stock trades or is quoted for the ten (10) trading days preceding the proposed conversion date. Subject to adjustment as described in the notes, the conversion price may not be more than \$0.20 nor less than \$0.10. There are no registration requirements with respect to the shares of common stock underlying the notes or the warrants.

In addition, we issued (i) five-year warrants to purchase an aggregate of 812,500 shares of our common stock at an exercise price of \$0.125 per share, and (ii) five-year warrants to purchase an aggregate of 812,500 shares of our common stock at an exercise price of \$0.175 per share to the Purchasers. These warrants were issued as an antidilution adjustment under certain common stock purchase warrants held by the Purchasers that were acquired from us in September 2010.

On March 31, 2014, we entered into separate Amendments to Convertible Notes and Warrants (collectively, the “Amendments”) with three accredited investors (collectively, the “Investors”) who own certain convertible promissory notes (collectively, the “Notes”) and warrants (collectively, the “Warrants”) previously issued by us on various dates between December 5, 2007 and September 23, 2011, including the April 2011 Convertible Notes.

Prior to the Amendments, the Notes were past maturity and were in default, resulting in the accrual of interest at the applicable default interest rate. The Amendments extended the maturity date of each of the Notes to April 1, 2016, which permits us to classify them as long-term liabilities. As a result of the Amendments, the Notes are no longer in default and the non-default interest rate for all of the Notes was set at 12% per annum, which represents a reduction from the default interest rates of 15% at which interest had been accruing. By entering into the Amendments, we also agreed to increase the currently outstanding principal amount of the Notes by 12% from a total of \$693,260 to a total of \$776,451.

During the period from October 2011 to February 2014, the Investors had converted, at conversion prices between \$.0546 and \$.07 per share, portions of principal and interest outstanding under the Notes and certain other convertible promissory notes previously issued to them by us. Certain antidilution provisions applicable to such notes should have resulted in such conversions being effected at a conversion price of \$.042 per share. Accordingly, pursuant to the Amendments, we issued to the investors an aggregate of 4,507,105 shares of the Company's Common Stock, which represents the additional shares of Common Stock that would have been issued to the Investors had such conversions been effected at \$.042 per share.

The Amendments also set the conversion price of the Notes, as well as the exercise price at which shares of our common stock can be purchased under the Warrants, at \$.042 per share. By virtue of the Amendments, the expiration dates of the Warrants also were extended from dates between September 3, 2015 and September 23, 2016 to January 1, 2017.

As of September 30, 2014, there have not been any conversions of the April 2011 10% Convertible Notes and the 12% extension fee noted above increased the principal balance by \$48,048 to a principal balance of \$448,448.

JULY & AUGUST 2011 10% CONVERTIBLE NOTES

During the three months ended September 30, 2011, we raised \$357,656 in five separate 10% convertible notes. Those notes had a fixed conversion price of \$0.09 per share and carried an interest rate of 10%. The convertible notes matured in July and August 2012. We also issued those investors five year warrants to purchase 3,973,957 shares of common stock at \$0.125 per share.

We measured the fair value of the warrants and the beneficial conversion feature of the notes and recorded a \$257,926 discount against the principal of the notes. We amortized this discount using the effective interest method over the term of the note.

Effective March 31, 2014, the holders of three of the five notes totaling \$100,000 converted all of their principal and accrued interest into 1,438,700 shares of our common stock at the contractual conversion price of \$0.09 per share.

In September 2014, we entered into a forbearance agreement with the holder of the remaining two notes in which we agreed to repay his notes by October 31, 2014 and in which we also agreed to extend his warrants by two years. We recorded a charge of \$143,363 in the September 2014 period related to this warrant extension due to the change in the fair value of the warrants.

Subsequent to September 30, 2014, we paid off in full the remaining outstanding principal balance and interest balances on the two remaining notes with cash payments of \$382,748 (see Note 15).

SEPTEMBER 2011 CONVERTIBLE NOTES

In September 2011, we issued \$253,760 of convertible notes, convertible at \$0.07 per share. Such notes originally matured in September 2012.

On March 31, 2014, we entered into separate Amendments to Convertible Notes and Warrants (collectively, the "Amendments") with three accredited investors (collectively, the "Investors") who own certain convertible promissory notes (collectively, the "Notes") and warrants (collectively, the "Warrants") previously issued by us on various dates between December 5, 2007 and September 23, 2011, including the September 2011 Convertible Notes.

Prior to the Amendments, the Notes were past maturity and were in default, resulting in the accrual of interest at the applicable default interest rate. The Amendments extended the maturity date of each of the Notes to April 1, 2016, which permits us to classify them as long-term liabilities. As a result of the Amendments, the Notes are no longer in default and the non-default interest rate for all of the Notes was set at 12% per annum, which represents a reduction from the default interest rates of 15% at which interest had been accruing. By entering into the Amendments, we also agreed to increase the currently outstanding principal amount of the Notes by 12%, which in the case of the September 2011 Notes, they increased from \$9,760 to \$10,931

During the period from October 2011 to February 2014, the Investors had converted, at conversion prices between \$.0546 and \$.07 per share, portions of principal and interest outstanding under the Notes and certain other convertible promissory notes previously issued to them by us. Certain antidilution provisions applicable to such notes should have resulted in such conversions being effected at a conversion price of \$.042 per share. Accordingly, pursuant to the Amendments, we issued to the investors an aggregate of 4,507,105 shares of the Company's Common Stock, which represents the additional shares of Common Stock that would have been issued to the Investors had such conversions been effected at \$.042 per share.

