

STEMCELLS INC
Form 10-K
March 15, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2011

or

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

COMMISSION FILE NUMBER 0-19871

STEMCELLS, INC.

(Exact name of Registrant as specified in its charter)

A Delaware Corporation
(State or other jurisdiction of

incorporation or organization)

94-3078125
(I.R.S. Employer

Identification No.)

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7707 GATEWAY BLVD

NEWARK, CA
(Address of principal offices)

94560
(zip code)

Registrant's telephone number, including area code:

(510) 456-4000

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

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, \$0.01 par value	NASDAQ Global Market
Junior Preferred Stock Purchase Rights	

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

None

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

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

Aggregate market value of common stock held by non-affiliates at June 30, 2011: \$72,494,157. Inclusion of shares held beneficially by any person should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of management policies of the registrant, or that such person is controlled by or under common control with the Registrant.

Common stock outstanding at March 2, 2012: 23,294,881 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement relating to the registrant's 2011 Annual Meeting of Stockholders to be filed with the Commission pursuant to Regulation 14A are incorporated by reference in Part III of this report.

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FORWARD LOOKING STATEMENTS

THIS REPORT CONTAINS FORWARD-LOOKING STATEMENTS AS DEFINED UNDER THE FEDERAL SECURITIES LAWS. ACTUAL RESULTS COULD VARY MATERIALLY. FACTORS THAT COULD CAUSE ACTUAL RESULTS TO VARY MATERIALLY ARE DESCRIBED HEREIN AND IN OTHER DOCUMENTS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION. READERS SHOULD PAY PARTICULAR ATTENTION TO THE CONSIDERATIONS DESCRIBED IN THE SECTION OF THIS REPORT ENTITLED MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS AS WELL AS ITEM 1A UNDER THE HEADING RISK FACTORS.

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Throughout this Form 10-K, the words we, us, our, and StemCells refer to StemCells, Inc., including our directly and indirectly wholly-owned subsidiaries. Common stock refers to the common stock of StemCells, Inc., \$0.01 par value.

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PART I

Item 1. BUSINESS
Overview

StemCells, Inc. is engaged in the research, development, and commercialization of stem cell therapeutics and related tools and technologies for academia and industry. We believe that understanding cells and cell biology, and in particular stem cells, will play an increasingly important role in the understanding of human diseases and in the discovery of new medical therapies. Consequently, we are focused on developing and commercializing (i) stem and progenitor cells as the basis for novel therapeutics and therapies, and (ii) cells and related tools and technologies to enable stem cell-based research and drug discovery and development.

Our primary research and development efforts are focused on identifying and developing stem and progenitor cells as potential therapeutic agents. We currently have two therapeutic product development programs: (i) our CNS Program, which is developing applications for HuCNS-SC[®] cells, our proprietary human neural stem cell product candidate, and (ii) our Liver Program, which is characterizing our proprietary human liver cells as a potential therapeutic product. We estimate that degenerative conditions of the central nervous system (CNS) and the liver together currently affect more than 35 million people in the United States.⁽¹⁾

In our CNS Program, we are in clinical development with our HuCNS-SC cells for a range of disorders of the central nervous system. The CNS includes the brain, spinal cord and eye, and we are currently the only stem cell company in clinical development for indications in all three organs comprising the CNS, specifically:

- (i) with respect to the brain,

in February 2012, we completed a Phase I clinical trial in Pelizeaus-Merzbacher Disease (PMD), a fatal myelination disorder in the brain, and we expect to report final data from this study in late March 2012; in November 2011, we announced interim data from this study, including MRI analysis of one patient which shows changes consistent with the early development of new myelin in the regions in which our HuCNS-SC cells were transplanted;

previously, we completed a Phase I clinical trial in infantile and late infantile neuronal ceroid lipofuscinosis (NCL, also often referred to as Batten disease), which is a neurodegenerative disorder of the brain, and data from that trial showed that our HuCNS-SC cells were well tolerated, non-tumorigenic, and there was evidence of engraftment and long-term survival of the transplanted HuCNS-SC cells; and

we are also conducting preclinical studies of our HuCNS-SC cells in Alzheimer's disease,

- (ii) with respect to the spinal cord, we are conducting a Phase I/II clinical trial of our HuCNS-SC cells in Switzerland for the treatment of chronic spinal cord injury, and we completed the enrollment and dosing of the first patient cohort in December 2011, and

- (iii) with respect to the eye, in January 2012, we received authorization from the U.S. Food and Drug Administration (FDA) to conduct a Phase I/II clinical trial for dry age-related macular degeneration (AMD), the most common form of AMD.

In our Liver Program, we are focused on identifying and developing liver cells as potential therapeutics for a range of liver diseases. We have identified a subset of our human liver engrafting cells (hLEC) which we believe

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- (1) This estimate is based on information from the Alzheimer's Association, the Alzheimer's Disease Education & Referral Center (National Institute on Aging), the National Parkinson Foundation, the National Institutes of Health's National Institute on Neurological Disorders and Stroke, the Foundation for Spinal Cord Injury Prevention, Care & Cure, the Travis Roy Foundation, the Centers for Disease Control and Prevention, the Wisconsin Chapter of the Huntington's Disease Society of America, the American Liver Foundation, and the Cincinnati Children's Hospital Medical Center.

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may be a candidate for product development. In October 2011, we formed a wholly-owned subsidiary to focus on both the therapeutic and research tool applications of our hLEC technologies and to serve as an investment vehicle for those interested in a pure play liver cell company.

In our tools and technologies programs, we are engaged in developing and commercializing applications of our technologies to enable stem cell-based research. We currently market a range of proprietary cell culture products and antibody reagents under the SC Proven[®] brand. Our cell culture products include iSTEM[®], GS1-R[®], GS2-M[®], RHB-A[®], RHB-Basal[®], NDiff[®] N2B27, NDiff[®] N2 and NDiff N27 supplements. Our antibody reagents include STEM24[®], STEM10[®], STEM121[®], and STEM123[®], which can be used for cell detection, isolation and characterization. Academic and industrial laboratories conducting stem cell research need specialized cell culture products and reagents for the derivation, growth, maintenance, and manipulation of stem cells, as well as their detection, isolation and characterization in both *in vitro* and *in vivo* models. As this type of research continues to grow, the market for such cell culture products and reagents should also continue to expand. We are seeking to leverage our proprietary technologies, including technologies relating to embryonic stem cells, induced pluripotent stem (iPS) cells, and tissue-derived (adult) stem cells, for use in stem cell-based research. Several of the cell technologies and intellectual property related to our enabling cell technologies programs were acquired in April 2009 through our acquisition of substantially all of the operating assets and liabilities of Stem Cell Sciences Plc (SCS).

The Potential of Our Tissue-Derived Cell-Based Therapeutics

Stem cells are building block cells as they produce all the mature functional cell types found in normal organs. Stem cells have two defining characteristics: (i) they produce all of the mature cell types of the particular organ, and (ii) they self renew – that is, some of the cells developed from stem cells are themselves new stem cells. Progenitor cells are cells that have already developed from stem cells, but can still produce one or more mature cell types within an organ. Stem cells are rare; to date only four human stem cells have been identified and characterized *in vivo*: (i) the hemotopoietic stem cell, (ii) the mesenchymal stem cell, (iii) the neural stem cell, and (iv) the embryonic stem cell. Because of this self-renewal property, we believe that stem cell-based therapies may have the potential to return an impaired organ to proper function for the life of the patient.

Many degenerative diseases are caused by the loss of normal cellular function in a particular organ. When cells are damaged or destroyed, they no longer produce, metabolize or accurately regulate the many substances essential to life. There is no technology existing today that can deliver these essential substances precisely to the sites of action, under the appropriate physiological regulation, in the appropriate quantity, or for the duration required to cure the degenerative condition. Cells, however, can do all of this naturally. Transplantation of stem or progenitor cells may therefore prevent the loss of, or even generate new, functional cells and thereby potentially maintain or restore organ function and the patient's health.

We are focused on identifying and purifying tissue-derived stem and progenitor cells for use in homologous therapy. Homologous therapy means the use of cells derived from a particular organ to treat a disease of that same organ (for example, use of brain-derived neural stem cells for treatment of CNS disorders and liver-derived cells for treatment of liver disorders). Tissue-derived stem cells are developmentally pre-programmed to become the mature functional cells of the organ from which they were derived. We believe that homologous use of purified, unmodified tissue-derived cells is the most direct way to provide for engraftment and differentiation into functional cells, and should minimize the risk of transplantation of unwanted cell types.

We use cells derived from donated fetal or adult tissue sources, which are supplied to us in compliance with all applicable state and federal regulations. We are not involved in any activity directed toward human cloning, nor do we have any plans to start such activities. We are currently developing embryonic stem cells and iPS cells as potential research tools. We are not currently developing embryonic or induced pluripotent stem cells for therapeutic use, although we may in the future explore their applicability as cell-based therapeutic products.

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Business Strategy

Our aim is to create a sustainable business based on our belief that understanding cells and cell biology will play an increasingly important role in life science research and in the discovery, development and implementation of new medical therapies. Our primary strategy is to identify multiple types of human stem and progenitor cells with therapeutic and commercial importance, to develop techniques and processes to purify these cells for direct transplant and to expand and bank these cells, to advance these cells into clinical development and ultimately, to commercialize them as cell-based therapeutic products.

The fundamental competencies required to execute this strategy are knowledge and expertise in cell biology, particularly stem cell biology, and a commitment to rigorous and robust research and development. We believe that these competencies are critical to identifying, characterizing and understanding cells with therapeutic potential and importance.

Consequently, we have made significant investments in our research and development, clinical and regulatory, and cell processing and process development capabilities. Our management and staff have many years of experience in the stem cell field and in developing potential cell therapies. Two of the four human stem cells identified and characterized to date (the hematopoietic and neural stem cells) were discovered by scientists who are currently on our staff, and we believe we were the first company to receive authorization from the FDA to conduct a clinical trial of a purified neural stem cell product candidate, as well as the first to complete such a clinical trial. We are committed to proving that groundbreaking science, especially in the field of stem cell biology, has the potential to create truly breakthrough medicine.

Many of our core competencies in cell biology have applicability beyond the development of therapeutic products. Therefore, another element of our business strategy is to leverage these core competencies to develop non-therapeutic applications for our cell technologies, which we believe represent nearer-term commercial opportunities. As scientific and medical research increasingly focuses on stem cells and cell biology, our technologies are expected to have utility as tools to help enable this research. We currently market specialized cell culture products and antibody reagents through our SC Proven product line and are seeking to develop and commercialize applications of our technologies for use in stem cell-based research.

Further, a key element of our business strategy is to obtain patent protection for the compositions, processes and uses of multiple types of cells, as well as for those technologies that appear applicable and useful to enable cell-based research. We believe that patent protection will be available to the first to identify and isolate any of the finite number of different types of human stem and progenitor cells, and the first to define methods to culture such cells, making the commercial development of cell-based therapeutics and enabling applications financially feasible. In addition to discovering and developing technologies in-house, we have obtained from various academic and commercial institutions rights to certain inventions relating to stem and progenitor cells, cell culture media, and technologies to reprogram, isolate and manipulate cells. We expect to continue to expand our search for, and to seek to acquire rights from third parties relating to, new stem and progenitor cells and cell technologies. We have created an extensive patent estate, see Patents, Proprietary Rights and Licenses, below.

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Therapeutic Product Development Programs

Overview

The following table summarizes the current status of, and the anticipated initial indications for, our two therapeutic product development programs. A more detailed discussion of each of these follows the table.

CNS Program

Cell-based therapeutics to restore or preserve function to central nervous system tissue by protecting, repairing or replacing dysfunctional or damaged cells.

Diseases and Disorders of the Brain

Pelizeaus-Merzbacher Disease:

Four-patient Phase I clinical trial completed February 2012. Data expected to be reported in late March 2012.

Interim data from this Phase I trial, including MRI data, showed changes consistent with the early development of new myelin.

Demonstrated *in vivo* proof of principle by showing in the myelin deficient shiverer mouse that transplanted HuCNS-SC cells can:

generate and integrate myelin producing oligodendrocytes into the mouse brain; and

tightly wrap the mouse nerve axons to form myelin sheath.

Neuronal Ceroid Lipofuscinosis (also known as Batten disease):

Six-patient Phase I clinical trial completed in January 2009. Trial results show HuCNS-SC cells well tolerated and not tumorigenic, and that there was evidence of engraftment and survival of the transplanted cells.

Demonstrated *in vivo* proof of principle by showing in a mouse model for infantile NCL that transplanted HuCNS-SC cells can:

continuously produce the enzyme that is deficient in infantile NCL;

protect host neurons from death; and

delay the loss of motor function in HuCNS-SC transplanted mice.

Alzheimer's Disease:

Entered into a collaboration in April 2011 to study the therapeutic potential of our HuCNS-SC cells in Alzheimer's disease. Earlier findings show that mouse neural stem cells can enhance memory in a mouse model of Alzheimer's disease.

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Demonstrated that our HuCNS-SC cells are capable of engrafting and surviving in the hostile environment reflective of an Alzheimer's brain, which characteristically features abnormal accumulations of brain lesions called plaques and tangles.

Diseases and Disorders of the Spinal Cord

Spinal Cord Injury:

Conducting 12-patient Phase I/II clinical trial in Switzerland for chronic spinal cord injury, including both complete and incomplete injuries. First patient cohort enrollment completed December 2011.

Demonstrated *in vivo* proof of principle by showing in a mouse model for spinal cord injury that transplanted HuCNS-SC cells can:

restore motor function in injured animals;

directly contribute to functional recovery (and that when human cells are ablated restored function is lost); and

become specialized oligodendrocytes and neurons.

Diseases and Disorders of the Eye

Age-Related Macular Degeneration:

16-patient Phase I/II clinical trial authorized by FDA in January 2012.

Demonstrated *in vivo* proof of principle by showing in the Royal College of Surgeons rat, a widely accepted model for retinal degeneration, that HuCNS-SC cells can:

protect photoreceptor cells from death; and

prevent or slow loss of vision.

Liver Program

Cellular therapy to restore function to liver tissue by replacing dysfunctional or damaged cells.

Demonstrated *in vivo* engraftment and survival of hLEC in a mouse model of liver degeneration.

Detected human serum albumin and alpha-1-antitrypsin in serum of transplanted animals.

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Demonstrated the generation of key structural elements of the liver, the bile canaliculi, that are required for bile transport.

Identified cell surface markers and methods for selection of hLEC from livers of a broad range of age and quality, including livers deemed not suitable for transplantation.

Identified a subset of hLEC that may be a candidate for product development.

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CNS Program

Many neurodegenerative diseases involve the failure of central nervous system tissue (i.e., the brain, spinal cord and eye) due to the loss of functional cells. Our CNS Program is initially focusing on developing clinical applications in which transplanting HuCNS-SC cells would protect or restore organ function of the patient before such function is irreversibly damaged or lost due to disease progression. Our initial target indications are (i) Pelizaeus-Merzbacher Disease, and more generally, diseases in which deficient myelination plays a central role, such as cerebral palsy or multiple sclerosis; (ii) spinal cord injury, (iii) disorders in which retinal degeneration plays a central role, such as age-related macular degeneration or retinitis pigmentosa. These disorders affect a significant number of people in the United States and there currently are no effective long-term therapies for them.

Our lead product candidate, HuCNS-SC cells, is a purified and expanded composition of normal human neural stem cells. Alternative therapies based on cells derived from cancer cells, embryonic stem cells, iPS cells, animal-derived cells, or unpurified mixes of cell types have a significantly higher safety hurdle to overcome and while they may provide an effective therapy, technologies to remove potentially harmful cells are still being developed and tested. Furthermore, our HuCNS-SC cells can be directly transplanted, unlike embryonic stem cells or iPS cells, which require one or more prerequisite differentiation steps prior to administration in order to preclude teratoma formation (tumors of multiple differentiated cell types). It is still unclear whether cellular transplants derived from embryonic stem cells or iPS cells can avoid forming teratomas or other abnormal cellular structures due to contaminating cell types in the transplant product.

Our preclinical research has shown *in vivo* that HuCNS-SC cells engraft, migrate, differentiate into neurons and glial cells, and survive for as long as one year with *no sign* of tumor formation or adverse effects. Moreover, the HuCNS-SC cells were still producing progeny cells at the end of the test period. These findings show that our neural stem cells, when transplanted, act like normal neural stem cells, suggesting the possibility of a continual replenishment of normal human neural cells in transplant recipients. In the longer term, then, we believe stem cells have the potential to restore or replace lost cells and cellular function.

We hold a substantial portfolio of issued and allowed patents in the neural stem cell field, which cover the isolation, expansion and use of neural stem and progenitor cells, as well as the compositions of the cells themselves. See Patents, Proprietary Rights and Licenses, below.

Diseases and Disorders of the Brain

Pelizaeus-Merzbacher Disease (PMD)

Pelizaeus-Merzbacher Disease, a rare, degenerative, central nervous system disorder, is one of a group of genetic disorders known as leukodystrophies. Leukodystrophies involve abnormal growth of the myelin sheath, which is the fatty substance that surrounds nerve fibers in the brain and spinal cord. PMD is most commonly caused by a genetic mutation that affects an important protein found in myelin, proteolipid protein. PMD is most frequently diagnosed in early childhood and is associated with abnormal eye movements, abnormal muscle function, and in some cases, seizures. The course of the disease is marked by progressive neurological deterioration resulting in premature death.

In February 2012, we completed a Phase I clinical trial in PMD. A total of four patients were transplanted with HuCNS-SC cells and were evaluated periodically over a 12-month period. The study is designed to help detect evidence of new myelin, including by magnetic resonance imaging (MRI) of the brain, changes in neuropsychological tests of development and cognitive function, and clinical changes in neurological function. In November 2011, we reported interim data from this study, including MRI analysis of a patient which shows changes consistent with the early development of new myelin in the regions in which the clinical investigators transplanted our HuCNS-SC cells. Data from the completed Phase I trial are expected to be announced in late March 2012. The trial was conducted at the University of California, San Francisco (UCSF) Children's Hospital.

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In our preclinical research, we have shown that HuCNS-SC cells differentiate into oligodendrocytes, the myelin producing cells, and produce myelin. We have transplanted HuCNS-SC cells into the brain of the mutant shiverer mouse, which is deficient in myelin, and shown widespread engraftment of human cells that matured into oligodendrocytes, and that the human oligodendrocytes myelinated the mouse axons.

Other Myelin Disorders.

Loss of myelin characterizes conditions such as multiple sclerosis, cerebral palsy and certain genetic disorders (for example, Krabbe's disease and metachromatic leukodystrophy). Loss of myelin can also play a role in certain spinal cord indications. Based on our preclinical data, we believe our HuCNS-SC product candidate may have applicability to a range of myelin disorders.

Neuronal Ceroid Lipofuscinosis (NCL; also known as Batten disease).

Neuronal ceroid lipofuscinosis (NCL), which is often referred to as Batten disease, is a neurodegenerative disease that affects infants and young children. Infantile and late infantile NCL are brought on by inherited genetic mutations which result in either a defective or missing enzyme, leading to the accumulation of cellular waste product in various neuronal cell types. This accumulation eventually interferes with normal cellular and tissue function, and leads to seizures and progressive loss of motor skills, sight and mental capacity. Today, NCL is always fatal.

We completed a six-patient Phase I clinical trial of our HuCNS-SC cells in infantile and late infantile NCL in January 2009. We believe that this clinical trial was the first FDA-authorized trial to evaluate purified human neural stem cells as a potential therapeutic agent. Overall, the trial data demonstrated that the HuCNS-SC cells, the transplantation procedure and the immunosuppression regimen were well tolerated by all six patients, and the patients' medical, neurological and neuropsychological conditions, following transplantation, appeared consistent with the normal course of the disease. In addition to this favorable safety profile, there was evidence of engraftment and long-term survival of the HuCNS-SC cells. This Phase I trial was conducted at OHSU Doernbecher Children's Hospital.

In October 2010, we initiated a Phase Ib clinical trial in infantile and late infantile NCL at OHSU in order to evaluate the safety and preliminary efficacy our HuCNS-SC cells in patients in earlier stages of the disease. However, in April 2011, despite diligent efforts to identify and enroll eligible patients, we discontinued the trial due to lack of patient accrual.

Our preclinical data demonstrate that HuCNS-SC cells, when transplanted in a mouse model of infantile NCL, engraft, migrate throughout the brain, produce the relevant missing enzyme, measurably reduce the toxic storage material in the brain, protect host neurons so that more of them survive, and delay the loss of motor function compared to a control group of non-transplanted mice. A summary of this data was published in September 2009 in the peer-reviewed journal *Cell Stem Cell*. We have also demonstrated *in vitro* that HuCNS-SC cells produce the enzyme that is deficient in late infantile NCL.

Alzheimer's Disease.

Alzheimer's disease is a progressive, fatal neurodegenerative disorder that results in loss of memory and cognitive function. Today, there is no cure or effective treatment option. According to the Alzheimer's Association, approximately 5.4 million Americans have Alzheimer's disease, including nearly half of people aged 85 and older. The prevalence of Alzheimer's disease is expected to increase rapidly as a result of our aging population.

In April 2011, we entered into a collaboration with a world renowned leader in Alzheimer's disease research at the University of California, Irvine (UCI) to study the therapeutic potential of our HuCNS-SC cells in Alzheimer's disease. Our collaborator's published research has shown that mouse neural stem cells enhance memory in a mouse model of Alzheimer's disease, and the goal of the collaboration is to replicate these results

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using our human neural stem cells. Previously, we conducted studies of our HuCNS-SC cells in another model of Alzheimer's disease as part of a collaboration with researchers at the McLaughlin Research Institute. This research, which was funded by a National Institutes of Health (NIH) grant, demonstrated that our HuCNS-SC cells are capable of engrafting and surviving in the hostile environment reflective of an Alzheimer's brain, which characteristically features abnormal accumulations of brain lesions called plaques and tangles.

In September 2011, the California Institute of Regenerative Medicine (CIRM) awarded us and our collaborators a Disease Team Therapy Development Planning Award which totaled approximately \$100,000. We were one of only four companies awarded a disease team planning grant. These funds helped us prepare and submit an application for a Disease Team Therapy Development Research Award in January 2012 for the study of HuCNS-SC cells as a potential treatment for Alzheimer's disease. The CIRM has indicated that each Research Award will be up to \$20 million, payable over four years, to fund preclinical and IND-enabling activities with the aim of starting human clinical trials within the four-year window. The CIRM has indicated it plans to approve and fund Research Awards in the Summer of 2012.

Diseases and Disorders of the Spinal Cord

Spinal Cord Injury.

According to a recent study initiated by the Christopher and Dana Reeve Foundation, nearly 1.3 million people in the United States are estimated to be living with chronic spinal cord injury. There are no therapies today that can address the paralysis or loss of function caused by a spinal cord injury, but neural stem cells may have the potential to provide a novel therapeutic approach.

We are conducting a Phase I/II clinical trial in Switzerland to evaluate our HuCNS-SC cells as a treatment for chronic spinal cord injury. A total of twelve patients are expected to enroll in the study, all of whom will be three to twelve months post-injury. The study will follow a progressive study design, beginning with patients with complete injuries and then enrolling patients with incomplete injuries, all as classified by the American Spinal Injury Association Impairment Scale (AIS). We completed the enrollment and dosing of the first patient cohort, all of whom had complete injuries classified as AIS A, in December 2011. In addition to assessing safety, the trial will evaluate preliminary efficacy using defined clinical endpoints, such as changes in sensation, motor function, and bowel/bladder function. The trial is being conducted at University Hospital Balgrist in Zurich and was authorized by Swissmedic, the regulatory agency for therapeutic products in Switzerland.

The results of numerous preclinical studies demonstrate the therapeutic potential of our human neural stem cells for the treatment of spinal cord injury. Using a mouse model of spinal cord injury, our collaborators at the Reeve-Irvine Research Center at the University of California, Irvine have shown that our HuCNS-SC cells have the potential to protect and regenerate damaged nerves and nerve fibers, and that injured mice transplanted with our HuCNS-SC cells showed improved motor function compared to control animals. Inspection of the spinal cords from the treated mice showed significant levels of human neural cells derived from the transplanted stem cells. Some of these cells were oligodendrocytes, the specialized neural cell that forms the myelin sheath around axons, while others had become neurons and showed evidence of synapse formation, a requirement for proper neuronal function. The researchers then selectively ablated the human cells, and found that the functional improvement was lost, thus demonstrating that the human cells had played a direct role in the functional recovery of the transplanted mice. Moreover, our preclinical studies show that our human neural stem cells enable a significant and persistent recovery of motor function when transplanted in spinal cord-injured mice at both sub-acute and chronic injury time points.

In January 2012, we submitted an application to the CIRM for a disease team research award for cervical spinal cord injury. The Research Award may be up to \$20 million, payable over four years, to fund preclinical and IND-enabling activities with the aim of starting human clinical trials within a four-year window. The CIRM has indicated it plans to approve and fund Research Awards in the summer of 2012.

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Diseases and Disorders of the Eye

Retinal Disorders.

The retina is a thin layer of neural cells that lines the back of the eye and is responsible for converting external light into neural signals. A loss of function in retinal cells leads to impairment or loss of vision. The most common forms of retinal degeneration are age-related macular degeneration (AMD) and retinitis pigmentosa. AMD is the leading cause of vision loss and blindness in people over the age of 55 and afflicts some 30 million people worldwide.

In January 2012, we were authorized by the FDA to conduct a Phase I/II clinical trial in dry age-related macular degeneration, the more common form of AMD. The trial is expected to enroll a total of 16 patients and will evaluate the safety and preliminary efficacy of our HuCNS-SC cells as a treatment for dry AMD. Patients' vision will be evaluated using conventional methods of ophthalmological assessment at predetermined intervals over a one-year period.

Our preclinical data have shown that our HuCNS-SC cells, when transplanted in a well-established animal model of retinal degeneration, engraft long-term, can protect photoreceptors (the key cells involved in vision) from progressive degeneration, and can slow or prevent loss of visual function. In this model, called the Royal College of Surgeons (RCS) rat, a genetic mutation causes dysfunction of the retinal pigmented cells, which leads to progressive loss of the photoreceptors and ultimately, loss of visual function in the rat. Our preclinical data shows that our human neural stem cells protect both rod and cone photoreceptors in the eye from progressive degeneration and preserve visual function long term. The cone photoreceptors are light sensing cells that are highly concentrated within the macula of the human eye, and the ability to protect these cells suggests a promising approach to treating AMD. A summary of our preclinical data was featured as the cover article in February 2012 edition of the international peer-reviewed *European Journal of Neuroscience*.

Other CNS Collaborations.

We have established a number of research collaborations to assess both the *in vitro* potential of the HuCNS-SC cells and the effects of transplanting HuCNS-SC cells into preclinical animal models, including a collaboration with researchers at the Stanford University School of Medicine to evaluate our human neural stem cells in animal models of stroke. The results of these studies demonstrate the targeted migration of the cells toward the stroke lesion and differentiation toward the neuronal lineage. Another study with researchers at Stanford's School of Medicine demonstrated that HuCNS-SC cells labeled with magnetic nanoparticles could non-invasively track the survival and migration of human cells within the brain.

Liver Program

According to the American Association for the Study of Liver Diseases, approximately 25 million Americans are afflicted with liver-related disease each year. In many of these diseases, such as hepatitis, liver failure, blood-clotting disorder, cirrhosis, and liver cancer, the liver slowly loses function as liver cells are damaged or destroyed by the disease process. Eventually, an organ transplant is required in order to restore liver function to the patient. Organ transplants, however, are limited by the supply of suitable organs, and the transplant is generally done at the very late stages of the disease, in part because there are many more patients who need a transplant than there are suitable organs available. Moreover, the transplant procedure itself is very invasive.

Liver stem or progenitor cells have the potential to offer an alternative treatment for some of these liver diseases. A liver cellular therapy or cell-based therapeutic could provide or support liver function in patients with liver disease and would have a number of advantages over whole organ transplants. Such a product could potentially (i) expand the range of patients who would be treatable, (ii) allow for treatment in earlier stages of disease, and (iii) be less invasive and better tolerated.

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We have identified a subset of our proprietary human liver engrafting cells (hLEC) which we believe may be a candidate for product development. Numerous preclinical studies show that the hLEC demonstrate essential liver enzymatic functions *in vitro* and that hLEC engraft and show basic function of hepatocytes when transplanted into immunodeficient mice with a metabolic defect.

We hold a portfolio of issued and allowed patents in the liver field which cover the isolation and use of both hLEC cells and the isolated subset, as well as the composition of the cells themselves. See Patents, Proprietary Rights and Licenses, below.

In October 2011, we formed a wholly-owned subsidiary to focus on both the therapeutic and research tool applications of our hLEC technologies and to serve as an investment vehicle for those interested in a pure play liver cell company.

Tools and Technologies Programs

Overview

Cells, and stem cells in particular, are an important resource for researchers seeking to understand human diseases, advance medical research and develop more effective therapies. Stem cells provide potentially unlimited sources of different cell types owing to their ability to be expanded and subsequently differentiated into particular cell types. Embryonic stem cells, for example, have the ability to become any one of the more than 200 specialized cell types found in the human body (they are said to be *pluripotent*); induced pluripotent stem (iPS) cells also possess this ability. Because of this versatility, these cells are valuable tools for examining and researching the fundamental biology of cells and the pathways involved in early development and tissue formation. In recent years, the pharmaceutical industry has become increasingly interested in using stem cell-based assays in its drug discovery and development efforts.

Specialty Cell Culture Products and Antibody Reagents

Stem cell research is a growing and highly specialized field. Because of their nature, stem and progenitor cells are rare and they require specific conditions to survive and thrive. For this reason, researchers require specialized cell culture products that enable the derivation, growth, maintenance, and manipulation of such cells. One of the greatest challenges facing researchers is the limited quality and quantity of stem and progenitor cells available. The challenge is in maintaining the pluripotency or multipotency of stem or progenitor cells in culture, i.e., keeping these cells from differentiating into other cell types, which is their natural tendency. Our cell biology expertise has enabled us to develop and commercialize proprietary cell culture products to optimize the derivation, growth, maintenance, and differentiation of stem cells. In contrast to common industry practice, we have developed media formulations that are free of animal serum and feeder cells (helper cells added to promote cell growth), which are known sources of undesirable agents affecting stem cell performance and safety.

