Clough Global Equity Fund
Form N-CSR
June 03, 2011

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM N-CSR

CERTIFIED SHAREHOLDER REPORT OF REGISTERED

MANAGEMENT INVESTMENT COMPANIES

Investment Company Act file number: 811-21712

Clough Global Equity Fund

(exact name of registrant as specified in charter)

1290 Broadway, Suite 1100, Denver, Colorado 80203

(Address of principal executive offices) (Zip code)

Erin E. Douglas, Secretary

Clough Global Equity Fund

1290 Broadway, Suite 1100

Denver, Colorado 80203

(Name and address of agent for service)

Registrant s telephone number, including area code: 303-623-2577

Date of fiscal year end: March 31

Date of reporting period: March 31, 2011

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Item 1. **Reports to Stockholders.**

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Clough Global Funds

Shareholder Letter

March 31, 2011

To our Shareholders:

Performance:

During the twelve-months ended March 31, 2011, the Clough Global Allocation Fund s total return, assuming reinvestment of all distributions, was 17.30% based on the net asset value and 10.20% based on the market price of the stock. That compares with 15.65% return for the S&P 500 for the same period. Since the Fund s inception on July 28, 2004, the total growth in net asset value assuming reinvestment of all distributions has been 8.42%, this compares to a average annual total return of 5.03% for the S&P 500 through March 31, 2011. Total distributions since inception has been $8.41 per share, and based on the current dividend rate of $0.30 per share, offer a yield of 7.39% on market price as of March 31, 2011, of $16.24.

During the twelve-months ended March 31, 2011, the Clough Global Equity Fund s total return, assuming reinvestment of all distributions, was 17.05% based on the net asset value and 16.07% based on the market price of the stock. That compares with 15.65% return for the S&P 500 for the same period. Since the Fund s inception on April 27, 2005, the total growth in net asset value assuming reinvestment of all distributions has been 7.67%, this compares to a average annual total return of 4.49% for the S&P 500 through March 31, 2011. Total distributions since inception has been $7.47 per share, and based on the current dividend rate of $0.29 per share, offer a yield of 7.55% on market price as of March 31, 2011, of $15.37.

During the twelve-months ended March 31, 2011, the Clough Global Opportunities Fund s total return, assuming reinvestment of all distributions, was 16.21% based on the net asset value and 15.27% based on the market price of the stock. That compares with 15.65% return for the S&P 500 for the same period. Since the Fund s inception on April 25, 2006, the total growth in net asset value assuming reinvestment of all distributions has been 4.28%, this compares to a average annual total return of 2.53% for the S&P 500 through March 31, 2011. Total distributions since inception has been $5.85 per share, and based on the current dividend rate of $0.27 per share, offer a yield of 7.80% on market price as of March 31, 2011, of $13.85.

Fiscal Year Fund Review:

The last twelve months have been characterized by volatile financial markets despite an upward trend in global equities. Early in 2010, the sovereign debt crisis in Europe reminded investors of the still lengthy restructuring ahead for the European Union. Concerns over the solvency of the peripheral EU governments and ultimately the health of the Continent s banking system pressured markets and led to the first of a series of on-going government bailouts. Later in the Fall, in response to slowing growth, the U.S. Federal Reserve embarked upon a second campaign of quantitative easing (QE2) which helped restore a bid to asset prices, in particular for equities and commodities. Periodic taxpayer-led bailouts and unconventional monetary policies are to be expected in an environment of ongoing

balance sheet deleveraging by overly-indebted banking systems and households in Europe and the United States.

The Fed s QE2 policy also helped push the value of the US dollar lower, as the US dollar index declined more than 15% from its 2010 high. The weak dollar was a catalyst for a broad sentiment shift as global investors pared their emerging markets equity holdings in favor of those in developed markets. In essence that shift has been away from tighter monetary policy of Asia and Brazil, who are dealing with cyclical inflation pressures, towards the United States and Europe where the markets were being assisted by easy money, government bailouts and low interest rates. This was a headwind for the Funds emerging markets exposure.

The strongest performing areas for the Funds came from our energy, aerospace manufacturing holdings, as well as from consumer cyclical stocks. Despite a relatively weak year for emerging markets, our strategies focused on Asian household consumption growth also worked well.

We thought that free cash flow would be the equity story for 2010 but the performance of that strategy was mixed. Some stocks we thought were particularly undervalued actually declined. These include Microsoft (MSFT), a company which, although it offers an 11% free cash flow yield and double digit growth as technology upgrade cycles emerge, was nevertheless down 11.39% in 2010. Google (GOOG), still one of the fastest growing large companies in the world, appreciated a mere 3.46%. We continue to believe these holdings have great promise for 2011.

Other free cash flow stories, however, performed quite well. Transdigm Group Corp. Inc. (TDG), a leading global designer and producer of aircraft components and The Goodyear Tire and Rubber Company (GT), a leading manufacturer and distributer of tires benefited from rebounds in end-market demand, which was amplified by significant pricing power at both companies.

The energy sector also performed well as high energy prices supported increased earnings for both exploration and production companies and oil equipment and service providers. National Oilwell Varco (NOV), one of the largest providers of machinery and related equipment for oil-drilling rigs benefited from higher spending budgets from its customers, as well as market share gains due to its leading technology position. Another holding, Golar LNG Inc (GLNG), owns and operates a fleet of liquid natural gas (LNG) tankers. The increased demand for LNG from Europe and Asia has benefited Golar as has China s ongoing need to increase and diversify its sources of energy. High barriers to entry in Golar s business have supported its higher valuation.

Our position in Bank of America has been a drag on Fund performance. Despite strong lending margins, helped by what is likely to be an extended period of very low deposit rates, a marked decrease in credit losses and a significant increase in the bank s capital adequacy ratios, Bank of America stock has lagged. The shares now trade at a discount to tangible book value suggesting that firm is worth no more than its liquidation value. We believe the national consumer and corporate franchise, which includes the

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Shareholder Letter

Clough Global Funds

March 31, 2011

Merrill Lynch and Countrywide Financial platforms, are severely undervalued and believe that management will successfully execute its turnaround strategy.

The Funds position in Genworth Financial shares also hurt returns. Genworth is a mortgage insurance provider and was hobbled during the 2008 credit crisis and housing bust, though fundamentals are much better today. We believe housing is undergoing a gradual recovery in the US, albeit the slope of that recovery is far from steep. While Glenworth s balance sheet has improved meaningfully, we have not seen a recovery in new policy issuance that we expected and that growth is necessary for the thesis to play out. We have exited this position for now.

The Funds continued to maintain a focus on generating income with a portion of the portfolio allocated to fixed income markets. This allocation helps us generate our managed distribution target and also provides diversification for the Funds to help reduce volatility. Low yields on US Treasury bonds have made the task of generating attractive returns in fixed income markets more difficult, so we have expanded our yield-focused strategies beyond just US Treasuries and mortgage-backed securities. Corporate bonds were the biggest allocation to our yield-focused strategies and we believe they continue to produce equity-like returns. Our corporate bond allocation averaged approximately 10% of total assets over the period.

Our yield-generating strategies also included specialty finance company equities such as Business Development Companies (BDC s) and Mortgage Real Estate Investment Trusts (M-REITs). BDCs are REIT-like structures that invest in the debt structures of companies not large enough to finance themselves in the public markets. The Funds exposure to BDCs was on average 3% during the fiscal year and the BDC holdings returned roughly 30% in 2010. Finally, M-REIT s are publically traded portfolios of agency and non-agency mortgage backed securities. We believe the mortgage REIT s are the best way to monetize the historically steep yield curve. The Funds had approximately 6% on average allocated to this sector and our holdings of M-REITs returned nearly 20% for the year.

Outlook for the Next Twelve Months:

We have seen a strong global economic recovery since the depths of the 2008 credit crisis. This recovery was driven by extraordinary fiscal stimulus, bank and government bailouts and unorthodox monetary policies. Nonetheless, the underlying trend towards fiscal consolidation and balance sheet restructuring, particularly in the developed world economies continues. As these policies normalize, and in some instances reverse, we would expect global growth to slow over the next couple of years. Such an environment is not necessarily bearish for equity markets and we see plenty of opportunity for investors over the next several years. We have made modest changes to our long-term thematic exposures as we enter 2011.

The Funds remain focused on quality, large cap multi-nationals with dominant strategic positions, and high free cash levels which can be used to benefit shareholders. As far as sectors are concerned, we continue to prefer North American auto, auto parts and aerospace

manufacturers, and firms leveraged to the high growth being seen in the wireless device sector. Further, our yield focused strategies continue to emphasize BDCs, M-REITs and corporate bonds. We have been reducing our holdings in the commodity sector, including some of our long-held investments in the energy sector which have performed well. The flip side of slower growth is likely a reduction in inflationary pressures in the emerging markets which will improve sentiment. We think emerging markets are likely to return as market leaders later in the year, particularly if growth in the developed economies falters. We are rebuilding our holdings of Chinese consumer-oriented equities.

We sincerely appreciate your interest in our Funds. If you have any questions about your investment, please call 1-877-256-8445.

Sincerely,

Charles I. Clough, Jr.

Past performance is no guarantee of future results.

The information in this Portfolio Managers Shareholder Commentary represents the opinions of the individual Portfolio Managers and is not intended to be a forecast of future events, a guarantee of future results, or investment advice.

The S&P 500 Index is the Standard & Poor s composite index of 500 stocks, a widely recognized, unmanaged index of common stock prices. It is not possible to invest directly in an Index.