The Amendments also set the conversion price of the Notes, as well as the exercise price at which shares of our common stock can be purchased under the Warrants, at \$.042 per share. By virtue of the Amendments, the expiration dates of the Warrants also were extended to January 1, 2017.

The following table shows the conversions into principal of the September 2011 Convertible Notes by fiscal year:

Activity in the September 2011 Convertible Notes	
Initial principal balance	\$253,760
Conversions during the fiscal year ended March 31, 2012	(15,000)
Conversions during the fiscal year ended March 31, 2013	(60,000)
Conversions during the fiscal year ended March 31, 2014	(169,000)
Increase in principal balance due to extension fee	1,171
Conversions during the six months ended September 30, 2014	(10,931)
Balance as of September 30, 2014	\$-

As noted in the above table, the remaining balance of the September 2011 Convertible Notes converted into equity during the six months ended September 30, 2014.

LAW FIRM NOTE

On March 22, 2012, we entered into a Promissory Note with our corporate law firm for the amount of \$75,000, which represented the majority of the amount we owed to that firm at that time. The Promissory Note originally had a maturity date of December 31, 2012 and bears interest at 5% per annum. The note is convertible at the option of the holder into shares of our common stock at a 10% discount to the market price of the common stock on the date prior to conversion with a floor price on such conversions of \$0.08 per share. The holder subsequently agreed to extend the Maturity Date of the Note first to October 1, 2013, then to September 30, 2013, and now the expiration date of this note is again extended to October 1, 2014. As of September 30, 2014, there have not been any conversions of the Law Firm Note.

Subsequent to September 30, 2014, we paid off in full the outstanding principal balance and interest balance on the note with a cash payment of \$50,000 and an issuance of 170,020 common shares (see Note 15).

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6. EQUITY TRANSACTIONS

COMMON STOCK AND WARRANTS

The following are Aethlon Medical, Inc.'s Equity Transactions in the Six Months Ended September 30, 2014.

In the three months ended June 30, 2014, we completed unit subscription agreements with seven accredited investors pursuant to which we issued 2,192,444 shares of our common stock and 1,096,222 warrants to purchase our common stock for net cash proceeds of \$320,800. Such warrants have exercise prices ranging from \$0.193 to \$0.236 per share.

As discussed above in Note 5, during the three months ended June 30, 2014, we issued 15,714,286 shares of restricted common stock to the holder of one of the Series A 12% Convertible Notes in exchange for the conversion in full of the \$660,000 principal balance of that note, 7,603,968 shares of restricted common stock in exchange for conversion of \$343,200 of accrued interest and 75,000 shares of restricted common stock as a restructuring fee. During that period, we also issued the other holder of the Series A 12% Convertible Notes 2,591,846 shares of restricted common stock in exchange for conversion of \$116,970 of accrued interest and 25,000 shares of restricted common stock as a restructuring fee.

During the three months ended June 30, 2014, we issued 219,127 shares of common stock pursuant to our S-8 registration statement covering our Amended 2010 Stock Plan at an average price of \$0.17 per share in payment for legal services, internal controls consulting services and regulatory consulting services collectively valued at \$38,268 based on the value of the services provided.

During the three months ended September 30, 2014, we issued 359,956 shares of common stock pursuant to our S-8 registration statement covering our Amended 2010 Stock Plan at an average price of \$0.14 per share in payment for legal and scientific consulting services valued at \$49,090 based on the value of the services provided.

During the three months ended September 30, 2014, we issued 390,301 shares of restricted common stock at an average price of \$0.19 per share in payment for investor relations consulting services valued at \$75,000 based on the value of the services provided.

During the three months ended September 30, 2014, we issued 1,937,505 shares of restricted common stock to the holders of three convertible notes in exchange for the partial or full conversion of principal and interest in the aggregate amount of \$81,375 at a conversion price of \$0.042 per share.

On July 24, 2014, we issued an aggregate of 2,503,966 shares of restricted common stock and a seven-year warrant to issue up to 1,251,983 shares of common stock at an exercise price of \$0.132 per share to Dr. Chetan Shah, a director. The common stock and warrant were issued to Dr. Shah upon the conversion of an aggregate of \$220,349 of unpaid principal and accrued interest due under a 10% Convertible Note previously issued to Dr. Shah by us on July 9, 2013.

On September 17, 2014, we issued to the holder of the remaining 2008 10% Convertible Note units consisting of an aggregate of 478,188 shares of restricted common stock and unit warrants to acquire up to an aggregate of 239,094 shares of common stock at an exercise price of \$0.096 per share (see Note 5). The units were issued to the note holder upon the conversion of an aggregate of \$45,906 of unpaid principal and accrued interest due under the promissory note, which represented the entire amount outstanding under the note. We recorded a loss on debt conversion of \$65,493 on this transaction.