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Our current range of cell culture products, which are sold under the SC Proven brand, includes iSTEM, GS1-R, GS2-M, RHB-A, RHB-Basal, NDiff N2, and NDiff N2B27. The following table describes each of these in more detail:

iSTEM	A serum-free, feeder-free medium that maintains mouse embryonic stem cells in their pluripotent ground state by using selective small molecule inhibitors to block the pathways which induce differentiation.
RHB-A	A defined, serum-free culture medium for the selective culture of human and mouse neural stem cells and their maintenance and expansion as adherent cell populations.
RHB-Basal	A defined, serum-free basal medium. When supplemented with specific growth factors, this media is specifically formulated for the propagation and differentiation of adherent neural stem cells. RHB-Basal can also be tailored to specific-cell type requirements by the addition of customer preferred supplements.
NDiff N2	A defined serum-free scell culture supplement for the derivation, maintenance, expansion and/or differentiation of human and mouse embryonic stem (ES) cells and tissue-derived neural stem cells supplement.
NDiff N2-AF	A serum-free and animal component-free version of NDiff N2.
NDiff N2B27	A defined, serum-free medium for the differentiation of mouse embryonic stem cells to neural cell types.
NDiff N27-AF	A serum-free and animal component-free version of NDiff N27.
GS1-R	The first defined, serum-free media formulation shown to enable the derivation and long-term maintenance of true, germline competent rat embryonic stem cells without the addition of cytokines or growth factors.
GS2-M	A defined, serum- and feeder-free medium for the derivation and long-term maintenance of true, germline competent mouse iPS cells.

We also currently market a number of antibody reagents for use in cell detection, isolation and characterization. These reagents are also under the SC Proven brand. The following table describes each of these in more detail:

STEM24	A human antibody that recognizes human CD24, also known as Heat Stable Antigen (HSA), a glycoprotein expressed on the surface of many human cell types, including immature human hematopoietic cells, peripheral blood lymphocytes, erythrocytes, and many human carcinomas. CD24 is also a marker of human neural differentiation.
STEM101	A human-specific mouse antibody that recognizes the Ku80 protein found in human nuclei.
STEM121	A human-specific mouse antibody that recognizes a cytoplasmic protein of human cells.
STEM123	A human-specific mouse antibody that recognizes human glial fibrillary acidic protein (GFAP).

Other products marketed under SC Proven include total cell genomic DNA (gDNA), RNA and protein lysate reagents purified from homogenous stem cell populations for intra-comparative studies, such as Epigenetic fingerprinting, Southern, Western and Northern blots, PCR, RT-PCR, and microarrays. This range of purified stem cell line lysates includes:

Mouse embryonic stem (ES) cells propagated in proprietary SC Proven 2i inhibitor-based GS2-M media; and

Mouse ES cell-derived and fetal tissue-derived neural stem (NS) cells propagated in proprietary SC Proven RHB-A® media.

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Other Technologies

In addition to our cell therapeutics and research reagent programs, we hold a number of non-core technologies which we feel present important licensing opportunities. The most significant of these are likely to be certain proprietary technology within the Company for the generation of transgenic rats and for drug screening using stem and progenitor cells.

Transgenic Rat Program.

As part of our acquisition of assets from SCS in April 2009, we acquired exclusive rights to an intellectual property portfolio that broadly covers rat pluripotent stem cells, methods for using these cells to generate transgenic rats, and media for the culturing of these cells. This intellectual property was based upon research done at the University of Edinburgh, which showed for the first time the successful derivation and culture of true germline competent rat ES cells required for precise genetic engineering.

In August 2010, researchers demonstrated for the first time the creation of genetically modified rats using rat pluripotent cells that have been gene targeted via homologous recombination, a method which involves adding DNA sequences to the cells to delete (knock-out), add (knock-in) or otherwise modify genes of interest. This work resulted in the successful generation of knock-out rats missing the tumor suppressor gene p53 and served as a proof-of-principle for creating genetically engineered rats using rat ES cells. Prior to this breakthrough, these types of genetic manipulations were only possible in mice, and genetically engineered mice are widely used as disease models. While both mice and rats are used as animal models of human disease, aspects of the rat's physiology, behavior, and metabolism are closer to the human, making rats the preferred species for drug development and studying human disease. Moreover, the rat cells used to generate these genetically engineered rats were cultured using a proprietary 2i inhibitor-based media formulation marketed as part of our SC Proven line of specialty cell culture products under the product name GS1-R. GS1-R is the first and only commercially available medium shown to enable the derivation and long-term maintenance of the true rat pluripotent cells required for precise genetic manipulation.

We believe that over the past few years a number of researchers have used our rat pluripotent cell technology to derive different knock-out and knock-in rat models. And, over this time, the first of the patents in this portfolio issued (GB Patent No. 2451523), and the proprietary media patent application was allowed in Europe (EPO Patent No. 1999249). We are therefore exploring our rat pluripotent cell technology and our inhibitor-based media as important licensing and commercial opportunities.

Cell-based Assays for Drug Discovery and Development.

The pharmaceutical industry has recognized that cell-based assays could reduce the time and cost associated with drug discovery and development by providing a more predictive and physiologically relevant platform earlier in the development process. Today, pharmaceutical companies and other research institutions actively use human and animal cells in their drug discovery and development efforts, and they are increasingly interested in using stem cells for those efforts.

Because of our leading position in the neural stem cell field, our expertise and technologies may have utility in cell-based assay development efforts in the CNS field. For example, we have tested thousands of compounds on human neural stem cells and have identified a number of compounds that cause proliferation of these cells. We also believe that our hLEC cells may be useful in cell-based assays to test for liver toxicity. Liver toxicity is the most often cited cause of clinical trial failures and drug product withdrawals.

While we recently suspended our internal efforts in the drug assay field due to limited resources and our desire to focus on our therapeutic product development efforts, we nevertheless own or have exclusively licensed a number of patents related to technologies relevant to cell-based research, especially using either neural or liver

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cells. These include patents related to certain mammalian pluripotent and multipotent stem cells, cellular reprogramming, genetic manipulation of stem cells, the creation of genetically engineered animals used for research, technologies that facilitate the identification and isolation of specific stem cell types, and media formulations for the culture of stem cells. See Patents, Proprietary Rights and Licenses, below. We continue to explore ways of monetizing these assets for use in drug screening.

Contract Services and Supply Agreements

Our team members have been at the forefront of the research, development, manufacture and clinical translation of various different stem cells and cell-based therapies for over 20 years. We have demonstrated expertise in the development and implementation of state-of-the-art cell separation devices, bioreactors, closed systems and robotic platforms for manufacture of cells at the required scales. Leveraging this expertise, we now offer contract services for process development, process scale-up/scale-out and production, including use of our automated TAP Biosystems CompacT[®] SelecT Robotic platform.

In an extension of the process development and production services we have been contracted to scale-up and supply quantities of cell lines, reagents, cell line derivatives and assay protocols for use in client's drug development and other programs.

Our clients include the service division of a global biotechnology company developing new medicines, and a world-renowned scientific research institute.

Operations

Manufacturing

We have made considerable investments in our manufacturing operations. Our team includes world-recognized experts with proven track records in the development, manufacture and delivery of a range of different cell-based products. For clinical trials, our highly-qualified personnel manufacture cell products in clean room environments in compliance with current Good Manufacturing Practice (cGMP) and to quality standards that meet US as well as international regulatory requirements. By combining expertise and experience, we believe our expandable and bankable cell products can ultimately be manufactured and distributed at commercial-scale as stem cells in a bottle, much like an off-the-shelf pharmaceutical product. We believe we also have sufficient ability to manufacture the cell culture media and reagent products that we are currently selling commercially, and that we have sufficient resources to add additional media and reagent manufacturing capacity should the business need arise.

Marketing

Because of the early stage of our stem and progenitor cell-based therapeutic product development programs, we have not yet addressed questions of channels of distribution or marketing of potential future products. We sell and ship our proprietary cell culture products directly from our facility in Cambridge, U.K. Customers can order these products through our dedicated website (www.scproven.com). In addition, we have a number of co-exclusive distribution agreements with Millipore Corporation for the marketing and sale of certain of our cell culture products, including HEScGRO and ESGRO Complete.

Employees

As of December 31, 2011, we had 50 full-time employees, 12 of whom have Ph.D., M.D. or D.V.M. degrees. 40 full-time employees work in research and development and laboratory support services. No employees are covered by collective bargaining agreements. We consider our employee relations in general to be good.

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Patents, Proprietary Rights and Licenses

We believe that proprietary protection of our inventions will be critical to our future business. We vigorously seek out intellectual property that we believe might be useful in connection with our products, and have an active program of protecting our intellectual property. We may also from time to time seek to acquire licenses to important externally developed technologies.

We have exclusive or non-exclusive rights to a portfolio of patents and patent applications related to various stem and progenitor cells and methods of deriving and using them. These patents and patent applications relate to compositions of matter, methods of obtaining such cells, and methods for preparing, transplanting and utilizing these cells. We also own or have exclusive rights to exploit a number of patents that claim tools and techniques important to cell-based research. A number of these patents were acquired from SCS in April 2009.

Among our significant U.S. patents covering stem and progenitor cells are:

U.S. Patent No. 5,968,829, entitled Human CNS Neural Stem Cells, which covers our composition of matter for human CNS stem cells;

U.S. Patent No. 7,361,505, entitled Multipotent neural stem cell compositions, which covers mammalian neural stem cells derived from any tissue source, including embryonic, fetal, juvenile, or adult tissue;

U.S. Patent No. 7,153,686, entitled Enriched Central Nervous System Stem Cell and Progenitor Cell Populations, and Methods for Identifying, Isolating and Enriching such Populations, which claims the composition of matter of various antibody-selected neural stem cell populations;

U.S. Patent No. 6,777,233, entitled Cultures of Human CNS Neural Stem Cells, which discloses a neural stem cell culture with a doubling rate faster than days;

U.S. Patent No. 6,497,872, entitled Neural transplantation using proliferated multipotent neural stem cells and their progeny, which covers transplanting any neural stem cells or their differentiated progeny, whether the cells have been cultured in suspension or as adherent cells, for the treatment of any disease;

U.S. Patent No. 6,468,794, entitled Enriched central nervous system stem cell and progenitor cell populations, and methods for identifying, isolating and enriching for such populations, which covers the identification and purification of the human CNS stem cell;

U.S. Patent No. 5,851,832, entitled *In Vitro* growth and proliferation of multipotent neural stem cells and their progeny, which covers methods and compositions of proliferating and expanding human CNS cell cultures;

U.S. Patent No. 6,294,346, entitled Use of multipotent neural stem cells and their progeny for the screening of drugs and other biological agents, which describes the use of human neural stem cells as a tool for screening the effects of drugs and other biological agents on such cells, such as small molecule toxicology studies;

U.S. Patent No. 7,211,404, entitled Liver engrafting cells, assays, and uses thereof, which covers the isolation and use of an enriched population of hepatic liver engrafting cells; and

Among our significant U.S. patents covering cell-based research tools and technologies are:

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U.S. Patent Nos. 7,005,299 and 6,150,169, both entitled Expression of heterologous genes according to a targeted expression profile, which cover the use of a gene sequence called IRES (internal ribosome entry site), a pivotal technology to target exogeneous gene expression in stem cells, thereby facilitating their identification and use; and

U.S. Patent No. 6,878,542 and 7,256,041, both entitled Isolation, selection and propagation of animal transgenic stem cells, and U.S. Patent No. 6,146,888, entitled Method of enriching for mammalian stem cells, which cover the isolation of stem cells using a nucleic acid construct including a selectable marker.

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Of the fourteen patents identified above as being amongst significant patents, five are owned by us and nine are exclusively licensed to us. The table below sets out the anticipated expiration dates of these patents absent the grant of any patent term extension, whether under the Hatch Waxman Act (Pub. L. 98-417) or otherwise, which information will be included in our future 10-K filings:

Patents Owned	5,968,829 (2017); 7,153,686 (2019); 6,777,233 (2017); 6,468,794 (2019); 7,211,404 (2022)
Patents Exclusively Licensed (licensor included):	7,361,505 (NeuroSpheres, 2015); 6,497,872 (NeuroSpheres, 2019); 5,851,832 (NeuroSpheres, 2015); 6,294,346 (NeuroSpheres, 2018); 7,005,299 (University of Edinburgh 2014); 6,150,169 (University of Edinburgh 2014); 6,878,542 (University of Edinburgh 2014); 7,256,041 (University of Edinburgh 2014); 6,146,888 (University of Edinburgh 2014)

We also rely upon trade-secret protection for our proprietary information and know-how, and we take active measures to control access to this information. We believe that our know-how will also provide a significant competitive advantage.

Our policy is to require our employees, consultants and significant scientific collaborators and sponsored researchers to execute confidentiality agreements upon the commencement of any employment or consulting relationship with us. These agreements generally provide that all confidential information disclosed by us or developed during the course of the individual's relationship with us is to be kept confidential and not disclosed to third parties except in specific circumstances. In the case of employees and consultants, the agreements generally provide that all inventions conceived by the individual in the course of rendering services to us will be our exclusive property.

Licenses Agreements

Since inception, we have entered into a number of license agreements with academic organizations and commercial entities, including NeuroSpheres, Ltd. (Neurospheres), ReNeuron Ltd. (ReNeuron), Stem Cell Therapeutics Corp. (SCT), genOway SA (genOway), the University of Edinburgh, the California Institute of Technology (Cal Tech), Cambridge University, RIKEN Institute, and Oregon Health & Science University (OHSU), to either acquire or license out intellectual property rights. Under these license agreements, there are typically obligations of due diligence and the requirement to pay royalties on products that use patented technology licensed under these agreements. The license agreements with some of these institutions relate largely to stem or progenitor cells or to processes and methods for the isolation, identification, expansion, or culturing of stem or progenitor cells. Generally speaking, these license agreements will terminate upon expiration, revocation or invalidation of the licensed patents, unless governmental regulations require a shorter term. Typically, the licensee under each of these license agreements can terminate the agreement at any time upon notice. At this time, we do not believe the future success of our research and development efforts depend significantly on any particular license agreement or research collaboration. Nevertheless, we describe the more important license agreements below.

NeuroSpheres

In March 1994, we entered into a contract research and license agreement with NeuroSpheres, which was clarified in a license agreement dated as of April 1, 1997. Under the agreement as clarified, we obtained an exclusive patent license from NeuroSpheres in the field of transplantation, subject to a limited right of NeuroSpheres to purchase a nonexclusive license from us, which right was not exercised and has expired. We have developed additional intellectual property relating to the subject matter of the license. We entered into an additional license agreement with NeuroSpheres as of October 30, 2000, under which we obtained an exclusive license in the field of non-transplant uses, such as drug discovery and drug testing and clarified our rights under NeuroSpheres patents for generating cells of the blood and immune system from neural stem cells. Together, our

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rights under the licenses are exclusive for all uses of the technology. All of the product-based royalty rates in the license agreement between the Company and NeuroSpheres are in the single digits. We made up-front payments to NeuroSpheres of 6,500 shares of our common stock in October 2000 and \$50,000 in January 2001, and we will make additional cash payments when milestones are achieved under the terms of the October 2000 agreement. In addition, in October 2000 we reimbursed NeuroSpheres for patent costs amounting to \$341,000. Milestone payments, payable at various stages in the development of potential products, would total \$500,000 for each product that is approved for market. In addition, beginning in 2004, annual payments of \$50,000 became due, payable by the last day of the year and fully creditable against royalties due to NeuroSpheres under the October 2000 Agreement. Our agreements with NeuroSpheres will terminate at the expiration of all patents licensed to us, but can terminate earlier if we breach our obligations under the agreement and do not cure the breach, or if we declare bankruptcy.

In July 2008, we amended our 1997 and 2000 license agreements with NeuroSpheres. Six of the patents covered by the license agreements are the basis of our patent infringement suits against Neuralstem. Under the terms of the amendment, we agreed to pay all reasonable litigation costs, expenses and attorney's fees incurred by NeuroSpheres in the declaratory judgment suit between us and Neuralstem. In return, we are entitled to off-set all litigation costs incurred in that suit against amounts that would otherwise be owed under the license agreements, such as annual maintenance fees, milestones and royalty payments.

University of Edinburgh

In January 2006, we entered into an exclusive, world-wide license agreement with the University of Edinburgh covering approximately twelve separate patent families in the stem cell field. Since then, the parties added some additional patent families and dropped some patent families which were not considered core to our business activities. Today, the license agreement patent families, including several that cover culture media and research technologies, one that covers purified populations of neural stem cells, some that cover cell reprogramming technologies, and one that covers the manipulation and use of embryonic stem cells for the derivation of research animal models, such as knock-out rats, with one or more missing genes. Under the license agreement, we have the exclusive right to commercialize the technologies in all fields. We have been paying royalties to the University of Edinburgh on the commercial sale of certain SC Proven products, and will pay royalties on all net sales of products covered by any of the intellectual property licensed under this agreement. All of the product-based royalty rates in the license agreement between the Company and the University of Edinburgh are in the single digits and there are no provisions under the University of Edinburgh license agreement for the payment of potential milestones by the Company.

ReNeuron

In July 2005, we entered into an agreement with ReNeuron under which we granted ReNeuron a license that allows ReNeuron to exploit its c-mycER conditionally immortalized adult human neural stem cell technology for therapy and other purposes. We received shares of ReNeuron common stock, as well as a cross-license to the exclusive use of ReNeuron's technology for certain diseases and conditions, including lysosomal storage diseases, spinal cord injury, cerebral palsy, and multiple sclerosis. The agreement also provides for full settlement of any potential claims that either we or ReNeuron might have had against the other in connection with any putative infringement of certain of each party's patent rights prior to the effective date of the agreement. As part of the agreement, we received in aggregate, approximately 10,097,000 ordinary shares of ReNeuron common stock, net of approximately 122,000 shares that were transferred to NeuroSpheres. Between 2007 and 2011, we sold our entire holdings of shares of ReNeuron common stock for aggregate net proceeds of approximately \$3,743,000. As of June 30, 2011, we no longer hold any shares of ReNeuron.

Stem Cell Therapeutics

In August 2006, we entered into an agreement with Stem Cell Therapeutics, a Canadian corporation listed on the Toronto Stock Exchange, granting it a non-exclusive, royalty-bearing license to use several of our patents for treating specified diseases of the central nervous system; the grant does not include any rights to cell

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transplantation. SCT granted us a royalty-free non-exclusive license to certain of its patents for research and development and a royalty-bearing non-exclusive license for certain commercial purposes. SCT paid an up-front license fee; the license also provides for other payments including annual maintenance, milestones and royalties.

genOway

In October 2008, we entered into a license agreement with genOway, a leading transgenics company located in France, in which we granted a non-exclusive sublicense to genOway for the use of Internal Ribosome Entry Site (IRES) technology. The IRES technology enables the dual expression of a protein of interest and a selectable marker, thereby enabling researchers to genetically modify any mammalian cell and monitor the activity of a particular gene of interest in living cells or tissues without blocking the normal function of the gene. The IRES technology is particularly important for evaluating the success of gene knock-outs or knock-ins in stem cells and for the successful creation of transgenic rodent disease models. The IRES technology has been used to develop hundreds of genetically modified models in the past decade, and the technology is now considered to be the reference technology for transgene expression in some key rodent animal models, such as humanized models, reporter model, and cell trafficking models. The IRES technology is covered by one of the patent families exclusively licensed to us by the University of Edinburgh, specifically U.S. Patents No. 7,005,299 and 6,150,169 and their foreign counterparts.

In March 2012, we agreed to amend the genOway license agreement to give genOway exclusive worldwide rights, including a right to grant sublicenses, under the IRES patent family in order to commercialize transgenic mice, and provide related services such as the genetic engineering of such mice. Under this exclusive license agreement, as amended, we are to receive a six figure lump sum payment in lieu of annual maintenance fees, as well as single digit royalties on licensed products and services.

Other Commercial Licenses

We have approximately fifteen other license agreements with commercial entities, which we entered into in the ordinary course of business to monetize certain of our patents. A number of these include sublicenses to certain patents exclusively licensed to us from either NeuroSpheres or the University of Edinburgh. Some of these are license agreements to commercialize cells. A number of these are license agreements to our research tools patents, such as the IRES and selectable marker technologies described above. We have an on-going licensing program at the Company with the goal of identifying likely infringers of our intellectual property rights in order to generate license revenues.

Scientific Advisory Board

Members of our Scientific Advisory Board provide us with strategic guidance primarily in regard to our therapeutic products research and development programs, as well as assistance in recruiting employees and collaborators. Each Scientific Advisory Board member has entered into a consulting agreement with us. These consulting agreements specify the compensation to be paid and require that all information about our products and technology be kept confidential. All of the Scientific Advisory Board members are employed by employers other than us and may have commitments to, or consulting or advising agreements with, other entities that limit their availability to us. The Scientific Advisory Board members have generally agreed, however, for so long as they serve as consultants to us, not to provide any services to any other entities that would conflict with the services the member provides to us. We are entitled to terminate the arrangements if we determine that there is such a conflict.

The following persons are members of our Scientific Advisory Board:

Irving L. Weissman, M.D., Chairman of our Scientific Advisory Board, is the Virginia and Daniel K. Ludwig Professor of Cancer Research, Professor of Pathology and Professor of Developmental Biology at Stanford University, Director of the Stanford University Institute for Stem Cell Biology and Regenerative Medicine, and Director of the Stanford Ludwig Center for Cancer Stem Cell Research and Medicine, all

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in Stanford, California. Dr. Weissman's lab was responsible for the discovery and isolation of the first ever mammalian tissue stem cell, the hematopoietic (blood-forming) stem cell. Dr. Weissman was responsible for the formation of three stem cell companies, SyStemix, Inc., StemCells, Inc. and Cellerant, Inc. Dr. Weissman co-discovered the mammalian and human hematopoietic stem cells and the human neural stem cell. He has extended these stem cell discoveries to cancer and leukemia, discovering the leukemic stem cells in human and mouse acute or blast crisis myeloid leukemias, and has enriched the cancer stem cells in several human brain cancers as well as human head and neck squamous cell carcinoma. Past achievements of Dr. Weissman's laboratory include identification of the states of development between stem cells and mature blood cells, the discovery and molecular isolation and characterization of lymphocyte and stem cell homing receptors, and identification of the states of thymic lymphocyte development. His laboratory at Stanford has developed accurate mouse models of human leukemias, and has shown the central role of inhibition of programmed cell death in that process. He has also established the evolutionary origins of pre-vertebrate stem cells, and identified and cloned the transplantation genes that prevent their passage from one organism to another. Dr. Weissman has been elected to the National Academy of Science, the Institute of Medicine of the National Academies, the American Academy of Arts and Sciences, the American Society of Microbiology, and several other societies. He has received the Kaiser Award for Excellence in Preclinical Teaching, the Pasarow Foundation Award for Cancer Research, the California Scientist of the Year (2002), the Kovalenko Medal of the National Academy of Sciences, the Elliott Joslin Medal for Diabetes Research, the de Villiers Award for Leukemia Research, the Irvington Award for Immunologist of the Year, the Bass Award of the Society of Neurosurgeons, the New York Academy of Medicine Award for Medical Research, the Alan Cranston Award for Aging Research, the Linus Pauling Award for Biomedical Research, the E. Donnell Thomas Award for Hematology Research, the van Bekkum Award for Stem Cell Research, the Outstanding Investigator Award from the National Institutes of Health, Robert Koch Award for research in the hemopoietic system, and many other awards. In 2010, Dr. Weissman was appointed as an Honorary Director of the Center for Biotech and BioMedicine and the Shenzhen Key Lab of Gene and Antibody Therapy at the Graduate School of Shenzhen at Tsinghua University. He was also appointed as an Honorary Professor at Peking Union Medical College and an Honorary Investigator at the State Key Laboratory of Experimental Hematology, Institute of Hematology and Blood Disease Hospital at the Chinese Academy of Medical Sciences and Peking Union Medical College. In 2011, Dr. Weissman was elected to the National Academy of Sciences Council.

David J. Anderson, Ph.D., is Seymour Benzer Professor of Biology, California Institute of Technology, Pasadena, California and Investigator, Howard Hughes Medical Institute. His laboratory was the first to isolate a multipotent, self-renewing, stem cell for the peripheral nervous system, the first to identify instructive signals that promote the differentiation of these stem cells along various lineages, and the first to accomplish a direct purification of peripheral neural stem cells from uncultured tissue. Dr. Anderson's laboratory also was the first to isolate transcription factors that act as master regulators of neuronal fate. More recently, he has identified signals that tell a neural stem cell to differentiate to oligodendrocytes, the myelinating glia of the central nervous system, as well as factors for astrocyte differentiation. Dr. Anderson is a co-founder of the Company and was a founding member of the scientific advisory board of the International Society for Stem Cell Research. Dr. Anderson also serves on the scientific advisory board of Allen Institute for Brain Science. He has held a presidential Young Investigator Award from the National Science Foundation, a Sloan Foundation Fellowship in Neuroscience, and has been Donald D. Matson lecturer at Harvard Medical School. He has received the Charles Judson Herrick Award from the American Association of Anatomy, the 1999 W. Alden Spencer Award in Neurobiology from Columbia University, and the Alexander von Humboldt Foundation Award. Dr. Anderson has been elected to the National Academy of Science and is a member of the American Academy of Arts and Sciences.

Fred H. Gage, Ph.D., is Professor, Laboratory of Genetics, The Salk Institute for Biological Studies, La Jolla, California and Adjunct Professor, Department of Neurosciences, University of California, San Diego, California. Dr. Gage's lab was the first to discover Neurogenesis in the adult human brain.

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His research focus is on the development of strategies to induce recovery of function following central nervous system damage. Dr. Gage is a co-founder of StemCells and of BrainCells, Inc., and a member of the scientific advisory board of each. Dr. Gage also serves on the Scientific Advisory Board of Ceregene, Inc, and he is a founding member of the scientific advisory board of the International Society for Stem Cell Research. Dr. Gage has been the recipient of numerous awards, including the 1993 Charles A. Dana Award for Pioneering Achievements in Health and Education, the Christopher Reeves Medal, the Decade of the Brain Medal, the Max-Planck research Prize, and the Pasarow Foundation Award. Professor Gage is a member of the Institute of Medicine, a member of the National Academy of Science, and a Fellow of the American Academy of Arts and Science.

Government Regulation

Our research and development activities and the future manufacturing and marketing of our potential therapeutic products are, and will continue to be, subject to regulation for safety and efficacy by numerous governmental authorities in the United States and other countries.

U.S. Regulations

In the United States, pharmaceuticals, biologicals and medical devices are subject to rigorous regulation by the U.S. Food and Drug Administration (FDA). The Federal Food, Drug and Cosmetic Act, the Public Health Service Act, applicable FDA regulations, and other federal and state statutes and regulations govern, among other things, the testing, manufacture, labeling, storage, export, record keeping, approval, marketing, advertising, and promotion of our potential products. Product development and approval within this regulatory framework takes a number of years and involves significant uncertainty combined with the expenditure of substantial resources. In addition, many jurisdictions, both federal and state, have restrictions on the use of fetal tissue.

FDA Marketing Approval

The steps required before our potential therapeutic products may be marketed in the United States include:

Steps	Considerations
1. Preclinical laboratory and animal tests	Preclinical tests include laboratory evaluation of the cells and the formulation intended for use in humans for quality and consistency. <i>In vivo</i> studies are performed in normal animals and specific disease models to assess the potential safety and efficacy of the cell therapy product.
2. Submission of an Investigational New Drug (IND) application	The IND is a regulatory document submitted to the FDA with preclinical and manufacturing data, a proposed development plan and a proposed protocol for a study in humans. The IND becomes effective 30 days following receipt by the FDA, provided there are no questions, requests for delay or objections from the FDA. If the FDA has questions or concerns, it notifies the sponsor, and the IND will then be on clinical hold until the sponsor responds satisfactorily. In general an IND must become effective before U.S. human clinical trials may commence.

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3. Human clinical trials

Clinical trials involve the evaluation of a potential product under the supervision of a qualified physician, in accordance with a protocol that details the objectives of the study, the parameters to be used to monitor safety and the efficacy criteria to be evaluated. Each protocol is submitted to the FDA as part of the IND. The protocol for each clinical study must be approved by an independent Institutional Review Board (IRB) of the institution at which the study is conducted and the informed consent of all participants must be obtained. The IRB reviews the existing information on the product, considers ethical factors, the safety of human subjects, the potential benefits of the therapy, and the possible liability of the institution. The IRB is responsible for ongoing safety assessment of the subjects during the clinical investigation.

Clinical development is traditionally conducted in three sequential phases, Phase I, II and III.

Phase I studies for a product are designed to evaluate safety in a small number of subjects in a selected patient population by assessing adverse effects, and may include multiple dose levels. This study may also gather preliminary evidence of a beneficial effect on the disease.

Phase II studies typically involve a larger, but still limited, patient population to determine biological and clinical effects of the investigational product and to identify possible adverse effects and safety risks of the product in the selected patient population.

Phase III studies are undertaken to demonstrate clinical benefit or effect in a statistically significant manner and to test further for safety within a broader patient population, generally at multiple study sites.

The FDA continually reviews the clinical trial plans and results and may suggest changes or may require discontinuance of any trial at any time if significant safety issues arise.

4. Submission of a Biologics Licensing Application (BLA)

The results of the preclinical studies and clinical studies are submitted to the FDA in an application for marketing approval authorization.

5. Regulatory Approval

The testing and approval process will require substantial time, effort and expense. The time for approval is affected by a number of factors, including relative risks and benefits demonstrated in clinical trials, the availability of alternative treatments and the severity of the disease. Additional animal studies

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or clinical trials may be requested during the FDA review period, which might add to that time. FDA approval of the application(s) is required prior to any commercial sale or shipment of the therapeutic product. Biologic product manufacturing facilities located in certain states also may be subject to separate regulatory and licensing requirements.