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Clough Global Allocation Fund

Portfolio Allocation

March 31, 2011

Asset Allocation*

Common Stock US	56.86%
Common Stock Foreign	19.16%
ETFs	-0.24%
Total Equities	**75.78%**
Corporate Debt	8.95%
Government L/T	10.30%
Asset/Mortgage-backed	0.09%
Preferred Stock	0.31%
Total Fixed Income	**19.65%**
Short-Term Investments	1.63%
Options	0.00%
Other (Foreign Cash)	2.94%
Rights & Warrants	0.00%
Total Other	**4.57%**
TOTAL INVESTMENTS	100.00%

Global Securities Holdings^

United States	74.66%
Brazil	8.94%
China	4.10%
Great Britain	2.30%
Canada	2.05%
Bermuda	1.78%
Singapore	1.16%
Hong Kong	0.93%
South Korea	0.82%
Malaysia	0.78%
The Netherlands	0.75%
Switzerland	0.55%

Taiwan	0.53%
Russia	0.21%
Indonesia	0.20%
Philippines	0.19%
France	0.09%
Japan	0.09%
Cayman Islands	-0.13%
TOTAL INVESTMENT	100.00%

* *Includes securities sold short.*

^ *Includes securities sold short and foreign cash balances.*

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Portfolio Allocation

Clough Global Equity Fund

March 31, 2011 (Unaudited)

Asset Allocation*

Common Stock US	62.08%
Common Stock Foreign	19.21%
ETFs	-0.47%
Total Equities	**80.82%**
Corporate Debt	8.49%
Government L/T	5.97%
Asset/Mortgage-backed	0.26%
Preferred Stock	0.31%
Total Fixed Income	**15.03%**
Short-Term Investments	1.17%
Options	0.00%
Other (Foreign Cash)	2.98%
Rights & Warrants	0.00%
Total Other	**4.15%**
TOTAL INVESTMENTS	100.00%

Global Securities Holdings^

United States	74.84%
Brazil	8.75%
China	4.08%
Great Britain	2.30%
Canada	2.02%
Bermuda	1.85%
Singapore	1.15%
Hong Kong	0.93%
South Korea	0.81%
Malaysia	0.78%
The Netherlands	0.75%
Switzerland	0.58%
Taiwan	0.53%
Russia	0.21%
Philippines	0.19%
Indonesia	0.18%
France	0.09%
Japan	0.09%

Cayman Islands	-0.13%
TOTAL INVESTMENTS	100.00%

* *Includes securities sold short.*
^ *Includes securities sold short and foreign cash balances.*

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Clough Global Opportunities Fund

Portfolio Allocation

March 31, 2011 (Unaudited)

Asset Allocation*

Common Stock US	56.45%
Common Stock Foreign	19.13%
ETFs	-0.80%
Total Equities	**74.78%**
Corporate Debt	8.96%
Government L/T	11.49%
Asset/Mortgage-backed	0.06%
Preferred Stock	0.31%
Total Fixed Income	**20.82%**
Short-Term Investments	1.23%
Options	0.18%
Other (Foreign Cash)	2.99%
Rights & Warrants	0.00%
Total Other	**4.40%**
TOTAL INVESTMENTS	100.00%

Global Securities Holdings^

United States	74.70%
Brazil	8.91%
China	4.10%
Great Britain	2.31%
Canada	2.05%
Bermuda	1.80%
Singapore	1.16%
Hong Kong	0.93%
South Korea	0.82%
Malaysia	0.78%
The Netherlands	0.75%
Taiwan	0.53%
Switzerland	0.52%
Russia	0.21%
Indonesia	0.19%
Philippines	0.19%
Japan	0.09%

France	0.09%
Cayman Islands	-0.13%
TOTAL INVESTMENTS	100.00%

* *Includes securities sold short.*
^ *Includes securities sold short and foreign cash balances.*

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Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Trustees of

Clough Global Allocation Fund,

Clough Global Equity Fund, and

Clough Global Opportunities Fund:

We have audited the accompanying statements of assets and liabilities of Clough Global Allocation Fund, Clough Global Equity Fund, and Clough Global Opportunities Fund (each a Fund , collectively the Funds), including the statements of investments, as of March 31, 2011, and the related statements of operations and cash flows for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the periods presented. These financial statements and financial highlights are the responsibility of the Funds management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. The Funds are not required to have, nor were we engaged to perform, an audit of their 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 Funds internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our procedures included confirmation of securities owned as of March 31, 2011, by correspondence with the custodian and brokers; where replies were not received from brokers, we performed other auditing procedures. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of Clough Global Allocation Fund, Clough Global Equity Fund, and Clough Global Opportunities Fund as of March 31, 2011, the results of their operations and their cash flows for the year then ended, the changes in their net assets for each of the two years in the period then ended, and the financial highlights for each of the periods presented, in conformity with accounting principles generally accepted in the United States of America.

DELOITTE & TOUCHE LLP

Denver, Colorado

May 18, 2011

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Clough Global Allocation Fund

Statement of Investments

March 31, 2011

	Shares	Value
COMMON STOCKS 105.54%		
Basic Materials 0.91%		
Anglo American PLC - Unsponsored ADR[a]	6,794	$175,421
Gerdau S.A. - Sponsored A DR[a][b]	24,229	302,862
Walter Energy, Inc.[a]	9,300	1,259,499
		1,737,782
Communications 10.39%		
CBS Corp. - Class B[a]	20,029	501,526
Chunghwa Telecom Co., Ltd. - ADR[a]	34,835	1,085,459
Cisco Systems, Inc.[a]	69,000	1,183,350
DiGi.Com Bhd	33,800	319,168
Google, Inc. - Class A[a][b][c]	10,154	5,952,376
Liberty Media Corp. - Capital - Series A[a][b][c]	6,070	447,177
Liberty Media Corp. - Class A[a][c]	41,200	660,848
Liberty Media Corp. - Starz - Series A[a][b][c]	1,407	109,183
Maxis Bhd	771,900	1,371,134
NII Holdings, Inc.[a][b][c]	16,318	679,971
Philippine Long Distance Telephone Co.	9,050	484,613
Qihoo 360 Technology Co., Ltd. - ADR[c]	3,334	98,653
Telekom Malaysia Bhd	240,900	321,333
Valassis Communications, Inc.[a][b][c]	7,000	203,980
Verizon Communications, Inc.[a][b]	106,813	4,116,573
Viacom, Inc. - Class B[a]	12,500	581,500
The Walt Disney Co.[a][b]	41,358	1,782,116
		19,898,960
Consumer Cyclical 8.13%		
Arezzo Industria e Comercio S.A.[c]	27,052	376,953
Bosideng International Holdings, Ltd.	1,140,000	338,546
Cie Generale des Etablissements Michelin - Class B	7,673	648,098
Cooper Tire & Rubber Co.[a][b]	77,582	1,997,736
Gol Linhas Aereas Inteligentes S.A. - ADR[a][b][c]	117,074	1,607,426
The Goodyear Tire & Rubber Co.[a][b][c]	362,948	5,436,961
Hanesbrands, Inc.[c]	10,200	275,808
Localiza Rent A Car S.A.	52,156	831,225
MGM Resorts International[a][c]	52,000	683,800

	Shares	Value
Tenneco, Inc.[a][c]	42,833	1,818,261
TRW Automotive Holdings Corp.[a][b][c]	20,646	1,137,182
	Shares	**Value**
Consumer Cyclical (continued)		
Visteon Corp.[a][b][c]	6,681	$417,496
		15,569,492
Consumer Non - cyclical 3.85%		
Abbott Laboratories[a]	14,100	691,605
Celltrion, Inc.	9,390	297,891
Cia de Bebidas das Americas - ADR[a]	25,700	727,567
Community Health Systems, Inc.[a][b][c]	6,600	263,934
Health Management Associates, Inc. - Class A[a][c]	26,800	292,120
Hypermarcas S.A.[c]	18,600	244,939
Julio Simoes Logistica S.A.	116,852	707,847
LifePoint Hospitals, Inc.[a][c]	7,000	281,260
Man Wah Holdings, Ltd.	869,800	1,127,149
Raia S.A.[c]	18,700	294,820
Safeway, Inc.[a][b]	34,757	818,180
Santos Brasil Participacoes S.A.	57,000	924,485
Tenet Healthcare Corp.[a][b][c]	38,600	287,570
Thermo Fisher Scientific, Inc.[a][b][c]	7,500	416,625
		7,375,992
Energy 25.93%		
Coal 4.08%		
Alpha Natural Resources, Inc.[a][b][c]	35,643	2,116,125
Arch Coal, Inc.[a]	33,307	1,200,384
Consol Energy, Inc.[a]	19,374	1,039,028
Massey Energy Co.[a]	17,300	1,182,628
Peabody Energy Corp.[a][b]	31,604	2,274,224
		7,812,389
Oil & Gas Producers 14.08%		
Anadarko Petroleum Corp.[a][b]	25,007	2,048,573
Brigham Exploration Co.[a][c]	26,218	974,785
Canadian Natural Resources, Ltd.[a]	33,500	1,655,905
Chesapeake Energy Corp.[a]	23,400	784,368
Devon Energy Corp.[a][b]	5,800	532,266
Golar LNG, Ltd.[a][b]	61,389	1,570,331
Hess Corp.[a][b]	19,200	1,636,032
InterOil Corp.[a][b][c]	34,350	2,563,884
Marathon Oil Corp.[a]	67,400	3,593,094
Newfield Exploration Co.[a][b][c]	10,200	775,302
Nexen, Inc.[a]	39,000	971,880

OAO Lukoil - Sponsored ADR[(a)]	7,723	553,353
Occidental Petroleum Corp.[(a)]	17,326	1,810,394
OGX Petroleo e Gas Participacoes S.A.[(c)]	125,300	1,501,927
Petrohawk Energy Corp.[(a)(c)]	66,600	1,634,364
Southwestern Energy Co.[(a)(c)]	29,700	1,276,209

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Statement of Investments

Clough Global Allocation Fund

March 31, 2011

	Shares	Value
Energy (continued)		
Suncor Energy, Inc.[a]	39,282	$1,761,405
Ultra Petroleum Corp.[a][c]	8,500	418,625
Whiting Petroleum Corp.[a][b][c]	12,200	896,090
		26,958,787
Oil & Gas Services 7.77%		
Baker Hughes, Inc.[a][b]	44,000	3,230,920
Calfrac Well Services, Ltd.[a]	14,400	464,157
Cameron International Corp.[a][b][c]	60,463	3,452,437
Core Laboratories NV[a]	8,759	894,907
Ensco PLC - Sponsored ADR[a][b]	30,072	1,739,364
National Oilwell Varco, Inc.[a]	43,993	3,487,325
Tenaris S.A. - ADR[a][b]	3,800	187,948
Transocean, Ltd.[a][b][c]	10,900	849,655
Weatherford International, Ltd.[a][b][c]	25,951	586,493
		14,893,206
TOTAL ENERGY		49,664,382
Financial 30.41%		
Banks 4.80%		
Agricultural Bank of China, Ltd. - Class H[c]	1,583,000	897,472
Banco Bradesco S.A. - ADR	8,335	172,951
Banco do Brasil S.A.	15,971	288,088
Banco Santander Brasil S.A. - ADR[a]	54,100	663,266
Bank of China, Ltd. - Class H	3,126,300	1,740,283
China Construction Bank Corp. - Class H	1,664,870	1,560,304
China Merchants Bank Co., Ltd. - Class H	306,000	847,754
Industrial & Commercial Bank of China - Class H	1,378,000	1,144,414
Itau Unibanco Holding S.A. - ADR	12,039	289,538
Lloyds Banking Group PLC[a][c]	378,200	352,439
M&T Bank Corp.[a][b]	14,057	1,243,623
Standard Chartered PLC	1	26
		9,200,158