During the three months ended September 30, 2014, we issued to four investors 2,673,231 shares of restricted common stock through the cash exercise of eight warrants for \$259,474 of cash at an average exercise price of approximately \$0.10 per share. As an inducement to those investors, we issued them replacement warrants to acquire up to an aggregate of 2,673,231 shares of common stock on the same terms as the warrants they exercised.

During the three months ended September 30, 2014, we issued and sold to three accredited investors units consisting of (a) one hundred thousand (100,000) restricted shares of our common stock, par value \$.001 per share, at prices per share ranging from \$0.091 to \$0.094 and (b) a five-year warrant to purchase fifty thousand (50,000) shares of common stock at exercise prices ranging from \$0.136 to \$0.143 per share. In total, the investors purchased for cash an aggregate of \$90,000 of units. The investors acquired an aggregate of 974,982 shares of common stock and warrants to acquire up to an aggregate of 487,491 shares of Common Stock.

7. RELATED PARTY TRANSACTIONS

DUE TO RELATED PARTIES

Certain of our officers and other related parties have advanced us funds, agreed to defer compensation and/or paid expenses on our behalf to cover working capital deficiencies. These unsecured and non-interest-bearing liabilities have been included as due to related parties in the accompanying consolidated balance sheets.

Other related party transactions are disclosed elsewhere in these notes to consolidated financial statements.

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8. OTHER CURRENT LIABILITIES

Other current liabilities were comprised of the following items:

	September 30, 2014	March 31, 2014
Accrued interest	\$570,741	\$1,165,335
Accrued legal fees	179,465	179,465
Accrued liquidated damages	362,800	362,800
Other accrued liabilities	103,598	147,774
Total other current liabilities	\$1,216,604	\$1,855,374

As of the date of this report, various promissory and convertible notes payable in the aggregate principal amount of \$473,422 (as identified in Notes 4 and 5 above) have reached maturity and are past due. We are continually reviewing other financing arrangements to retire all past due notes. At September 30, 2014, we had accrued interest in the amount of \$471,041 associated with these defaulted notes in accrued liabilities payable (see Notes 4 and 5).

9. FAIR VALUE MEASUREMENTS

We follow FASB ASC 820, "FAIR VALUE MEASUREMENTS AND DISCLOSURES" ("ASC 820") in connection with assets and liabilities measured at fair value on a recurring basis subsequent to initial recognition. The guidance applies to our derivative liabilities. We had no assets or liabilities measured at fair value on a non-recurring basis for any period reported.

ASC 820 requires that assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories: We measure the fair value of applicable financial and non-financial assets based on the following fair value hierarchy:

Level 1: Quoted market prices in active markets for identical assets or liabilities.

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3: Unobservable inputs that are not corroborated by market data.

The hierarchy noted above requires us to minimize the use of unobservable inputs and to use observable market data, if available, when determining fair value.

The fair value of our recorded derivative liabilities is determined based on unobservable inputs that are not corroborated by market data, which is a Level 3 classification. We record derivative liabilities on our balance sheet at fair value with changes in fair value recorded in our consolidated statements of operations.

At September 30, 2014, we no longer had any derivative liabilities as all of the holders of the financial instruments that had price antidilution protection waived such price antidilution protection.

Our fair value measurements at the March 31, 2014 reporting date are classified based on the valuation technique level noted in the table below:

Description	March 31, 2014	Quoted Prices in Active Markets for (Level 1)	Significant Other Observable (Level 2)	Significant Unobservable (Level 3)
Derivative Liabilities	\$10,679,067	\$	– \$	– \$10,679,067
Total Assets	\$10,679,067	\$	– \$	– \$10,679,067

The following outlines the significant weighted average assumptions used to estimate the fair value information presented, in connection with our warrant and embedded conversion option derivative instruments utilizing the Binomial Lattice option pricing model:

The following outlines the significant weighted average assumptions used to estimate the fair value information presented, in connection with our warrant and embedded conversion option derivative instruments utilizing the Binomial Lattice option pricing model:

Six Months Ended September 30, 2013

Risk free interest rate	0.02% - 0.62%
Average expected life	0.25 – 3 years
Expected volatility	78.9% - 104.5%
Expected dividends	None

The table below sets forth a summary of changes in the fair value of our Level 3 financial instruments for the six months ended September 30, 2014:

	April 1, 2014	Recorded New Derivative Liabilities	Change in estimated fair value recognized in results of operations	Reclassification of Derivative Liability to Paid in capital	September 30, 2014
Derivative liabilities	\$ 10,679,067	\$ –	\$ –	\$ (10,679,067)	\$ –

The table below sets forth a summary of changes in the fair value of our Level 3 financial instruments for the six months ended September 30, 2013:

	April 1, 2013	Recorded New Derivative Liabilities	Change in estimated fair value recognized in results of operations	Reclassification of Derivative Liability to Paid in capital	September 30, 2013
Derivative liabilities	\$ 3,588,239	\$ –	\$ 2,382,877	\$ (106,501)	\$ 5,864,615

10. STOCK COMPENSATION

The following table breaks out the components of our share-based compensation expenses relating to shares and options granted and the effect on basic and diluted loss per common share during the three and six months ended

September 30, 2014 and 2013.