6. Post-marketing studies

After receiving FDA marketing approval for a product for an initial indication, further clinical trials may be required to gain approval for the use of the product for additional indications. The FDA may also require post-marketing testing and surveillance to monitor for adverse effects, which could involve significant expense, or the FDA may elect to grant only conditional approvals subject to collection of post-marketing data.

FDA Manufacturing Requirements

Among the conditions for product licensure is the requirement that the prospective manufacturer's quality control and manufacturing procedures conform to the FDA's current good manufacturing practice (GMP) requirements. Even after a product's licensure approval, its manufacturer must comply with GMP on a continuing basis, and what constitutes GMP may change as the state of the art of manufacturing changes. Domestic manufacturing facilities are subject to regular FDA inspections for GMP compliance, which are normally held at least every two years. Foreign manufacturing facilities are subject to periodic FDA inspections or inspections by the foreign regulatory authorities. Domestic manufacturing facilities may also be subject to inspection by foreign authorities.

Orphan Drug Act

The Orphan Drug Act provides incentives to drug manufacturers to develop and manufacture drugs for the treatment of diseases or conditions that affect fewer than 200,000 individuals in the United States. Orphan drug status can also be sought for treatments for diseases or conditions that affect more than 200,000 individuals in the United States if the sponsor does not realistically anticipate its product becoming profitable from sales in the United States. We may apply for orphan drug status for certain of our therapies. Under the Orphan Drug Act, a manufacturer of a designated orphan product can seek tax benefits, and the holder of the first FDA approval of a designated orphan product will be granted a seven-year period of marketing exclusivity in the United States for that product for the orphan indication. While the marketing exclusivity of an orphan drug would prevent other sponsors from obtaining approval of the same compound for the same indication, it would not prevent other compounds or products from being approved for the same use including, in some cases, slight variations on the originally designated orphan product.

FDA Human Cell and Tissue Regulations

Our research and development is based on the use of human stem and progenitor cells. The FDA has initiated a risk-based approach to regulating Human Cell, Tissue and Cellular and Tissue-based (HCT/P) products and has published current Good Tissue Practice (GTP) regulations. As part of this approach, the FDA has published final rules for registration of establishments that recover, process, store, label, package, or distribute HCT/P products or that screen or test the donor of HCT/P products, and for the listing of such products. In addition, the FDA has published rules for determining the suitability of donors of cells and tissue, the eligibility of the cells and tissues for clinical use and for current good tissue practice for manufacturers using them. We have adopted policies and procedures to comply with these regulations.

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Other Regulations

In addition to safety regulations enforced by the FDA, we are also subject to regulations under the Occupational Safety and Health Act, the Environmental Protection Act, the Toxic Substances Control Act, and other present and potential future foreign, federal, state, and local regulations.

International Law

Outside the United States, we will be subject to regulations that govern the import of drug products from the United States or other manufacturing sites and foreign regulatory requirements governing human clinical trials and marketing approval for our products. The requirements governing the conduct of clinical trials, product licensing, pricing, and reimbursements vary widely from country to country. In particular, the European Union (EU) is revising its regulatory approach to biotechnology products, and representatives from the United States, Japan and the EU are in the process of harmonizing and making more uniform the regulations for the registration of pharmaceutical products in these three markets. This process increases uncertainty over regulatory requirements in our industry. Furthermore, human stem and progenitor cells may be regulated in the EU and other countries as transplant material or as a somatic cell therapy medicinal product, depending on the processing, indication and country.

Environment

We have made, and will continue to make, expenditures for environmental compliance and protection. Expenditures for compliance with environmental laws have not had, and are not expected to have, a material effect on our capital expenditures, results of operations or competitive position.

Reimbursement and Health Care Cost Control

Reimbursement for the costs of treatments and products such as ours from government health administration authorities, private health insurers and others, both in the United States and abroad, is a key element in the success of new health care products. Significant uncertainty often exists as to the reimbursement status of newly approved health care products.

The revenue and profitability of some health care-related companies have been affected by the continuing efforts of governmental and third party payors to contain or reduce the cost of health care through various means. Payors are increasingly attempting to limit both coverage and the levels of reimbursement for new therapeutic products approved for marketing by the FDA, and are refusing, in some cases, to provide any coverage for uses of approved products for disease indications for which the FDA has not granted marketing approval. In certain foreign markets, pricing or profitability of prescription pharmaceuticals is subject to government control. In the United States, there have been a number of federal and state proposals to implement government control over health care costs.

The U.S. Patient Protection and Affordance Care Act and the Health Care and Education Reconciliation Act were signed into law in March 2010. A number of provisions of those laws require further rulemaking action by governmental agencies to implement. The laws change access to health care products and services and create new fees for the pharmaceutical and medical device industries. Future rulemaking could increase rebates, reduce prices or the rate of price increases for health care products and services, or require additional reporting and disclosure. The laws also include new authorization to the FDA to approve companies to market biosimilar products within the United States, although biosimilar regulation and rulemaking has not yet been adopted. We cannot predict the timing or impact of any such future rulemaking on our business.

Competition

In most instances, the targeted indications for our initial products in development have no effective long-term therapies at this time. However, we do expect that our initial products will have to compete with a variety of therapeutic products and procedures. Other pharmaceutical and biotechnology companies currently offer a

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number of pharmaceutical products to treat lysosomal storage diseases, neurodegenerative and liver diseases, and other diseases for which our technologies may be applicable. Many pharmaceutical and biotechnology companies are investigating new drugs and therapeutic approaches for the same purposes, which may achieve new efficacy profiles, extend the therapeutic window for such products, alter the prognosis of these diseases, or prevent their onset. We believe that our products, when and if successfully developed, will compete with these products principally on the basis of improved and extended efficacy and safety and their overall economic benefit to the health care system. The market for therapeutic products that address degenerative diseases is large and competition is intense. Many companies have significant products approved or in development that could be competitive with our potential products. We expect competition to increase.

Competition for any stem and progenitor cell products that we may develop may be in the form of existing and new drugs, other forms of cell transplantation, ablative and simulative procedures, medical devices, and gene therapy. We believe that some of our competitors are also trying to develop stem and progenitor cell-based technologies. We may also face competition from companies that have filed patent applications relating to the use of genetically modified cells to treat disease, disorder or injury. In the event our therapies should require the use of such genetically modified cells, we may be required to seek licenses from these competitors in order to commercialize certain of our proposed products, and such licenses may not be granted.

If we develop products that receive regulatory approval, they would then have to compete for market acceptance and market share. For certain of our potential products, an important success factor will be the timing of market introduction of competitive products. This is a function of the relative speed with which we and our competitors can develop products, complete the clinical testing and approval processes, and supply commercial quantities of a product to market. These competitive products may also impact the timing of clinical testing and approval processes by limiting the number of clinical investigators and patients available to test our potential products.

We expect that all of these products will compete with our potential stem and progenitor cell-based products based on efficacy, safety, cost, and intellectual property positions. While we believe that these will be the primary competitive factors, other factors include, in certain instances, obtaining marketing exclusivity under the Orphan Drug Act, availability of supply, manufacturing, marketing and sales expertise and capability, and reimbursement coverage.

The research markets served by our tools and technologies are highly competitive, complex and dynamic. Technological advances and scientific discoveries have accelerated the pace of change in biological research, and stem cell technologies have been evolving particularly fast. In these markets we face a wide array of competitors, ranging from specialized companies with strengths in niche segments of the life science markets to large manufacturers offering a broad portfolio of products, tools and services. Many of these competitors have significant financial, operational, sales, and marketing resources, and experience in research and development. In some cases, these and other competitors are also our customers, distributors and suppliers. In addition, many of our products can be home brewed by customers following publicly available procedures and methodologies.

Reliable independent information on sales and market share of products produced by our competitors is not generally available. We believe, however, based on our own estimates, that no one company is so dominant that it prevents other companies from competing effectively. We compete mainly by focusing on specialty products, which are custom designed for use in stem cell-based research, where we believe our expertise, intellectual property and reputation give us competitive advantage. We believe that, in this particular market niche, our products and technologies offer customers specific advantages over those offered by our competitors. We compete by offering innovative, quality-controlled products, consistently made and designed to produce reproducible results. We continue to make investments in research and development, quality management, quality improvement, and product innovation. We tend to avoid head to head competition against entrenched competitors with commoditized products.

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Reverse Stock Split

We effected a 1-for-10 reverse stock split on July 6, 2011. As a result of the reverse stock split, the outstanding shares of common stock issued and outstanding were reduced from approximately 139 million to 13.9 million. Concurrent with the reverse stock split, we reduced the authorized number of common shares from 250 million to 75 million. The reverse stock split proportionately reduced all issued and outstanding shares of our common stock, as well as common stock underlying stock options, warrants and other common stock based equity grants outstanding immediately prior to the effectiveness of the reverse stock split. The exercise price on outstanding equity-based grants was proportionately increased, and the number of shares available under our equity-based plans was proportionately reduced. Share and per share data (except par value) for the periods presented reflect the effects of this reverse stock split. References to numbers of shares of common stock and per share data in the accompanying financial statements and notes thereto have been adjusted to reflect the reverse stock split on a retroactive basis.

Available Information

The following information can be obtained free of charge through our website at <http://www.stemcellsinc.com> or by sending an e-mail message to irpr@stemcellsinc.com:

our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to these reports as soon as reasonably practicable after such material is electronically filed with the Securities and Exchange Commission;

our policies related to corporate governance, including StemCells' Code of Conduct and Ethics and Procedure for Submission of Complaints; and

the charters of the Audit Committee, the Compensation & Stock Option Committee and the Corporate Governance & Nominating Committee of our Board of Directors.

The public may read and copy any material we file with the SEC at the SEC's Public Reference Room at 100 F Street, N.E., Washington, DC, 20549. The public may obtain information on the operations of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site, <http://www.sec.gov>, which contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC.

Item 1A. RISK FACTORS

This annual report on Form 10-K contains forward-looking statements that involve risks and uncertainties. Our business, operating results, financial performance, and share price may be materially adversely affected by a number of factors, including but not limited to the following risk factors, any one of which could cause actual results to vary materially from anticipated results or from those expressed in any forward-looking statements made by us in this annual report on Form 10-K or in other reports, press releases or other statements issued from time to time. Additional factors that may cause such a difference are set forth elsewhere in this annual report on Form 10-K.

Risks Related to our Business

Any adverse development relating to our HuCNS-SC product candidate, such as a significant clinical trial failure, could substantially depress our stock price and prevent us from raising additional capital.

At present, our ability to progress as a company is significantly dependent on a single product candidate, our HuCNS-SC cells (purified human neural stem cells), and on early stage clinical trials. Any clinical, regulatory or other development that significantly delays or prevents us from completing any of our trials, any material safety issue or adverse side effect to any study participant in any of these trials, or the failure of these trials to show the

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results expected would likely depress our stock price significantly and could prevent us from raising the substantial additional capital we will need to further develop our cell technologies. Moreover, any material adverse occurrence in our first clinical trials could substantially impair our ability to initiate additional clinical trials to test our HuCNS-SC cells, whether in other potential indications or otherwise. This, in turn, could adversely impact our ability to raise additional capital and pursue our planned research and development efforts.

We have limited capital resources and we may not obtain the significant additional capital needed to sustain our research and development efforts.

We have limited liquidity and capital resources and must obtain significant additional capital resources in order to sustain our product development efforts, acquire businesses, technologies and intellectual property rights which may be important to our business, continue preclinical and clinical testing of our therapeutic products, pursue regulatory approvals, acquire capital equipment, laboratory and office facilities, establish production capabilities, maintain and enforce our intellectual property portfolio, and support our general and administrative expenses and other working capital requirements. In addition, we will require additional capital resources to continue to develop and grow our enabling cell technologies programs. We rely on cash reserves and proceeds from equity and debt offerings, proceeds from the transfer, license, lease, or sale of our intellectual property rights, equipment, facilities, or investments, and government grants and funding from collaborative arrangements, if obtainable, to fund our operations.

We intend to pursue opportunities for additional fundraising in the future through equity or debt financings, corporate alliances or combinations, grants or collaborative research arrangements, sales or dispositions of assets, or any combination of these. However, external financing in the current financial environment may be particularly difficult, and the source, timing and availability of any future fundraising will depend principally upon market conditions, and, more specifically, on progress in our research, preclinical and clinical development programs. Funding may not be available when needed at all or on terms acceptable to us. While we actively manage our programs and resources in order to conserve cash between fundraising opportunities, our existing capital resources may not be sufficient to fund our operations beyond the next twelve months. Lack of necessary funds may require us, among other things, to delay, scale back or eliminate some or all of our research and product development programs, planned clinical trials, and/or our capital expenditures or to license our potential products or technologies to third parties. If we exhaust our cash reserves and are unable to realize adequate additional fundraising, we may be unable to meet operating obligations and be required to initiate bankruptcy proceedings or delay, scale back or eliminate some or all of our research and product development programs.

Our product development programs are based on novel technologies and are inherently risky.

We are subject to the risks of failure inherent in the development of products based on new technologies. The novel nature of these therapies creates significant challenges in regard to product development and optimization, manufacturing, government regulation, third party reimbursement, and market acceptance. For example, the pathway to regulatory approval for cell-based therapies, including our therapeutic product candidates, may be more complex and lengthy than the pathway for conventional drugs. These challenges may prevent us from developing and commercializing products on a timely or profitable basis or at all.

Our technologies are at early stages of discovery and development, and we may fail to develop any commercially acceptable or profitable products.

We have incurred significant operating losses and negative cash flows since inception. We have not achieved profitability and may not be able to realize sufficient revenue to achieve or sustain profitability in the future. We have yet to develop any therapeutic products that have been approved for marketing, and we do not expect to become profitable within the next several years, but rather expect to incur additional and increasing operating losses. Before commercializing any therapeutic product, we will need to obtain regulatory approval from the FDA or from equivalent foreign agencies after conducting extensive preclinical studies and clinical

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trials that demonstrate that the product candidate is safe and effective. Except for the Phase I NCL and Phase I PMD trials we completed, and our currently ongoing Phase I/II clinical trial in spinal cord injury, we have had no experience conducting human clinical trials. We expect that none of our cell-based therapeutic product candidates will be commercially available for several years, if at all.

While regulatory agencies in the United States and Switzerland have approved the clinical study of our cells in a total of four indications, there can be no assurance that any of our clinical trials will be completed or result in a successful outcome.

We may elect to delay or discontinue studies or clinical trials based on unfavorable results. Any product developed from, or based on, cell technologies may fail to:

survive and persist in the desired location;

provide the intended therapeutic benefit;

engraft into existing tissue in the desired manner; or

achieve therapeutic benefits equal to, or better than, the standard of treatment at the time of testing.

In addition, our therapeutic products may cause undesirable side effects. Results of preclinical research in animals may not be indicative of future clinical results in humans.

Ultimately if regulatory authorities do not approve our products or if we fail to maintain regulatory compliance, we would be unable to commercialize our products, and our business and results of operations would be harmed. Even if we do succeed in developing products, we will face many potential obstacles such as the need to develop or obtain manufacturing, marketing and distribution capabilities. Furthermore, because transplantation of cells is a new form of therapy, the marketplace may not accept any products we may develop.

Moreover, because our cell-based therapeutic products will be derived from tissue of individuals other than the patient (that is, they will be non-self or allogeneic transplant products), patients will likely require the use of immunosuppressive drugs. While immunosuppression is now standard in connection with allogeneic transplants of various kinds, such as heart or liver transplants, long-term maintenance on immunosuppressive drugs can result in complications such as infection, cancer, cardiovascular disease, and renal dysfunction. An immunosuppression regimen was used with our therapeutic product candidate in all our clinical trials to date, and is included in the protocol for our clinical trial for dry age-related macular degeneration.

Our success will depend in large part on our ability to develop and commercialize products that treat diseases other than Pelizeaus-Merzbacher Disease (PMD), NCL or other rare diseases.

Although our initial clinical trials have initially focused on evaluating our neural stem cell product for the treatment of infantile and late infantile NCL (Batten disease) and for Pelizeaus-Merzbacher Disease, these diseases are rare and the markets for treating these diseases are small. Accordingly, even if we obtain marketing approval for our HuCNS-SC product candidate for NCL or for PMD, in order to achieve profitability, we will likely need to obtain approval to treat additional diseases that present more significant market opportunities.

Acquisitions of companies, businesses or technologies may substantially dilute our stockholders and increase our operating losses.

We may make acquisitions of businesses, technologies or intellectual property rights or otherwise modify our business model in ways we believe to be necessary, useful or complementary to our current business. For example, in April 2009, we acquired substantially all of the operating assets and liabilities of Stem Cell Sciences Plc (SCS). Any such acquisition or change in business activities may require assimilation of the operations, products or product candidates and personnel of the acquired business and the training and integration of its

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employees, and could substantially increase our operating costs, without any offsetting increase in revenue. Acquisitions may not provide the intended technological, scientific or business benefits and could disrupt our operations and divert our limited resources and management's attention from our current operations, which could harm our existing product development efforts. We would likely issue equity securities to pay for any other future acquisitions. The issuance of equity securities for an acquisition could be substantially dilutive to our stockholders. Any investment made in, or funds advanced to, a potential acquisition target could also significantly adversely affect our results of operation and could further reduce our limited capital resources. Any acquisition or action taken in anticipation of a potential acquisition or other change in business activities could substantially depress the price of our stock. In addition, our results of operations may suffer because of acquisition-related costs or the post-acquisition costs of funding the development of an acquired technology or product candidates or operation of the acquired business, or due to amortization or impairment costs for acquired goodwill and other intangible assets. In December 2011, for example, we determined that the intangible in-process research and development (IPR&D) asset related to the assays technology was impaired. In part because of management's decision to focus on our therapeutic product development programs and not to allocate time and resources to the assays program, we determined that we could not predict the future cash flows from this asset and that the approximately \$655,000 carrying value of the asset should be written-off in full.

Costs and disruptions from the management of the acquired SCS business may impair our business.

In April 2009, we acquired substantially all of the operating assets and liabilities of SCS, including its former subsidiaries in England and Australia. To realize the anticipated benefits of this acquisition, we must successfully manage and coordinate business operations in multiple geographies, which is a complex, costly and time-consuming process. Therefore we devote a significant amount of our management's time and attention to managing our operations outside the United States. As a result, we may have difficulty maintaining employee morale and retaining key employees, consultants and collaborators. We may also encounter incompatible methods, practices or policies or unanticipated difficulties integrating information technology, communications and other systems. Managing our consolidated operations may also entail numerous operational, legal and financial risks and uncertainties.

We have payment obligations resulting from real property owned or leased by us in Rhode Island, which diverts funding from our cell-based therapeutics research and development and enabling cell technologies programs.

Prior to our reorganization in 1999 and the consolidation of our business in California, we carried out our former encapsulated cell therapy programs in Lincoln, Rhode Island, where we also had our administrative offices. Although we have vacated the Rhode Island facilities, we remain obligated to make lease payments and payments for operating costs for our former science and administrative facility, which we have leased through June 30, 2013. These costs, before sub-tenant rental income, amounted to approximately \$1,863,000 in 2011; our rent payments will increase over the term of the lease, and our operating costs may increase as well. In addition to these costs of our former science and administrative facility, we are obligated to make debt service payments and payments for operating costs of approximately \$400,000 per year for our former encapsulated cell therapy pilot manufacturing facility, which we own. We have currently subleased a portion of the science and administrative facility, and we are seeking to sublease the remaining portion, but we cannot be sure that we will be able to keep any part of the facility subleased for the duration of our obligation. We are currently seeking to sublease the pilot manufacturing facility, but may not be able to sublease or sell the facility in the future. These continuing costs significantly reduce our cash resources and adversely affect our ability to fund further development of our cell technologies. In addition, changes in real estate market conditions and assumptions regarding the length of time it may take us to either fully sublease, assign or sell our remaining interest in the our former research facility in Rhode Island may have a significant impact on and cause large variations in our quarter to quarter results of operations. In 1999, in connection with exiting our former research facility in Rhode Island, we created a reserve for the estimated lease payments and operating expenses related to it. The reserve is periodically re-evaluated and adjusted based on assumptions relevant to real estate market conditions and the

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estimated time until we can either fully sublease, assign or sell our remaining interests in the property. At December 31, 2011, the reserve was \$2,135,000. For the year 2011, we incurred \$1,248,000 in operating expenses net of sub-tenant income for this facility. Expenses for this facility will fluctuate based on changes in tenant occupancy rates and other operating expenses related to the lease. Even though it is our intent to sublease, assign, sell, or otherwise divest ourselves of our interests in the facility at the earliest possible time, we cannot determine with certainty a fixed date by which such events will occur. In light of this uncertainty, based on estimates, we will periodically re-evaluate and adjust the reserve, as necessary, and we may make significant adverse adjustments to the reserve in the future.

We may be unable to obtain partners to support our product development efforts when needed to commercialize our technologies.

Equity and debt financings alone may not be sufficient to fund the cost of developing our cell technologies, and we may need to rely on partnering or other arrangements to provide financial support for our product development efforts. In addition, in order to successfully develop and commercialize our technologies, we may need to enter into various arrangements with corporate sponsors, pharmaceutical companies, universities, research groups, and others. With the exception of our distribution agreements with Millipore Corporation, we have no such agreements. While we have engaged, and expect to continue to engage, in discussions regarding such arrangements, we may fail to obtain any such agreement on terms acceptable to us. Even if we enter into such arrangements, we may not be able to satisfy our obligations under them or renew or replace them after their original terms expire. Furthermore, these arrangements may require us to grant rights to third parties, such as exclusive marketing rights to one or more products, may require us to issue securities to our collaborators and may contain other terms that are burdensome to us or result in a decrease in our stock price.

If we are unable to protect our patents and proprietary rights, our business, financial condition and results of operations may be materially harmed.

We either own or exclusively license a number of patents and pending patent applications related to various stem and progenitor cells, including human neural stem cell cultures, as well as methods of deriving and using them. We also own or exclusively license a number of patents and patent applications related to certain mammalian pluripotent and multipotent stem cells, cellular reprogramming, genetic manipulation of stem cells, the creation of genetically engineered animals used for research, technologies that facilitate the identification and isolation of specific stem cell types, and media formulations for the culture of stem cells. The process of obtaining patent protection for products such as those we propose to develop is highly uncertain and involves complex and continually evolving factual, legal and occasionally ethical questions. The governmental authorities that consider patent applications can deny or significantly reduce the patent coverage requested in an application either before or after issuing the patent and procedures exist in all relevant geographies for third parties to challenge even issued patents. In addition, changes to the laws protecting intellectual property rights could adversely impact the perceived or actual value of our Company. Consequently, we do not know whether any of our pending applications will result in the issuance of patents, whether any of our issued patents will be invalidated or restricted, whether any existing or future patents will provide sufficient protection or significant commercial advantage, or whether others will circumvent or invalidate these patents, whether or not lawfully. In addition, our patents may not afford us adequate protection from competing products. Moreover, because patents issue for a limited term, our patents may expire before we can commercialize a product covered by the issued patent claims or before we can utilize the patents profitably. Some of our most important patents begin to expire in 2015.

If we learn of third parties who infringe our patent rights, we may decide to initiate legal proceedings to enforce these rights. In 2006, for example, we filed suit against Neuralstem, Inc. for patent infringement. Patent litigation, including the pending litigation to which we are a party, is inherently unpredictable and highly risky and may result in unanticipated challenges to the validity or enforceability of our intellectual property, antitrust claims or other claims against us, which could result in the loss of these intellectual property rights. Litigation proceedings can be very time-consuming for management and are also very costly and the parties we bring

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actions against may have significantly greater financial resources than our own. We may not prevail in these proceedings and if we do not prevail we could be liable for damages as well as the costs and attorney fees of our opponents.

Proprietary trade secrets and unpatented know-how are also important to our research and development activities. We cannot be certain that others will not independently develop the same or similar technologies on their own or gain access to our trade secrets or disclose such technology or that we will be able to meaningfully protect our trade secrets and unpatented know-how. We require our employees, consultants and significant scientific collaborators and sponsored researchers to execute confidentiality agreements upon the commencement of an employment or consulting relationship with us. These agreements may, however, fail to provide meaningful protection or adequate remedies for us in the event of unauthorized use, transfer or disclosure of such information or technology.

If we are unable to obtain necessary licenses to third-party patents and other rights, we may not be able to commercially develop our expected products.

A number of pharmaceutical, biotechnology and other companies, universities and research institutions have filed patent applications or have received patents relating to cell therapy, stem and progenitor cells and other technologies potentially relevant to, or necessary for, our expected products. We cannot predict which, if any, of these applications will issue as patents or how many of these issued patents will be found valid and enforceable. There may also be existing issued patents which we are currently unaware of which would be infringed by the commercialization of one or more of our product candidates. If so, we may be prevented from commercializing these products unless the third party is willing to grant a license to us. We may be unable to obtain licenses to the relevant patents at a reasonable cost, if at all, and may also be unable to develop or obtain alternative non-infringing technology. If we are unable to obtain such licenses or develop non-infringing technology at a reasonable cost, our business could be significantly harmed. Also, any infringement lawsuits commenced against us may result in significant costs, divert our management's attention and result in an award against us for substantial damages, or potentially prevent us from continuing certain operations.

We are aware of intellectual property rights held by third parties that relate to products or technologies we are developing. For example, some aspects of our cell-based therapeutic product candidates involve the use of growth factors, antibodies and other reagents that may, in certain cases, be the subject of third party rights. Before we commercialize any product using these growth factors, antibodies or reagents, we may need to obtain license rights from third parties or use alternative growth factors, antibodies and reagents that are not then the subject of third party patent rights. We currently believe that the commercialization of our products as currently planned will not infringe these third party rights, or, alternatively, that we will be able to obtain necessary licenses or otherwise use alternative non-infringing technology. However, third parties may nonetheless bring suit against us claiming infringement. If we are unable to prove that our technology does not infringe their patents, or if we are unable to obtain necessary licenses or otherwise use alternative non-infringing technology, we may not be able to commercialize any products.

We have obtained rights from companies, universities and research institutions to technologies, processes and compounds that we believe may be important to the development of our products. These licensors, however, may cancel our licenses or convert them to non-exclusive licenses if we fail to use the relevant technology or otherwise breach these agreements. Loss of these licenses could expose us to the risk that our technology infringes the rights of third parties. We can give no assurance that any of these licenses will provide effective protection against our competitors.

We compete with companies that have significant advantages over us.

The market for therapeutic products to treat diseases of, or injuries to, the central nervous system (CNS) is large and competition is intense. The majority of the products currently on the market or in development are small molecule pharmaceutical compounds, and many pharmaceutical companies have made significant

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commitments to the CNS field. We believe cellular therapies, if proven safe and effective, will have unique properties that will make them desirable over small molecule drugs, none of which currently replace damaged tissue. However, any cell-based therapeutic to treat diseases of, or injuries to, the CNS is likely to face intense competition from small molecules, biologics, as well as medical devices. We expect to compete with a host of companies, some of which are privately owned and some of which have resources far greater than ours.

In the liver field, there are no broad-based therapies for the treatment of liver disease at present. The primary therapy is liver transplantation, which is limited by the availability of matched donor organs. Liver-assist devices, when and if they become available, could also be used to help patients while they await suitably matched organs for transplantation. Liver transplantation may remain the standard of care even if we successfully develop a cellular therapy. In addition, new therapies may become available before we successfully develop a cell-based therapy for liver disease.

The life science and research markets are each highly competitive. Most of our competitors have greater financial resources than we do, making them better equipped to license technologies and intellectual property from third parties or to fund research and development, manufacturing and marketing efforts. Our competitors can be expected to continue to improve the design and performance of their products and to introduce new products with competitive price and performance characteristics. In order to compete successfully in these markets, we will likely need to continue to invest in research and development, sales and marketing and customer service and support. We cannot assure you that we will have sufficient resources to continue to make such investments.

The research market is heavily dependent on government funding, and changes in government funding can adversely affect revenues for our tools and technologies products.

Our customers include researchers at academic institutions, pharmaceutical and biotechnology companies and government laboratories, all of whom fund much of their stem cell research using government monies, such as grants. A number of these customers, for example, are dependent for their funding upon grants from U.S. government agencies, such as the U.S. National Institutes of Health (NIH) and agencies in other countries. The level of government funding of research and development is unpredictable. Research and development spending of our customers can fluctuate based on spending priorities and, as was experienced in 2009, general economic conditions. There have been instances when NIH grants have been frozen or otherwise unavailable for extended periods. The availability of governmental research funding may also continue to be adversely affected by the current economic downturn. Any reduction or delay in governmental funding could cause our customers to delay or forego purchases or reallocate their budgets in a manner adverse to us, in which case our anticipated revenues could be materially lower.

Development of our technologies is subject to, and restricted by, extensive government regulation, which could impede our business.

Our research and development efforts, as well as any ongoing or future clinical trials, and the manufacturing and marketing of any products we may develop, will be subject to, and restricted by, extensive regulation by governmental authorities in the United States and other countries. The process of obtaining FDA and other necessary regulatory approvals for human therapeutics is lengthy, expensive and uncertain. FDA and other legal and regulatory requirements applicable to the development and manufacture of the cells and cell lines required for our preclinical and clinical products could substantially delay or prevent us from producing the cells needed to initiate additional clinical trials. We or our collaborators may fail to obtain the necessary approvals to commence or continue clinical testing or to manufacture or market our potential products in reasonable time frames, if at all. In addition, the U.S. Congress and other legislative bodies may enact regulatory reforms or restrictions on the development of new therapies that could adversely affect the regulatory environment in which we operate or the development of any products we may develop.