	Shares	Value
Diversified Financial Services 7.41%		
Bank of America Corp.[a]	287,452	3,831,735
CIT Group, Inc.[a][b][c]	13,800	587,190
Citigroup, Inc.[a][b][c]	832,342	3,678,952
First Niagara Financial Group, Inc.[a][b]	40,800	554,064
IntercontinentalExchange, Inc.[a][c]	3,271	404,099
MGIC Investment Corp.[a][b][c]	195,797	1,740,635

	Shares	Value
Financial (continued)		
New York Community Bancorp, Inc.[a][b]	30,896	$533,265
People s United Financial, Inc.[a]	40,697	511,968
The PMI Group, Inc.[a][b][c]	199,042	537,413
Radian Group, Inc.[a]	185,755	1,264,992
Valley National Bancorp[a]	39,600	552,816
		14,197,129
Insurance 2.67%		
Genworth Financial, Inc. - Class A[a][b][c]	146,957	1,978,041
Hartford Financial Services Group, Inc.[a][b]	76,567	2,061,950
Maiden Holdings, Ltd.[a][d]	23,900	179,011
XL Capital, Ltd.[a][b]	36,000	885,600
		5,104,602
Investment Companies 5.34%		
Ares Capital Corp.[a]	142,024	2,400,206
Golub Capital BDC, Inc.[a]	53,100	837,918
Indochina Capital Vietnam Holdings, Ltd.[a][c][e]	15,595	57,389
Knight Capital Group, Inc. - Class A[a][b][c]	39,717	532,208
Medley Capital Corp.[a][b][c]	34,088	415,192
PennantPark Investment Corp.[a]	177,530	2,116,157
Solar Capital, Ltd.[a]	131,618	3,143,031
Solar Senior Capital, Ltd.[a][c]	39,147	729,309
		10,231,410
Real Estate 0.12%		
BHG S.A. - Brazil Hospitality Group[c]	10,279	143,232
BHG S.A. - Brazil Hospitality Group, Receipt Shares[c][e]	1,315	18,324
Mingfa Group International Co., Ltd.[d]	217,014	67,794
		229,350
REITs 10.07%		
American Capital Agency Corp.[a]	30,044	875,482
Annaly Capital Management, Inc.[a]	161,700	2,821,665

Apollo Commercial Real Estate Finance, Inc.[(a)(b)]	47,600	778,260
Ascendas Real Estate Investment Trust	838,000	1,356,224
Ascott Residence Trust	346,374	329,749
CapitaCommercial Trust	1,201,000	1,324,387
Capstead Mortgage Corp.[(a)(b)]	157,584	2,013,924
Cypress Sharpridge Investments, Inc.[(a)(b)]	86,800	1,100,624
Dynex Capital, Inc.[(a)]	90,102	906,426

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Clough Global Allocation Fund

Statement of Investments

March 31, 2011

	Shares	Value
Financial (continued)		
Hatteras Financial Corp.[(a)(b)]	131,208	$3,689,569
Host Hotels & Resorts, Inc.[(a)]	19,862	349,770
Invesco Mortgage Capital, Inc.[(a)]	70,782	1,546,587
MFA Financial, Inc.[(a)(b)]	177,662	1,456,828
Starwood Property Trust, Inc.[(a)]	32,633	727,716
		19,277,211
TOTAL FINANCIAL		58,239,860
Industrial 8.63%		
BE Aerospace, Inc.[(a)(c)]	53,395	1,897,124
China State Construction International Holdings, Ltd.	798,200	728,570
Crown Holdings, Inc.[(a)(b)(c)]	18,121	699,108
Goodrich Corp.[(a)(b)]	6,700	573,051
GZI Transport, Ltd.	765,700	433,125
Jardine Strategic Holdings, Ltd.[(a)]	21,295	568,577
Jiangsu Expressway Co., Ltd. - Class H	1,330,493	1,491,525
KBR, Inc.[(a)]	5,864	221,483
MSCI, Inc. -Class A[(a)(c)]	7,800	287,196
Omron Corp.	7,375	207,295
Owens Corning[(a)(b)(c)]	23,298	838,495
Owens-Illinois, Inc.[(a)(c)]	72,454	2,187,386
Sensata Technologies Holding NV[(a)(b)(c)]	30,512	1,059,682
TE Connectivity, Ltd.[(a)]	15,600	543,192
TransDigm Group, Inc.[(a)(b)(c)]	24,135	2,023,237
Verisk Analytics, Inc. -Class A[(a)(c)]	25,895	848,320
Zhejiang Expressway Co., Ltd. - Class H	2,106,000	1,916,871
		16,524,237
Technology 11.92%		
Apple, Inc.[(a)(c)]	5,473	1,907,067
Arrow Electronics, Inc.[(a)(b)(c)]	45,400	1,901,352
Avnet, Inc.[(a)(c)]	36,200	1,234,058
Broadcom Corp. - Class A[(a)(b)(c)]	13,500	531,630
Fidelity National Information		

Services, Inc.[(a)(b)]	30,300	990,507
Fiserv, Inc.[(a)(b)(c)]	9,900	620,928
HTC Corp.	8,000	312,856
Ingram Micro, Inc. - Class A[(a)(b)(c)]	41,800	879,054
International Business Machines Corp.[(a)(b)]	40,300	6,571,721
Microsoft Corp.[(a)(b)]	194,214	4,925,267
Oracle Corp.[(a)(b)]	2,384	79,554
Samsung Electronics Co., Ltd.	2,163	1,837,747
SanDisk Corp.[(a)(c)]	4,383	202,012
Xerox Corp.[(a)(b)]	78,537	836,419
		22,830,172

	Shares	Value
Utilities 5.37%		
Babcock & Wilcox Co.[(a)(b)(c)]	8,025	$267,874
CMS Energy Corp.[(a)(b)]	29,300	575,452
DPL, Inc.[(a)(b)]	38,100	1,044,321
Edison International[(a)(b)]	7,100	259,789
National Grid PLC -Sponsored ADR[(a)(b)]	113,700	5,462,148
Northeast Utilities[(a)(b)]	17,200	595,120
Oneok, Inc.[(a)(b)]	9,900	662,112
Power Assets Holdings, Ltd.	211,000	1,410,546
		10,277,362
TOTAL COMMON STOCKS		
(Cost $174,025,317)		202,118,239
EXCHANGE TRADED FUNDS 5.77%		
iShares FTSE China 25 Index Fund[(a)]	64,500	2,899,920
iShares iBoxx $ High Yield Corporate Bond Fund[(a)(b)]	31,101	2,860,048
SPDR Gold Trust[(a)(b)(c)]	37,800	5,285,196
		11,045,164
TOTAL EXCHANGE TRADED FUNDS		
(Cost $8,708,729)		11,045,164
PREFERRED STOCKS 0.43%		
The Goodyear Tire & Rubber Co., 5.875%	15,900	812,172
TOTAL PREFERRED STOCKS		
(Cost $795,993)		812,172

Description and Maturity Date	**Principal Amount**	**Value**
CORPORATE BONDS 12.17%		
American Axle & Manufacturing, Inc. 03/01/2017, 7.875% [a]	$755,000	770,100
Anheuser-Busch InBev Worldwide, Inc. 11/17/2015, 9.750% [a]	1,585,000	1,002,366
ArvinMeritor, Inc. 03/15/2018, 10.625% [a]	425,000	480,250
BE Aerospace, Inc. 07/01/2018, 8.500% [a]	525,000	582,750
Bombardier, Inc. 05/01/2034, 7.450% [a][d]	505,000	487,325
CITIC Resources Holdings, Ltd. 05/15/2014, 6.750% [a][f]	450,000	472,500
Citigroup, Inc. 03/05/2038, 6.875% [a]	585,000	644,949
Constellation Brands, Inc. 09/01/2016, 7.250% [a]	675,000	733,219

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Statement of Investments

Clough Global Allocation Fund

March 31, 2011

Description and Maturity Date	Principal Amount	Value
CORPORATE BONDS (continued)		
Crown Americas LLC / Crown Americas Capital Corp. II		
05/15/2017, 7.625%[(a)]	$700,000	$764,750
Dana Holding Corp.		
02/15/2021, 6.750% [(a)]	430,000	432,150
Felcor Lodging LP		
10/01/2014, 10.000%[(a)]	450,000	516,375
Ford Motor Credit Co., LLC		
10/01/2014, 8.700%[(a)]	850,000	964,736
Forest Oil Corp.		
06/15/2019, 7.250%[(a)]	600,000	630,000
General Cable Corp.		
04/01/2017, 7.125%[(a)(b)]	700,000	725,375
Genworth Financial, Inc.		
06/15/2020, 7.700%[(a)]	490,000	502,285
Gol Finance		
07/20/2020, 9.250%[(a)(d)]	545,000	585,194
The Goldman Sachs Group, Inc.		
02/01/2041, 6.250% [(a)]	580,000	579,541
Graphic Packaging International, Inc.		
10/01/2018, 7.875%[(a)]	305,000	328,256
Hanesbrands, Inc.		
12/15/2016, 8.000%[(a)]	490,000	533,487
Hidili Industry International Development, Ltd.		
11/04/2015, 8.625%[(a)(d)]	585,000	590,850
Iron Mountain, Inc.		
01/01/2016, 6.625%[(a)]	625,000	631,250
Itau Unibanco Holding S.A.		
11/23/2015, 10.500%[(a)(d)]	1,520,000	963,587
JPMorgan Chase & Co.		
04/23/2019, 6.300%[(a)]	675,000	747,387
Lear Corp.		
03/15/2018, 7.875%[(a)]	600,000	655,500
Morgan Stanley		
01/25/2021, 5.750%[(a)]	435,000	439,207
Newfield Exploration Co.		
05/15/2018, 7.125%[(a)]	250,000	270,000
Petrohawk Energy Corp.		
06/01/2015, 7.875%[(a)]	675,000	718,875
Pioneer Natural Resources Co.		
03/15/2017, 6.650%[(a)]	525,000	571,398
President and Fellows of Harvard College		
10/01/2037, 6.300%[(a)]	826,000	930,726
Range Resources Corp.		
05/15/2019, 8.000%[(a)]	600,000	664,500
Rearden G Holdings EINS GmbH		
03/30/2020, 7.875%[(a)(d)]	440,000	479,600
Silgan Holdings, Inc.		