	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Six Months Ended September 30, 2014	Six Months Ended September 30, 2013
Vesting of stock options	89,793	73,856	260,680	124,243
Incremental fair value of option modifications	–	957	–	1,914
Vesting expense associated with CEO restricted stock grant	–	–	–	64,444
Total share-based compensation expense	\$89,793	\$74,813	\$260,680	\$190,601
Total share-based compensation expense included in net loss	\$89,793	\$73,856	\$260,680	\$190,601
Weighted average number of common shares outstanding – basic and diluted	259,369,911	187,643,582	243,494,916	182,004,220
Basic and diluted loss per common share	\$(0.00) \$(0.00) \$(0.00) \$(0.00

All of the stock-based compensation expense recorded during the six months ended September 30, 2014 and 2013, which totaled \$260,680 and \$190,601, respectively, is included in payroll and related expense in the accompanying condensed consolidated statements of operations. Stock-based compensation expense recorded during the six months ended September 30, 2014 and 2013 had no impact on basic and diluted loss per common share.

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We review share-based compensation on a quarterly basis for changes to the estimate of expected award forfeitures based on actual forfeiture experience. The cumulative effect of adjusting the forfeiture rate for all expense amortization is recognized in the period the forfeiture estimate is changed. The effect of forfeiture adjustments for the three and six month periods ended September 30, 2014 was insignificant.

On June 6, 2014, our Board of Directors approved the following grants of options to certain officers and directors of the Company:

To Mr. James A. Joyce, an option to acquire an aggregate of 1,500,000 shares of our common stock at an exercise price of \$0.19 per share, the closing price of our common stock on the date of grant. The fair value of this stock option at the date of grant was \$246,000. The option vested as to 500,000 shares on the grant date for a vesting expense of \$82,000 and will vest as to an additional 500,000 shares on each of the first two anniversaries of the grant date. Unless earlier exercised or terminated, the option will expire June 6, 2024.

To Mr. Rodney S. Kenley, an option to acquire an aggregate of 250,000 shares of our common stock at an exercise price of \$0.19 per share, the closing price of our common stock on the date of grant. The fair value of this stock option at the date of grant was \$41,000. The option vested as to 83,333 shares on the grant date for a vesting expense of \$13,667 and will vest as to an additional 83,333 shares on the first anniversary of the grant date and 83,334 shares on the second anniversary of the grant date. Unless earlier exercised or terminated, the option will expire June 6, 2024.

To Mr. James B. Frakes, an option to acquire an aggregate of 250,000 shares of our common stock at an exercise price of \$0.19 per share, the closing price of our common stock on the date of grant. The fair value of this stock option at the date of grant was \$41,000. The option vested as to 83,333 shares on the grant date for a vesting expense of \$13,667 and will vest as to an additional 83,333 shares on the first anniversary of the grant date and 83,334 shares on the second anniversary of the grant date. Unless earlier exercised or terminated, the option will expire June 6, 2024.

To Dr. Richard H. Tullis, an option to acquire an aggregate of 50,000 shares of our common stock at an exercise price of \$0.19 per share, the closing price of our common stock on the date of grant. The fair value of this stock option at the date of grant was \$8,200. The option vested as to 16,667 shares on the grant date for a vesting expense of \$2,733 and will vest as to an additional 16,667 shares on the first anniversary of the grant date and 16,666 shares on the second anniversary of the grant date. Unless earlier exercised or terminated, the option will expire June 6, 2024.

In addition to the above grants to our officers, on June 6, 2014, our Board of Directors also approved the grant of options to five employees to acquire an aggregate of 370,000 shares of our common stock at an exercise price of \$0.19 per share, the closing price of our common stock on the date of grant. The aggregate fair value of those stock options at the date of grant was \$60,680. Those options vested as to 123,333 shares on the grant date for a vesting expense of \$20,227 and will vest as to an additional 123,333 shares on the first anniversary of the grant date and 123,334 shares

on the second anniversary of the grant date. Unless earlier exercised or terminated, the option will expire June 6, 2024.

In addition to the share-based compensation expense for the specific stock option grants noted above, our total share-based compensation expense for the three and six months ended September 30, 2014 includes ongoing vesting expense associated with stock grants from prior periods.

Changes to 2012 Board Compensation Program

In July 2012, the Board approved a Board Compensation Program (the “2012 Program”), which modified and superseded the 2005 Directors Compensation Program that had been in effect previously. On June 6, 2014, the Board approved certain changes to the 2012 Program. Under the modified 2012 Program, in which only non-employee Directors may participate, a new eligible Director will receive an initial grant of \$50,000 worth of options to acquire shares of common stock, with such grant being valued at the exercise price based on the average of the closing bid prices of our common stock for the five trading days preceding the first day of the fiscal year. These options will have a term of ten years and will vest 1/3 upon grant and 1/3 upon each of the first two anniversaries of the date of grant.