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We base our research and development on the use of human stem and progenitor cells obtained from human tissue, including fetal tissue. The U.S. federal and state governments and other jurisdictions impose restrictions on the acquisition and use of fetal tissue, including those incorporated in federal Good Tissue Practice, or GTP, regulations. These regulatory and other constraints could prevent us from obtaining cells and other components of our products in the quantity or quality needed for their development or commercialization of both therapeutic products and certain of our enabling cell technologies. These restrictions change from time to time and may become more onerous. Additionally, we may not be able to identify or develop reliable sources for the cells necessary for our potential products – that is, sources that follow all state and federal laws and guidelines for cell procurement. Certain components used to manufacture our stem and progenitor cell product candidates will need to be manufactured in compliance with the FDA’s Good Manufacturing Practices, or GMP. Accordingly, we will need to enter into supply agreements with companies that manufacture these components to GMP standards.

Noncompliance with applicable requirements both before and after product marketing approval, if any, can subject us, our third party suppliers and manufacturers, and our other collaborators to administrative and judicial sanctions, such as, among other things, warning letters, fines and other monetary payments, recall or seizure of products, criminal proceedings, suspension or withdrawal of regulatory approvals, interruption or cessation of clinical trials, total or partial suspension of production or distribution, injunctions, limitations on or the elimination of claims we can make for our products, and refusal of the government to enter into supply contracts or fund research, or delay in approving or refusal to approve new drug applications.

We are dependent on the services of key personnel.

We are highly dependent on the principal members of our management and scientific staff, including our chief executive officer, our vice presidents, and the heads of key departments or functions, and on some of our outside consultants. Although we have entered into employment agreements with some of these individuals, they may terminate their agreements at any time. In addition, our operations are dependent upon our ability to attract and retain additional qualified scientific and management personnel. We may not be able to attract and retain the personnel we need on acceptable terms given the competition for experienced personnel among pharmaceutical, biotechnology and health care companies, universities and research institutions.

Our activities involve hazardous materials and experimental animal testing; improper handling of these animals and materials by our employees or agents could expose us to significant legal and financial penalties.

Our research and development activities involve the controlled use of test animals as well as hazardous chemicals and potentially hazardous biological materials such as human tissue. Their use subjects us to environmental and safety laws and regulations such as those governing laboratory procedures, exposure to blood-borne pathogens, use of laboratory animals, and the handling of biohazardous materials. Compliance with current or future laws and regulations may be expensive and the cost of compliance could adversely affect us.

Although we believe that our safety procedures for using, handling, storing, and disposing of hazardous and potentially hazardous materials comply with the standards prescribed by applicable state, federal and international law, the risk of accidental contamination or injury from these materials cannot be eliminated. In the event of such an accident or of any violation of these or future laws and regulations, state or federal authorities could curtail our use of these materials; we could be liable for any civil damages that result, the cost of which could be substantial; and we could be subjected to substantial fines or penalties. In addition, any failure by us to control the use, disposal, removal, or storage, or to adequately restrict the discharge, or to assist in the cleanup, of hazardous chemicals or hazardous, infectious or toxic substances could subject us to significant liability. Any such liability could exceed our resources and could have a material adverse effect on our business, financial condition and results of operations. Moreover, an accident could damage our research and manufacturing facilities and operations and result in serious adverse effects on our business.

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Natural disasters and violent acts of public protest may cause damage or disruption to us and our employees, facilities, information systems, vendors, and customers.

Our operations are concentrated in Northern California. The western United States has experienced a number of earthquakes, wildfires, flooding, landslides, and other natural disasters in recent years. These occurrences could damage or destroy our facilities which may result in interruptions to our business and losses that exceed our insurance coverage. In addition, we know that certain individuals are strenuously opposed to certain types of medical research, including animal testing and embryonic stem cell research engaged in by both us and many of our customers. Acts of both legal and illegal public protest, including picketing and bioterrorism, could affect the markets in which we operate and our business operations. Any of these events could cause a decrease in both our actual and anticipated revenue, earnings and cash flows.

The development, manufacturing and commercialization of cell-based therapeutic products expose us to product liability claims, which could lead to substantial liability.

By developing and, ultimately, commercializing therapeutic products, we are exposed to the risk of product liability claims. Product liability claims against us could result in substantial litigation costs and damage awards against us. We have obtained liability insurance that covers our clinical trials, and we will need to increase our insurance coverage if and when we begin commercializing products. We may not be able to obtain insurance on acceptable terms, if at all, and the policy limits on our insurance policies may be insufficient to cover our liability.

The manufacture of cell-based therapeutic products is novel, highly regulated, critical to our business, and dependent upon specialized key materials.

The manufacture of cell-based and related products is complicated and difficult, dependent upon substantial know-how and subject to the need for continual process improvements to be competitive. Our manufacturing experience is limited and the technologies are comparatively new. In addition, our ability to scale-up manufacturing to satisfy the various requirements of our planned clinical trials, such as GTP, GMP and release testing requirements, is uncertain. Manufacturing disruptions may occur and despite efforts to regulate and control all aspects of manufacturing, the potential for human or system failure remains. Manufacturing irregularities or lapses in quality control could have a serious adverse effect on our reputation and business, which could cause a significant loss of stockholder value. Many of the materials that we use to prepare our cell-based and related products are highly specialized, complex and available from only a limited number of suppliers or derived from a biological origin. At present, some of our material requirements are single sourced, and the loss of one or more of these sources may adversely affect our business if we are unable to obtain alternatives or alternative sources at all or upon terms that are acceptable to us.

Because health care insurers and other organizations may not pay for our products or may impose limits on reimbursements, our ability to become profitable could be adversely affected.

In both domestic and foreign markets, sales of potential therapeutic products are likely to depend in part upon the availability and amounts of reimbursement from third-party health care payor organizations, including government agencies, private health care insurers and other health care payors, such as health maintenance organizations and self-insured employee plans. There is considerable pressure to reduce the cost of therapeutic products. Government and other third party payors are increasingly attempting to contain health care costs by limiting both coverage and the level of reimbursement for new therapeutic products and by refusing, in some cases, to provide any coverage for uses of approved products for disease indications for which the FDA or other relevant authority has not granted marketing approval. Moreover, in some cases, government and other third party payors have refused to provide reimbursement for uses of approved products for disease indications for which the FDA or other relevant authority has granted marketing approval. Significant uncertainty exists as to the reimbursement status of newly approved health care products or novel therapies such as ours. Even if we obtain regulatory approval to market our products, we can give no assurance that reimbursement will be provided

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by such payors at all or without substantial delay or, if such reimbursement is provided, that the approved reimbursement amounts will be sufficient to enable us to sell products we develop on a profitable basis. Changes in reimbursement policies could also adversely affect the willingness of pharmaceutical companies to collaborate with us on the development of our cellular technologies. In certain foreign markets, pricing or profitability of prescription pharmaceuticals is subject to government control. We also expect that there will continue to be a number of federal and state proposals to implement government control over health care costs. Efforts to change regulatory and reimbursement standards are likely to continue in future legislative sessions. We do not know what legislative proposals federal or state governments will adopt or what actions federal, state or private payors for health care goods and services may take in response to such proposals or legislation. We cannot predict the effect of government control and health care reimbursement practices on our business.

Ethical and other concerns surrounding the use of stem or progenitor-based cell therapy may negatively affect regulatory approval or public perception of our product candidates, which could reduce demand for our products or depress our stock price.

The use of stem cells for research and therapy has been the subject of considerable public debate, with many people voicing ethical, legal and social concerns. Although these concerns have mainly been directed to the use of embryonic stem cells, which we are not presently pursuing for therapeutic use, the distinction between embryonic and non-embryonic stem cells is frequently overlooked; moreover, our use of human stem or progenitor cells from fetal sources might raise these or similar concerns. In addition, we are continuing the development of embryonic stem cells and iPS cells as potential research tools, and we may in the future explore their applicability as cell-based therapeutic products. Negative public attitudes toward stem cell therapy could result in greater governmental regulation of stem cell therapies, which could harm our business. The use of these cells could give rise to ethical and social commentary adverse to us, which could harm the market price of our common stock. Additional government-imposed restrictions on the use of embryos or human embryonic stem cells in research and development could also cause an adverse effect on us by harming our ability to establish important partnerships or collaborations, delaying or preventing the development of certain non-therapeutic products, and causing a decrease in the price of our stock or by otherwise making it more difficult for us to raise additional capital. For example, concerns regarding such possible regulation could impact our ability to attract collaborators and investors. Also, existing regulatory constraints on the use of embryonic stem cells may in the future be extended to use of fetal stem cells, and these constraints might prohibit or restrict us from conducting research or from commercializing products. Similarly, concerns and moral objections to embryonic and fetal-tissue derived technologies could delay or prevent us from patenting or enforcing our patents in certain geographies. Also, existing and potential government regulation of embryonic tissue may lead researchers to leave the field of stem cell research or the country altogether, in order to assure that their careers will not be impeded by restrictions on their work. Similarly, these factors may induce graduate students to choose other fields less vulnerable to changes in regulatory oversight, thus exacerbating the risk that we may not be able to attract and retain the scientific personnel we need in face of the competition among pharmaceutical, biotechnology and health care companies, universities and research institutions for what may become a shrinking class of qualified individuals.

Our corporate documents and Delaware law contain provisions that could make it difficult for us to be acquired in a transaction that might be beneficial to our stockholders.

Our board of directors has the authority to issue shares of preferred stock and to fix the rights, preferences, privileges, and restrictions of these shares without stockholder approval. These provisions in our corporate documents, along with certain provisions under Delaware law, may make it more difficult for a third party to acquire us or discourage a third party from attempting to acquire us, even if the acquisition might be beneficial to our stockholders.

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Risks Related to Our Stock

Our stock price has been, and will likely continue to be, highly volatile, which may negatively affect our ability to obtain additional financing in the future.

The market price per share of our common stock has been and is likely to continue to be highly volatile due to the risks and uncertainties described in this section of this Annual Report on Form 10-K, as well as other factors, including:

our ability to develop and test our technologies;

our ability to patent or obtain licenses to necessary technologies;

conditions and publicity regarding the industry in which we operate, as well as the specific areas our product candidates seek to address;

competition in our industry;

economic and other external factors or other disasters or crises;

price and volume fluctuations in the stock market at large that are unrelated to our operating performance; and

comments by securities analysts, or our failure to meet market expectations.

Over the two-year period ended December 31, 2011, the trading price of our common stock as reported on the NASDAQ Global Market ranged from a high of \$15.80 to a low of \$0.70 per share. As a result of this volatility, an investment in our stock is subject to substantial risk. Furthermore, the volatility of our stock price could negatively impact our ability to raise capital or acquire businesses or technologies.

Our stock could be delisted from the NASDAQ Global Market, which could affect our stock's market price and liquidity.

Our common stock is currently listed on the NASDAQ Global Market. If we fail to satisfy any of the listing requirements of the NASDAQ Stock Market (NASDAQ), our common stock may be put under review or removed from listing on the NASDAQ Global Market.

On March 3, 2011, we were notified by NASDAQ that the closing bid price of our common stock had been below \$1.00 per share for 30 consecutive business days, and therefore we did not meet the requirements for continued listing on the NASDAQ Global Market. In accordance with NASDAQ rules, we had 180 calendar days, or until August 30, 2011, to regain compliance with this minimum bid price requirement by having our common stock close at a price of \$1.00 per share or higher for a minimum of ten consecutive business days during the initial 180-day compliance period. In July 2011, following the affirmative vote of our stockholders at our Annual Meeting, we effected a one-for-ten reverse stock split. Later in July 2011, we received notification from NASDAQ that we had regained compliance with the minimum bid price requirement for continued listing on the NASDAQ Global Market.

We are contractually obligated to issue shares in the future, diluting the interest of current stockholders.

As of December 31, 2011, there were outstanding warrants to purchase 17,434,483 shares of our common stock, at a weighted average exercise price of \$2.92 per share, outstanding options to purchase 875,494 shares of our common stock, at a weighted average exercise price of \$20.13 per share, and outstanding restricted stock units for 357,541 shares of our common stock. We expect to issue additional options and restricted stock units to purchase shares of our common stock to compensate employees, consultants and directors, and may issue additional shares to raise capital, to acquire other companies or technologies, to pay for services, or for other corporate purposes. Any such issuances will have the effect

of diluting the interest of current stockholders.

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None

Item 2. PROPERTIES

In December 2010, we entered into a commercial lease agreement with BMR-Gateway Boulevard LLC (BMR), as landlord, for approximately 43,000 square feet of office and research space at BMR s Pacific Research Center in Newark, California. The initial term of the lease is approximately eleven and one-half years, and we relocated our corporate headquarters and core research activities from a facility located at the Stanford Research Park in Palo Alto, California, to this facility in July 2011. The lease for the Palo Alto facility expired on August 31, 2011. We will pay approximately \$18,000,000 in aggregate as rent over the term of the lease to BMR. As part of the lease, BMR agreed to provide various financial allowances so that we can build initial and future laboratories, offices and other improvements, subject to customary terms and conditions relating to landlord-funded tenant improvements. As part of the lease, we have until January 2013 an option to lease up to an additional 30,000 square feet in the building.

In September 2010, we entered into a two-year sublease agreement with Caliper Life Sciences, Inc., for approximately 13,200 square feet in a facility located in Mountain View, California for part of our R&D operations. We will pay approximately \$695,000 in aggregate as rent over the term of the lease.

We continue to lease a facility in Lincoln, Rhode Island obtained in connection with our former encapsulated cell technology: our former research laboratory and corporate headquarters building which contains 62,500 square feet of wet labs, specialty research areas and administrative offices held on a lease agreement that goes through June 2013, as well as own a 21,000 square-foot pilot manufacturing facility and a 3,000 square-foot cell processing facility financed by bonds issued by the Rhode Island Industrial Facilities Corporation. We have subleased small portions of the 62,500 square foot facility, amounting to approximately 30 percent of the total space. We are actively seeking to sublease, assign or sell our remaining interests in these properties.

In January 2011, we amended the existing lease agreements of our wholly-owned subsidiary, Stem Cell Sciences (U.K.) Ltd, effectively reducing our leased space from approximately 5,000 square feet to approximately 1,900 square feet of office and lab space. We expect to pay approximately \$60,000 as rental payments for 2012. StemCells, Inc. is the guarantor of Stem Cell Sciences (U.K.) Ltd s obligations under the existing lease.

Item 3. LEGAL PROCEEDINGS

In July 2006, we filed suit against Neuralstem, Inc. in the Federal District Court for the District of Maryland, alleging that Neuralstem s activities violate claims in four of the patents we exclusively licensed from NeuroSpheres, specifically U.S. Patent No. 6,294,346 (claiming the use of human neural stem cells for drug screening), U.S. Patent No. 7,101,709 (claiming the use of human neural stem cells for screening biological agents), U.S. Patent No. 5,851,832 (claiming methods for proliferating human neural stem cells), and U.S. Patent No. 6,497,872 (claiming methods for transplanting human neural stem cells). In May 2008, we filed a second patent infringement suit against Neuralstem and its two founders, Karl Johe and Richard Garr. In this suit, which we filed in the Federal District Court for the Northern District of California, we allege that Neuralstem s activities infringe claims in two patents we exclusively license from NeuroSpheres, specifically U.S. Patent No. 7,361,505 (claiming composition of matter of human neural stem cells derived from any source material) and U.S. Patent No. 7,115,418 (claiming methods for proliferating human neural stem cells). In addition, we allege various state law causes of action against Neuralstem arising out of its repeated derogatory statements to the public about our patent portfolio. Also in May 2008, Neuralstem filed suit against us and NeuroSpheres in the Federal District Court for the District of Maryland seeking a declaratory judgment that the 505 and 418 patents are either invalid or are not infringed by Neuralstem and that Neuralstem has not violated California state law. In

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August 2008, the California court transferred our lawsuit against Neuralstem to Maryland for resolution on the merits. In July 2009, the Maryland District Court granted our motion to consolidate these two cases with the litigation we initiated against Neuralstem in 2006. Discovery is ongoing in these cases and we anticipate a trial date in late 2012 or early 2013.

In addition to the actions described above, in April 2008, we filed an opposition to Neuralstem's European Patent No. 0 915 968 (methods of isolating, propagating and differentiating CNS stem cells), because the claimed invention is believed by us to be unpatentable over prior art, including the patents exclusively licensed by us from NeuroSpheres. In December 2010, the European Patent Office ruled that all composition claims in Neuralstem's 968 European patent were invalid and unpatentable over prior art including several of the NeuroSpheres patents licensed to us. Neuralstem has appealed this decision.

Effective 2008, as part of an indemnification agreement with NeuroSpheres, we are entitled to offset all litigation costs incurred in this patent infringement suit, against amounts that would otherwise be owed to NeuroSpheres under our exclusive license agreements with NeuroSpheres, such as annual maintenance fees, milestones and royalty payments. Under the terms of our license agreements, we are required to make annual payments of \$50,000 to NeuroSpheres, and we expect to make these annual payments through the remaining life of the patent which, at December 31, 2010, was approximately 14 years. We have therefore capitalized \$700,000 (14 years at \$50,000 per year) to offset litigation costs. The amount capitalized is not dependent on the achievement of any milestones or related to any other contingent payments which may become due under the arrangement. We will reduce this asset by \$50,000 per year in lieu of the cash payments due to NeuroSpheres. As the \$50,000 annual payments are fully creditable against royalties due to NeuroSpheres, we have classified the capitalized amount as prepaid royalties under Other assets, non-current on our accompanying Consolidated Balance Sheets. We have concluded that the estimated balance of \$650,000, as of December 31, 2011, is a fair estimate and realizable against future milestone and royalty payments to NeuroSpheres, and that litigation costs incurred above this amount will be expensed as incurred. Management will reevaluate this estimate on a quarterly basis based on actual costs and other relevant factors.

Item 4. MINE SAFETY DISCLOSURES

Not applicable.

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Our stock is traded on the NASDAQ Global Market under the symbol STEM. The quarterly ranges of high and low bid prices per share for the last two fiscal years as reported by NASDAQ are shown below:

	High	Low
2011		
First Quarter	\$ 11.20	\$ 7.80
Second Quarter	\$ 9.76	\$ 5.05
Third Quarter	\$ 6.58	\$ 4.30
Fourth Quarter	\$ 2.14	\$ 0.70
2010		
First Quarter	\$ 15.80	\$ 11.20
Second Quarter	\$ 12.20	\$ 8.90
Third Quarter	\$ 11.90	\$ 7.50
Fourth Quarter	\$ 12.70	\$ 7.80

Share prices have been adjusted for the 1-for-10 reverse stock split effected in July 2011. No cash dividends have been declared on our common stock since our inception.

PERFORMANCE GRAPH

We show below the cumulative total return to our stockholders during the period from December 31, 2006 through December 31, 2011⁽³⁾ in comparison to the cumulative return on the Standard & Poor's 500 Index and the Amex Biotechnology Index during that same period.

The stock price performance shown on the graph below is not necessarily indicative of future stock price performance.

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	December 31, 2006	December 31, 2007	December 31, 2008	December 31, 2009	December 31, 2010	December 31, 2011
StemCells, Inc.	\$ 100.00	\$ 56.60	\$ 51.32	\$ 47.55	\$ 40.75	\$ 3.09
S&P 500 Index	\$ 100.00	\$ 103.53	\$ 63.69	\$ 78.62	\$ 88.67	\$ 88.67
Amex Biotechnology Index	\$ 100.00	\$ 104.28	\$ 85.80	\$ 124.91	\$ 172.04	\$ 144.70

(3) Cumulative total returns assume a hypothetical investment of \$100 on December 31, 2006.

The information under Performance Graph is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference in any Company filing under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this 10-K and irrespective of any general incorporation language in those filings.

(b) Approximate Number of Holders of Common Stock

As of March 2, 2012, there were approximately 235 holders of record of our common stock and the closing price of our common stock on the NASDAQ Global Market was \$1.07 per share.

The number of record holders is based upon the actual number of holders registered on the books of our transfer agent at such date and does not include holders of shares in street names or persons, partnerships, associations, corporations, or other entities identified in security position listings maintained by depository trust companies.

(c) Recent Sales of Unregistered Securities (last three years ending December 31, 2011)

We did not issue unregistered securities in 2011.

Equity Compensation Plan Information

The following table provides certain information with respect to all of our equity compensation plans in effect as of December 31, 2011.

Plan Category	Equity Compensation Plan Information		
	Number of Securities to be Issued upon Exercise of Outstanding Stock Options, Warrants and Rights (a)	Weighted-Average Exercise Price of Outstanding Stock Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column(a)) (c)
Equity compensation plans approved by security holders(1)	1,233,040	\$ 14.29	1,039,966

(1) Consists of stock options issued to employees and directors, restricted stock units issued to employees and stock options issued as compensation to consultants for consultation services. These stock options and restricted stock units were issued under our 1992 Equity Incentive Plan, Directors Stock Option Plan, StemCells, Inc. Stock Option Plan, and our 2001, 2004 and 2006 Equity Incentive Plans.

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The following selected financial and operating data are derived from our audited consolidated financial statements. The selected financial and operating data should be read in conjunction with Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation and the consolidated financial statements and notes thereto contained elsewhere in this Form 10-K.

	2011	Year Ended December 31,			2007
		2010	2009	2008	
(In thousands, except per share amounts)					
Consolidated Statements of Operations					
Revenue from licensing agreements and grants	\$ 558	\$ 928	\$ 608	\$ 232	\$ 57
Revenue from product sales	663	499	385		
Research and development expenses	19,938	21,019	19,930	17,808	19,937
General and administrative expenses	8,202	9,377	9,530	8,296	7,927
Wind-down expenses(1)	287	222	650	866	783
Impairment of intangible asset(2)	655				
Gain (loss) on change in fair value of warrant liabilities(3)	6,612	3,005	1,899	(937)	
Net loss	(21,329)	(25,244)	(27,026)	(29,087)	(25,023)
Basic and diluted loss per share	\$ (1.50)	\$ (2.05)	\$ (2.55)	\$ (3.52)	\$ (3.14)
Shares used in computing basic and diluted loss per share amounts	14,188	12,330	10,605	8,272	7,977

	2011	2010	December 31,		2007
			2009	2008	
(In thousands)					
Consolidated Balance Sheets					
Cash and cash equivalents	\$ 13,311	\$ 19,708	\$ 38,618	\$ 30,043	\$ 9,759
Marketable securities	3,281	191	197	4,182	29,847
Total assets	25,205	30,602	51,190	41,230	48,283
Accrued wind-down expenses(1)	2,135	3,300	4,506	5,513	6,143
Fair value of warrant liabilities(3)	6,042	6,672	9,677	8,440	
Long-term debt, including capital leases	331	540	785	867	1,034
Stockholders' equity	10,725	15,481	30,495	21,809	35,212

- (1) Relates to wind-down and exit expenses in respect of our Rhode Island facility and relocation of our operations in Australia. See Note 11 Wind-down and exit costs in the Notes to the Consolidated Financial Statements of Part II, Item 8 of this Form 10-K for further information.
- (2) Relates to the impairment of our intangible asset. See Note 6 Goodwill and Other Intangible assets in the Notes to Consolidated Financial Statements of Part II, Item 8 of this Form 10-K for further information.
- (3) Relates to the fair value of warrants issued as part of our financings in November 2008, November 2009 and December 2011. See Note 13 Warrant Liability in the Notes to Consolidated Financial Statements of Part II, Item 8 of this Form 10-K for further information.

Table of Contents**Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This report contains forward looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act that involve substantial risks and uncertainties. Such statements include, without limitation, all statements as to expectation or belief and statements as to our future results of operations; the progress of our research, product development and clinical programs; the need for, and timing of, additional capital and capital expenditures; partnering prospects; costs of manufacture of products; the protection of, and the need for, additional intellectual property rights; effects of regulations; the need for additional facilities; and potential market opportunities. Our actual results may vary materially from those contained in such forward-looking statements because of risks to which we are subject, including the fact that additional trials will be required to confirm the safety and demonstrate the efficacy of our HuCNS-SC cells for the treatment of Pelizeaus-Merzbacher disease (PMD), spinal cord injury, and age-related macular degeneration (AMD) or any other disease; uncertainty as to whether the U.S. Food and Drug Administration (FDA), Swissmedic, or other regulatory authorities will permit us to proceed with clinical testing of proposed products despite the novel and unproven nature of our technologies; the risk that our clinical trials or studies could be substantially delayed beyond their expected dates or cause us to incur substantial unanticipated costs; uncertainties in our ability to obtain the capital resources needed to continue our current research and development operations and to conduct the research, preclinical development and clinical trials necessary for regulatory approvals; the uncertainty regarding our ability to obtain a corporate partner or partners, if needed, to support the development and commercialization of our potential cell-based therapeutics products; the uncertainty regarding the outcome of our clinical trials or studies we may conduct in the future; the uncertainty regarding the validity and enforceability of our issued patents; the risk that we may not be able to manufacture additional master and working cell banks when needed; the uncertainty whether any products that may be generated in our cell-based therapeutics programs will prove clinically safe and effective; the uncertainty whether we will achieve significant revenue from product sales or become profitable; uncertainties regarding our obligations with respect to our former facilities in Rhode Island; obsolescence of our technologies; competition from third parties; intellectual property rights of third parties; litigation risks; and other risks to which we are subject. All forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by the cautionary statements and risk factors set forth in *Risk Factors* in Part I, Item 1A of this Form 10-K.

Overview***The Company***

We are engaged in researching, developing, and commercializing stem cell therapeutics and enabling tools and technologies for stem cell-based research and drug discovery and development. Our research and development (R&D) programs are primarily focused on identifying and developing potential cell-based therapeutics which can either restore or support organ function. In particular, since we relocated our corporate headquarters to California in 1999, our R&D efforts have been directed at refining our methods for identifying, isolating, culturing, and purifying the human neural stem cell and human liver engrafting cells (hLEC) and developing these as potential cell-based therapeutics for the central nervous system (CNS) and the liver, respectively. In our CNS Program, our HuCNS-SC[®] product candidate (purified human neural stem cells) is currently in clinical development for several indications – Pelizeaus-Merzbacher Disease (PMD), a myelination disorder in the brain, chronic spinal cord injury and dry age-related macular degeneration (AMD). In February 2012, we completed our Phase I clinical trial in PMD, and the data from this trial is expected to be reported in late March 2012. We are conducting a Phase I/II clinical trial in Switzerland for the treatment of chronic spinal cord injury. This trial was authorized by Swissmedic and we completed the enrollment and dosing of the first patient cohort of this trial in December 2011. In January 2012, we received authorization from the FDA to conduct a Phase I/II clinical trial in dry AMD, and we expect to initiate this trial later in 2012. We previously completed a Phase I clinical trial in infantile and late infantile NCL, and the data from that trial showed that our HuCNS-SC cells were well tolerated and non-tumorigenic, and that there was evidence of engraftment and long-term survival of the transplanted HuCNS-SC cells. In our Liver Program, we are focused on identifying and

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developing liver cells as potential therapeutics for a range of liver diseases. We have identified a subset of our human liver engrafting cells (hLEC) which we believe may be a candidate for product development. In October 2011, we formed a wholly-owned subsidiary to focus on both the therapeutic and research tool applications of our hLEC technologies and to serve as an investment vehicle for those interested in a pure play liver cell company. For a brief description of our significant therapeutic research and development programs see Overview Research and Development Programs in the Business Section of Part I, Item 1 of this Form 10-K. We have also conducted research on several other cell types and in other areas, which could lead to other possible product candidates, process improvements or further research activities.

We are also engaged in developing and commercializing applications of our technologies to enable research, which we believe represent current and nearer-term commercial opportunities. Our portfolio of technologies includes cell technologies relating to embryonic stem cells, induced pluripotent stem (iPS) cells, and tissue-derived (adult) stem cells; expertise and infrastructure for providing cell-based assays for drug discovery; a cell culture products and antibody reagents business; and an intellectual property portfolio with claims relevant to cell processing, reprogramming and manipulation, as well as to gene targeting and insertion. Many of these enabling technologies were acquired in April 2009 as part of our acquisition of the operations of Stem Cell Sciences Plc (SCS). See Note 5, Acquisition of SCS Operations, in the Notes to Consolidated Financial Statements in Part II, Item 8 of this Form 10-K for further information.

We have not derived any revenue or cash flows from the sale or commercialization of any products except for license revenue for certain of our patented cells and sales of cell culture products for use in research. As a result, we have incurred annual operating losses since inception and expect to incur substantial operating losses in the future. Therefore, we are dependent upon external financing from equity and debt offerings and revenue from collaborative research arrangements with corporate sponsors to finance our operations. We have no such collaborative research arrangements at this time and there can be no assurance that such financing or partnering revenue will be available when needed or on terms acceptable to us.

Before we can derive revenue or cash inflows from the commercialization of any of our therapeutic product candidates, we will need to: (i) conduct substantial *in vitro* testing and characterization of our proprietary cell types, (ii) undertake preclinical and clinical testing for specific disease indications; (iii) develop, validate and scale-up manufacturing processes to produce these cell-based therapeutics, and (iv) obtain required regulatory approvals. These steps are risky, expensive and time consuming.

Overall, we expect our R&D expenses to be substantial and to increase for the foreseeable future as we continue the development and clinical investigation of our current and future product candidates. However, expenditures on R&D programs are subject to many uncertainties, including whether we develop our product candidates with a partner or independently. We cannot forecast with any degree of certainty which of our current product candidates will be subject to future collaboration, when such collaboration agreements will be secured, if at all, and to what degree such arrangements would affect our development plans and capital requirements. In addition, there are numerous factors associated with the successful commercialization of any of our cell-based therapeutics, including future trial design and regulatory requirements, many of which cannot be determined with accuracy at this time given the stage of our development and the novel nature of stem cell technologies. The regulatory pathways, both in the United States and internationally, are complex and fluid given the novel and, in general, clinically unproven nature of stem cell technologies. At this time, due to such uncertainties and inherent risks, we cannot estimate in a meaningful way the duration of, or the costs to complete, our R&D programs or whether, when or to what extent we will generate revenues or cash inflows from the commercialization and sale of any of our therapeutic product candidates. While we are currently focused on advancing each of our product development programs, our future R&D expenses will depend on the determinations we make as to the scientific and clinical prospects of each product candidate, as well as our ongoing assessment of the regulatory requirements and each product candidate's commercial potential.