08/15/2016, 7.250%[a]	500,000	545,000
Spirit Aerosystems, Inc.		
10/01/2017, 7.500%[a]	550,000	594,000
Star Energy Geothermal Wayang Windu, Ltd.		
02/12/2015, 11.500%[a][d]	450,000	517,500
Starwood Hotels & Resorts Worldwide, Inc.		
05/15/2018, 6.750%[a][b]	675,000	736,594

Description and Maturity Date	**Principal Amount**	**Value**
CORPORATE BONDS (continued)		
TAM Capital 2, Inc.		
01/29/2020, 9.500%[a][f]	$520,000	$574,600
Tenneco, Inc.		
08/15/2018, 7.750%[a]	300,000	321,750
Terex Corp.		
11/15/2017, 8.000%[a]	582,000	616,192
TOTAL CORPORATE BONDS (Cost $21,518,766)		23,304,124
ASSET/MORTGAGE BACKED SECURITIES 0.39%		
Freddie Mac REMICS		
Series 2006-3155, Class SA,		
11/15/2035, 36.570%[a][g]	66,656	70,190
Government National Mortgage Association (GNMA)		
Series 2007-37, Class SA,		
03/20/2037, 21.227%[a][g]	115,428	130,727
Series 2007-37, Class SB,		
03/20/2037, 21.227%[a][g]	23,838	28,092
Small Business Administration Participation Certificates		
Series 2008-20L, Class 1,		
12/01/2028, 6.220%[a]	485,722	530,749
TOTAL ASSET/MORTGAGE BACKED SECURITIES (Cost $681,537)		759,758
FOREIGN GOVERNMENT BONDS 1.97%		
Brazilian Government International Bonds		
01/05/2016, 12.500%[a]	5,150,000	3,608,549
01/10/2028, 10.250%[a]	259,000	159,832
TOTAL FOREIGN GOVERNMENT BONDS (Cost $3,498,294)		3,768,381
GOVERNMENT & AGENCY OBLIGATIONS 11.76%		

U.S. Treasury Bonds		
05/15/2040, 4.375%[(a)]	1,550,000	1,514,406
U.S. Treasury Notes		
04/30/2016, 2.625% [(a)]	7,000,000	7,114,296
08/15/2018, 4.000% [(a)]	13,000,000	13,891,722
TOTAL GOVERNMENT & AGENCY OBLIGATIONS (Cost $22,333,398)		22,520,424

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Clough Global Allocation Fund

Statement of Investments

March 31,2011

	Shares	Value
SHORT-TERM INVESTMENTS 2.21%		
Dreyfus Treasury Prime Money Market Fund (0.000% 7-day yield)[h]	4,241,015	$4,241,015
TOTAL SHORT-TERM INVESTMENTS		
(Cost $4,241,015)		4,241,015

	Value
Total Investments -140.24%	
(Cost $235,803,049)	268,569,277
Liabilities in Excess of Other Assets - (40.24%)	(77,067,339)
NET ASSETS - 100.00%	$191,501,938

SCHEDULE OF SECURITIES

SOLD SHORT [c]	**Shares**	**Value**
COMMON STOCKS		
Aetna, Inc.	(5,400)	$(202,122)
Apollo Group, Inc. - Class A	(7,004)	(292,137)
Bed Bath & Beyond, Inc.	(4,400)	(212,388)
Berkshire Hathaway, Inc. - Class B	(11,800)	(986,834)
Cie Generale d Optique Essilor International S.A.	(5,600)	(415,861)
Diamond Offshore Drilling, Inc.	(12,373)	(961,382)
Kohl s Corp.	(5,000)	(265,200)
Macy s, Inc.	(16,360)	(396,894)
Noble Corp.	(7,231)	(329,878)
Toll Brothers, Inc.	(318)	(6,287)
		(4,068,983)
EXCHANGE TRADED FUNDS		
Energy Select Sector SPDR Fund	(18,258)	(1,457,171)
iShares Dow Jones U.S. Real Estate Index Fund	(5,002)	(297,119)
iShares MSCI South Korea Index Fund	(16,433)	(1,057,463)
United States Oil Fund LP	(63,139)	(2,688,459)
Vanguard REIT ETF	(105,410)	(6,165,431)
		(11,665,643)

TOTAL SECURITIES SOLD SHORT (Proceeds $14,048,235)	$(15,734,626)

(a) Pledged security; a portion or all of the security is pledged as collateral for securities sold short or borrowings as of March 31, 2011. (See Note 1 and Note 6)

(b) Loaned security; a portion or all of the security is on loan at March 31, 2011.

(c) Non-income producing security.

(d) Security exempt from registration under Rule 144A of the Securities Act of 1933. These securities may be resold in transactions exempt from registration, normally to qualified institutional buyers. As of March 31, 2011, these securities had a total value of $3,870,861 or 2.02% of net assets.

(e) Fair valued security; valued by management in accordance with procedures approved by the Fund s Board of Trustees. As of March 31, 2011, these securities had a total value of $75,713 or 0.04% of total net assets.

(f) Securities were purchased pursuant to Regulation S under the Securities Act of 1933, which exempts securities offered and sold outside of the United States from registration. Such securities cannot be sold in the United States without either an effective registration statement filed pursuant to the Securities Act of 1933, or pursuant to an exemption from registration. These securities have been deemed liquid under guidelines approved by the Fund s Board of Trustees. As of March 31, 2011, the aggregate market value of those securities was $1,047,100, representing 0.55% of net assets.

(g) Floating or variable rate security - rate disclosed as of March 31, 2011.

(h) Less than 0.0005%.

See Notes to the Financial Statements.

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Statement of Investments

Clough Global Equity Fund

March 31, 2011

	Shares	Value
COMMON STOCKS 112.81%		
Basic Materials 0.91%		
Anglo American PLC - Unsponsored ADR[a]	12,536	$323,679
Gerdau S.A.- Sponsored ADR[a][b]	39,858	498,225
Walter Energy, Inc.[a]	15,100	2,044,993
		2,866,897
Communications 10.71%		
CBS Corp. - Class B[a]	32,698	818,758
Chunghwa Telecom Co., Ltd. - ADR[a][b]	56,632	1,764,653
Cisco Systems, Inc.[a][b]	113,700	1,949,955
DiGi.Com Bhd	55,500	524,078
Google, Inc. - Class A[a][c]	16,616	9,740,465
Liberty Media Corp. - Capital - Series A[a][b][c]	9,887	728,375
Liberty Media Corp. - Class A[a][c]	67,400	1,081,096
Liberty Media Corp. - Starz - Series A[a][b][c]	2,279	176,851
Maxis Bhd	1,262,900	2,243,302
NII Holdings, Inc.[a][c]	32,991	1,374,735
Philippine Long Distance Telephone Co.	14,825	793,855
Qihoo 360 Technology Co., Ltd. - ADR[c]	5,473	161,946
Telekom Malaysia Bhd	395,200	527,151
Valassis Communications, Inc.[a][c]	23,000	670,220
Verizon Communications, Inc.[a][b]	174,763	6,735,366
Viacom, Inc. - Class B[a]	20,500	953,660
The Walt Disney Co.[a][b]	79,320	3,417,899
		33,662,365
Consumer Cyclical 8.26%		
Arezzo Industria e Comercio S.A.[c]	44,369	618,255
Bosideng International Holdings, Ltd.	1,872,000	< face="Times New Roman"style="font-size:1.0pt;">

Operating expenses:				
Sales and marketing	70.4	51.1	81.0	56.4
Research and development	51.1	41.1	68.5	48.5
General and administrative	32.0	17.8	35.7	18.4
Severance and related costs		3.2		1.9
Operating loss	(91.6)	(56.5)	(126.4)	(69.0)
Other income (expense), net	(4.4)	0.1	(3.2)	0.0
Interest income, net	0.9	1.7	2.0	1.2

Loss before income tax provision	(95.10)	(54.7)	(127.6)	(67.8)
Income tax provision				
Net loss	(95.1)%	(54.7)%	(127.6)%	(67.8)%
Preferred stock dividends accrued	(3.6)	(3.3)	(4.3)	(2.9)
Beneficial conversion feature on preferred stock			)	(31.8)
Net loss attributable to common stockholders	(98.7)%	(58.0)%	(131.9)%	(102.5)%

	Three Months Ended June 30, 2006	June 30, 2005	Six Months Ended June 30, 2006	June 30, 2005
Domestic revenues	86.6 %	89.7 %	86.3 %	88.2 %
Export revenues to:				
Europe	12.6	7.4	10.6	7.6
Canada	0.3	1.0	1.6	0.6
Asia	0.4	1.8	1.3	3.5
Latin America	0.1	0.1	0.2	0.1
Net revenues	100.0 %	100.0 %	100.0 %	100.0 %

Net Revenues. Net revenues for the quarter and six months ended June 30, 2006 were $1.2 million and $2.1 million, respectively, compared to $1.7 million and $2.9 million for the same periods in 2005, primarily because projected sales did not meet our expectations as we continued our strategic move to concentrate on our intrusion prevention/detection, entity identification and regulated information compliance and data privacy products. Product revenues decreased $0.4 million and $0.8 million, respectively, for the quarter and six months ended June 30, 2006 compared to the same periods in 2005. Customer support and maintenance revenue decreased $0.1 million for the quarter and remained consistent for the six months ended June 30, 2006 compared to the same periods in 2005.

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Concentration of Revenues. Revenues from sales to various U.S. government entities totaled $0.9 million, or 72.4% of revenues, for the quarter ended June 30, 2006 compared to $1.3 million, or 76.7% of revenues, for the same period in 2005. Revenues from sales to various U.S. government entities totaled $1.4 million, or 70.0% of revenues, for the six months ended June 30, 2006 compared to $2.1 million, or 71.0% of revenues, for the same period in 2005. Although, we expect our concentration of revenues to vary among customers in future quarters depending upon the timing of certain sales, we anticipate that sales to government customers will continue to account for a significant portion of our revenues in future quarters. Sales to the government present risks in addition to those involved in sales to commercial customers which could adversely affect our revenues, including potential disruption to appropriation and spending patterns and the government s reservation of the right to cancel contracts and purchase orders for its convenience. Although we do not believe that the cancellation of any particular order would have a material adverse effect on our financial results or that any of our revenues with government customers are subject to renegotiation, a large number of cancelled or renegotiated government orders could possibly have a material adverse effect on our financial results. Currently, we are not aware of any proposed cancellation or renegotiation of any of our existing arrangements with government entities and, historically, government entities have not cancelled or renegotiated orders which had a material adverse effect on our business.