At the beginning of each fiscal year, each existing Director eligible to participate in the 2012 Program also will receive a grant of \$35,000 worth of options valued at the exercise price based on the average of the closing bid prices of the Common Stock for the five trading days preceding the first day of the fiscal year. Such options will vest on the first anniversary of the date of grant. In lieu of per meeting fees, under the 2012 Program eligible Directors will receive an annual Board retainer fee of \$30,000. The modified 2012 Program also provides for the following annual retainer fees: Audit Committee Chair - \$5,000, Compensation Committee chair - \$5,000, Audit Committee member - \$4,000, Compensation Committee member - \$4,000 and Lead independent director - \$15,000.

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As a result of the modified 2012 Program on June 6, 2014, we issued 184,211 stock options to each of our three outside directors. Those grants vest over the fiscal year ending March 31, 2015 and have an exercise price of \$0.19 per share.

All of the foregoing actions - the changes in base salaries, the option grants and the changes to the Directors Compensation Program discussed herein - were approved and recommended by the Company's Compensation Committee prior to approval by the Board.

The following outlines the significant weighted average assumptions used to estimate the fair value information presented, with respect to stock option grants utilizing the Binomial Lattice option pricing models at, and during the six months ended September 30, 2014:

Risk free interest rate	2.6%
Average expected life	10 years
Expected volatility	90.23%
Expected dividends	None

The expected volatility was based on the historic volatility. The expected life of options granted was based on the "simplified method" as described in the SEC's guidance due to changes in the vesting terms and contractual life of current option grants compared to our historical grants.

In May 2013, we granted to a scientific advisory board member and a scientific consultant a three year option to purchase 125,000 shares of our common stock at a price of \$0.11 per share.

In July 2013, our compensation committee and Board of Directors approved the issuance of four stock option grants to four of our executives. The options carried an exercise price of \$0.10 per share, have a ten year life and vest over the following schedule: 25% on July 1, 2014, 25% on July 1, 2015, 25% on July 1, 2016 and 25% on July 1, 2017. The numbers of shares underlying each of the stock option grants were as follows: 2,000,000 shares to our chief executive officer and 500,000 shares each to our president, chief science officer and chief financial officer (see Note 10).

The following outlines the significant weighted average assumptions used to estimate the fair value information, which is based on historical data, with respect to stock option grants utilizing the Binomial Lattice option pricing models at, and during the six months ended September 30, 2013:

Risk free interest rate	0.38% - 2.50%
Average expected life	3 years - 10 years
Expected volatility	94.6% - 102.7%
Expected dividends	None

The expected volatility was based on the historic volatility. The expected life of options granted was based on the "simplified method" as described in the SEC's guidance due to changes in the vesting terms and contractual life of current option grants compared to our historical grants.

Options outstanding that have vested and are expected to vest as of September 30, 2014 are as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term in Years
Vested	24,294,227	\$ 0.26	3.96
Expected to vest	4,711,811	\$ 0.14	9.15
Total	29,006,038		

A summary of stock option activity during the six months ended September 30, 2014 is presented below:

	Number of Options	Range of Exercise Price	Weighted Average Exercise Price
Stock options outstanding at March 31, 2014	26,133,407	\$0.076 - \$0.41	\$ 0.25
Exercised	—	—	—
Granted	2,972,631	0.19	\$ 0.19
Cancelled/Expired	(100,000)	0.19	0.19
Stock options outstanding at September 30, 2014	29,006,038	\$0.076 - \$0.41	\$ 0.24
Stock options exercisable at September 30, 2014	24,294,227	\$0.076 - \$0.41	\$ 0.26

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At September 30, 2014, there was approximately \$497,783 of unrecognized compensation cost related to share-based payments, which is expected to be recognized over a weighted average period of 2.19 years.

On September 30, 2014, our stock options had a negative intrinsic value since the closing price of our common stock on that date of \$0.12 per share was below the weighted average exercise price of our stock options.

11. WARRANTS

A summary of warrant activity during the six months ended September 30, 2014 is presented below:

	Amount	Range of Exercise Price	Weighted Average Exercise Price
Warrants outstanding at March 31, 2014	70,709,475	\$0.042 - \$0.25	\$ 0.13
Exercised	(2,166,104)	\$0.086 - \$0.12	\$ 0.10
Issued	15,375,614	\$0.042 - \$0.24	\$ 0.07
Cancelled/Expired	(1,136,364)	\$0.13	\$ 0.13
Warrants outstanding at September 30, 2014	82,782,621	\$0.042 - \$0.25	\$ 0.10
Warrants exercisable at September 30, 2014	82,782,621	\$0.042 - \$0.25	\$ 0.10

The following outlines the significant weighted average assumptions used to estimate the fair value information presented, with respect to warrants utilizing the Binomial Lattice option pricing models at, and during, the six months ended September 30, 2014:

Risk free interest rate	0.79% - 2.29%
Average expected life	5 years - 7 years
Expected volatility	90.1% - 95.8%
Expected dividends	None

12. DARPA CONTRACT AND RELATED REVENUE RECOGNITION

As discussed in Note 1, we entered into a contract with the DARPA on September 30, 2011. Under the DARPA award, we have been engaged to develop a therapeutic device to reduce the incidence of sepsis, a fatal bloodstream infection that often results in the death of combat-injured soldiers. The award from DARPA was a fixed-price contract with potential total payments to us of \$6,794,389 over the course of five years. Fixed price contracts require the achievement of multiple, incremental milestones to receive the full award during each year of the contract. Under the terms of the contract, we will perform certain incremental work towards the achievement of specific milestones against which we will invoice the government for fixed payment amounts.