Given the early stage of development of our therapeutic product candidates, any estimates of when we may be able to commercialize one or more of these products would not be meaningful. Moreover, any estimate of the

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time and investment required to develop potential products based upon our proprietary HuCNS-SC and hLEC technologies will change depending on the ultimate approach or approaches we take to pursue them, the results of preclinical and clinical studies, and the content and timing of decisions made by the FDA, Swissmedic and other regulatory authorities. There can be no assurance that we will be able to develop any product successfully, or that we will be able to recover our development costs, whether upon commercialization of a developed product or otherwise. We cannot provide assurance that any of these programs will result in products that can be marketed or marketed profitably. If certain of our development-stage programs do not result in commercially viable products, our results of operations could be materially adversely affected.

The research markets served by our tools and technologies products are highly competitive, complex and dynamic. Technological advances and scientific discoveries have accelerated the pace of change in biological research, and stem cell technologies have been evolving particularly fast. We compete mainly by focusing on specialty media and antibody reagent products and cell-based assays, which are custom designed for use in stem cell-based research, where we believe our expertise, intellectual property and reputation give us competitive advantage. We believe that, in this particular market niche, our products and technologies offer customers specific advantages over those offered by our competitors. We compete by offering innovative, quality-controlled products, consistently made and designed to produce reproducible results. We continue to make investments in research and development, quality management, quality improvement, and product innovation. We cannot assure you that we will have sufficient resources to continue to make such investments. For the year ended December 31, 2011, we generated revenues from the sale of specialty cell culture products of approximately \$663,000. We can give no assurances that we will be able to continue to generate such revenues in the future.

Significant Events

Therapeutic Product Development

In February 2011, the fourth and final patient in our Phase I clinical trial in Pelizaeus-Merzbacher Disease, was enrolled and transplanted with our HuCNS-SC human neural stem cells. This trial, which is being conducted at UCSF Benioff Children's Hospital, is the first to evaluate neural stem cells as a potential treatment for a myelination disorder.

In March 2011, we initiated a Phase I/II clinical trial of our HuCNS-SC human neural stem cells in chronic spinal cord injury. The trial is expected to enroll a total of 12 patients who are three to 12 months post-injury, and will include patients with both complete and incomplete injuries as classified by the American Spinal Injury Association Impairment Scale (AIS). The trial was authorized by Swissmedic and is being conducted in Switzerland at the Balgrist University Hospital, University of Zurich, a world leading medical center for spinal cord injury and rehabilitation.

In April 2011, we entered into a collaboration with a world renowned leader in Alzheimer's disease research, to study the therapeutic potential of our HuCNS-SC human neural stem cells in Alzheimer's disease. Published research has shown that mouse neural stem cells enhance memory in a mouse model of Alzheimer's disease, and the goal of this collaboration is to replicate these results using our human neural stem cells.

In June 2011, at the International Society for Stem Cell Research (ISSCR) *9th Annual Meeting*, we presented evidence of engraftment, migration and the long-term survival of our HuCNS-SC neural stem cells following transplantation into patients with a severe neurological disorder. Importantly, the results show that the cells can persist following the cessation of immunosuppression. The data supports our premise regarding the viability and utility of neural stem cell therapy as a potential treatment for a wide range of CNS disorders.

In September 2011, the first patient in our Phase I/II clinical trial in chronic spinal cord injury was enrolled and successfully transplanted with our HuCNS-SC cells. This landmark clinical trial has a unique design, in which patients with progressively decreasing severity of injury will be treated in three sequential cohorts. The first patient has an injury classified as AIS A, with complete loss of sensation and mobility from the waist down.

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In November 2011, we reported that an interim review of one patient's MRIs from our Phase I PMD trial showed changes consistent with the development of new myelin in the regions in which the HuCNS-SC cells were transplanted, and that the safety data suggest the procedure and cells have been well tolerated.

In December 2011, we successfully completed the enrollment and dosing of the first cohort of patients in our Phase I/II clinical trial in chronic spinal cord injury. The first cohort of patients all have spinal cord injury classified as AIS A, the most severe level identified by the AIS. We also announced that enrollment for the remainder of the trial, which will include patients classified as AIS B and AIS C, would be open to patients living in the United States and Canada.

In January 2012, we published preclinical data demonstrating that our proprietary HuCNS-SC cells protect host photoreceptors and preserve vision in a well-established animal model of retinal disease. Moreover, the number of cone photoreceptors, which are responsible for central vision, remained constant over an extended period. The preclinical results are highly relevant to human disorders of vision loss, the most notable of which is dry age-related macular degeneration (AMD). The data was featured as the cover article in the international peer-reviewed *European Journal of Neuroscience*.

In January 2012, the FDA authorized the initiation of a Phase I/II clinical trial of our proprietary HuCNS-SC cells in AMD, the most common form of AMD. AMD is the leading cause of vision loss and blindness in people over 55 years of age, and approximately 30 million people worldwide are afflicted with the disease. There are no approved treatments for dry AMD.

In February 2012, the fourth and final patient in our Phase I PMD trial completed the twelve-month follow up and evaluations required by the trial protocol. Results of the trial will be reported at the European Leukodystrophy Association meeting to be held in Paris, France, March 31-April 1, 2012.

Tools and Technologies Programs

In January, 2011 we launched STEM24 and STEM139, two new antibody reagents that has utility for the isolation and detection of a range of different human cell types.

In March 2011, we launched nine new products and three related kits to facilitate stem cell research. This new line of purified nucleic acid and protein stem cell lysate products enable stem cell researchers to more accurately test and validate stem cell lines and associated genes and gene products. These new reagents are serum-free and are produced by purification of the DNA, RNA or protein content of the lysates of homogenous mouse stem cell lines.

Also in March 2011, we launched three new cell culture supplements for the derivation, culture and differentiation of human and mouse embryonic stem cells, induced pluripotent stem cells, and tissue-derived neural stem cells. These new supplements provide researchers with additional choices to use either a defined, serum-free, or a defined, serum-free and animal component-free version of culture supplements that are considered to be fundamental reagents for stem cell research.

In July 2011, a collaborative study was published which used commercially available SC Proven serum-free cell culture media for the reproducible and robust production of large numbers of genetically stable, self-renewing cells that retain true multi-potent biological function over extended culture periods. This work overcame a key hurdle to the use of non-immortalized cells for regenerative medicine, and demonstrated the utility of human tissue-derived neural stem cells as a scalable platform for cell-based drug discovery and drug screening applications. The paper was published in a special edition of *Neurochemistry International* dedicated to The Potential of Stem Cells for 21st Century Neuroscience.

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Financing and Other Business-related Activities

In January 2011, we sold 1,000,000 shares of our common stock to selected institutional investors at a price of \$10.00 per share. We received net proceeds, after deducting offering expenses and fees, of approximately \$9,400,000. The investors were also granted an option to purchase an additional 600,000 shares at \$10.00 per share. The option was not exercised and expired on February 18, 2011. The shares were offered under our effective shelf registration statement previously filed with the SEC.

In July 2011, we relocated our corporate headquarters and U.S.-based research and development operations to Newark, California. Our new facilities comprise newly constructed, custom designed laboratory and office space, and house the majority of our U.S. workforce.

In July 2011, following the affirmative vote of our stockholders at our Annual Meeting, we effected a one-for-ten reverse stock split which reduced the number of shares outstanding from approximately 139 million to approximately 13.9 million.

In July 2011, we received notification from The NASDAQ Stock Market that we had regained compliance with the minimum bid price requirement needed to continue listing on the NASDAQ Global Market. The NASDAQ Listing Rules require the Company's stock to evidence a closing bid price of \$1.00 per share or more for ten consecutive days.

In September 2011, the California Institute of Regenerative Medicine (CIRM) awarded us a Disease Team Therapy Development Planning Award totaling approximately \$100,000. We were one of only four companies to be awarded a disease team planning grant, which helped us and our collaborators prepare and submit an application for a Disease Team Therapy Development Research Award to evaluate our proprietary HuCNS-SC cells as a potential treatment for Alzheimer's disease. Each Research Award may be up to \$20 million, payable over four years, to fund preclinical and IND-enabling activities with the aim of starting human clinical trials within a four-year window.

In December 2011, we raised gross proceeds of \$10 million through a public offering of 8,000,000 Units and 8,000,000 Series B warrants. The combination of Units and Series B warrants were sold at a public offering price of \$1.25 per Unit. Each Series B warrant gives the holder the right to purchase one Unit at an exercise price of \$1.25 per Unit and is exercisable until May 2, 2012, the 90th trading day after the date of issuance. Each Unit consists of one share of our common stock and one Series A warrant. Each Series A warrant gives the holder the right to purchase one share of our common stock at an initial exercise price of \$1.40 per share. The Series A warrants are immediately exercisable upon issuance and will expire on the fifth anniversary of the closing date of the initial financing transaction in December 2011. The shares were offered under our effective shelf registration statement previously filed with the SEC.

In January 2012, we submitted two applications to the CIRM for disease team research awards, one for Alzheimer's disease and the second for spinal cord injury. Each Research Award may be up to \$20 million, payable over four years, to fund preclinical and IND-enabling activities with the aim of starting human clinical trials within a four-year window. The CIRM has indicated it plans to approve and fund Research Awards in the summer of 2012.

Critical Accounting Policies and the Use of Estimates

The accompanying discussion and analysis of our financial condition and results of operations are based on our Consolidated Financial Statements and the related disclosures, which have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). The preparation of these Consolidated Financial Statements requires management to make estimates, assumptions, and judgments that affect the reported amounts in our Consolidated Financial Statements and accompanying notes. These estimates

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form the basis for making judgments about the carrying values of assets and liabilities. We base our estimates and judgments on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, and we have established internal controls related to the preparation of these estimates. Actual results and the timing of the results could differ materially from these estimates.

Warrant Liability

We account for our warrants in accordance with U.S. GAAP which defines how freestanding contracts that are indexed to and potentially settled in a company's own stock should be measured and classified. Authoritative accounting guidance prescribes that only warrants issued under contracts that cannot be net-cash settled, and are both indexed to and settled in the Company's common stock can be classified as equity. As part of both our November 2008 and November 2009 financings, we issued warrants with five year terms to purchase 1,034,483 and 400,000 shares of our common stock at \$23.00 and \$15.00 per share respectively. As part of our December 2011 financing, we issued Series A Warrants with five year terms to purchase 8,000,000 shares at \$1.40 per share and Series B Warrants with a ninety trading days terms to purchase 8,000,000 units at \$1.25 per unit. Each unit underlying the Series B warrant consists of one share of our common stock and one Series A Warrant. As the warrant agreements did not meet the specific conditions for equity classification, we are required to classify the fair value of the warrants issued as a liability, with subsequent changes in fair value to be recorded as income (loss) on change in fair value of warrant liability. The fair value of the warrants related to the 2008 and 2009 financings is determined using the Black-Scholes-Merton (Black-Scholes) option pricing model and the fair value of the warrants related to the 2011 financing is determined using the Monte Carlo simulation model. The fair value is affected by changes in inputs to those models including our stock price, expected stock price volatility, the contractual term and the risk-free interest rate. The use of the Monte Carlo simulation model requires input of additional subjective assumptions including the progress of our R&D programs and its affect on potential future financings. We will continue to classify the fair value of the warrants as a liability until the warrants are exercised, expire or are amended in a way that would no longer require these warrants to be classified as a liability. The estimated fair value of our warrant liability at December 31, 2011, was approximately \$6,042,315.

Stock-Based Compensation

U.S. GAAP requires us to recognize expense related to the fair value of our stock-based compensation awards, including employee stock options and restricted stock units. Employee stock-based compensation is estimated at the date of grant based on the award's fair value using the Black-Scholes option pricing model and is recognized as expense ratably over the requisite service period. The Black-Scholes option pricing model requires the use of certain assumptions, the most significant of which are our estimates of the expected volatility of the market price of our stock, the expected term of the award, and the risk-free interest rate. Our estimate of the expected volatility is based on historical volatility. The expected term represents the period during which our stock-based awards are expected to be outstanding. In 2011, we estimated this amount based on historical experience of similar awards, giving consideration to the contractual terms of the awards, vesting requirements, and expectation of future employee behavior, including post-vesting terminations. Our estimate of the risk-free interest rate is based on U.S. Treasury debt securities with maturities close to the expected term of the option as of the date of grant. We review our valuation assumptions at each grant date and, as a result, our assumptions in future periods may change. At the end of each reporting period we estimate forfeiture rates based on our historical experience within separate groups of employees and adjust stock-based compensation expense accordingly. For the year ended December 31, 2011, employee stock-based compensation expense (stock options, restricted stock units and 401(k) Plan employer match in form of shares) was approximately \$3,261,000. As of December 31, 2011, total compensation cost related to unvested stock options and restricted stock units not yet recognized was approximately \$3,288,000, which is expected to be recognized as expense over a weighted-average period of 1.9 years.

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Wind-down expenses

Rhode Island

In connection with our wind-down of our research and manufacturing operations in Lincoln, Rhode Island, and the relocation of our corporate headquarters and remaining research laboratories to California in October 1999, we provided a reserve for our estimate of the exit cost obligation. The reserve reflects estimates of the ongoing costs of our former research and administrative facility in Lincoln, which we hold on a lease that terminates on June 30, 2013. We are seeking to sublease, assign, sell, or otherwise divest ourselves of our interest in the facility at the earliest possible time, but we cannot determine with certainty a fixed date by which such events will occur, if at all.

In determining the facility exit cost reserve amount, we are required to consider our lease payments through the end of the lease term and estimate other relevant factors such as facility operating expenses, real estate market conditions in Rhode Island for similar facilities, occupancy rates, and sublease rental rates projected over the course of the leasehold. We re-evaluate the estimate each quarter, taking into account changes, if any, in each of the underlying factors. The process is inherently subjective because it involves projections into time from the date of the estimate through the end of the lease and it is not possible to determine any of the factors except the lease payments with certainty over that period.

Management forms its best estimate on a quarterly basis, after considering actual sublease activity, reports from our broker/realtor about current and predicted real estate market conditions in Rhode Island, the likelihood of new subleases in the foreseeable future for the specific facility and significant changes in the actual or projected operating expenses of the property. We discount the projected net outflow over the term of the lease to arrive at the present value, and adjust the reserve to that figure. The estimated vacancy rate for the facility is an important assumption in determining the reserve because changes in this assumption have the greatest effect on estimated sublease income. In addition, the vacancy rate estimate is the variable most subject to change, while at the same time it involves the greatest judgment and uncertainty due to the absence of highly predictive information concerning the future of the local economy and future demand for specialized laboratory and office space in that area. The average vacancy rate of the facility over the last nine years (2003 through 2011) was approximately 73%, varying from 62% to 89%. As of December 31, 2011, based on current information available to management, the vacancy rate is projected to be approximately 69% from 2012 through the end of the lease. These estimates are based on actual occupancy as of December 31, 2011, predicted lead time for acquiring new subtenants, historical vacancy rates for the area and assessments by our broker/realtor of future real estate market conditions. Due to the short time remaining on the lease period, the reserve assumes no additional tenants from 2012 to the end of the lease. A 5% increase or decrease in the operating expenses for the facility from 2012 on would have increased or decreased the reserve by approximately \$48,000. Management does not wait for specific events to change its estimate, but instead uses its best efforts to anticipate them on a quarterly basis.

For the year ended December 31, 2011, we recorded actual expenses against this reserve, net of subtenant income, of approximately \$1,248,000. Based on management's evaluation of the factors mentioned above, and particularly the projected vacancy rates described above, we adjusted the reserve in 2011 by recording an additional \$287,000 as wind-down expenses. At December 31, 2011, the reserve was \$2,135,000.

Australia

On April 1, 2009, as part of our acquisition of the SCS operations, we acquired certain operations near Melbourne, Australia. In order to reduce operating complexity and expenses, we made the decision to close our site in Australia and consolidate personnel and programs to our Cambridge, U.K. and Palo Alto, California sites. At June 30, 2009, we established a reserve of approximately \$310,000 for the estimated costs to close down and exit our Australia operations. The reserve reflects the estimated cost to terminate our facility lease in Australia (which provided for an original termination date of December 31, 2010), employee termination benefits and

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other liabilities associated with the wind-down and relocation of our operations in Australia. As of December 31, 2010, the facility lease agreement has been terminated and our operations in Australia have been relocated to Cambridge, U.K. and Palo Alto, California. We recorded actual expenses, net of foreign currency translation changes, of approximately \$241,000 against this reserve. At December 31, 2010, we concluded that all costs related to the close down and exit of our Australia operations have been recorded against the reserve and we closed the reserve by crediting the remaining reserve balance of \$69,000 to wind-down expense.

Goodwill and Other Intangible Assets (Patent and License Costs)

Goodwill of approximately \$1,895,000 at December 31, 2011, relates to the acquisition of SCS operations. Goodwill and intangible assets deemed to have indefinite lives are not amortized but are subject to annual impairment tests. If the assumptions and estimates used to allocate the purchase price are not correct, or if business conditions change, purchase price adjustments or future asset impairment charges could be required. We test goodwill for impairment on an annual basis or more frequently if we believe indicators of impairment exist. Impairment evaluations involve management estimates of asset useful lives and future cash flows. Significant management judgment is required in the forecasts of future operating results that are used in the evaluations, and it is possible, even likely, that the plans and estimates used may be incorrect. If our actual results, or the plans and estimates used in future impairment analysis are lower than the original estimates used to assess the recoverability of these assets, we could incur additional impairment charges in a future period. We completed our annual impairment testing during the fourth quarter of 2011, and determined that there was no impairment of goodwill.

Other intangible assets, net were approximately \$2,011,000 at December 31, 2011. Intangible assets with finite useful lives are amortized generally on a straight-line basis over the periods benefited. Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Prior to fiscal year 2001, we capitalized certain patent costs, which are being amortized over the estimated life of the patent and would be expensed at the time such patents are deemed to have no continuing value. Since 2001, all patent costs are expensed as incurred. License costs are capitalized and amortized over the estimated life of the license agreement. In 2010, we wrote-off the unamortized amount of approximately \$67,000 for certain license agreements that we terminated. In December 2011, in part because of management's decision to focus on our therapeutic product development programs and not to allocate time and resources to the assays technology, we determined that we could not predict the future cash flows from the intangible IPR&D asset related to the assays technology. Therefore, we determined that the intangible asset was impaired and wrote off the approximately \$655,000 carrying value of the asset.

Impairment of Long-Lived Tangible Assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. If property, plant, and equipment are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the assets exceeds its estimated fair market value. In 2010, we recorded a charge of approximately \$63,000, to adjust the fair value of certain lab equipment we expect to dispose. No such impairment was recognized during the years 2011 and 2009.

Income Taxes

When accounting for income taxes, we recognize deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities. Income tax receivables and liabilities and deferred tax assets and liabilities are recognized based on the amounts that more likely than not will be sustained upon ultimate settlement with taxing authorities.

Developing our provision for income taxes and analyzing our tax positions requires significant judgment and knowledge of federal and state income tax laws, regulations and strategies, including the determination of deferred tax assets and liabilities and, any valuation allowances that may be required for deferred tax assets.

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We assess the likelihood of realizing our deferred tax assets to determine whether an income tax valuation allowance is required. Based on such evidence that can be objectively verified, we determine whether it is more likely than not that all or a portion of the deferred tax assets will be realized. The main factors that we consider include:

cumulative losses in recent years;

income/losses expected in future years; and

the applicable statute of limitations.

Tax benefits associated with uncertain tax positions are recognized in the period in which one of the following conditions is satisfied: (1) the more likely than not recognition threshold is satisfied; (2) the position is ultimately settled through negotiation or litigation; or (3) the statute of limitations for the taxing authority to examine and challenge the position has expired. Tax benefits associated with an uncertain tax position are reversed in the period in which the more likely than not recognition threshold is no longer satisfied.

We concluded that the realization of deferred tax assets is dependent upon future earnings, if any, the timing an value.

We recognize that our strong financial results in 2016 were due significantly to the gains recognized on the sale of our Williamsburg, Brooklyn property, which is a non-recurring event (and was excluded in calculating our annual incentive payouts). However, Dime believes its new growth plan and the executive management team that is executing the plan will be instrumental in continuing to build profitability in the future. In 2016, our core return on tangible equity (excluding the non-recurring gain on sale) was 9.4% compared to 9.8% in 2015.

Despite outstanding financial returns, the board and management recognize the relative performance of the Company's stock, and recognize that it did not perform favorably by comparison with a number of regional peers. Even though book value increased 15.2% during the year ended December 31, 2016 from \$11.96 to \$13.78 per share and nearly \$1 per share of new capital was added to shareholder value without diluting existing shareholder value, these results were not fully reflected in our stock price.

The Compensation and HR Committee uses these analyses to assist it in understanding market practices and trends and to develop and evaluate the effectiveness of recommended performance-linked compensation strategies. Generally, the Compensation and HR Committee endorses a median target pay level approach, with actual pay commensurate with relative performance. To that end, the flexibility provided by the Annual Incentive Plan ("AIP") permits the Compensation and HR Committee to take market conditions into account each year.

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Pay Mix

The following bar graph reflects the breakdown of each NEO's total compensation, including the approximate target portion, which was performance linked as either Long Term Incentive cash ("Cash LTI") or AIP compensation during the year ended December 31, 2016.

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- (1) Base salary reflects the amounts discussed in "Compensation Program Components – Base Salary."
 - (2) Annual Incentive, which is considered to be performance-based, reflects the amounts discussed in "Compensation Program Components – Short-Term Incentive Plan."
 - (3) Cash LTI, which is considered to be performance-based, reflects the amounts discussed in "Compensation Program Components – Long-Term Incentive Plan."
 - (4) Equity LTI, which is not considered to be performance-based, reflects the amounts discussed in "Compensation Program Components – Long-Term Incentive Plan."

Say on Pay Results

At the Company's 2016 annual shareholder's meeting, approximately 95.6% of the votes by shareholders were cast in favor of a non-binding resolution to approve NEO compensation. The Compensation and HR Committee regarded the results of this vote as supportive of its approach to NEO compensation and, therefore, did not change its executive compensation policies or programs as a consequence of the shareholder vote. The Company continues to offer an annual say-on-pay vote.

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Sound Governance Practices and Policies

The Company's significant compensation practices and policies are summarized as follows:

WHAT WE DO

Pay for performance: Significant portions of the NEO compensation are delivered through variable compensation plans where payouts are contingent on Company performance relative to pre-established goals.

Use of multiple performance measures: Both the annual and multi-year long-term incentive plans use multiple performance measures to reflect a holistic assessment of performance.

Clawback policy: The Company has adopted a policy to recoup performance based payments to all executive officers eligible under these plans in the event of financial restatements.

Negative discretion: The Compensation and HR Committee may exercise negative discretion to reduce the formulaic pay-for-performance compensation to adjust for risk-based considerations.

CEO annual incentive based 100% on corporate performance: All other NEOs have a combination of corporate and individual performance to earn annual incentive.

Long-Term Incentives ("LTI"): LTI for non-CEO NEOs were awarded 25/75 in cash and Common Stock with 50% of the total award performance-based. For 2017, long-term incentive awards will only be made in shares of Common Stock. Cash was eliminated as a partial form of long-term incentive. This was done to better align executive awards with shareholder interests.

WHAT WE DON'T DO

Permit hedging and pledging of Company stock: The Company prohibits executive officers and Outside Directors from hedging or pledging Company stock in order to mitigate excessive risk taking and strengthen the alignment of executives and shareholder interests.

No "gross-up" reimbursement for income tax liabilities associated with equity award vesting and/or pass through dividends on unvested equity award shares.

Balance of short-term and sustained results: The Company uses a balanced approach to annual and long-term incentives that reinforces performance without encouraging inappropriate risk taking.

Stock ownership and retention guidelines: The Company requires minimum stock retention to further align the interests of the NEOs with those of shareholders.

Pay caps on cash-based awards: The Company uses pay caps at the individual or overall plan funding levels to mitigate risk.

Double trigger requirement for severance in change of control payments and equity vesting

Risk Assessments of incentive compensation: are performed by both the outside compensation consultant, and the Risk Committee of the Company's board of directors.

CEO LTI: CEO award for LTI was 100% cash. For 2017, it is now awarded 100% in Common Stock, and the CEO Cash LTI award was eliminated.

No excessive perquisites.

No repricing of underwater stock options.

Our Compensation Philosophy

The goals of the executive compensation program are to enable the Company to attract, develop and retain an executive team capable of maximizing the Company's performance for the benefit of its shareholders. The Company's executive compensation philosophy is, consistent with prudent banking business practices, to provide competitive target compensation opportunities with actual amounts earned commensurate with its financial performance and the generation of long-term value for shareholders through dividends and stock price appreciation. To accomplish these goals, the Company sets a base salary to provide a reasonable level of predictable base income and near- and long-term performance-based compensation to provide the NEOs with clear opportunities to increase the value of their compensation by positive contribution to stockholder interests. Pay opportunities are targeted at market median with opportunities to increase or decrease pay based on our performance. The pay elements are intended to balance an appropriate mix of risk and return. Annual incentive awards are designed to provide incentives to encourage efforts to attain near-term goals which do not encourage excessive risk taking. Long-term performance-based incentive and time-vested restricted stock awards are structured to align the executive's interests with those of the Company's shareholders and serve to retain executives over the long term.

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Table of ContentsBenchmarking and Peer Group

The Company utilizes a comparison group of peer savings or commercial banks when making certain compensation decisions. The table below shows how the peer group was chosen and how it is used:

HOW THE PEER GROUP IS CHOSEN

The Company approximates the median total asset size of the peer group.

The peer group members operate in the Company's region.

The Company engages a nationally recognized compensation consulting firm to evaluate and recommend an appropriate peer group.

The Company approximates the median market capitalization of the peer group.

The peer group has a similar overall business model to the Company.

HOW THE COMPENSATION AND HR COMMITTEE USES THE PEER GROUP

For input in developing base salary ranges, annual incentive targets and LTI award ranges.

To assess the competitiveness of total direct compensation awarded to executives.

As an input in designing compensation plans, benefits and perquisites.

To benchmark share ownership guidelines.

To validate whether executive compensation programs are aligned with Company performance.

To assess our pay-performance alignment.

The peer group utilized was comprised of the following companies in both 2015 and 2016:

Company Name	City and State of Corporate Headquarters	Total Assets ⁽¹⁾	Market Capitalization ⁽¹⁾
Astoria Financial Corp.	Lake Success, NY	\$ 14.56	\$ 1.89
Flushing Financial Corporation	Uniondale, NY	6.06	0.84
Investors Bancorp Inc.	Short Hills, NJ	23.17	4.32
Kearny Financial Corporation	Fairfield, NJ	4.50	1.16
Northfield Bancorp, Inc.	Woodbridge, NJ	3.85	0.97
OceanFirst Financial Corporation	Toms River, NJ	5.17	0.97
Oritani Financial Corporation	Township of Washington, NJ	3.67	0.72
Provident Financial Services Inc.	Iselin, NJ	9.50	1.87
Sterling Bancorp	Montebello, NY	14.18	3.17
Sun Bancorp Inc.	Mount Laurel, NJ	2.26	0.49
TrustCo Bank Corporation	Glenville, NY	4.87	0.84
Valley National Bancorp	Wayne, NJ	22.86	3.07
Median		5.62	1.07
Dime Community Bancshares, Inc.	Brooklyn, NY	6.01	0.75

⁽¹⁾As of December 31, 2016. Amount is in billions.

Compensation Program Components

The Company's 2016 compensation program for NEOs consisted of four key elements:

- Base salary to provide a reasonable level of recurring income;
- Annual incentives to motivate the NEOs to achieve short-term operating objectives;
- Long-term incentives designed to retain talented employees and provide an incentive to maximize shareholder return in the longer term; and
- Benefits consisting of certain retirement plans, termination benefits, fringe benefits and perquisites, in some instances for a large group of employees and in others limited to one or more executives.

The remainder of this section discusses each of these components and the decisions made for 2016.

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The Company seeks to pay competitive base salaries by establishing a median pay level approach. Executive base salary levels are generally reviewed on an annual basis and adjusted as appropriate, with no guarantee of annual increases. The Company desires to compensate executives fairly while being sensitive to managing fixed costs.

For 2016 base salaries, the Compensation and HR Committee considered prevailing market conditions, individual contributions, Company performance, and the input of a competitive compensation review conducted by a nationally recognized compensation consulting firm. The base salaries for 2016 for Messrs. Pucella, Harris and King were increased to be in-line with peer competitors. Mr. Mahon's salary was increased by 10.0% as he was promoted to President as part of a multi-year strategy to adjust his base pay in consideration of the increase in his position responsibilities. Mr. Palagiano's salary remained unchanged in light of his pending retirement.

Name	2015 Salary	2016 Salary	% Increase	
Vincent F. Palagiano	\$ 725,000	\$ 725,000	0.0	%
Kenneth J. Mahon	500,000	550,000	10.0	
Michael Pucella	316,725	330,000	4.2	
Daniel J. Harris	355,788	395,000	11.0	
Timothy B. King	332,561	342,000	2.8	

AIP

Our AIP is a short-term incentive plan administered under the 2013 Equity and Incentive Plan to provide our NEOs with the opportunity to earn an annual cash payment based on corporate and individual performance. The degree of achievement is calculated based on pre-determined, formulaic performance measures, subject to Compensation and HR Committee discretionary adjustments in consideration of other risk and/or performance considerations.

The following table sets forth the potential payments for each of our NEOs under the 2016 AIP.

Name and Principal Positions ⁽¹⁾	Salary	Threshold (\$) and % of Salary	Target (\$) and % of Salary	Superior (\$) and % of Salary
Vincent F. Palagiano Chairman of the Board and CEO	\$ 725,000	\$ 181,250 25.0 %	\$ 362,500 50.0 %	\$ 543,750 75.0 %
Kenneth J. Mahon President and COO	550,000	\$ 137,500 25.0 %	\$ 275,000 50.0 %	\$ 412,500 75.0 %
Michael Pucella EVP and CAO	330,000	\$ 57,750 17.5 %	\$ 115,500 35.0 %	\$ 173,250 52.5 %
Daniel J. Harris ⁽²⁾ EVP and CLO	395,000	\$ 69,125 17.5 %	\$ 138,250 35.0 %	\$ 207,375 52.5 %
Timothy B. King	342,000	\$ 59,850	\$ 119,700	\$ 179,550

EVP and CRIO	17.5	%	35.0	%	52.5	%
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(1)The positions listed for each NEO are as of December 31, 2016. See page 14 for titles as of January 1, 2017.