Gross Profit. Gross profit was $0.7 million or 61.9% of net revenues for the quarter ended June 30, 2006, compared to $1.0 million or 56.7% of net revenues for the quarter ended June 30, 2005. Gross profit was $1.2 million or 58.8% of net revenues for the six months ended June 30, 2006, compared to $1.6 million or 56.2% of net revenues for the six months ended June 30, 2005. Gross profit margins as a percentage of net revenues increased from the same period in the prior year due to a favorable shift in product mix. Gross profit on product revenues for the quarter and six months ended June 30, increased from 45.6% and 44.3%, respectively, in 2005 to 55.2% and 50.1%, respectively, in 2006 due to the transition to our more profitable software-based products. Gross profit on customer support and maintenance revenues for the quarter and six months ended June 30, decreased from 94.7% and 93.4%, respectively, in 2005 to 87.9% and 76.4%, respectively, in 2006, as more costs associated with maintenance contracts were incurred during the quarter.

Gross profit as a percentage of net revenues is impacted by several factors, including shifts in product mix, changes in channels of distribution, revenue volume, fluctuations in third-party assembly costs, pricing strategies, and fluctuations in revenues of integrated third-party products.

Sales and Marketing. Sales and marketing expenses decreased to $0.8 million for the quarter ended June 30, 2006, compared to $0.9 million for the quarter ended June 30, 2005. Sales and marketing expenses remained relatively constant at $1.7 million for the six months ended June 30, 2006, compared to $1.6 million for the six months ended June 30, 2005. Sales and marketing expenses may vary as a percentage of net sales in the future. However, we believe that these costs will trend downward through the end of the year due to reductions in personnel and discretionary sales and marketing expenditures.

Research and Development. Research and development expenses decreased to $0.6 million for the quarter ended June 30, 2006 compared to $0.7 million for the quarter ended June 30, 2005. Research and development expenses remained relatively constant at $1.4 million for the six months ended June 30, 2006, compared to $1.4 million for the six months ended June 30, 2005. Research and development costs are expensed in the period incurred. Research and development expenses may vary as a percentage of net sales in the future; however, we believe that these costs will trend downward through the end of the year as some engineering expenses will move to cost of sales on development contracts.

General and Administrative. General and administrative expenses increased to $0.4 million for the quarter ended June 30, 2006 compared to $0.3 million for the quarter ended June 30, 2005. General and administrative expenses increased to $0.7 million for the six months ended June 30, 2006, compared to $0.5 million for the six months ended June 30, 2005. This increase was primarily due to stock-based compensation expense totaling $363 thousand recognized in

2006 under SFAS123(R). It is expected that general and administrative expenses will trend slightly downward through the end of the year because of personnel reductions and other cost cutting efforts. General and administrative expense may vary as a percentage of net sales in the future.

Interest. Net interest income decreased to $11 thousand for the quarter ended June 30, 2006 compared to $29 thousand for the same period in 2005. Net interest income increased to $41 thousand for the six months ended June 30, 2006 compared to $33 thousand for the same period in 2005. Net interest income may vary in the future based on our cash flow and rate of return on investments.

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Liquidity and Capital Resources

Our principal source of liquidity at June 30, 2006 is approximately $0.3 million of cash and cash equivalents. At June 30, 2006 working capital was $0.4 million compared to $2.9 million at June 30, 2005.

Cash used in operations for the six months ended June 30, 2006 was $2.9 million, primarily due to a net loss of $2.6 million, a decrease in accounts payable and accrued expenses of $0.2 million, a reduction in deferred revenue of $0.2 million, an increase in accounts receivable of $0.4 million and a reduction in the provision for doubtful accounts of $13 thousand. This cash decrease was partially offset by stock-based compensation of $0.4 million, depreciation expense of $59 thousand, a decrease in inventories of $49 thousand and a decrease in prepaid expenses and other assets of $47 thousand. Cash used in operations for the six months ended June 30, 2005 was $1.0 million, primarily due to an operating loss of $2.0 million, a decrease in accounts payable and accrued expenses of $0.2 million and a decrease in the provision for doubtful accounts of $0.2 million. This cash usage was partially offset by depreciation and amortization of $0.1 million, a decrease in accounts receivable of $0.9 million, an increase in deferred revenue of $0.1 million and a decrease in prepaid expenses and other assets of $0.2 million. Future fluctuations in inventory balances, accounts receivable and accounts payable will be dependent upon several factors, including, but not limited to, quarterly sales, our strategy in building inventory in advance of receiving orders from customers, and the accuracy of our forecasts of product demand and component requirements.

Cash provided by investing activities in the six months ended June 30, 2006 was $3 thousand of net purchases of property and equipment offset by maturities of short-term investments of $0.5 million, compared to cash used in investing activities of $2.4 million for the six months ended June 30, 2005, which consisted primarily of the net purchases of short-term investments of $2.4 million and net purchases of property and equipment of $0.1 million partially offset by maturities of short-term investments of $0.1 million.

Cash used in financing activities in the six months ended June 30, 2006 was $0.1 million, primarily consisting of the payment of dividends on preferred stock, compared to cash provided by financing activities in the six months ended June 30, 2005 was $2.4 million, consisting of net financing proceeds from a private placement of $2.5 million, partially offset by payment of dividends on preferred stock of $115 thousand.

At June 30, 2006, the Company did not have any material commitments for capital expenditures.

During the three months ended June 30, 2006, the Company funded its operations through the use of cash and cash equivalents.

As of June 30, 2006, we had cash, cash equivalents and short-term investments in the amount of approximately $0.3 million, down from approximately $3.3 million as of December 31, 2005. We funded our operations and met our cash requirements during the three months ended June 30, 2006 through the use of cash and cash equivalents. On March 29, 2006, we established a $1.0 million line of credit with Silicon Valley Bank. Our existing cash resources, line of credit and projections for increased revenues for the remainder of 2006, may not provide sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months. It is likely that we may need to seek additional debt or equity financing to fund our operations for the next year. The sufficiency of our cash resources depend to a certain extent on general economic, financial, competitive or other factors beyond our control. Moreover, despite actions to reduce our costs and improve our profitability, our operating losses and net operating cash outflows may continue through at least the third quarter of 2006. We may not be able to achieve the revenue and gross margin objectives necessary to achieve positive cash flow or profitability without obtaining additional equity financing. We do not currently have any arrangements for additional financing and we may not be able to secure additional debt or equity financing on terms acceptable to us, or at all, at the time when we need such funding. Additionally, we may not have sufficient availability under our credit line when additional funds are needed. Furthermore, because our stockholders equity of $0.6 million as of June 30, 2006 is less than the $2.5 million required by Nasdaq, we currently face delisting from The Nasdaq Capital Market and must raise additional equity or generate at least $1.9 million of net income in order to meet continued listing requirements. If our business does not generate sufficient cash flow from operations and sufficient future financings are not available, we may not be able to operate or grow our business, pay our expenses when due, fund our other liquidity needs or maintain our listing on The Nasdaq Capital Market. Moreover, any financing raised by us may restrict our business activities for future capital raising efforts or cause dilution to our current stockholders.

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We may explore the possible acquisitions of businesses, products and technologies that are complementary to our existing business. We are continuing to identify and prioritize additional security technologies, which we may wish to develop, either internally or through the licensing, or acquisition of products from third parties. While we may engage from time to time in discussions with respect to potential acquisitions, there can be no assurances that any such acquisitions will be made or that we will be able to successfully integrate any acquired business. In order to finance such acquisitions and working capital it may be necessary for us to raise additional funds through public or private financings. Any equity or debt financings, if available at all, may be on terms, which are not favorable to us and, in the case of equity financings, may result in dilution to our stockholders.

Off-Balance Sheet Arrangements.

As of June 30, 2006, we did not have any significant off-balance sheet arrangements, as defined by Item 303(c)(2) of Regulation S-B.

Factors That May Affect Future Results of Operations

Numerous factors may affect our business and future results of operations. These factors include current economic and market conditions, the effect of military actions on government and corporate spending on information security products, spending patterns of, and appropriations to, U.S. government departments, technological changes, competition and market acceptance, acquisitions, product transitions, timing of orders, manufacturing and suppliers, reliance on outsourcing vendors and other partners, intellectual property and licenses, third-party products, dependence on government customers, international operations, intellectual property issues, liquidity and cash resources and effects of restructuring plans and cost reductions. The discussion below addresses some of these and other factors. For a more thorough discussion of these and other factors that may affect our business and future results, see the discussion under the caption Factors That May Affect Future Results of Operations in our Annual Report on Form 10-KSB for the year ended December 31, 2005.

Our cash, cash equivalents, and investments decreased from $3.3 million at December 31, 2005 to $0.3 million at June 30, 2006 due to results of operations. If our net cash outflows continue, we may not have sufficient cash to operate our business and may not be able to maintain our Nasdaq listing.

As of June 30, 2006, we had cash, cash equivalents and investments in the amount of approximately $0.3 million, down from approximately $3.3 million as of December 31, 2005. Our existing cash resources, line of credit and projections for increased revenues for the remainder of 2006, may not provide sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months. It is likely that we may need to seek additional debt or equity financing to fund our operations for the next year. The sufficiency of our cash resources depend to a certain extent on general economic, financial, competitive or other factors beyond our control. Moreover, despite actions to reduce our costs and improve our profitability, our operating losses and net operating cash outflows may continue through at least the third quarter of 2006. As a result, we may not be able to achieve the revenue and gross margin objectives necessary to achieve positive cash flow or profitability without obtaining additional equity financing. We do not currently have any arrangements for additional financing and we may not be able to secure additional debt or equity financing on terms acceptable to us, or at all, at the time when we need such funding. If our business does not generate sufficient cash flow from operations and sufficient financing resources are not available, we may not be able to operate or grow our business, pay our expenses when due or fund our other liquidity needs. We may not have sufficient availability under our credit line when we need additional funds. Furthermore, we may not be able to secure additional debt or equity financing on terms that are acceptable to us, or at all, on a timely basis. Therefore, if our business does not generate sufficient cash flow from operations and sufficient financing resources are not available, we may not be able to operate or grow our business, pay our expenses when due or fund our other liquidity needs.