Originally, only the base year (year one contract) was effective for the parties, however, DARPA subsequently exercised the option on the second, third and fourth years of the contract. DARPA has the option to enter into the contract for year five. The milestones are comprised of planning, engineering and clinical targets, the achievement of which in some cases will require the participation and contribution of third party participants under the contract. There can be no assurance that we alone, or with third party participants, will meet such milestones to the satisfaction of the government and in compliance with the terms of the contract or that we will be paid the full amount of the contract revenues during any year of the contract term. We commenced work under the contract in October 2011.

Due to budget restrictions within the Department of Defense, on February 10, 2014, DARPA reduced the scope of our contract in years three through five of the contract. The reduction in scope focused our research on exosomes, viruses and blood processing instrumentation. This scope reduction will reduce the possible payments under the contract by \$858,491 over years three through five. We recently completed a re-budgeting of the expected costs on the remaining years of the DARPA contract based on the reduced milestones and have concluded that the reductions in our costs due to the scaled back level of work will almost entirely offset the anticipated revenue levels based on current assumptions.

During the six months ended September 30, 2014, we invoiced DARPA for three milestones totaling \$444,723. The details of those milestones were as follows:

Milestone 2.4.2.2 – Determine capacity requirements of affinity resin to multiple simultaneous targets. The milestone payment was \$197,362. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we were able to determine the capacity requirements of affinity resin to multiple simultaneous targets. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

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Milestone 2.4.2.4 – Finish construction and delivery of 25 experimental cartridges for testing by the system integrator. The milestone payment was \$50,000. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we delivered the 25 cartridges to the systems integrator as part of our submission for approval. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone M9 – Target capture > 90% in 24 hours for at least 3 targets ex vivo in blood or blood components using the optimized cartridge. The milestone payment was \$197,361. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we were able to capture approximately 90% in 24 hours for at least 3f targets ex vivo in blood or blood components using the optimized cartridge. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

In the six months ended September 30, 2013, we invoiced DARPA for four milestones totaling \$808,739. The details of those milestones were as follows:

Milestone 2.3.2.2 – Formulate initial design work based on work from the previous phase. Begin to build and test selected instrument design and tubing sets. The milestone payment was \$195,581. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we were able to formulate the initial design work and to build and test selected instrument design and tubing sets as part of our submission for approval. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone 2.3.2.2 – Write and test software and conduct ergonomic research. Begin discussions with the systems integrator. The milestone payment was \$195,581. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We obtained wrote and tested software and conducted ergonomic research and began discussions with the systems integrator. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone 2.3.3.2 – Cartridge construction with optimized affinity matrix design for each potential target. Complete the capture agent screening. The milestone payment was \$208,781. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We completed the cartridge construction with optimized affinity matrix design for each potential target and completed the capture agent screening. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

Milestone M5 – Target capture > 90% in 24 hours for at least three targets in blood or blood components. The milestone payment was \$208,781. Management considers this milestone to be substantive as it was not dependent on the passage of time nor was it based solely on another party's efforts. We demonstrated that we were able to capture approximately 90% in 24 hours for at least three of the agreed targets in blood or blood components. The report was accepted by the contracting officer's representative and the invoice was submitted thereafter.

13. COMMITMENTS AND CONTINGENCIES

LEASE COMMITMENTS

We rented approximately 2,300 square feet of executive office space at 8910 University Center Lane, Suite 660, San Diego, CA 92122 at the rate of \$6,475 per month on a four year lease that expired in September 2014. We continued leasing that space for the month of October and, effective November 1, 2014, moved into a new facility of approximately 2,576 square feet located at 9635 Granite Ridge Drive, San Diego, CA 92123 under a 39 month lease with an initial rental rate of \$6,054 per month. We believe this new leased facility will be satisfactory for our office needs over the term of the lease.

We also rent approximately 1,700 square feet of laboratory space at 11585 Sorrento Valley Road, Suite 109, San Diego, California 92121 at the rate of \$3,917 per month on a one year lease that previously was scheduled to expire in October 2014 and was recently extended to in October 2015. We believe this new leased facility will be satisfactory for our laboratory needs over the term of the lease

Our Exosome Sciences, Inc. subsidiary rents approximately 2,055 square feet of office and laboratory space at 11 Deer Park Drive, South Brunswick, NJ at the rate of \$3,596 per month on a one year lease that previously was scheduled to expire in October 2014 and was recently extended to in October 2015. We believe this new leased facility will be satisfactory for ESI's operational needs over the term of the lease.