(2)Mr. Harris resigned effective January 6, 2017.

Target represented the payout level for performance at 100%. Threshold performance results in a payout of 50% of target and a superior performance results in a payout of 150% of target. Performance below threshold results in no payout.

The award opportunities were then linked with performance goals established early in 2016 to assist the Company in meeting its growth and profitability objectives for the year, which were rooted in the formal capital plan reviewed and approved by the Board of Directors (the "Capital Plan"). The three significant corporate financial measures ("Corporate Measures") were: Core ROA (weighted 25%), non-interest expense to average assets (weighted 25%) and Reported EPS (weighted 50%).

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The Corporate Measures and results of the AIP goals for 2016 were as follows:

Corporate Measures ⁽¹⁾	Weight	Threshold	Target	Superior	Result	Result as an Interpolated Percentage of the Target	Weighted Result
Reported EPS	50 %	\$ 0.92	\$ 1.23	\$ 1.54	\$ 1.26	104.9 %	52.45 %
Core ROA	25 %	0.73 %	0.97 %	1.21 %	0.83 %	71.1 %	17.78 %
Non-interest expense to average assets	25 %	1.68 %	1.34 %	1.01 %	1.31 %	104.5 %	26.13 %
TOTAL							96.34 %

(1) Please refer to the Appendix within this Proxy for a discussion of the computation of the key measures.

Results of the Corporate Measures relative to the pre-established objectives were used to determine preliminary payout levels at the end of 2016. To balance incentives to achieve financial results against the need to discourage excessive risk-taking, the Compensation and HR Committee also considered Company performance on supplemental measures, including efficiency ratio, non-performing assets (in dollars and as a percentage of average total assets), net charge-offs (in dollars and as a percentage of average loans) and capital ratios, relative to historical and peer results. The Compensation and HR Committee may exercise positive or negative judgment to adjust the payout levels from the preliminary amounts based on its review of performance of supplemental or other relevant measures, but may not increase the payouts above the pre-established maximums.

Corporate Measures apply 100% for Messrs. Palagiano and Mahon. For Messrs. Pucella, Harris and King, performance of the Corporate Measures noted above determined 50% of their annual incentive opportunity. The remaining 50% was derived from their performance on pre-established individual strategic goals, deemed highly valuable to the Company's achievement of its 2016 growth and profitability objectives. The table below presents the target awards approved by the Compensation and HR Committee for each NEO. Based upon the overall financial results and the aforementioned supplemental measures, the Compensation and HR Committee approved the following annual incentive payouts in consideration of performance relative to their respective corporate and individual target incentive opportunities:

Name	Target	Total Achieved	2016 AIP Payment	Payment as a % of Target
Vincent F. Palagiano ⁽¹⁾	\$ 362,500	\$ 349,240	\$ 349,240	96.3 %
Kenneth J. Mahon ⁽¹⁾	275,000	264,941	264,941	96.3 %
Michael Pucella	115,500	128,902	140,000	121.2 %
Daniel J. Harris	138,250	100,000	100,000	72.3 %
Timothy B. King	119,700	121,620	120,000	100.3 %
Total for NEOs	1,010,950	\$ 964,703	\$ 974,181	
% of Net Income			1.3 %	

(1) Annual incentives for Messrs. Palagiano and Mahon were based 100% on Corporate Measures.

The approved 2016 AIP payment for Mr. Pucella was increased by approximately \$11,000 as a result of the successful completion of the sale of the real estate and relocation of the corporate headquarters.

LTI

Our compensation philosophy identifies equity-based compensation as an effective means of creating a link between the interests of our shareholders, our financial performance and the retention of executive management. In 2016, Dime introduced performance shares and reallocated the LTI mix for each of the NEOs other than Mr. Palagiano.

Considering Mr. Palagiano's already significant stock ownership, and pending retirement as CEO in 2016, the Committee provided his long-term incentives in the form of 100% performance-based cash. Our LTI is administered under our 2013 Equity and Incentive Plan.

The LTI for each of the other NEOs was changed in 2016 such that the LTI provided 50% in the form of time-vested restricted stock awards, and split the remaining 50% that was previously paid in the form of Cash LTI to a mix of 25% Cash LTI (based on Relative TSR) and 25% as performance share awards (based on Cumulative EPS and ROAE).

The Compensation and HR Committee and management supported introduction of the new performance share awards to further align executive performance with shareholder interests.

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The following table sets forth information on the target LTI award made to the NEOs for 2016. This includes Cash LTI awards, performance-based share awards (“PSA”), and time-vested restricted stock awards (“RSA”). The range of potential Cash LTI payouts under the 2016 LTI is based 100% on a pre-determined performance goal for the relative 3-year TSR for the performance period from January 1, 2016 through December 31, 2018. Once a defined threshold level of performance is achieved, payouts can vary from 50% of the target for a baseline level of acceptable performance to a maximum payout of 150% of the target, which is paid only for exceptional performance. Payouts will be interpolated between these points.

PSAs will vest based on the achievement of two pre-determined performance goals: 3-year cumulative EPS and average annualized reported ROAE, for the performance period from January 1, 2016 through December 31, 2018, each weighted equally. During March 2016, the Compensation and HR Committee approved threshold, target and maximum opportunities based on consultation with the independent compensation consulting firm for the Cash LTI and PSAs. Target performance for each component represents our budget performance, threshold payout level (50% of the target) represents a baseline level of acceptable performance to receive any award and maximum payout (150% of the target) represents exceptional performance. Performance in between these levels will be interpolated. Please refer to the Appendix within this Proxy for a discussion of the computation of Cumulative Core EPS.

Name	Performance-based		Time-vested	Grant Date Fair Value of RSAs (\$) ⁽¹⁾
	Cash LTI	PSA	Number of Shares of RSA (#)	
Vincent F. Palagiano ⁽²⁾	\$ 471,250	-	-	-
Kenneth J. Mahon	82,500	\$ 82,500	9,111	\$ 165,000
Michael Pucella	32,175	32,175	3,553	64,350
Daniel J. Harris ⁽³⁾	49,375	49,375	5,453	98,750
Timothy B. King	33,345	33,345	3,682	66,690

⁽¹⁾ Calculated based upon a grant date fair value of \$18.11 per award, the closing price of the Common Stock on April 29, 2016.

⁽²⁾ Mr. Palagiano’s LTI is paid solely in cash due to his significant Common Stock ownership.

⁽³⁾ Mr. Harris resigned effective January 6, 2017 and forfeited his 2016 LTI award.

The Compensation and HR Committee does not have discretion to increase the size of the payout or to award compensation if the goals are not met, but may exercise negative discretion considering the Company’s performance relative to peers and other relevant factors. PSA’s are awarded as shares of Common Stock in the first quarter of 2019 if the NEO is employed on December 31, 2018. If an NEO’s employment terminates prior to the end of a performance period due to death, disability or retirement, the Company’s obligation will be prorated for performance as of the date of termination and paid at the end of the performance period unless the Compensation and HR Committee determines otherwise. The Compensation and HR Committee may provide for immediate payout in the case of death. In the event of a change of control, performance will be assessed through the change of control date and prorated payment made as soon as possible after that date. If the actual performance results cannot be calculated, the target will be used.

Payout Under 2014 – 2016 LTI Program. Our LTI program in 2014 was a cash performance based arrangement that reflected defined performance goals for the 3-year period ended December 31, 2016. Relative TSR reflected 50% of

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the award, with specific absolute goals split 25% to reward cumulative earnings EPS and ROAE. Performance was assessed in March 2017 and certified by the Compensation and HR Committee for payout in March 2017. The established performance goals, actual achievement levels and LTI earned for the measurement period are shown in the following table:

Performance Goal	Weight	Threshold	Target	Maximum	Result	Achievement (% of Target)	Weighted Achievement ⁽¹⁾
TSR (percentile rank in peer group) ⁽²⁾	50 %	40th	50th	74th	8th	0 %	0 %
Cumulative Core EPS ⁽³⁾	25 %	\$ 2.78	\$ 3.09	\$ 3.40	\$ 3.34	140.63 %	35.16 %
Average Annualized Reported ROAE	25 %	6.73 %	7.92 %	9.10 %	9.22 %	150.00 %	37.50 %
TOTAL							72.66 %

The Weighted Achievement is calculated as the Achievement (% of Target) multiplied by the weighting of the respective performance goal in determining the payout amount. In accordance with the plan, TSR was provided a (1)50% weighting, while Cumulative Core EPS and Average Annualized Reported ROAE were each provided a 25% weighting. See "Compensation Program Components – Long-term Incentive Plan" for a further discussion of the applicable provisions of the plan.

The peer group for this LTI component was developed, as of December 31, 2013, by a nationally recognized compensation consulting firm, and consisted of the following: Astoria Financial Corporation, Flushing Financial Corp., Investors Bancorp, Inc., Kearny Financial Corp, Northfield Bancorp, OceanFirst Financial Corporation, Oritani Financial Corp., Provident Financial, Sterling Bancorp, Sun Bancorp, Inc., TrustCo Bank Corp and Valley National Bancorp.

(3)Please refer to the Appendix within this Proxy for a discussion of the computation of Cumulative Core EPS.

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The cash payments made under the 2014 – 2016 LTI Program were as follows:

Name	Weighted Achievement %	Payment Upon Settlement
Vincent F. Palagiano	72.7	\$ 290,630
Kenneth J. Mahon	72.7	87,189
Michael Pucella	72.7	38,508
Daniel J. Harris ⁽¹⁾	72.7	46,864
Timothy B. King	72.7	41,778

(1) Mr. Harris resigned effective January 6, 2017, however, was entitled to his 2014 LTI award since he completed the performance period.

The Compensation and HR Committee, in its effort to align the program with shareholder interests, weights TSR as 50% of the criteria in determining payouts of the long-term incentives for the NEOs. Despite the Company’s strong financial performance on an absolute basis and compared to its peer group, in recent periods, its TSR has lagged the same peer groups. Long-term incentive compensation reflected this circumstance, as recent payments to the NEOs have been limited and contain no payments relative to TSR.

Executive Agreements

Employment Agreements with Messrs. Palagiano and Mahon

During 2016, the Bank and the Company maintained employment agreements with Mr. Palagiano and Mr. Mahon that protected both the Company and those individuals in the event of certain separation events. The Compensation and HR Committee believes the terms of our employment agreements are in line with industry standards and are necessary to maintain a stable management team. See “Executive Compensation – Agreements with Our Named Executive Officers Upon Termination of Service and Change in Control” for additional information on the agreements.

Retention Agreements with Other NEOs

During 2016, the Bank and the Company maintained Retention Agreements with Messrs. Pucella, Harris and King to secure the executives continued availability and attention to the Bank’s affairs, relieved of distractions arising from the possibility of a change of control. The Retention Agreement with Mr. Harris was terminated upon his resignation on January 6, 2017. The Compensation and HR Committee believes the terms of our retention agreements are in line with industry standards and are necessary to maintain a stable management team. See “Executive Compensation – Agreements with Our Named Executive Officers Upon Termination of Service and Change in Control” for additional information on the agreements.

Deferred Compensation and Retirement Benefits

Retirement Plan

The Bank maintains the Retirement Plan of Dime Community Bank (the “Retirement Plan”), a noncontributory, tax-qualified defined benefit pension plan for all eligible employees; however, all participant benefits under the Retirement Plan were frozen effective April 1, 2000, and no benefits have been accrued under the Retirement Plan since that date.

401(k) Plan

The Bank maintains the 401(k) Plan, which is a tax-qualified defined contribution plan permitting salaried employees with at least one year of service to make pre-tax salary deferrals under Section 401(k) of the Internal Revenue Code of 1986 (the “Code”). Each participant receives a fully vested contribution of 3% of “covered compensation” as defined in the 401(k) Plan, up to applicable Internal Revenue Service (“IRS”) limits. The 3% contribution was required through 2006, after which it became discretionary.

Effective January 1, 2017, the eligibility rules of the 401(k) Plan were amended to permit salaried and part-time employees with at least one month of service to participate in the plan. Upon eligibility, 3% of pre-tax salary is automatically deferred unless the employee elects a different contribution percentage.

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ESOP

The Company maintains a tax-qualified employee stock ownership plan ("ESOP") for the benefit of eligible employees. The ESOP enables employees to acquire an ownership interest in the Company and accumulate additional retirement benefits. All of the Company's and Bank's salaried employees are eligible to become participants in the ESOP after one year of employment. The Company intends to merge the ESOP into the 401(k) Plan during 2017. Please refer to Note 13 of the Company's financial statements included in its Annual Report on Form 10-K for the year ended December 31, 2016 for information on the ESOP.

BMP

The BMP is a non-qualified deferred compensation plan that provides our NEOs with supplemental retirement benefits. We believe the benefits provided through the BMP reflect competitive practices for similarly situated officers employed by our peers whose tax-qualified retirement benefits are limited by the Code. The Compensation and HR Committee reviews the BMP design periodically with due consideration given to prevailing market practice, overall executive compensation philosophy and cost to the Company. See "Executive Compensation – Pension Benefits" for information on the terms of the BMP. Our NEOs and certain other officers are eligible to participate in the BMP, as described on page 35 of this proxy. Currently all of our NEOs participate in the BMP.

Perquisites

The Compensation and HR Committee believes that perquisites should be limited in scope and have a business-related purpose. The Committee periodically reviews perquisites to ensure alignment with the desired philosophy. The Committee approves specific perquisites or benefits for individuals based on the needs of the position.

In 2016, perquisites for all of the NEOs included an automobile allowance and tax preparation fees which, are represented under "Executive Compensation – Summary Compensation Table" under Footnote 7.

Role of the Compensation and HR Committee, Management and Consultants/Advisors

Role of the Compensation and HR Committee

The Compensation and HR Committee consists of four independent members of the Board. The Chairman of the Compensation and HR Committee presents a summary of each Committee meeting during the Board meetings. The Committee met four times during the year ended December 31, 2016.

The Compensation and HR Committee's primary responsibilities include the following:

- Oversees administration of the process for determining the compensation and benefits of officers and employees of the Bank
- Assists the Board in its oversight of the human resources activities of the Company and its subsidiaries
- Evaluates the performance of the CEO and executive officers in determination of base salary
- Evaluates the annual incentive program, based on Corporate and Individual performance components, in determination of cash awards to the CEO and executive officers
- Evaluates the long-term incentive program, based on the Company's absolute and relative performance, in determination of cash and equity awards
- Review and approve all Employee Agreements for executive officers.
- Recommends Director compensation to the Board
- Oversees the Company's compliance with all regulations related to executive compensation
- Review and approve the CD&A

The Committee, with the assistance of management and the compensation consultant, reviews its philosophy and executive compensation programs annually.

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In order for the Compensation and HR Committee to make decisions regarding base salary, annual and long-term incentives, and other aspects of the Company's benefit programs, members of Management and Human Resources ("HR") are asked to provide input on Corporate objectives and individual performance goals. Input from members of Management and HR are considered to be suggestions and recommendations for the Committee's consideration. Management is not present during discussions of their own compensation.

Role of the Compensation Consultant and Advisors

The Compensation and HR Committee utilizes legal counsel and a nationally recognized compensation consulting firm, to assist in performing its duties. The Committee relies on legal counsel to advise on its obligations and rights under applicable corporate, securities and employment laws, to assist in interpreting the Company's obligations and rights under compensation plans and agreements, and to draft plans and agreements to document business decisions. Mercer (US) Inc. ("Mercer") served as independent advisor to the Compensation and HR Committee for benchmarking and decisions related to the 2016 compensation program. At the end of 2016, the Compensation and HR Committee changed its compensation consulting firm to Meridian Compensation Partners LLC ("Meridian") because it has broader banking industry experience, and also to obtain a more diverse perspective on executive compensation programs. The consulting firm is engaged to annually analyze the Company's executive pay levels, by each of the four key elements cited and in total, and the Company's performance.

The Compensation and HR Committee evaluated the independence of both compensation consulting firms as well as legal counsel to assess whether their work raised conflicts of interest under NASDAQ listing standards and SEC rules. Based on this review, Mercer, Meridian, and legal counsel were all determined to be independent and their work did not raise any conflicts of interest.

Other Policies and Practices

Stock Ownership and Retention Requirement - The Company has a policy that requires Mr. Mahon and, until his retirement on December 31, 2016 required Mr. Palagiano, to own shares of Common Stock with an aggregate value at least equal to 500% of his annual rate of base salary. The policy was amended in December 2016 to require Senior Executive Vice Presidents to own shares of Common Stock with an aggregate value at least equal to 300% of their annual rate of base salary, and increase the requirement for Executive Vice Presidents to own shares of Common Stock with an aggregate value at least equal to 200% (from the previous 100%) of their annual rate of base salary. Messrs. Pucella, Harris and King were subject to the Executive Vice President requirements. The stock ownership requirement is phased in ratably over five years for newly appointed executive officers. Shares owned directly and in vested retirement accounts, shares in vested accounts under the Company's BMP and unvested restricted stock awards count toward this limit. Unexercised stock options do not count toward this requirement. The following table indicates the stock ownership requirement applicable to each NEO as well as the stock ownership of each as of the Record Date:

Name of NEO ⁽¹⁾	Stock Ownership Requirement (# of Shares)	Stock Ownership Counted Toward Requirement (# of Shares)
Vincent F. Palagiano ⁽²⁾	181,704	1,121,451
Kenneth J. Mahon	206,767	528,412
Michael Pucella	34,075	156,220
Timothy B. King	35,314	255,686

(1) Mr. Harris resigned effective January 6, 2017, and is thus no longer subject to stock ownership requirements and is excluded from the table.

(2) For Mr. Palagiano, the stock ownership requirement listed was as of December 31, 2016 (his final day of employment as the Company's CEO).

The Company's policy further requires that each executive officer who is not in full compliance with the Company's stock ownership guidelines must retain 100% of the net shares (after taxes and acquisition costs) acquired through stock option exercises and restricted stock vesting until he or she attains full compliance with the ownership guidelines.

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Clawback Policy - The Company has adopted a policy permitting it to seek recovery of certain performance-based compensation in the event of a financial restatement due to the Company's material non-compliance with the financial reporting requirements of the federal securities laws. In the event of such a restatement, performance-based compensation paid during the prior three years will be reviewed to determine if the right to, or amount of, such compensation was based on the achievement of performance goals derived from the financial statements and if so, whether the right to, or amount of, such compensation would be different based on the financial restatement. If, based on this review, an overpayment has occurred, the Company may require the recipient to repay the excess amount. This policy applies to the Company's and Bank's executive officers.

Restrictions on Hedging and Pledging - Executive officers and Directors of the Company and its subsidiaries are prohibited from: (i) entering into transactions designed to hedge or offset a decrease in the market value of Common Stock; and (ii) pledging, hypothecating, or otherwise encumbering shares of Common Stock as collateral for indebtedness.

Impact of Accounting and Tax Treatment

Section 162(m) - Section 162(m) of the Code imposes a \$1,000,000 annual limit per executive officer on the Company's federal tax deduction for certain types of compensation paid to the NEOs other than the Chief/Principal Financial Officer. It has been the Compensation and HR Committee's practice to structure the compensation and benefit programs offered to the NEOs with a view to maximizing the tax deductibility of amounts paid. However, in structuring compensation programs and making compensation decisions, the Compensation and HR Committee considers a variety of factors, including the Company's tax position, the materiality of the payments and tax deductions involved, and the need for flexibility to address unforeseen circumstances. After considering these factors, the Compensation and HR Committee may decide to authorize payments all or part of which would be nondeductible for federal tax purposes. It is anticipated that any compensation for 2016 that is rendered non-deductible by this limit will not have a material effect. Payments made on account of a change of control under the employment and retention agreements described above might include non-deductible payments.

Sections 4999 and 280G - Section 4999 of the Code imposes a 20% excise tax on certain "excess parachute payments" made to "disqualified individuals." Under section 280G of the Code, such excess parachute payments are also nondeductible to the Company. If payments that are contingent on a change of control to a disqualified individual (which includes the NEOs) exceed three times the individual's "base amount," they constitute "excess parachute payments" to the extent they exceed one time the individual's base amount.

Pursuant to their Employment Agreements or Retention Agreements, the Company or Bank will reimburse Messrs. Mahon, Pucella, and King, and previously would have reimbursed Messrs. Palagiano and Harris, for the amount of the excise tax, if any, and make an additional gross-up payment so that, after payment of the excise tax and all income and excise taxes imposed on the reimbursement and gross-up payments, Messrs. Palagiano, Mahon, Pucella, Harris, and King each would retain approximately the same net after-tax amounts under the Employment Agreement or Retention Agreement that he would have retained if there was no excise tax. Neither the Bank nor the Company is permitted to claim a federal income tax deduction for the portion of the change of control payment that constitutes an excess parachute payment, the excise tax reimbursement payment or the gross-up payment.

Accounting Considerations - The Compensation and HR Committee is informed of the financial statement implications of the elements of the NEO compensation program. However, the probable contribution of a compensation element to the objectives of the Company's NEO compensation program and its projected economic cost, which may or may not be reflected on the Company's financial statements, are the primary drivers of NEO compensation decisions.

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Risk Assessment

The Company's compensation program is designed to mitigate risk by: (1) providing non-performance-based salaries, retirement and fringe benefits that permit executives to pay living expenses and plan for the future without reliance on incentives, (2) incorporating cash incentives to reward current successes, in relation to forecast performance derived from the Capital Plan, and (3) including long-term incentives in the form of RSAs, performance-based shares and cash, as well as maintaining stock ownership and retention requirements, to sustain focus on long-term shareholder value. The Compensation and HR Committee exercises substantial discretion in awarding annual incentives, including a retrospective assessment of management's performance in light of prevailing business conditions, to discourage excessive focus on formulaic goals. This retrospective assessment includes, in addition to financial measures, consideration of indicators of business prudence such as credit quality and capital ratios. Management stock ownership and retention requirements and equity-based retirement benefits provided through the Company's tax-qualified ESOP and related BMP assure that management retains a significant financial interest in the long-term performance of the Common Stock, and sensitivity to the potential long-term effects of short-term business strategies, throughout their tenure with the Company. The Company believes these features recognize a balance between the need to accept risk exposure in the successful operation of its business and the need to identify and prudently manage such risks.

In addition to assisting with the competitive review of executive compensation, a nationally recognized compensation consulting firm has been engaged to assist the Compensation and HR Committee in conducting a risk review of the Company's incentive compensation programs. Based upon its review, the compensation consultant indicated its belief that the incentive plans place a proper balance of reinforcing performance while not encouraging inappropriate risk taking behavior.

Compensation and HR Committee Report

The Compensation and HR Committee has reviewed and discussed the Compensation Discussion and Analysis required by Item 402(b) of Regulation S-K with management; and

Based on the review and discussions, the Compensation and HR Committee recommended to the Board of Directors that the Compensation Discussion and Analysis be included in the Company's Proxy Statement on Schedule 14A for the 2017 Annual Meeting of Shareholders.

COMPENSATION AND HR COMMITTEE OF DIME COMMUNITY BANCSHARES, INC.

Omer S. J. Williams, Chair
Anthony Bergamo, Member
Steven D. Cohn, Member
Kathleen M. Nelson, Member

Compensation and HR Committee Interlocks and Insider Participation

There are no interlocks, as defined under the rules and regulations of the SEC, between the Company and the current members of the Compensation and HR Committee and corporations with respect to which they are affiliated, or otherwise.

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EXECUTIVE COMPENSATION

The following table provides information about the compensation paid for services rendered in all capacities by the NEOs for the year ending December 31, 2016. Included in 2016 “All Other Compensation” is the final one-time allocation of ESOP surplus shares following the full prepayment of the outstanding ESOP loan balance. See Note 7(a) to this table for additional detail.

Summary Compensation Table

Name and Principal Positions	Year	Salary ⁽¹⁾	Equity Incentive Plan Awards		Non-Equity Incentive Plan Compensation ⁽⁴⁾		Change in Pension Value and Nonqualified Deferred Compensation Earnings ⁽⁵⁾⁽⁶⁾	All Other Compensation ⁽⁷⁾⁽⁸⁾	Total
			Performance-based Stock Awards ⁽²⁾	Time-Vesting Restricted Stock Awards ⁽³⁾	Annual Incentive Award	Long-Term Cash Incentive Award			
Vincent F. Palagiano, Chairman of the Board and CEO ⁽⁹⁾	2016	\$ 725,000	\$ —	\$ —	\$ 349,240	\$ 714,380	\$ 503,583	\$ 672,467	\$ 2,96
	2015	725,000	—	—	345,000	335,475	279,559	791,511	2,47
	2014	710,000	—	—	388,500	335,475	1,571,906	718,441	3,72
Kenneth J. Mahon President and COO ⁽¹⁰⁾	2016	550,000	82,500	165,000	264,941	87,189	36,929	581,767	1,76
	2015	500,000	—	125,000	219,000	70,200	—	404,016	1,31
	2014	450,400	—	120,000	238,500	70,200	271,459	382,520	1,53
Michael Pucella EVP and CAO	2016	330,000	32,175	64,350	140,000	38,508	25,157	480,577	1,11
	2015	316,725	—	61,761	120,000	43,875	—	63,171	605,
	2014	307,500	—	53,000	140,000	43,875	140,162	60,451	744,
Daniel J. Harris EVP and CLO ⁽¹¹⁾	2016	395,000	49,375	98,750	100,000	46,864	—	127,769	817,
	2015	355,788	—	74,715	145,000	53,078	—	66,129	694,
	2014	345,425	—	64,500	140,000	53,078	—	63,022	666,

Timothy B. King EVP and CRIO ⁽¹²⁾	2016	342,000	33,345	66,690	120,000	41,778	22,318	532,885	1,15
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(1) Salary represents amount earned for the fiscal year, whether or not actually paid during such year.

The amounts reported are the aggregate grant date fair value of the awards computed in accordance with FASB ASC Topic 718. Awards consist of performance-based stock awards which vest based on the achievement of certain performance criteria. The performance-based awards assume the probable outcome of performance conditions for the targeted potential value of the award. For valuation and discussion of the assumptions related to

(2) these awards, see Note 15 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K. Based on the fair value at grant date, the following are the maximum potential values of the performance shares for the 2016 – 2018 performance period assuming maximum level of performance is achieved: Mr. Mahon, \$123,750; Mr. Pucella, \$48,263; Mr. King, \$50,018. Mr. Harris' would have been \$74,063 if he did not forfeit his award due to his resignation on January 6, 2017.

The amounts reported are the aggregate grant date fair value of the awards computed in accordance with FASB ASC Topic 718. Awards consist of restricted stock which vests ratably over four years. For valuation and discussion of the assumptions related to these awards, see Note 15 to the Consolidated Financial Statements in the

(3) Company's Annual Report on Form 10-K. The disclosed amounts do not reflect the value of dividends paid on unvested restricted stock, which is included in the Summary Compensation Table under the caption "All Other Compensation."

Amount represents cash payments made to the NEO under the Cash LTI or the AIP in the respective year. Please refer to "Compensation Discussion and Analysis – Compensation Program Components – Long-Term Incentive

(4) Program" for the determination of the LTI payout shown for 2016, and "Compensation and Discussion Analysis – Compensation Program Components Short-term Incentive Plan" for the determination of the AIP payout shown for 2016.

Includes for each NEO: (a) the increase (if any) for the fiscal year in the present value of the individual's accrued benefit (whether or not vested) under the Retirement Plan and BMP calculated by comparing the present value of each individual's accrued benefit under both such plans in accordance with FASB ASC Topic 715 ("ASC Topic 715") as of the plan's measurement date in such fiscal year to the present value of the individual's accrued benefit as of the plan's measurement date in the prior fiscal year, plus (b) the amount of interest accrued on defined contribution deferred compensation balances at a rate in excess of 120% of the applicable federal long-term rate under section 1274(d) of the Code. There were no "above-market earnings" associated with these amounts.

The Company does not regard amounts reported for 2016 under the caption "Change in Pension Value and Nonqualified Deferred Compensation Earnings" in the Summary Compensation Table as recurring compensation.

All of the Company's defined benefit plans have been frozen to future benefits since 2000. The compensation amount associated with Change in Pension Value and Nonqualified Deferred Compensation Earnings therefore results solely from the application of different actuarial valuation assumptions during each period. The 2016

(6) earnings amounts shown in the column entitled "Change in Pension Value and Nonqualified Deferred Compensation Earnings" resulted from reductions in the statutory discount rate assumption of 16 basis points for the Retirement Plan valuation and 8 basis points for the BMP valuation, as well as the Society of Actuaries' recent issuance of new mortality tables projecting longer life expectancies. The amounts in the column entitled "Total Excluding the Change in Pension Value and Nonqualified Deferred Compensation Earnings" represent total compensation excluding the amounts listed in the column entitled "Change in Pension Value and Nonqualified Deferred Compensation Earnings."

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The NEOs participate in certain group life, health, and disability insurance and medical reimbursement plans not disclosed in the Summary Compensation Table that are generally available to salaried employees and do not discriminate in scope, terms and operation. For 2016, the figure shown for each NEO includes the following items exceeding \$10,000 in value:

Name	Life Insurance		401(k) Plan		BMP (b)	Other(c)	Total
	Premiums	Automobile	Employer Cash Contribution	ESOP Allocation (a)			
Vincent F. Palagiano	\$ 85,061	\$ 18,119	\$ 7,950	\$ 478,762	\$ 81,235	\$ 1,340	\$ 672,467
Kenneth J. Mahon	14,794	17,015	7,950	478,762	50,803	12,443	581,767
Michael Pucella	1,206	12,000	7,950	432,994	19,940	6,487	480,577
Daniel J. Harris	854	12,000	7,950	71,496	28,750	6,719	127,769
Timothy B. King	833	12,000	7,950	484,229	21,114	6,759	532,885

Amount represents both the annual ESOP allocation as well as the final one-time allocation of surplus shares following the full prepayment of the outstanding ESOP loan balance. The value of the final ESOP allocation to each NEO was as follows: Palagiano - \$460,612; Mahon - \$460,612; Pucella - \$414,844; Harris - \$53,345; and King - \$466,079. The value was determined based upon the \$20.10 closing price of the Common Stock on the last trading day of 2016. (See Notes 1 and 13 to the audited consolidated financial statements in the Company's 2016 Annual Report on Form 10-K, which discuss the manner in which ESOP expense is recognized).