Our stock is subject to delisting from the Nasdaq Capital Market which could adversely effect the price and liquidity of our shares.

The Nasdaq Capital Market maintains certain minimum requirements to maintain the Nasdaq listing of our common stock. In particular, Nasdaq Marketplace Rule 4320(c)(2)(B) requires us to have at least one of (1) $2,500,000 in stockholders equity, (2) $35,000,000 market value of listed securities or (3) $500,000 of net income from continuing operations for the most recently completed fiscal year or two of the three most recently completed fiscal years. As of June 30, 2006, our stockholders equity was approximately $635,000, and as of August 1, 2006, the market value of our common stock was approximately $2,889,000 based on 7,046,213 shares outstanding and a closing price of $0.41 per share. In addition, we have reported net losses from continuing operations in each of the last three most recently completed fiscal years. On June 14, 2006, Nasdaq notified us we failed to meet the minimum stockholders equity requirements. Although we presented a plan for compliance to Nasdaq, on June 1, 2006, Nasdaq informed us that they plan to delist our stock based on the minimum equity deficiency. On August 3, 2006, we appealed Nasdaq s determination and we presented our appeal to the Nasdaq Listing Qualifications Panel. We are currently awaiting a decision from Nasdaq, but we cannot assure you that they will grant our appeal or, if they do, that we will be able to comply with any conditions to our continued listing.

In addition, Nasdaq Marketplace Rule 4310(c)(4) require the minimum bid price of our common stock to be at least $1.00 per share. On June 26, 2006, Nasdaq notified us that our common stock had not maintained the required minimum bid per share for more than 30 consecutive trading days. In accordance with Marketplace Rule 4310(c)(8)(D), we have 180 calendar days, or until December 26, 2006, to regain compliance with this requirement.

Although we are currently exploring a range of alternatives to increase the amount of our cash, we may not be able to complete an alternative transaction on acceptable terms, if at all, and may not be able to regain compliance with the minimum stockholders equity requirements. Further, the price of our stock is subject to a number of factors outside of our control and we may not be able to regain compliance with the minimum bid price requirements. Therefore, Nasdaq may seek to delist our shares of common stock from The Nasdaq Capital Market. In that event, our common stock likely would trade in a less efficient market such as the OTC Bulletin Board or in the pink sheets maintained by the National Quotation Bureau, Inc. Furthermore, our common stock may become subject to the penny stock rules adopted by the SEC which impose additional sales price requirements on broker dealers who sell our shares. Consequently, the delisting of our common stock may adversely impact our stock price, the liquidity of our common stock and our general business reputation.

If we fail to respond to rapid technological changes in the network security, data protection, regulated information compliance, entity identification and spyware prevention industries, we may lose customers or our products may become obsolete.

The network security, data protection, regulated information compliance, entity identification and spyware prevention industries are characterized by frequent product introductions, rapidly changing technology and continued evolution of industry standards. We must introduce upgrades to our products rapidly in response to customer needs, such as new computer viruses or other novel external attacks on computer networks as well as the adoption privacy and data protection laws. In addition, the nature of the network security, data protection, regulated information compliance, entity identification and spyware prevention industries requires our products to be compatible and interoperable with numerous security products, networking products, workstation and personal computer architectures and computer and network operating systems offered by various vendors, including our competitors. As a result, our success depends upon our ability to develop and introduce in a timely manner new products and enhancements to our products that meet changing customer requirements and evolving industry and legal standards. The development of technologically advanced network security, data protection, regulated information compliance, entity identification and spyware prevention products is a complex and uncertain process requiring high levels of innovation, rapid response and accurate anticipation of technological and market trends. We cannot assure you that we will be able to identify, develop, manufacture, market or support new or enhanced products successfully in a timely manner. Further, the introduction of new products or product enhancements by us or our competitors or the adoption of new or amended privacy or data protection laws may shorten the life cycle of our existing products or cause our existing products to become obsolete.

Our revenues have decreased to $2.1 million for the first six months of 2006 from $2.9 million for the same period in 2005 and have generally decreased since 2003 in connection with a shift to sales of our newer product lines. If our network intrusion detection, regulated information compliance, spyware prevention and entity identification products do not achieve market acceptance, our revenues will suffer.

We have continued to transition our sales strategy from our lower margin SecureCom and PDS security appliance products to the development and sales of our higher margin network intrusion detection/prevention, regulated information compliance, entity identification and spyware products. During this transition, sales of our new products were not enough to counteract the loss in sales associated with our older products. As a result, our net revenues remained relatively constant at approximately $6.0 million in 2004 and 2005 but have declined in the first half of 2006 compared to the same period in 2005 due to a longer than expected sales cycle.

Our new network security products, regulated information compliance systems, entity identification and spyware products have only been in the market place for a limited period of time and may have longer sales cycles than our previous products. Although response to our products has been positive, we have not yet received broad market acceptance. We cannot assure you that our present or future products will achieve market acceptance on a sustained basis.

In order to achieve market acceptance and achieve future revenue growth, we must introduce complementary security products, incorporate new technologies into our existing product lines and design, develop and successfully commercialize higher performance products in a timely manner. We cannot assure you that we will be able to offer new or complementary products that gain market acceptance quickly enough to avoid decreased revenues during current or future product introductions or transitions.

We resemble a developmental stage company and our business strategy may not be successful.

From our founding in 1983 until 2000, we derived substantially all of our revenue from the design, manufacture and sale of local area networking equipment. In order to permit us to focus our resources solely on developing and marketing our network security products, we sold our local area networking assets and related networking divisions in a series of sales from 2000 to 2002.

As a result of these sales, we now depend exclusively on revenues generated from the sale of our network security products, which have received limited market acceptance. Moreover, we have only recently introduced our regulated compliance and data privacy systems and our spyware prevention and entity identification products. Although initial response to these products has been positive, the market for these products has only begun to emerge and sales of these products may not occur as quickly as we expect. Consequently, we resemble a developmental stage company and will face the following inherent risks and uncertainties:

- the need for our network security products, regulated information compliance systems, data privacy protection systems, entity identification products and spyware prevention products to achieve market acceptance and produce a sustainable revenue stream;
- our ability to manage costs and expenses;
- our dependence on key personnel;
- our ability to obtain financing on acceptable terms; and
- our ability to offer greater value than our competitors.

Our business strategy may not successfully address these risks. If we fail to recognize significant revenues from the sales of our network security products and regulated information compliance systems, our business, financial condition and operating results would be materially adversely affected.

We incurred a net loss of $2.6 million for the six months ended June 30, 2006 and have an accumulated deficit of $54.7 million as of June 30, 2006. As a result, we must generate substantially greater revenues from sales in order to achieve profitability.

We have incurred significant operating losses and are uncertain about our future operating results. For the six months ended June 30, 2006, we incurred a net loss of $2.6 million and had an accumulated deficit of approximately $54.7 million as of June 30, 2006. We need to generate and sustain substantially greater revenues from the sales of our products if we are to achieve profitability. If we are unable to achieve these greater revenues, our losses will continue indefinitely, and we may never achieve or sustain profitability or generate positive cash flow.

We face intense competition from both start-up and established companies that may have significant advantages over us and our products.

The market for network security solutions is intensely competitive. There are numerous companies competing with us in various segments of the data security markets, and their products may have advantages over our products in areas such as conformity to existing and emerging industry standards, interoperability with networking and other security products, management and security capabilities, performance, price, ease of use, scalability, reliability, flexibility, product features and technical support.

Our principal competitors in the network intrusion prevention and detection market include Internet Security Systems, Inc., Cisco Systems, Inc., Symantec, Inc., Network Associates, Inc., Tipping Point Technologies, a division of 3Com Corporation, and NFR Security, Inc. Our competitors in the regulated information compliance market include Vontu, Port Authority, Vericept, Reconnex, Tablus and a small number of start-up companies that entered the space within the last two years. Regarding the spyware prevention market, we currently directly and indirectly compete with a number of host-based spyware detection systems, such as Ad-Aware, Spybot S&D and Spy Sweeper and some inline proxy solutions such as Blue Coat Systems, Inc. Our current and potential competitors may have one or more of the following significant advantages over us:

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- greater financial, technical and marketing resources;
- better name recognition;
- more comprehensive security solutions;
- better or more extensive cooperative relationships; and
- larger customer base.

Although we believe our products compare favorably to our competitors products and create a sustainable business model, we cannot assure you that our products will achieve market acceptance or that we will be able to compete successfully with our existing or new competitors.

Military actions may disrupt our business by reducing spending for our products, increasing our costs and affecting our international operations.

We derive a substantial portion of our revenue from sales to United States government entities, including sales to various Army and other armed services bases. As a result, United States military actions or other events occurring in response to or in connection with them, including future terrorist attacks, actual conflicts involving the United States or its allies or military or trade disruptions could impact our operations by:

- reducing or delaying government, armed service or corporate spending on our products;
- increasing the cost and difficulty in obtaining materials or shipping products; and
- affecting our ability to conduct business internationally.

Should these events occur, our business, operating results and financial condition could be materially and adversely affected.

Our products can have long sales and implementation cycles, which may result in us incurring substantial expenses before realizing any associated revenues.

The sale and implementation of our products to large companies and government entities typically involves a lengthy education process and a significant technical evaluation and commitment of capital and other resources. This process is also subject to the risk of delays associated with customers internal budgeting and other procedures for approving capital expenditures, deploying new technologies within their networks and testing and accepting new technologies that affect key operations. As a result, sales and implementation cycles for our products can be lengthy, and we may expend significant time and resources before we receive any revenues from a customer or potential customer. Our quarterly and annual operating results could be materially harmed if orders forecasted for a specific customer for a particular period are not realized.

Our failure to realize the expected benefits of our recent restructuring efforts could adversely affect our operating results.

Since we began restructuring in 2002, we have incurred approximately $1.1 million in restructuring charges, severance, and related expenses. The objective of our restructuring plan was to reduce our cost structure to a sustainable level that is consistent with our current cash resources and the general economic climate. We have also implemented other strategic initiatives to strengthen our operations, such as reductions in our work force and facilities and aligning our organization around our business objectives. Any further work force reductions could result in temporary reduced productivity of our remaining employees. Additionally, our customers and prospects may delay or forgo purchasing our products due to a perceived uncertainty caused by our restructuring and other changes. Failure to achieve the desired results of our initiatives could seriously harm our business, results of operations and financial condition.

Consolidation in the network security industry may limit market acceptance of our products.