Rent expense approximated \$84,000 and \$68,000 for the six month periods ended September 30, 2014 and 2013, respectively.

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LEGAL MATTERS

From time to time, claims are made against us in the ordinary course of business, which could result in litigation. Claims and associated litigation are subject to inherent uncertainties and unfavorable outcomes could occur, such as monetary damages, fines, penalties or injunctions prohibiting us from selling one or more products or engaging in other activities.

The occurrence of an unfavorable outcome in any specific period could have a material adverse effect on our results of operations for that period or future periods. Other than as mentioned here, we are not presently a party to any pending or threatened legal proceedings.

14. SEGMENTS

We operate our businesses principally through two reportable segments: Aethlon, which represents our therapeutic business activities, and ESI, which represents our diagnostic business activities. Our reportable segments have been determined based on the nature of the potential products being developed. ESI did not have any operations in the six months ended September 30, 2013.

Aethlon's revenue is generated primarily from government contracts to date and ESI does not yet have any revenues. We have not included any allocation of corporate overhead to the ESI segment.

The following tables set forth certain information regarding our segments and other operations that conforms to the consolidated balance sheet and statement of operations presented in this Report:

	Six Months Ended	
	September 30,	
	2014	2013
Revenues:		
Aethlon	\$ 530,371	\$ 840,483
ESI	—	—
Total Revenues	\$ 530,371	\$ 840,483
Operating Losses:		
Aethlon	\$(1,294,453)	\$(1,013,592)

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ESI	(445,674)	–
Total Operating Loss	\$(1,773,200)	\$(1,013,592)
Net Losses:		
Aethlon	\$(4,202,873)	\$(3,653,168)
ESI	(356,539)	–
Net Loss Before Non-Controlling Interests	\$(4,592,485)	\$(3,653,168)
Cash:		
Aethlon	\$47,865	\$8,754
ESI	478,322	–
Total Cash	\$526,187	\$8,754
Total Assets:		
Aethlon	\$443,027	\$411,190
ESI	646,242	–
Total Assets	\$1,089,269	\$411,190
Capital Expenditures:		
Aethlon	\$–	\$–
ESI	–	–
Capital Expenditures	\$–	\$–
Depreciation and Amortization:		
Aethlon	\$8,885	\$4,727
ESI	9,791	–
Total Depreciation and Amortization	\$18,676	\$4,727
Interest Expense:		
Aethlon	\$156,799	\$216,502
ESI	–	–
Total Interest Expense	\$156,799	\$216,502

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15. SUBSEQUENT EVENTS

Management has evaluated events subsequent to September 30, 2014 through the date that the accompanying condensed consolidated financial statements were filed with the Securities and Exchange Commission for transactions and other events which may require adjustment of and/or disclosure in such financial statements.

Government Contracts

Subsequent to September 30, 2014, we collected \$247,361 under our DARPA contract, and under the Battelle subcontract we billed \$33,434 and we collected \$29,519.

Debt Reduction

Subsequent to September 30, 2014, we paid off the remaining principal and interest balances on the two remaining July & August 2011 10% Convertible Notes, which had been classified as being in default, with cash payments totaling \$382,748 (see Note 5).

Subsequent to September 30, 2014, we paid off in full the outstanding principal balance and interest balance on the Law Firm Note with a cash payment of \$50,000 and an issuance of 170,020 common shares (see Note 5).

Subsequent to September 30, 2014, we paid an aggregate of \$503,313 in principal and accrued interest on eight other outstanding notes. As a result, seven of the eight notes were paid in full. We owe an additional \$37,813 under the eighth note, which we expect to pay in full in January 2015.

Note Conversions

Subsequent to September 30, 2014, we issued an aggregate of 14,237,261 shares of common stock to two accredited investors upon the conversion of an aggregate of \$597,965 of unpaid principal and accrued interest due under promissory notes previously issued to the investors by the Company. The conversion price per share was \$0.042.

Subsequent to September 30, 2014, we issued an aggregate of 5,625,000 shares of common stock to convert in full the outstanding principal balance of \$225,000 and interest balance of \$11,250 on the remaining Amended and Restated Series A 12% Convertible Note through the issuance of 5,625,000 shares of common stock. The conversion price per share was \$0.042.

Issuance of Convertible Notes

Subsequent to September 30, 2014, we entered into a Subscription Agreement with two accredited investors providing for the issuance and sale of (i) convertible promissory notes in the aggregate principal amount of \$527,780 and (ii) five year warrants to purchase up to 2,356,160 shares of common stock at a fixed exercise price of \$0.168 per share. The convertible promissory notes bear interest at the annual rate of 10% and mature on April 1, 2016. The aggregate gross cash proceeds to us were \$415,000 after subtracting legal fees of \$35,000; the balance of the principal amount of the notes represents a \$27,780 due diligence fee and an original issuance discount. The convertible promissory notes are convertible at the option of the holders into shares of our common stock at a fixed price of \$0.112 per share, for up to an aggregate of 4,712,321 shares of common stock. There are no registration requirements with respect to the shares of common stock underlying the notes or the warrants.