Amount represents BMP benefits earned during the year ended December 31, 2016 associated with the 401(k) Plan and ESOP. For 2016, the ESOP component was determined based upon the \$20.10 closing price of the Common Stock on the last trading day of 2016.

Amount represents dividends paid on unvested restricted stock awards during 2016 for Messrs. Mahon, Pucella, Harris and King, and tax preparation services for Messrs. Palagiano, Mahon, Pucella and King.

Included in this amount for Messrs. Palagiano and Mahon for the 2015 and 2014 years are amounts from the amendment of the terms of their Employment Agreements (“BMP Annual Service Credits”). The terms of amended Employment Agreements with Messrs. Palagiano (until his December 31, 2016 retirement as CEO) and Mahon include computing bonus-related severance payments with reference to recent historical bonuses, a severance compensation multiple of three years of annual compensation, and a “double trigger” requiring either termination without cause or resignation with good reason. At the time the Employment Agreements were amended in 2010, the estimated value under a change of control (plus discharge) aggregated \$29.1 million, pre-tax. The Employment Agreements constitute contracts between the Company and the executives. In order to be binding upon the executives, any amendments require that the executives receive adequate consideration in return for the modifications. The Board offered \$4.4 million, in the aggregate, to the two executives, to be earned over a 5-year period beginning with the year ended December 31, 2011, under defined conditions, including that of providing continuing services to the Company over the earn-out period. In February 2011, the executives agreed to the changes, and the initial BMP Annual Service Credit installment was made to the BMP. Although the Company undertook the entire contractual obligation for the BMP Annual Service Credits in 2011, SEC reporting rules require that they be reported in the Summary Compensation Table ratably as they are credited to the executives’ BMP accounts. The BMP Annual Service Credits, which total \$1.4 million annually on a pre-tax basis, are not considered “performance based” compensation. However, by amending the Employment Agreements, the Company reduced the maximum potential payment obligation of the two Employment Agreements by an estimated \$17.6 million at the time of the amendments. The final BMP Annual Service Credit was made in 2015.

Mr. Palagiano retired as CEO effective December 31, 2016, retaining only the title of Chairman of the Board. The 2016 Long-Term Cash Incentive Award amount for Mr. Palagiano includes the early settlement, due to his retirement, of awards granted to him in 2015 and 2016.

(10)

Mr. Mahon was appointed as our CEO effective January 1, 2017, following Mr. Palagiano's retirement as an employee of Dime.

(1) Mr. Harris resigned effective January 6, 2017, however, qualifies as an NEO.

(2) Mr. King's summary compensation is presented only for the years in which he was an NEO.

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Grants of Plan-based Awards for Fiscal Year 2016

The following table sets forth information regarding plan-based awards granted to the NEOs during the last fiscal year.

Executive	Type	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards ⁽¹⁾			Estimated Future Payouts Under Equity Incentive Plan Awards ⁽²⁾			Time-vested Restricted Stock Awards Number of Shares	Grant Date Fair Value of Award
			Threshold (\$)	Target (\$)	Maximum (\$)	Threshold (#)	Target (#)	Maximum (#)		
Vincent F. Palagiano ⁽⁴⁾	Cash	3/24/2016	\$ 235,625	\$ 471,250	\$ 706,875	-	-	-	-	-
Kenneth J. Mahon	Cash	3/24/2016	41,250	82,500	123,750	-	-	-	-	-
	PSA	3/24/2016	-	-	-	2,378	4,756	7,132	-	-
	RSA	4/26/2016	-	-	-	-	-	-	9,111	\$ 165,000
Michael Pucella	Cash	3/24/2016	16,088	32,175	48,263	-	-	-	-	-
	PSA	3/24/2016	-	-	-	928	1,854	2,782	-	-
	RSA	4/26/2016	-	-	-	-	-	-	3,553	64,300
Daniel J. Harris ⁽⁵⁾	Cash	3/24/2016	24,688	49,375	74,063	-	-	-	-	-
	PSA	3/24/2016	-	-	-	1,422	2,846	3,314	-	-
	RSA	4/26/2016	-	-	-	-	-	-	5,453	98,700
Timothy B. King	Cash	3/24/2016	16,673	33,345	50,018	-	-	-	-	-
	PSA	3/24/2016	-	-	-	960	1,922	2,882	-	-
	RSA	4/26/2016	-	-	-	-	-	-	3,682	66,600

The information in these columns reflects the range of potential cash payouts under the 2016 Cash LTI. Actual amounts earned by each NEO are based 100% on a pre-determined performance goal for the relative 3-year TSR for the performance period from January 1, 2016 through December 31, 2018. NEOs can earn either a target payout which is paid for performance at expectation, a threshold payout level (50% of the target), which is paid for a baseline level of acceptable performance to receive any award, or a maximum payout (150% of the target) which is paid for exceptional performance.

The information in these columns reflects the range of possible awards for vesting of PSA. The awards will vest based on the achievement of two pre-determined performance goals: 3-year Cumulative Core EPS and average annualized reported ROAE, for the performance period from January 1, 2016 through December 31, 2018. During March 2016, the Compensation and HR Committee approved threshold, target and maximum opportunities based on consultation with the independent compensation consulting firm. Target performance represents our budget performance, threshold payout level (50% of the target) represents a baseline level of acceptable performance to receive any award and maximum payout (150% of the target) represents exceptional performance. Please refer to the Appendix within this Proxy for a discussion of the computation of Cumulative Core EPS.

(3)

The amounts in this column reflect the aggregate grant date fair value of the awards, using \$18.11, the closing price of the Common Stock on the grant date. See “Grant of Plan-Based Awards Table” for additional information on the restricted stock award grants.

- (4) Mr. Palagiano’s LTI is paid solely in cash due to his significant Common Stock ownership. The 2016 Cash LTI award for Mr. Palagiano was settled on a pro-rata basis, due to his retirement as CEO effective December 31, 2016.
- (5) Mr. Harris resigned effective January 6, 2017 and forfeited his 2016 LTI award.

2004 Stock Incentive Plan. The Company's Board of Directors has adopted the 2004 Stock Incentive Plan, which was approved by the Company's shareholders at their annual meeting held in 2004. Future awards under the plan were terminated upon reaching its tenth anniversary in 2014. The Compensation and HR Committee of the Board of Directors administered the 2004 Stock Incentive Plan and authorized all equity grants. All equity grants under the 2004 Stock Incentive Plan fully vest in the event of a change in control. Options granted under the 2004 Stock Incentive Plan are intended to qualify as “incentive stock options” under Section 422 of the Code. On April 30, 2012, a grant of restricted stock awards was made to NEOs as follows: Mr. Mahon – 6,753 shares; Mr. Pucella – 4,221 shares; Mr. Harris – 5,106 shares; and Mr. King – 4,432 shares. 25% of these awards vested on May 1, 2013, 2014, 2015, and 2016 respectively. On April 30, 2013, a grant of restricted stock awards was made to NEOs as follows: Mr. Mahon – 6,559 shares; Mr. Pucella – 4,100 shares; Mr. Harris – 4,959 shares; and Mr. King – 4,304 shares. 25% of these awards vested on May 1, 2014, 2015, and 2016 respectively, with the remaining shares vesting on May 1, 2017.

2013 Equity and Incentive Plan. The 2013 Equity and Incentive Plan was adopted by the Company’s Board of Directors and subsequently approved by the Company’s shareholders at their annual meeting held in 2013. The 2013 Equity and Incentive Plan provides the Company with the flexibility to make equity compensation available to Outside Directors, officers (including the CEO) and other employees of the Company or its subsidiaries, and to continue to offer cash-based incentive compensation in a tax-efficient manner to officers (including the CEO) and employees. As of the Record Date, up to 783,166 shares of Common Stock remained eligible for award grants to either to Directors, NEOs or other officers of the Company under the 2013 Equity and Incentive Plan.

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On April 30, 2014, a grant of restricted stock awards was made to NEOs as follows: Mr. Mahon – 7,362 shares; Mr. Pucella – 3,252 shares; Mr. Harris – 3,957 shares; and Mr. King – 3,528 shares. 25% of these awards vested on May 1, 2015 and 2016, respectively, with the remaining shares vesting in equal annual installments on May 1, 2017 and 2018. On April 30, 2015, a grant of restricted stock awards was made to NEOs as follows: Mr. Mahon – 7,852 shares; Mr. Pucella – 3,879 shares; Mr. Harris – 4,693 shares; and Mr. King – 4,073 shares. 25% of these awards vested on May 1, 2016, with the remaining shares vesting in equal annual installments on May 1, 2017, 2018, and 2019. On March 24, 2016, PSAs assuming target performance were granted to NEOs as follows: Mr. Mahon – 2,378 shares; Mr. Pucella – 928 shares; Mr. Harris – 1,422 shares, and Mr. King – 960 shares. These shares vest based upon the achievement of specific goals during the performance period, ending December 31, 2018. On April 29, 2016, a grant of restricted stock awards was made to NEOs as follows: Mr. Mahon – 9,111 shares; Mr. Pucella – 3,553 shares; Mr. Harris – 5,453 shares; and Mr. King – 3,682 shares. These shares vest in equal annual installments on May 1, 2017, 2018, 2019 and 2020, respectively.

Outstanding Equity Awards at 2016 Fiscal Year End

Name	Grant Date	Option Awards			Stock Awards		Performance Shares	
		Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#)	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Options (#)	Number of Shares of Restricted Stock That Have Not Vested (#) ⁽¹⁾	Market Value of Shares of Restricted Stock That Have Not Vested (\$) ⁽²⁾	Number of Shares of Stock That Have Not Vested (#) ⁽⁴⁾	Market Value of Shares of Stock That Have Not Vested (\$) ⁽²⁾
Vincent F. Palagiano	5/1/2007	112	-	-	5/1/2017 -	-	-	-
	7/31/2008	11,706	-	-	7/31/2018-	-	-	-
	4/30/2010	3,044	-	-	4/30/2020-	-	-	-
Kenneth J. Mahon	4/29/2011	9,709	-	-	4/29/2021-	-	-	-
	4/29/2013	-	-	-	-	1,640	\$ 32,964	-
	4/30/2014	-	-	-	-	3,682	74,008	-
	4/30/2015	-	-	-	-	5,889	118,369	-
	3/24/2016	-	-	-	-	-	-	4,756
	4/29/2016	-	-	-	-	9,111	183,131	-
	4/29/2013	-	-	-	-	1,025	\$ 20,603	-
Michael Pucella	4/30/2014	-	-	-	-	1,626	65,683	-
	4/30/2015	-	-	-	-	2,910	58,491	-
	3/24/2016	-	-	-	-	-	-	1,854
	4/29/2016	-	-	-	-	3,553	71,415	-

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	4/29/2013	-	-	-	-	1,240	\$ 24,924	-	-
Daniel J. Harris ⁽³⁾	4/30/2014	-	-	-	-	1,979	39,778	-	-
	4/30/2015	-	-	-	-	3,520	70,752	-	-
	3/24/2016	-	-	-	-	-	-	2,846	57,205
	4/29/2016	-	-	-	-	5,453	109,605	-	-
	4/29/2013	-	-	-	-	1,076	21,628	-	-
Timothy B. King	4/30/2014	-	-	-	-	1,764	35,456	-	-
	4/30/2015	-	-	-	-	3,055	61,406	-	-
	3/24/2016	-	-	-	-	-	-	1,922	38,632
	4/29/2016	-	-	-	-	3,682	74,008	-	-

Please refer to the sections titled "2004 Stock Incentive Plan" and "2013 Equity and Incentive Plan" commencing on (1)page 33 for a detailed discussion of the expiration and vesting dates for each of the unexercisable options and unvested restricted stock awards.

(2) Market value is calculated on the basis of \$20.10 per share, the closing sale price of the Common Stock on the Nasdaq Stock Market on the final trading day of 2016.

(3)Mr. Harris resigned effective January 6, 2017 and forfeited his remaining unvested stock awards.

These shares are subject to vesting based upon the achievement of specific goals. The amounts shown assume the (4)target level of performance is achieved. The actual award, if any, will be determined as of December 31, 2018 based on the performance from 2016 to 2018.

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Option Exercises and Stock Vested for Fiscal Year 2016

The following table sets forth the stock awards that vested for, and the option awards that were exercised by, the NEOs during the last fiscal year:

Name	Option Awards		Stock Awards	
	Number of Shares Acquired on Exercise	Value Realized on Exercise ⁽¹⁾	Number of Shares Acquired on Vesting (#)	Value Realized on Vesting (\$) ⁽²⁾
Vincent F. Palagiano	149,888	\$ 528,719	—	—
Kenneth J. Mahon	—	—	7,132	\$ 129,161
Michael Pucella	20,164	79,543	3,863	69,959
Daniel J. Harris	14,134	30,765	4,679	84,797
Timothy B. King	5,453	16,850	4,084	73,961

All option exercise transactions involving NEOs during 2016, except for 29,000 stock options of the total 149,888 exercised by Mr. Palagiano, consisted of the simultaneous issuance and sale of an equivalent number of shares of Common Stock to the options exercised. Value realized in the table above is calculated as the difference between the aggregate value received on the simultaneous sale of the underlying shares (net of applicable fees and brokerage commissions) and the aggregate exercise cost of the applicable options on the respective dates of exercise.

⁽¹⁾ Amount calculated on the basis of \$18.11 per share (the closing price for a share of Common Stock on the Nasdaq Stock Market on May 1, 2016) for various grants to the NEOs which contractually vested on that date.

Pension Benefits

Retirement Plan. The Bank maintains the Retirement Plan, a non-contributory, tax-qualified defined benefit pension plan for eligible employees. All salaried employees at least age 21 who have completed a minimum of one year of service are eligible to participate in the Retirement Plan. The Retirement Plan provides each participant, including Messrs. Palagiano, Mahon, Pucella and King, a benefit equal to 2% of the participant's average annual earnings multiplied by the participant's years (and any fraction thereof) of eligible employment (up to a maximum of 30 years). Such benefit is not reduced by a Social Security offset. A participant is fully vested in his or her benefit under the Retirement Plan after five years of service. The Retirement Plan is funded by the Bank on an actuarial basis and all assets are held in trust by the Retirement Plan trustee. Effective April 1, 2000, all participant benefits under the Retirement Plan were frozen, and no benefits have been accrued under the Retirement Plan since that date.

BMP. The Bank maintains the BMP, which provides eligible employees with benefits that would be due under the Retirement Plan, ESOP and 401(k) Plan, if such benefits were not limited under the Code. Retirement Plan benefit accruals were frozen effective April 1, 2000, thus eliminating related benefit accruals under the BMP. However, the present value of such benefits continues to increase as the participating NEOs approach normal retirement age. Messrs. Palagiano, Mahon, Pucella, and King participated in the BMP in 2016.

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The following table sets forth information regarding pension benefits accrued by the NEOs as of December 31, 2016 under our Retirement Plan and BMP. Our BMP is a non-qualified deferred compensation plan with both a defined benefit and defined contribution component. The defined benefit component noted in this table reflects BMP Annual Service Credits to Messrs. Palagiano and Mahon of \$581,155 and \$293,027, respectively, for each year from 2011 through 2015. Mr. Harris was not eligible to participate in the plans, and has been excluded from the table.

<u>Name</u>	<u>Plan Name</u>	<u>Number of Years Credited Service (#) ⁽¹⁾</u>	<u>Present Value of Accumulated Benefit (\$) ⁽¹⁾</u>	<u>Payments During Last Fiscal Year (\$) ⁽²⁾</u>
Vincent F. Palagiano	Retirement Plan	29.6	\$ 2,067,564	\$ 185,166
	BMP (Defined Benefit Portion)	29.6	5,697,615	—
Kenneth J. Mahon	Retirement Plan	19.7	925,409	—
	BMP (Defined Benefit Portion)	19.7	263,561	—
Michael Pucella	Retirement Plan	18.9	586,530	—
	BMP (Defined Benefit Portion)	18.9	—	—
Timothy B. King	Retirement Plan	16.5	444,686	—
	BMP (Defined Benefit Portion)	16.5	—	—

The figures shown are determined as of the plan's measurement date during 2016 under accounting principles generally accepted in the U.S. ("U.S. GAAP"), as disclosed in Notes 1 and 15 to the Company's audited consolidated financial statements included in the Company's 2016 Annual Report on Form 10-K. The discount rate and other assumptions used for this purpose are discussed in Note 15 to the audited consolidated financial statements included in the Company's 2016 Annual Report on Form 10-K. The assumed mortality rates were as follows: Mr. Palagiano, 2.47%, Mr. Mahon, 0.87%, Mr. Pucella, 0.67% and Mr. King, 0.47%.

The Retirement Plan, which is a 403(b) Plan, requires that participants receive distributions from the plan in the year following when the participant turns 75. Mr. Palagiano turned 75 in 2015, and began receiving distributions in 2016.

Non-Qualified Deferred Compensation

The following table shows the 2016 activity for each of our NEOs, as well as their defined contribution account balances in our BMP. The defined contribution component noted in this table reflects the supplemental retirement benefit each NEO received due to the compensation limitations imposed by the Code on benefits provided under tax-qualified plans, such as our ESOP, 401(k) Plan and Retirement Plan. Effective April 1, 2000, Retirement Plan benefit accruals were frozen, thus eliminating related benefit accruals under the BMP.

<u>Name</u>	<u>Executive Contributions in Last Fiscal Year (\$)</u>	<u>Company Contributions in Last Fiscal Year (\$) ⁽¹⁾</u>	<u>Aggregate Earnings in Last Fiscal Year (\$) ⁽²⁾</u>	<u>Aggregate Withdrawals/ Distributions (\$) ⁽³⁾</u>	<u>Aggregate Balance at Last Fiscal Year End (\$) ⁽¹⁾</u>
Vincent F. Palagiano	-	\$ 81,235	\$ 875,067	\$ 196,639	\$ 11,549,403
Kenneth J. Mahon	-	50,803	342,752	74,426	4,806,464
Michael Pucella	-	19,940	112,145	27,266	1,200,967
Daniel J. Harris	-	28,750	12,975	2,696	173,840
Timothy B. King	-	21,114	111,664	27,147	1,202,114

- (1) Company contributions in the last fiscal year and aggregate balance at last fiscal year end both reflect compensation items recognized in 2016 in the Summary Compensation Table.
- (2) Earnings did not accrue at above-market or preferential rates. These numbers are not reflected in the Summary Compensation Table.
- (3) Amount represents pass through dividends on shares of Common Stock held in the ESOP component of the BMP.

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Potential Payments to Our Named Executive Officers Upon Termination of Service or Change in Control

The following table provides an estimate of the value of NEO termination and change of control benefits, assuming termination of employment or a change in control occurred on December 31, 2016: Tax-qualified benefits payable under the Pension Plan, the 401(k) Plan, ESOP and vested balances under our non-qualified, deferred compensation plans are not included in this table. Our NEOs receive only earned and vested compensation and benefits as of their termination date upon voluntary termination of service. Mr. Harris voluntarily terminated his employment with the Bank on January 6, 2017 and therefore is not included in the table below.

The payments to our NEOs are governed by various agreements and arrangements described in the footnotes to the table. The timing of the payments described below to the NEOs may also be subject to Section 409A of the Code which may delay payment.

	Vincent F. Palagiano ⁽¹¹⁾	Kenneth J. Mahon	Michael Pucella	Timothy B. King
Death				
Death Benefit ⁽¹⁾	\$ 2,175,000	\$ 1,650,000	\$-	\$-
Restricted Stock Award ⁽⁷⁾	-	155,212	74,290	78,310
Performance-based Stock Award ⁽⁸⁾	-	9,167	3,575	3,705
Cash LTI Award ⁽⁹⁾	398,218	104,733	49,135	51,457
Disability				
Disability Benefit ⁽²⁾	2,175,000	\$ 1,650,000	-	-
Restricted Stock Award ⁽⁷⁾	-	155,212	74,290	78,310
Performance-based Stock Award ⁽⁸⁾	-	9,167	3,575	3,705
Cash LTI Award ⁽⁹⁾	398,218	104,733	49,135	51,457
Discharge without Cause or Resignation with Good Reason – No Change in Control				
Severance Pay ⁽³⁾	1,988,218	1,508,303	-	-
Cash Incentive Bonus ⁽⁴⁾	997,260	728,631	-	-
Health and Welfare Benefits ⁽⁵⁾	55,957	55,957	-	-
401(k) Payment ⁽⁶⁾	88,859	63,667	-	-
Restricted Stock Award ⁽⁷⁾	-	155,212	74,290	78,310
Performance-based Stock Award ⁽⁸⁾	-	9,167	3,575	3,705
Cash LTI Award ⁽⁹⁾	398,218	104,733	49,135	51,457
Discharge without Cause or Resignation with Good Reason – Change in Control Related				
Severance Pay ⁽³⁾	2,108,479	1,599,536	984,301	1,021,767
Cash Incentive Bonus ⁽⁴⁾	1,057,582	772,708	420,000	432,629
Health and Welfare Benefits ⁽⁵⁾	55,957	55,957	76,153	91,659
401(k) Payment ⁽⁶⁾	94,078	67,406	41,461	42,504
Restricted Stock Award ⁽⁷⁾	-	408,472	183,191	192,498
Performance-based Stock Award ⁽⁸⁾	-	27,500	10,725	11,115
Cash LTI Award ⁽⁹⁾	398,218	104,733	49,135	51,457
Tax Indemnification Payment ⁽¹⁰⁾	-	-	-	-
Change in Control – No Termination of Employment				
Restricted Stock Award ⁽⁷⁾	-	155,212	74,290	78,310
Performance-based Stock Award ⁽⁸⁾	-	9,167	3,575	3,705
Cash LTI Award ⁽⁹⁾	398,218	104,733	49,135	51,457

Tax Indemnification Payment¹⁰⁾ - - - -

On termination by reason of death, the Employment Agreement provides for: (i) payment of earned but unpaid salary, (ii) benefits to which the executive is entitled as a former employee, (iii) payment for all unused vacation days and floating holidays in the year of termination at the highest rate of annual salary for such year, and (iv) a death benefit, payable to the beneficiaries of the executive through life insurance or otherwise. The death benefit,⁽¹⁾ payable within 30 days of death, is the equivalent on a net after-tax basis of the benefit payable under a term life insurance policy with a stated face value of three times the executive's then annual base salary. The Retention Agreements provide no severance benefits on termination by reason of death, except for (a) earned but unpaid salary, and (b) benefits to which such executive is entitled as a former employee.

On termination by reason of disability, the Employment Agreement provides for: (i) payment of earned but unpaid salary, (ii) benefits to which the executive is entitled as a former employee, (iii) payment for all unused vacation days and floating holidays in the year of termination at the highest rate of annual salary for such year, and (iv) a disability benefit equal to three times the executive's then annual base salary, payable in a lump sum within thirty days after termination. The Retention Agreements provide no severance benefits on termination by reason of disability.⁽²⁾

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- In the event of a termination without cause or a resignation with good reason, the Employment Agreements provide for a lump sum salary severance payment in an amount equal to the present value of the salary that the executive would have earned if he had worked for the Company during the remaining unexpired employment period at the highest annual rate of salary (assuming, if a change in control has occurred, that annual 6% salary increases would apply from the time of the change in control). The present value of this payment is to be determined using a discount rate of six percent (6%) per year, compounded with the frequency corresponding to the Company's regular payroll periods with respect to its officers. In the event of a termination without cause or resignation with good reason, in either event during the assurance period immediately following a change in control (or within three months prior to and in connection with a change in control), the Retention Agreements provide for a lump sum
- (3) payment in an amount equal to the present value of the salary that the executive would have earned if he had continued working for the Bank during the remaining unexpired assurance period at the highest annual rate of salary achieved during the executive's period of actual employment with the Bank. The present value is to be determined using a discount rate equal to the applicable short-term federal rate prescribed under section 1274(d) of the Code, compounded using the compounding periods corresponding to the Bank's regular payroll periods for its officers. The assurance period for Messrs. Pucella and King is three years. In the event that the employee is a "specified employee" within the meaning of Section 409A of the Code, then, if necessary to comply with Section 409A, payments will be delayed and paid on the first day of the seventh month following separation from service, with any such delayed payments for Messrs. Mahon, Pucella, and King to be held in a grantor trust which satisfies the requirements of Revenue Procedure 92-65 until such date of payment.
- In the event of a termination without cause or a resignation with good reason, the Employment Agreements provide for a lump sum severance payment related to the annual cash incentive award in an amount equal to the lump sum salary severance described in footnote (3) above, multiplied by the greater of (i) the target annual cash incentive bonus award (expressed as a percentage of salary) in effect at the time of termination, or (ii) the average of the actual annual cash incentive bonus payments (expressed as a percentage of salary) earned for the most recent three years. In the event of a termination without cause or resignation with good reason, in either event during the assurance period immediately following a change in control (or within three months prior to and in connection with a change in control), the Retention Agreements provide for a lump sum payment equal to the amount of incentives the executive would have received under all cash bonus or annual incentive compensation plans maintained by, or
- (4) covering employees of, the Bank, if he had continued working for the Bank and had earned the maximum bonus or incentive award in each calendar year that ends during the remaining unexpired assurance period. For Messrs. Pucella, and King, these annual cash incentive bonus payments are to be equal to the product of: (a) the maximum percentage rate at which an award was ever available to him under such incentive compensation plan, multiplied by (b) the salary that would have been paid to him during each such calendar year at the highest annual rate of salary achieved. The assurance period for Messrs. Pucella, and King is three years. In the event that the employee is a "specified employee" within the meaning of Section 409A of the Code, then, if necessary to comply with Section 409A, payments will be delayed and paid on the first day of the seventh month following separation from service, with any such delayed payments for Messrs. Mahon, Pucella and King to be held in a grantor trust which satisfies the requirements of Revenue Procedure 92-65 until such date of payment.
- (5) In the event of a termination without cause or a resignation with good reason, the Employment Agreement provides for continued group life, health (including hospitalization, medical, major medical, and dental), accident and long-term disability insurance benefits, in addition to benefits to which the executive is entitled as a former employee, after taking into account the coverage provided by any subsequent employer. These continued benefits will be provided if and to the extent necessary to provide the executive and his family and dependents for a period of three years following termination of employment, with coverage identical to, and in any event no less favorable than, the coverage to which they would have been entitled under plans in effect on the date of termination of employment. If the executive's termination of employment occurs after a change in control, he may elect coverage to which he would be entitled under plans in effect on the date of his termination of employment or during the one-year period ending on the date of such change in control. These continued benefits will be determined as if the executive had continued working for the Company during the remaining unexpired employment period as defined in the Employment Agreement at the highest annual rate of compensation (assuming, if a change in control has

occurred, that annual 6% salary increases would apply from the time of the change in control) under the Employment Agreement. In the event of a termination without cause or resignation with good reason, in either event during the assurance period immediately following a change in control (or within three months prior to and in connection with a change in control), the Retention Agreements provide for continued group life, health (including hospitalization, medical and major medical), accident and long term disability insurance benefits, in addition to benefits to which the executive is entitled as a former employee, and after taking into account the coverage provided by any subsequent employer. These continued benefits will be provided if and to the extent necessary to provide the executive, for the remaining unexpired assurance period, with coverage equivalent to the coverage to which such Contract Employee would have been entitled under plans in effect on the date of his termination of employment, or, if his termination of employment occurs after a change of control, under plans in effect upon the change of control, if the benefits are greater. The continued benefits will be determined as if the Contract Employee had continued working for the Bank during the remaining unexpired assurance period at the highest annual rate of compensation achieved during the Contract Employee's period of actual employment with the Bank. The assurance period for Messrs. Pucella and King is three years. Each figure shown represents the present value of continued insurance benefits for a fixed period of three years for the NEOs and assumes no offset for benefits provided by a subsequent employer, calculated on the basis of the assumptions used by the Company in measuring its liability for retiree benefits other than pensions for financial statement purposes under ASC Topic 715. For more information concerning other major assumptions used for these calculations, please refer to Note 14 to the audited consolidated financial statements included in the Company's 2016 Annual Report on Form 10-K.

In the event of a termination without cause or a resignation with good reason, the Employment Agreements provide for a lump sum payment in an amount approximately equal to the present value of matching contributions for three years of participation in the 401(k) Plan, and the present value of excess benefits under the BMP that would have been due for three years participation in the 401(k) Plan if such benefits were not limited under the Code (assuming, if a change in control has occurred, that annual 6% salary increases would apply from the time of the change in control). Each such present value is determined using a discount rate of six percent per annum, compounded with the frequency corresponding to the Company's regular payroll periods with respect to its officers. In the event of (6) termination without cause or resignation with good reason during the assurance period immediately following a change in control (or within three months prior to and in connection with a change in control), the Retention Agreements provide for a lump sum payment approximately equal to the present value of matching contributions for participation in the 401(k) Plan during the remaining unexpired assurance period, where such present value is determined using a discount rate equal to the applicable short-term federal rate prescribed under section 1274(d) of the Code, compounded with the frequency corresponding to the Company's regular payroll periods with respect to its officers. The assurance period for Messrs. Pucella and King is three years.