Several of our competitors have acquired security companies with complementary technologies in the past. We expect consolidation in the network security industry to continue in the future. These acquisitions may permit our competitors to accelerate the development and commercialization of broader product lines and more comprehensive solutions than we currently offer. Acquisitions of vendors or other companies with which we have a strategic relationship by our competitors may limit our access to commercially significant technologies.

Further, business combinations in the network security industry are creating companies with larger market shares, customer bases, sales forces, product offerings and technology and marketing expertise, which may make it more difficult for us to compete.

Sales to government entities accounted for 70.0% of our revenues for the six months ended June 30, 2006 and 70.7% of our revenues for the year ended December 31, 2005. Sales to government customers involve unique risks, which could adversely impact our revenues.

We derived 70.0% of our revenues from sales to various U.S. government entities for the six months ended June 30, 2006, and 70.7% of our revenues from these sales for the year ended December 31, 2005. We expect to continue to derive a substantial portion of our revenues from U.S. government customers in the future. Sales to the government present risks in addition to those involved in sales to commercial customers, including potential disruption due to appropriation and spending patterns and the government s right to cancel contracts and purchase orders for its convenience. General political and economic conditions, which we cannot accurately predict, may affect the quantity and allocation of expenditures by federal departments. In addition, obtaining government contracts may involve long purchase and payment cycles, competitive bidding, qualification requirements, delays or changes in funding, budgetary constraints, political agendas, extensive specification development and price negotiations and milestone requirements. Each government entity also maintains its own rules and regulations with which we must comply and which can vary significantly among departments. As a result, cutbacks or re-allocations in the federal budget or losses of government sales due to other factors could have a material adverse effect on our revenues and operating results.

We derived 13.7% of our revenues from international sales in the six months ended June 30, 2006, and 10.7% of our revenues from these sales for the year ended December 31, 2005. Our ability to sell our products internationally is subject to certain risks which could harm our business.

Sales to foreign customers accounted for approximately 10.7% of our revenues for the year ended December 31, 2005, and 13.7% of our revenues for the six months ended June 30, 2006. We expect sales to foreign customers to continue to represent a significant portion of our revenues in the future. Our international operations are subject to many inherent risks that may adversely affect our business, financial condition and operating results, including:

- political, social and economic instability;
- trade restrictions;
- increases in duty rates and other potentially adverse tax consequences;
- exposure to different legal standards, particularly with respect to the protection of intellectual property;
- burdens of complying with a variety of foreign laws;
- unexpected changes in regulatory requirements;
- import and export license requirements and restrictions of the United States and each other country where we operate;
- fluctuations in currency exchange rates; and
- changes in local purchasing practices, including seasonal fluctuations in demand.

Sales through indirect channels accounted for 10.0% of our revenues for the six months ended June 30, 2006 and 36.2% of our revenue for the year ended December 31, 2005. Our revenues will suffer if we do not expand our sales through, or receive the anticipated benefits from our sales through, indirect sales channels.

We derived 10.0% of our revenues for the six months ended June 30, 2006, and 36.2% of our revenue for the year ended December 31, 2005, from sales through indirect sales channels, such as distributors, value added resellers, system integrators, original equipment manufacturers and managed service providers. We believe we must expand our sales through these indirect channels in order to increase our revenues. Although we are actively pursuing a strategy to increase the percentage of our revenues generated through these indirect sales channels, we cannot assure you that our products will gain market acceptance in these indirect sales channels or that sales through these indirect sales channels will increase our revenues as expected. Further, many of our competitors are also trying to sell their products through these indirect sales channels, which could result in lower prices and reduced profit margins for sales of our products.

We must adequately protect our intellectual property in order to prevent loss of valuable proprietary information.

We rely on a combination of patent, copyright, trademark and trade secret laws, confidentiality procedures and non-disclosure agreements to protect our proprietary technology. However, unauthorized parties may attempt to copy or reverse engineer aspects of our products or to obtain and use information that we regard as proprietary. Policing unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation of our intellectual property. This is particularly true in foreign countries where the laws may not protect proprietary rights to the same extent as the laws of the United States and may not provide us with an effective remedy against unauthorized use. If our protection of our intellectual property proves to be inadequate or unenforceable, others may be able to use our proprietary developments without compensation to us, resulting in potential cost advantages to our competitors.

We may incur substantial expenses defending ourselves against claims of infringement.

There are numerous patents held by many companies relating to the design and manufacture of network security systems. Although we are not aware of any instances in which our products violate the intellectual property rights of others or inappropriately use their technology, it is possible that third parties in the future may claim that our products infringe on their intellectual property rights. Any claim, with or without merit, could consume our management s time, result in costly litigation, cause delays in sales or implementations of our products or require us to enter into royalty or licensing agreements. Royalty and licensing agreements, if required and available, may be on terms unacceptable to us or detrimental to our business. Moreover, a successful claim of product infringement against us or our failure or inability to license the infringed or similar technology on commercially reasonable terms could seriously harm our business.

Fluctuations in our quarterly revenues may cause the price of our common stock to decline.

Our operating results have varied significantly from quarter to quarter in the past, and we expect our operating results to vary from quarter to quarter in the future due to a variety of factors, many of which are outside of our control. Although our revenues are subject to fluctuation, significant portions of our expenses are not variable in the short term, and we cannot reduce them quickly to respond to decreases in revenues. Therefore, if revenues are below our expectations, this shortfall is likely to adversely and disproportionately affect our operating results. Accordingly we may not attain positive operating margins in future quarters. Any of these factors could cause our operating results to be below the expectations of securities analysts and investors, which likely would negatively affect the price of our common stock.

The price of our common stock has been volatile in the past and may continue to be volatile in the future due to factors outside of our control.

The market price of our common stock has been highly volatile in the past and may continue to be volatile in the future. For example, for the six-month period ending June 30, 2006, the market price of our common stock on The Nasdaq Capital Market fluctuated between $0.40 and $2.87 per share. The market price of our common stock may fluctuate significantly in response to a number of factors, many of which are outside our control, including:

- variations in our quarterly operating results;
- changes in estimates of our financial performance by securities analysts;
- changes in market valuations of our competitors;
- announcements by us or our competitors of new products, significant contracts, acquisitions, strategic relationships, joint ventures or capital commitments;
- product or design flaws, product recalls or similar occurrences;
- additions or departures of key personnel;
- sales of common stock in the future; and
- fluctuations in stock market prices and volume, which can be particularly common among network security and other high technology companies.

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Our reductions in our work force may make it more difficult for us to attract and retain the personnel necessary to successfully operate our business.

We rely upon the continued service of a relatively small number of key technical, sales and senior management personnel. Our future success depends on retaining our key employees and our continuing ability to attract, train and retain other highly qualified technical, sales and managerial personnel. As a result, our employees could resign with little or no prior notice. We may not be able to attract, assimilate or retain other highly qualified technical, sales and managerial personnel in the future, especially given our recent reductions in force. The loss of any of our key technical, sales and senior management personnel or our inability to attract, train and retain additional qualified personnel could seriously harm our business.

Certain rights of the holders of our preferred stock and the terms of our secured credit line may hinder our ability to raise additional financing.

We cannot issue shares of capital stock with rights senior to those of our existing 5% preferred stock, Series 2 5% preferred stock or Series 3 5% preferred stock without the approval of at least a majority of the holders of our 5% preferred stock, all of the holders of our Series 2 5% preferred stock, and holders of at least 75% of our Series 3 5% preferred stock voting or acting as separate classes. We also cannot incur certain indebtedness without the approval of at least a majority of the holders of our 5% preferred stock. In addition, holders of the Series 3 5% preferred stock who are not executive officers or directors have the right to purchase a pro rata portion of certain future issuances of securities by us. Furthermore, the terms of our secured credit line with Silicon Valley Bank include covenants which restrict our ability to incur additional debt and pay certain dividends. The combination of these provisions could hinder or delay our ability to raise additional debt or equity financing.

You will experience substantial dilution upon the conversion or redemption of the shares of preferred stock and exercise of warrants that we issued in recent private placements.

On March 25, 2004, we completed a $5,000,000 private placement in connection with which we issued 1,000,000 shares of our 5% Convertible Preferred Stock and warrants to acquire 556,619 shares of our common stock. The conversion price for the preferred stock and the exercise price of the warrants is $3.144 per share. We also issued our placement agent a warrant for 64,408 shares of our common stock at an exercise price of $3.144 per share. As of August 1, 2006, there were 259,696 shares of 5% preferred stock, representing approximately 413,003 shares of common stock upon conversion, and warrants to purchase 621,027 shares of common stock outstanding.

In addition, on March 28, 2005, we completed a $2,663,000 private placement in connection with which we issued 1,065,200 shares of our Series 2 5% Convertible Preferred Stock and warrants to acquire 532,600 shares of our common stock. We also issued two affiliates of our placement agent warrants to purchase an aggregate of 60,390 shares of common stock. The conversion price for the preferred stock is $2.50 per share and the exercise price of the warrants is $2.77 per share. As of August 1, 2006, there were 460,000 shares of Series 2 5% preferred stock, representing 460,000 shares of common stock upon conversion, and warrants to purchase 592,990 shares of common stock outstanding.

Finally, on December 2, 2005, we completed a $1,230,843 private placement in connection with which we issued 564,607 shares of our Series 3 5% preferred stock and warrants to acquire 282,306 shares of our common stock. We also issued two affiliates of our placement agent warrants to purchase an aggregate of 27,531 shares of common stock. The conversion price of the preferred stock is $2.18 per share and the exercise price of the warrants is $2.58 per share. As of August 1, 2006, there were 468,735 shares of Series 3 5% preferred stock, representing 468,735 shares of common stock upon conversion, and warrants to purchase 309,837 shares of common stock outstanding.

On August 1, 2006, we had 7,046,213 shares of common stock outstanding. We expect the private placements discussed above to result in a further dilution to holders of our common stock upon conversion of the preferred stock and exercise of the warrants of 2,865,592 shares of common stock, or an approximately 40.7% increase in the number of shares of our common stock outstanding.