Common Stock Issuances

Subsequent to September 30, 2014, we issued 374,295 shares of common stock pursuant to our S-8 registration statement covering our Amended 2010 Stock Plan at an average price of \$0.146 per share in payment for legal and scientific consulting services valued at \$54,800 based on the value of the services provided.

Equity Unit Investments

Subsequent to September 30, 2014, we issued and sold to eight accredited investors units (the "Units") consisting of (a) one hundred thousand (100,000) restricted shares of common stock, par value \$.001 per share at prices per share ranging from \$0.105 to \$0.114 and (b) a five-year warrant to purchase fifty thousand (50,000) shares of common stock at exercise prices ranging from \$0.154 to \$0.167 per share (the "Unit Warrants"). In total, the investors purchased for cash an aggregate of \$501,700 of Units. The investors acquired an aggregate of 4,506,250 shares of common stock and Unit Warrants to acquire up to an aggregate of 2,253,125 shares of common stock.

Subsequent to September 30, 2014, we issued to an accredited investor Units consisting of an aggregate of 1,835,798 shares of common stock and Unit Warrants to acquire up to an aggregate of 1,837,798 shares of common stock at an exercise price of \$0.103 per share. The Units were issued to the investor upon the conversion of an aggregate of \$189,087 of unpaid principal and accrued interest due under two promissory notes (the remaining October & November 2009 10% Convertible Note and the April 2010 10% Convertible Note – see Note 5) previously issued to the investor by the Company. The amounts converted represented the entire principal and interest outstanding under the notes and the notes held by that holder were retired.

Subsequent to September 30, 2014, we sold \$3,300,000 of units, comprised of common stock and warrants (the “Units”), to three affiliated institutional investors (collectively the “Purchaser”) at a price of \$0.30 per Unit pursuant to a Securities Purchase Agreement (the “Agreement”). Each Unit consists of one share of common stock, \$0.001 par value per share, and five-year warrants to purchase 120% of the shares of common stock in the Unit (the “Warrants”), at an exercise price per share of \$0.30 (the “Financing”). Accordingly, a total of 11,000,000 shares of common stock and Warrants to purchase 13,200,000 shares of common stock were issued and sold pursuant to the Agreement.

As part of the terms of the Agreement, we entered into a Registration Rights Agreement with the Purchaser pursuant to which we agreed to file a registration statement to register for resale the shares of common stock sold in the Financing, including the shares of common stock underlying the Warrants, within 20 calendar days following the closing of the Financing. Subject to certain exceptions, in the event the registration statement does not become effective within certain time periods set forth in the Registration Rights Agreement, we would be required to pay the Purchaser in the Financing an amount in cash equal to two percent (2.0%) of the aggregate purchase price every month until such time as the registration statement becomes effective or the shares of common stock (and shares of common stock underlying the Warrants) sold in the Financing may be sold by the Purchaser pursuant to Rule 144 without any restrictions or limitations.

Roth Capital Partners served as sole placement agent for the Financing and received a cash fee of \$231,000, expense reimbursement of \$25,000, and a five-year warrant to purchase 550,000 shares of common stock at an exercise price of \$0.30 per share (the “Purchase Agent Warrant”) for its services in the Financing. In addition, we paid \$10,000 in legal expenses to the Purchaser’s counsel. We also paid \$32,572 to our counsel related to this financing. The net proceeds to us after the placement fee and legal fees were \$3,001,429.

Warrant Exercises and Issuance of New Warrants Upon Exercise

Subsequent to September 30, 2014, we issued an aggregate of 5,671,119 shares of common stock and seven-year warrants (the “Exchange Warrants”) to issue up to an aggregate of 5,671,119 shares of common stock at exercise prices ranging from \$0.093 to \$0.116 per share to eight accredited investors. One of the investors is Dr. Chetan Shah, a director of the Company. The common stock and Exchange Warrants were issued to the investors upon the cash

exercise of previously issued warrants held by them. The investors paid an aggregate of \$579,251 upon exercise of the previously outstanding warrants at exercise prices ranging from \$0.093 to \$0.115 per share. The foregoing transaction was privately negotiated with the group of participating warrant holders.

Warrant Exercises

Subsequent to September 30, 2014, we issued an aggregate of 21,516,640 shares of common stock to accredited investors upon the exercise of previously issued warrants. The warrants were exercised on a cashless or “net” basis. Accordingly, we did not receive any proceeds from such exercises. The cashless exercise of such warrants resulted in the cancellation of previously issued warrants to purchase an aggregate of 30,265,208 shares of common stock.

Stock Option Exercises

Subsequent to September 30, 2014, two former employees exercised stock options to purchase 50,000 common shares through a cash payment of \$9,500 with an exercise price of \$0.19 per share.

Restricted Stock Issuance to Service Provider

Subsequent to September 30, 2014, we issued 39,024 shares of restricted common stock in payment for investor relations services valued at \$8,000 based on the value of the services provided.