All restricted stock awards granted prior to January 1, 2014 under the 2004 Stock Incentive Plan fully vest upon a change in control unless they were forfeited prior to such change in control becoming effective. In addition, for grants made prior to January 1, 2014 under the 2004 Stock Incentive Plan, accelerated vesting occurs on a pro-rated basis for restricted stock awards upon either death or disability (as defined in the plan document) before termination of service with the Company has otherwise occurred and within six months prior to the scheduled vesting date. All (7) restricted stock awards granted on or after January 1, 2014 under either the 2004 Stock Incentive Plan or the 2013 Equity and Incentive Plan vest upon a change of control with a qualifying termination unless they were forfeited prior to such qualifying termination becoming effective. In addition, for grants made on or after January 1, 2014 under either Plan, accelerated vesting occurs on a pro-rated basis for restricted stock awards in the event of retirement, death or disability. The figures shown reflect the value of those restricted stock awards that would accelerate, calculated based on a per share value of \$20.10, which was the closing sale price for a share of Common Stock on December 31, 2016.

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In 2016, each of the NEOs other than Mr. Palagiano was granted PSAs with a performance period ending December 31, 2018. Descriptions of the award levels and criteria are set forth in the “Compensation Discussion and Analysis – Compensation Program Components – Long-term Incentive Plan.” Upon a change of control, death, disability or retirement, each amount is pro-rated based on performance through the date of such event. Since the amount of the performance awards cannot be determined at this time, the estimate has been prepared based on the target opportunities under each award.

In 2015, each of the NEOs was granted a Cash LTI award with a performance period ending December 31, 2017. In 2016, each of the NEOs was granted a Cash LTI award with a performance period ending December 31, 2018.

Descriptions of the payment levels and criteria are set forth in the “Compensation Discussion and Analysis – Compensation Program Components – Long-term Incentive Plan.” Upon a change of control, death, disability or retirement, each amount is pro-rated based on performance through the date of such event. Since the amount of the performance awards cannot be determined at this time, the estimate has been prepared based on the target opportunities under each award.

Cash and benefits paid to Mr. Mahon under the Employment Agreements and Messrs. Pucella and King under their Retention Agreements, together with payments under other benefit plans following a change of control of the Bank or the Company may constitute "excess parachute payments" under Section 280G of the Code, resulting in the imposition of a 20% excise tax on the recipient and the denial of the deduction for such excess amounts to the Company and the Bank. The Employment Agreements of Messrs. Palagiano and Mahon and the Retention Agreements of Messrs. Pucella and King include a provision indemnifying the executives on an after-tax basis for any excise taxes triggered under Section 4999 of the Code, as well as applicable Federal, State, and employment taxes that apply to the additional amounts paid (“Tax Indemnification Payment”). No Tax Indemnification Payment would have been payable to the NEO had a change of control occurred on December 31, 2016.

Mr. Palagiano’s Employment Agreement terminated effective upon his December 31, 2016 retirement as Chief Executive Officer, and he is no longer eligible to receive termination or change in control benefits.

Transactions with Certain Related Persons

The Company's Lending Policies Manual which is approved at least annually by the full Board, contains written procedures designed to ensure compliance with all laws related to transactions involving the Company or Bank and any Director, executive officer or their immediate family. The Company's Board of Directors monitors adherence to these policies on an annual basis.

Federal Reserve Board Regulation O requires that all Bank or Company loans or extensions of credit to certain executive officers, as defined in Regulation O ("Regulation O Officers"), and Directors must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with the general public and must not involve more than the normal risk of repayment or present other unfavorable features. The Bank has in the past made loans or extended credit to Regulation O Officers and also to certain persons related to Regulation O Officers and Directors. All such loans were: (i) made by the Bank in the ordinary course of business; (ii) made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons, and (iii) did not involve more than the normal risk of repayment or present other unfavorable features. Pursuant to its current written policy, the Bank is prohibited from advancing loans to the NEOs or Directors. As of the Record Date, the Bank owned one loan that was made to an executive officer other than the NEOs. This loan fully complied with Regulation O and the Bank’s policy regarding such loans, and, since inception, has not exceeded \$120,000.

Section 402 of the Sarbanes-Oxley Act of 2003 ("Sarbanes-Oxley") prohibits the extension of personal loans to Directors and executive officers of issuers (as defined in Sarbanes-Oxley). The prohibition, however, does not apply to mortgages advanced by an insured depository institution, such as the Bank, that is subject to the insider lending restrictions of Section 22(h) of the Federal Reserve Act.

Delaware General Corporate Law ("DGCL") §143 permits a Delaware corporation, such as the Company, to advance a loan to, guarantee the obligation of, or otherwise assist any officer or other employee of the corporation or its subsidiaries, including employees who are directors of the corporation, whenever, in the judgment of the directors, such loan, guaranty or assistance may reasonably be expected to benefit the corporation. The loan, guaranty or other assistance may be with or without interest, and may be unsecured, or secured in such manner as the board of directors shall approve, including, without limitation, a pledge of shares of stock of the corporation.

Pursuant to DGCL §144(a), no contract or transaction between a corporation and its directors or officers, or between a corporation and any other entity in which its directors or officers are directors or officers or have a financial interest, shall be voidable solely for this reason, or solely because the director or officer is present at, or participates in, the meeting of the Board or Committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if: (1) the material facts as to the Director's or officer's relationship to the contract or transaction are disclosed or known to the Board or Committee, and the Board or Committee in good faith authorizes the contract or transaction by the affirmative vote of a majority of the disinterested Directors, even though the disinterested Directors may be less than a quorum; (2) the material facts as to the Director's or officer's relationship to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or (3) the contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified by the Board, a Committee or the shareholders.

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Under New York State Banking laws, New York State-chartered savings banks such as the Bank are subject to rules regarding insider transactions. This includes specific types of transactions conducted by insiders, who are defined as: (1) the chairman of the board, president, executive vice president, secretary and treasurer of the Bank; (2) any other officer or employee of the Bank who participates or has authority to participate otherwise than in the capacity of a director of the Bank, in major policy-making functions of the Bank, regardless of whether he or she has an official title or whether his or her title contains a designation of assistant and regardless further, of whether he or she is serving without salary or other compensation; (3) any director of the Bank; and (4) any other person who has direct or indirect control over the voting rights of 10 percent of the shares of any class of voting stocks of the Bank or otherwise controls the management or policies of the Bank. The term "insider transaction" means any business transaction or series of related transactions by, between or on behalf of the Bank and: (1) an insider of the Bank; (2) a person related to an insider of the Bank; or (3) any other person where the transaction is made in contemplation of such person becoming an insider of the Bank. Board approval must be received and documented whenever an insider transaction (or aggregate of insider transactions) reaches a specific dollar threshold.

The Company has entered into a three-year consulting agreement with Mr. Devine, which commenced effective January 1, 2016. For amounts paid to Mr. Devine in 2016 under his consulting agreement, see "Proposal 1 – Election of Directors – Directors' Compensation."

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires the Company's executive officers and Directors, and persons who own more than 10% of the Common Stock, to file with the SEC reports of ownership and changes in ownership of Common Stock. Executive officers, Directors and greater than 10% shareholders are required by SEC regulation to furnish the Company with copies of all Section 16(a) forms that they file. Based solely on review of the copies of such forms received by the Company, or written representations from certain reporting persons, the Company believes that its executive officers, Directors and greater than 10% beneficial owners complied with all applicable filing requirements.

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PROPOSAL 2

RATIFICATION OF APPOINTMENT OF INDEPENDENT AUDITORS

General

The Audit Committee of the Board of Directors has appointed the firm of Crowe Horwath LLP to act as the Company's independent auditors (principal accountant) for the year ending December 31, 2017. A representative of Crowe Horwath LLP is expected to be present at the Annual Meeting, will be provided an opportunity to make a statement if he or she so desires, and is expected to be available to respond to appropriate questions. No determination has been made as to any action the Audit Committee would take if the shareholders do not ratify the appointment.

Audit Fees

The following table summarizes the aggregate fees either paid or contractually owed by the Company to Crowe Horwath LLP:

	Year Ended December 31,	
	2016	2015
Audit Fees (a)	\$ 511,500	\$ 505,100
Audit-Related Fees (b)	90,000	87,000
Tax Fees (c)	81,000	81,000
All Other Fees	-	-
Total	\$ 682,500	\$ 673,100

(a) Fees for audit services in 2016 and 2015 consisted of:

§ Audits of the Company's annual financial statements

§ Reviews of the Company's quarterly financial statements

§ Comfort letters, statutory and regulatory audits, consents and other services related to SEC matters in 2015 only

(b) Fees for audit-related services in 2016 and 2015 consisted of:

§ Financial accounting and reporting consultations

§ Internal control reviews

§ Employee benefit plan audits

(c) Fees paid to firms other than Crowe Horwath LLP for tax compliance services totaled \$20,426 in 2016 and \$39,310 in 2015.

Tax compliance services are services rendered based upon facts already in existence or transactions that have already occurred to document, compute, or obtain government approval for amounts to be included in tax filings and consisted of:

i. Federal, state and local income tax return assistance

- ii. Sales and use, property and other tax return assistance
- iii. Research & Development tax credit documentation and analysis for purposes of filing amended returns
- iv. Requests for technical advice from taxing authorities

There were no tax planning and advice service fees paid for 2016 or 2015. Tax planning and advice consists of services rendered with respect to proposed transactions or that alter a transaction to obtain a particular tax result.

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Pre-Approval Policy

The services performed by the independent auditor in 2016 were pre-approved in accordance with the Audit Committee's pre-approval policy. Pursuant to the policy, the Audit Committee must pre-approve all audit and permitted non-audit services to be provided by the independent auditor, including the fees and terms thereof.

THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS THAT SHAREHOLDERS VOTE "FOR" RATIFICATION OF THE APPOINTMENT OF CROWE HORWATH LLP AS THE COMPANY'S INDEPENDENT AUDITORS FOR THE YEAR ENDING DECEMBER 31, 2017.

PROPOSAL 3

ADVISORY VOTE ON THE COMPENSATION OF NAMED EXECUTIVE OFFICERS

The Company is seeking a non-binding advisory vote on the compensation of the Named Executive Officers as disclosed in this Proxy Statement.

As discussed in the Compensation Discussion and Analysis, the Company's executive compensation program has been designed to attract, retain and motivate the highest quality executive officers, directly link pay to the Company's performance, and build value for its shareholders. The Company's executive compensation philosophy is, with the benefit of objective input from an independent consultant, to provide competitive target compensation opportunities with actual amounts earned commensurate with financial performance and the generation of long-term value to shareholders. The Company believes that the compensation data in this Proxy Statement demonstrates the success of this philosophy.

This proposal, commonly known as a "Say-on-Pay" proposal, gives the Company's shareholders the opportunity to express their views on the compensation provided to the Named Executive Officers. This vote is not intended to address any specific item of compensation, but rather the overall compensation of the Named Executive Officers.

Accordingly, the Board invites you to review carefully the Compensation Discussion and Analysis, as well as the tabular and other disclosures on compensation under the section titled "Compensation Program Components" and approve the following resolution:

RESOLVED, that the compensation paid to the Company's Named Executive Officers, as disclosed pursuant to Item 402 of Regulation S-K, including the Compensation Discussion and Analysis, compensation tables and narrative discussion, is hereby APPROVED.

Under applicable law, the Say-on-Pay vote is advisory, and therefore not binding on the Company or its Board of Directors. The shareholders' advisory vote will not overrule any decision made by the Board or any of its Committees or create or imply any additional fiduciary duty by the Company's Directors. The Company's Board of Directors and Compensation and HR Committee value the opinions of shareholders and will consider the voting results, along with relevant factors, in connection with their ongoing executive compensation activities.

THE BOARD OF DIRECTORS RECOMMENDS AN ADVISORY VOTE "FOR" APPROVAL OF THE
COMPENSATION OF NAMED EXECUTIVE OFFICERS AS DESCRIBED IN THIS PROXY STATEMENT

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PROPOSAL 4

ADVISORY VOTE ON THE FREQUENCY OF FUTURE SHAREHOLDER ADVISORY VOTES ON THE COMPENSATION OF NAMED EXECUTIVE OFFICERS

The Company is seeking a non-binding advisory vote on whether future advisory votes on the compensation of its Named Executive Officers should occur every year, two years or three years.

After careful consideration, the Board of Directors has determined that holding an advisory vote on executive compensation annually is currently the most appropriate policy for the Company, and recommends that shareholders vote for the Company to hold annual advisory votes on executive compensation. Although the Company's executive compensation programs are designed to promote a long-term connection between pay and performance, executive compensation is disclosed annually. The Board believes that an annual advisory vote on executive compensation permits timely input from its shareholders.

You may elect to have the advisory vote held annually, every two years or every three years, or you may abstain. You are not voting to approve or disapprove the Board's recommendation. The vote is advisory and non-binding. Whichever of one year, two years or three years receives the greatest number of shareholder votes will be considered the option that has been selected by the shareholders. The Board will consider the outcome, along with other relevant factors, when considering the future frequency of the advisory vote on the compensation of the Named Executive Officers.

The Company will, at least once every six years, submit to an advisory vote of its shareholders a non-binding proposal similar to this Proposal 4, on the frequency of the Say-on-Pay advisory vote.

THE BOARD OF DIRECTORS RECOMMENDS AN ADVISORY VOTE FOR "EVERY YEAR" ON PROPOSAL 4

SHAREHOLDER COMMUNICATIONS WITH THE BOARD

The Company's Board of Directors provides a process for shareholders to send communications to the Board. The Company's Policy Regarding Shareholder Communication with the Board is available on its website at www.dime.com by selecting "Investor Relations," then in the "Investor Menu", select the drop down arrow next to "Corporate Overview" then select "Governance Documents".

OTHER MATTERS

As of the date of this Proxy Statement, the Company's Board of Directors is not aware of any other matters to be brought before the shareholders at the Annual Meeting. If, however, any other matters not known are properly brought before the meeting, the persons named in the accompanying proxy will vote the shares represented by all properly executed proxies on such matters in such manner as shall be determined by a majority of the Board of Directors.

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2018 ANNUAL MEETING SHAREHOLDER PROPOSALS

In order to be considered for inclusion in the Company's Proxy Statement and form of proxy for the annual meeting to be held in 2018, all shareholder proposals, including, but not limited to, nominations for Director, must be submitted to the Secretary of the Company at its offices at 300 Cadman Plaza West, 8th Floor, Brooklyn, New York 11201 on or before December 15, 2017. Under the Company's Bylaws, shareholder nominations for Director and shareholder proposals not included in the Company's 2017 Proxy Statement, in order to be considered for possible action by the shareholders at the annual meeting to be held in 2018, must be delivered to or received by the Secretary of the Company, at the address set forth above: (i) sixty days in advance of such meeting if such meeting is to be held on a day which is within thirty days preceding the anniversary of the previous year's annual meeting, or ninety days in advance of such meeting if such meeting is to be held on or after the anniversary of the previous year's annual meeting; and (ii) with respect to an annual meeting held at a time other than within the time periods set forth in the immediately preceding clause (i), the close of business on the tenth day following the date on which notice of such meeting is first given to shareholders. Notice shall be deemed to be first given to shareholders when disclosure of such date of the meeting of shareholders is first made in a press release reported to Dow Jones News Services, the Associated Press or a comparable national news service, or in a document publicly filed by the Company with the SEC pursuant to Section 13, 14 or 15(d) of the Exchange Act. A shareholder's notice to the Secretary shall set forth such information as required by, and otherwise comply with, the Company's Bylaws. Nothing in this paragraph shall be deemed to require the Company to include in its proxy statement and proxy card relating to an annual meeting any shareholder proposal or nomination which does not satisfy all of the requirements for inclusion established by the SEC in effect at the time such proposal or nomination is received.

The Board of Directors will review any shareholder proposals that are filed as required and determine whether such proposals satisfy applicable criteria for consideration at the annual meeting to be held in 2018.

Multiple Shareholders Sharing One Address

Only one copy of the Proxy Statement and Annual Report are being delivered to multiple shareholders sharing an address unless the Company has received contrary instructions from one or more of the shareholders. The Company will deliver promptly upon written or oral request separate copies of the Proxy Statement and Annual Report to a shareholder at a shared address to which a single copy of the Proxy Statement and Annual Report were delivered. Shareholders may notify the Company that they desire to receive a separate copy of the current or a future Proxy Statement and Annual Report by writing Dime Community Bancshares, Inc., 300 Cadman Plaza West, 8th Floor, Brooklyn, NY 11201, Attn: Investor Relations, or by telephoning the Investor Relations Department at (718) 782-6200, ext. 5260. By using either of these methods, shareholders sharing an address may additionally request delivery of a single copy of a Proxy Statement and Annual Report if they are receiving multiple copies.

Annual Report

A copy of the Annual Report to shareholders for the period ended December 31, 2016, including the consolidated financial statements prepared in conformity with U.S. GAAP for the year ended December 31, 2016, accompanies this Proxy Statement. The consolidated financial statements for the year ended December 31, 2016 have been audited by Crowe Horwath LLP, whose report appears in the Annual Report. Shareholders may obtain, free of charge, a copy of the Annual Report on Form 10-K filed with the SEC (without exhibits) by writing to Anthony J. Rose, Director of Investor Relations, Dime Community Bancshares, Inc., 300 Cadman Plaza West, 8th Floor, Brooklyn, New York 11201, or by calling (718) 782-6200, extension 5260, or by accessing the Company's corporate website www.dime.com.

By Order of the Board of Directors

Lance J. Bennett
Secretary
Brooklyn, New York
April 14, 2017

TO ASSURE THAT YOUR SHARES ARE REPRESENTED AT THE ANNUAL MEETING, PLEASE COMPLETE, SIGN, DATE AND PROMPTLY RETURN THE ACCOMPANYING PROXY CARD IN THE POSTAGE PAID ENVELOPE PROVIDED.

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APPENDIX

Defined terms

U.S. GAAP generally accepted accounting principles in the United States of America.

Performance Measures

Use of Non-U.S. GAAP Performance Measures

For purposes of certifying the Company's performance under its compensation plans, the Compensation Committee typically makes adjustments to the Company's U.S. GAAP results to ensure that the participants are compensated for the Company's core performance. These adjustments neither penalize nor reward for one-time charges, unusual gains, or similar non-core events. These disclosures should not be viewed as a substitute for operating results determined in accordance with U.S. GAAP, nor are they necessarily comparable to non-U.S. GAAP performance measures that may be presented by other companies.

Cash Return on Average Equity A non-U.S. GAAP measure computed by dividing cash basis net income by average stockholders' equity. Cash basis net income is computed by adding to net income, as derived in accordance with U.S. GAAP and reported in a company's consolidated statements of operations/income, the following expense items: (a) expense recognized to reduce the balance of long-lived intangible assets; and (2) compensation expense associated with stock benefit plans. Both of these expense items, if applicable, are disclosed in the "cash flows from operations" section of a company's consolidated statements of cash flows, and generate a corresponding increase in tangible regulatory capital in the period recognized.

Cumulative Core EPS A non-U.S. GAAP measure derived from EPS, and adjusted for various items recognized in EPS the extraction of which is deemed valuable in assessing the Company's consolidated operating results. A reconciliation of U.S. GAAP EPS and Core EPS for the Company for the three-year period ended December 31, 2016 is presented as follows:

	Cumulative for The Three Years Ended December 31, 2016	
EPS	\$	4.44
Curtailement of postretirement plan benefits	(0.05)
Prepayment fee income above financial forecasted levels	(0.32)
Gain on the sale of equity mutual funds and real estate	(0.04)
Gain on the sale of real estate	(1.02)
Prepayment of ESOP Share Acquisition Loan	0.31	
Prepayment expense on borrowings	0.02	
Core EPS	\$	3.34

Core Net Income A non-U.S. GAAP measure derived by adjusting reported net income by the after-tax effect for any significant unusual or non-recurring items, either favorable or unfavorable. A reconciliation of U.S. GAAP Net Income and Core Net Income for the Company for the year ended December 31, 2016 is presented as follows:

	Year Ended December 31, 2016 (Dollars in thousands)
Net Income	\$ 72,514

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Gain on the sale of real estate	(37,483)
Prepayment of ESOP Share Acquisition Loan	11,319	
Core Net Income	\$ 46,350	

Core ROA – Core Net Income divided by Average Assets. Average Assets is calculated by taking the quarterly asset balance from 10Q (including December of prior year) and dividing by five.

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Efficiency Ratio A financial measure computed by dividing non-interest expense by the sum of net interest income and non-interest income, excluding any gains or losses on sales of assets. All of these measures are disclosed in a company's consolidated statements of operations/income, and are derived in accordance with U.S. GAAP.

EPS Growth Rate A measurement of the growth from the beginning to ending operating periods in Diluted EPS as reported in a company's consolidated statements of operations/income. EPS is a financial measure derived in accordance with U.S. GAAP.

Reported Return on Equity A financial measure computed by dividing net income, as reported in a company's consolidated statements of operations or income, by average stockholders' equity, as reported in the respective summaries of net interest income. Both net income and average stockholders' equity are derived in accordance with U.S. GAAP.

Return on Average Risk Weighted Assets A non-U.S. GAAP measure computed by dividing net income, as reported in a company's consolidated statements of operations/income, by an average of the ending quarterly balances during the measurement period of total risk weighted assets for the banking subsidiary of each company. Ending quarterly total risk weighted assets are reported on Schedule RC-R of the banking institution's Call Report (or the comparable regulatory schedule) which is filed publicly with the respective regulatory agency. Under interagency guidelines governing the computation of risk-weighted assets, this measure is computed similarly by banking institutions. In analyzing the standalone performance of the Company, the computation of Return on Average Risk Weighted Assets utilizes net income.

Total Shareholder Return The return provided to a shareholder who invests in a share of the common stock of a company assuming full reinvestment of cash dividends into additional shares of the respective common stock. Amounts obtained from the Bloomberg financial database.

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Voting Items

The Board of Directors recommends you vote FOR the following:

1. Election of the following three nominees for Directors for terms to expire at the 2020 Annual Meeting of

Shareholders:

NOMINEES:

1) Kenneth J. Mahon

2) Steven D. Cohn

3) Robert C. Golden

The Board of Directors recommends you vote FOR the following proposals:

2. Ratification of the appointment of Crowe Horwath LLP as the Company's independent auditors for the year ending December 31, 2017.

3. Approval, by a non-binding advisory vote, of the compensation of the Company's Named Executive Officers.

The Board of Directors recommends you vote 1 year on the following proposal:

4. To recommend, by a non-binding advisory vote, the frequency of future advisory votes on the compensation of the Company's Named Executive Officers.

----- Before You Vote -----

How to Access the Proxy Materials

Proxy Materials Available to VIEW or RECEIVE:

NOTICE AND PROXY STATEMENT ANNUAL REPORT

How to View Online:

Have the information that is printed in the box marked by the arrowgXXXX XXXX XXXX XXXX (located on the following page) and visit: www.proxyvote.com.

How to Request and Receive a PAPER or E-MAIL Copy:

If you want to receive a paper or e-mail copy of these documents, you must request one. There is NO charge for requesting a copy. Please choose one of the following methods to make your request:

- 1) BY INTERNET: www.proxyvote.com
- 2) BY TELEPHONE: 1-800-579-1639
- 3) BY E-MAIL*: sendmaterial@proxyvote.com

* If requesting materials by e-mail, please send a blank e-mail with the information that is printed in the box marked by the arrowgXXXX XXXX XXXX XXXX (located on the following page) in the subject line.

Requests, instructions and other inquiries sent to this e-mail address will NOT be forwarded to your investment advisor. Please make the request as instructed above on or before May 11, 2017 to facilitate timely delivery.

----- How To Vote -----

Please Choose One of the Following Voting Methods

Vote In Person: If you choose to vote these shares in person at the meeting, you must request a "legal proxy." To do so, please follow the instructions at www.proxyvote.com or request a paper copy of the materials, which will contain the appropriate instructions. Many shareholder meetings have attendance requirements including, but not limited to, the possession of an attendance ticket issued by the entity holding the meeting. Please check the meeting materials for any special requirements for meeting attendance.

Vote By Internet: To vote now by Internet, go to www.proxyvote.com. Have the information that is printed in the box marked by the arrowgXXXX XXXX XXXX XXXX (located on the following page) available and follow the instructions.

Vote By Mail: You can vote by mail by requesting a paper copy of the materials, which will include a voting instruction form.

*** Exercise Your Right to Vote ***

Important Notice Regarding the Availability of Proxy Materials for the Shareholder Meeting to Be Held on May 25, 2017.

DIME COMMUNITY BANCSHARES, INC.

Meeting Information

Meeting Type: Annual Meeting

For holders as of: March 29, 2017

Date: May 25, 2017 Time: 10:00 AM

Location: Giando on the Water

400 Kent Avenue

Brooklyn, NY 11211

You are receiving this communication because you hold shares in the company named above.

This is not a ballot. You cannot use this notice to vote these shares. This communication presents only an overview of the more complete proxy materials that are available to you on the Internet. You may view the proxy materials online at www.proxyvote.com or easily request a paper copy (see reverse side).

We encourage you to access and review all of the important information contained in the proxy materials before voting.

See the reverse side of this notice to obtain proxy materials and voting instructions.

DIME COMMUNITY BANCSHARES, INC. 300 CADMAN PLAZA WEST, 8TH FLOOR BROOKLYN, NY 11201 ATTN: SHAREHOLDER RELATIONS VOTE BY INTERNET - www.proxyvote.com Use the Internet to transmit your voting instructions and for electronic delivery of information up until 11:59 P.M. Eastern Time the day before the cut-off date or meeting date. Have your proxy card in hand when you access the web site and follow the instructions to obtain your records and to create an electronic voting instruction form. ELECTRONIC DELIVERY OF FUTURE PROXY MATERIALS If you would like to reduce the costs incurred by our company in mailing proxy materials, you can consent to receiving all future proxy statements, proxy cards and annual reports electronically via e-mail or the Internet. To sign up for electronic delivery, please follow the instructions above to vote using the Internet and, when prompted, indicate that you agree to receive or access proxy materials electronically in future years. VOTE BY PHONE - 1-800-690-6903 Use any touch-tone telephone to transmit your voting instructions up until 11:59 P.M. Eastern Time the day before the cut-off date or meeting date. Have your proxy card in hand when you call and then follow the instructions. VOTE BY MAIL Mark, sign and date your proxy card and return it in the postage-paid envelope we have provided or return it to Vote Processing, c/o Broadridge, 51 Mercedes Way, Edgewood, NY 11717. TO VOTE, MARK BLOCKS BELOW IN BLUE OR BLACK INK AS FOLLOWS: E25635-P88593-Z69568 KEEP THIS PORTION FOR YOUR RECORDS THIS PROXY CARD IS VALID ONLY WHEN SIGNED AND DATED. DETACH AND RETURN THIS PORTION ONLY DIME COMMUNITY BANCSHARES, INC.

For All Withhold All For All Except To withhold authority to vote for any individual nominee(s), mark "For All Except" and write the number(s) of the nominee(s) on the line below. Proposals 1, 2, 3 and 4 are proposed by Dime Community Bancshares, Inc. The Board of Directors unanimously recommends a vote "FOR" all of the nominees in Proposal 1, a vote "FOR" Proposals 2 and 3 and a vote "FOR EVERY YEAR" on Proposal 4. 1. Election of the following three nominees for Directors for terms to expire at the 2020 Annual Meeting of Shareholders: NOMINEES: 01) Kenneth J. Mahon 02) Steven D. Cohn 03) Robert C. Golden For Against Abstain 2. Ratification of the appointment of Crowe Horwath LLP as the Company's independent auditors for the year ending December 31, 2017. 3. Approval, by a non-binding advisory vote, of the compensation of the Company's Named Executive Officers. Every Year Every 2 Years Every 3 Years Abstain 4. To recommend, by a non-binding advisory vote, the frequency of future advisory votes on the compensation of the Company's Named Executive Officers. 5. The proxies are authorized to vote upon such other business as may come before the Annual Meeting or any adjournment or postponement thereof in such manner as shall be determined by a majority of the Board of Directors. The undersigned hereby acknowledges receipt of the Notice of the Annual Meeting of Shareholders and the Proxy Statement, both dated April 14, 2017, for the Annual Meeting. To change the address on your account, please check the box at the right and indicate your new address in the address space on the reverse side. Please note that changes to the registered name(s) on the account may not be submitted via this method. Yes No I will attend the Annual Meeting. Note: Please sign exactly as your name or names appear on this Proxy. When shares are held jointly, each holder should sign. When signing as executor, administrator, attorney, trustee or guardian, please give full title as such. If the signer is a corporation, please sign full corporate name by duly authorized officer, giving full title as such. If signer is a partnership, please sign in partnership name by authorized person. Signature [PLEASE SIGN WITHIN BOX] Date Signature (Joint Owners) Date

Important Notice Regarding the Availability of Proxy Materials for the Annual Meeting: The Notice and Proxy Statement and Annual Report are available at www.proxyvote.com. DIME COMMUNITY BANCSHARES, INC. 300 Cadman Plaza West, 8th Floor Brooklyn, NY 11201 This Proxy is solicited on behalf of the Board of Directors of Dime Community Bancshares, Inc. for the Annual Meeting of Shareholders to be held on May 25, 2017. The undersigned shareholder of Dime Community Bancshares, Inc. hereby appoints Kathleen M. Nelson, Omer S. J. Williams, and Joseph J. Perry, or any of them, with full powers of substitution, to represent and to vote as proxy, as designated on the reverse side, all shares of common stock of Dime Community Bancshares, Inc. held of record by the undersigned on March 29, 2017, at the Annual Meeting of Shareholders (the "Annual Meeting") to be held at 10:00 a.m., Eastern Time, on May 25, 2017, or at any adjournment or postponement thereof, upon the matters described in the accompanying Notice of the Annual Meeting of Shareholders and Proxy Statement, both dated April 14, 2017, and upon such other matters as may properly come before the Annual Meeting. The undersigned hereby revokes all prior proxies. This Proxy, when properly executed, will be voted in the manner directed herein by the undersigned shareholder. If no direction is given, this Proxy will be voted FOR the election of all nominees in Proposal 1, FOR Proposals 2 and 3 and FOR EVERY YEAR on Proposal 4. If this Proxy is executed in such a way as not to withhold authority to vote for the election of any nominee, this Proxy shall be deemed to grant such authority. ADDRESS CHANGES/COMMENTS: (If you noted any Address Changes/Comments above, please mark corresponding box on the reverse side.) (Continued and to be signed on reverse side)