Further, the occurrence of certain events entitle holders of our Series 3 5% preferred stock to require us to redeem their shares for a number of shares of our common stock equal to the redemption price divided by 75% of the ten-day average of the volume weighted average price of our common stock ending on the day immediately preceding the holder s election to redeem, subject to a floor of $0.87 per share. Holders of our Series 2 5% preferred stock have similar redemption rights without a floor. The redemption price for the shares of Series 3 5% preferred stock equals the sum of (1) the greater of $2.834 and the volume weighted average price of our common stock on the trading day immediately preceding the redemption event multiplied by $2.18 divided by the conversion price of the Series 3 5% preferred stock then in effect plus (2) any accrued but unpaid dividends on the Series 3 5% preferred stock plus (3) any unpaid liquidated damages or other amounts payable to the holders of the Series 3 5% preferred stock. The redemption price for the shares of Series 2 5% preferred stock equals the sum of (1) the greater of $3.25 and the volume weighted average price of our common stock on the trading day immediately preceding the redemption event multiplied by $2.50 divided by the conversion price of the Series 2 5% preferred stock then in effect plus (2) any accrued but unpaid dividends on the Series 2 5% preferred stock plus (3) any unpaid liquidated damages or other amounts payable to the holders of the Series 2 5% preferred stock. As a result, assuming we have paid all liquidated damages and other amounts to the holders, accrued but unpaid dividends on July 28, 2006 of $17,256, a volume weighted average price of $0.41, which was the ten-day volume weighted average closing price of our common stock on July 28, 2006, and our 7,046,213 shares of common stock outstanding on July 28, 2006, we would issue approximately 9,137,599 shares of our common stock if a specified redemption event occurs and all holders of Series 3 5% preferred stock and Series 2 5% preferred stock elected to redeem their shares for common stock. This would represent an increase of approximately 129.7% in the number of shares of our common stock as of July 28, 2006.

The conversion of preferred stock or exercise of warrants we issued in our recent private placement may cause the price of our common stock to decline.

The holders of the shares of our 5% preferred stock and warrants we issued on March 25, 2004, may freely convert their shares of preferred stock and exercise their warrants and sell the underlying shares of common stock pursuant to an effective registration statement we filed on August 6, 2004. As of August 1, 2006, 740,304 shares of preferred stock had converted into 1,177,327 shares of common stock.

The holders of the shares of Series 2 5% preferred stock and warrants we issued on March 28, 2005, may freely convert their shares of preferred stock and exercise their warrants and sell the underlying shares of common stock pursuant to an effective registration statement we filed on May 5, 2005. As of August 1, 2006, 605,200 shares of Series 2 5% preferred stock had converted into 605,200 shares of common stock.

The holders of the shares of Series 3 5% preferred stock and warrants we issued on December 2, 2005, may freely convert their shares of preferred stock and exercise their warrants and sell the underlying shares of common stock pursuant to an effective registration statement we filed on January 5, 2006. As of August 1, 2006, 95,872 shares of Series 3 5% preferred stock had converted into 95,872 shares of common stock.

For the four weeks ended on July 28, 2006, the average daily trading volume of our common stock on The Nasdaq Capital Market was 31,021 shares. Consequently, if holders of preferred stock or warrants elect to convert their remaining shares or exercise their warrants and sell a material amount of their underlying shares of common stock on the open market, the increase in selling activity could cause a decline in the market price of our common stock. Furthermore, these sales, or the potential for these sales, could encourage short sales, causing additional downward pressure on the market price of our common stock.

The payment of accrued dividends on our preferred stock may strain our cash resources.

Shares of our 5% preferred stock accrue cash dividends equal to $0.25 per share per annum, payable in arrears on March 31 and September 30 of each year, shares of our Series 2 5% preferred stock accrue cash dividends equal to $0.125 per share per annum, payable in arrears on the first business day of March, June, September and December of each year and shares of our Series 3 5% preferred stock accrue cash dividends equal to $0.109 per share per annum, payable in arrears on the first business day of March, June, September and December of each year. The amount of the dividends on our Series 2 5% preferred stock may increase to $0.45 per share per annum and the amount of the dividends on our Series 3 5% preferred stock may increase to $0.3294 per share per annum upon the occurrence of certain event entitling the holders of these shares to redemption.

During 2005, we paid $123 thousand in dividends related to our 5% convertible preferred stock and $63 thousand in dividends related to our Series 2 5% preferred stock. At June 30, 2006, we had $16,187 dividends accrued related to our 5% preferred stock, $4,726 related to our Series 2 5% preferred stock and $4,199 related to our Series 3 5% preferred stock.

Delaware law provides that we may only pay dividends out of our capital surplus or, if no surplus is available, out of our net profits for the fiscal year the dividend is declared and/or the preceding fiscal year. We have not had net profits for the last two fiscal years ended as of December 31, 2005. However, we did have sufficient capital surplus, defined as the amount by which our net assets exceed our stated capital, based on par value of our outstanding shares as provided by Delaware law. Although we are currently able to pay accrued dividends on our outstanding shares of preferred stock, we cannot assure you that our net assets will continue to exceed our stated capital or that we will have net profits in order to pay these dividends in the future. These dividends continue to accrue on our outstanding shares of preferred stock, regardless of whether we are legally able to pay them. The accrual of these dividends may adversely affect our operating results. Moreover, the payment of these dividends could strain our available cash resources, which could adversely affect our ability to operate or grow our business.

In addition, our inability to pay dividends could require us to redeem outstanding shares of Series 2 5% preferred stock and Series 3 5% preferred stock for shares of our common stock issued at a price equal to 75% of the average of the volume weighted average price of our common stock for the ten days ending on the day immediately preceding an election to redeem, subject, in the case of the Series 3 5% preferred stock, to a floor of $0.87. As a result, the issuance, or potential issuance, of these additional shares of common stock could cause our stock price to decline. Furthermore, our inability to pay dividends could adversely affect our ability to raise equity financing in the future if required.

Our acquisition of complementary products or businesses may adversely affect our financial condition.

We have made acquisitions in the past, and, in the future, we may acquire or invest in additional companies, business units, product lines or technologies to accelerate the development of products and sales channels complementary to our existing products and sales channels. Negotiation of potential acquisitions and integration of acquired products, technologies or businesses could divert our management s time and resources. Future acquisitions could cause us to issue equity securities that would dilute your ownership of us, incur debt or contingent liabilities, amortize intangible assets or write off in-process research and development, goodwill and other acquisition-related expenses that could seriously harm our financial condition and operating results. Further, if we are not able to properly integrate acquired products, technologies or businesses with our existing products and operations, train, retain and motivate personnel from the acquired business or combine potentially different corporate cultures, we may not receive the intended benefits of our acquisitions, which could adversely affect our business, operating results and financial condition.

Compliance with export regulations may hinder our sales to foreign customers.

Certain of our data security products incorporate encryption and other technology that may require clearance and export licenses from the U.S. Department of Commerce under United States export regulations. Any inability to obtain these clearances or licenses or any foreign regulatory approvals, if required, on a timely basis could delay sales and have a material adverse effect on our operating results.

Provisions of our charter documents and Delaware law may have anti-takeover effects.

Certain provisions of our certificate of incorporation and bylaws, such as our ability to offer blank check preferred stock and the inability of our common stockholders to act by written consent, could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders. We are also subject to the provisions of Section 203 of the Delaware General Corporation Law, which restricts certain business combinations with interested stockholders and could inhibit a non-negotiated merger or other business combination.

Our management and preferred stockholders exercise significant control over our company and may approve or take actions that may be adverse to your interests.

As of August 1, 2006, our executive officers, directors and preferred stockholders beneficially own approximately 23.5% of our voting power. As a result, these stockholders will be able to exercise significant control over all matters requiring stockholder approval, including the election of directors and the approval of significant corporate transactions, which could delay or prevent someone from acquiring or merging with us or providing us with additional financing if required. These stockholders may use their influence to approve or take actions that may be adverse to your interests.

Item 3. CONTROLS AND PROCEDURES

We have carried out an evaluation, under the supervision and the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of March 31, 2006, pursuant to Rule 13a-15(b) under the Exchange Act. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed is recorded, processed, summarized and reported in a timely manner.

We have carried out an evaluation, under the supervision and participation of our management, including our Chief Executive Officer and Chief Financial Officer, of any changes in our internal controls over financial reporting that occurred during the quarterly period ended June 30, 2006, and our Chief Executive Officer and Chief Financial Officer have concluded that there was no change during the quarterly period ended June 30, 2006 that has materially affected or is reasonably expected to materially affect our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

We are subject to legal proceedings and claims that arise in the ordinary course of business. We do not believe that the outcome of those matters will have a material adverse affect on our consolidated financial position, operating results or cash flows. However, there can be no assurance such legal proceedings will not have a material impact.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Annual Meeting of Stockholders was held on June 13, 2006, at the Radisson Hotel, Dallas North in Richardson, Texas. The following is a brief description of each matter voted upon by stockholders, including a number of votes cast for, against, or withheld with regard to each matter of nominee.

(1) Election of five (5) directors to serve until the next Annual Meeting of Stockholders and until their respective successors are duly elected and qualified.

	FOR	**WITHHELD**
G. Ward Paxton	7,029,934	152,691
T. Joe Head	7,061,681	120,944
James F. Gero	7,062,719	119,906
J. Fred Bucy, Jr.	7,061,731	120,894
Donald M. Johnston	7,059,006	123,619

(2) Ratification and approval for issuance of shares of the Company s common stock sufficient to fully provide for the conversion or redemption of the Company s Series 3 5% Convertible Preferred Common Stock and the exercise of warrants to purchase the Company s common stock the Company sold in a private placement on December 2, 2005.

FOR	**AGAINST**	**ABSTAIN**
3,752,085	182,172	291,924

(3) Ratification and approval for the issuance of shares of Company s common stock upon the conversion or redemption of shares of the Company s Series 3 5% Convertible Preferred Stock and warrants purchased by G. Ward Paxton, the Company s Chairman, President and Chief Executive Officer and James F. Gero, one of the Company s directors in the private placement offering on December 2, 2005.

FOR	**AGAINST**	**ABSTAIN**
3,185,140	185,702	300,299

(4) Ratification and approval of selection by the Board of Directors of KBA Group LLP as independent auditors of the Registrant for the fiscal year ending December 31, 2006.

FOR	AGAINST	ABSTAIN
7,105,597	64,002	13,025

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Item 6. EXHIBITS

The following Exhibits are filed with this report form 10-QSB:

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) of the Exchange Act.
31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) of the Exchange Act.
32.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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S I G N A T U R E S

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	INTRUSION INC.
Date: August 11, 2006	/s/ G. Ward Paxton G. Ward Paxton Chairman, President & Chief Executive Officer (Principal Executive Officer)
Date: August 11, 2006	/s/ Michael L. Paxton Michael L. Paxton Vice President, Chief Financial Officer, Treasurer & Secretary (Principal Financial & Accounting Officer)

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