STEMCELLS INC
Form DEF 14A
April 30, 2007

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

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of the Securities
Exchange Act of 1934 (Amendment No.   )

Filed by the Registrant þ
Filed by a Party other than the Registrant o

Check the appropriate box:

o Preliminary Proxy Statement
o **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**
þ Definitive Proxy Statement
o Definitive Additional Materials
o Soliciting Material Pursuant to §240.14a-12

STEMCELLS, INC.
(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

þ No fee required.
o Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11.

1) Title of each class of securities to which transaction applies:

2) Aggregate number of securities to which transaction applies:

3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

4) Proposed maximum aggregate value of transaction:

5) Total fee paid:

o Fee paid previously with preliminary materials.

o Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

1) Amount Previously Paid:

2) Form, Schedule or Registration Statement No.:

3) Filing Party:

4) Date Filed:

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STEMCELLS, INC.
3155 Porter Drive
Palo Alto, CA 94304

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS
To be Held on June 12, 2007

To the Stockholders of
STEMCELLS, INC.

Notice is hereby given that the Annual Meeting of Stockholders of StemCells, Inc. (StemCells or the company) will be held on June 12, 2007 at 2 P.M., local time, at 3155 Porter Drive, Palo Alto, CA 94304 for the following purposes:

1. To elect Class I directors to serve until the 2010 Annual Meeting of Stockholders;

2. To consider and vote upon a proposal to ratify the selection of Grant Thornton LLP as independent public accountants for the company for the fiscal year ending December 31, 2007;

3. To consider and vote upon a proposal to amend the 2006 Equity Incentive Plan as proposed;

4. To transact any and all other business that may properly come before the meeting.

The Board of Directors has fixed the close of business on April 26, 2007 as the record date for determining those stockholders who are entitled to notice of and to vote at the meeting. The stock transfer books will not be closed between the record date and the date of the meeting.

Representation of at least a majority of all outstanding shares of Common Stock of StemCells is required to constitute a quorum. Accordingly, it is important that your shares be represented at the meeting. WHETHER OR NOT YOU PLAN TO ATTEND THE ANNUAL MEETING, PLEASE SIGN AND DATE THE ENCLOSED PROXY AND RETURN IT PROMPTLY IN THE ENCLOSED ENVELOPE. Your proxy may be revoked at any time prior to the time it is voted.

Please read the proxy material carefully. Your vote is important, and the company appreciates your cooperation in considering and acting on the matters presented.

By Order of the Board of Directors,

Kenneth B. Stratton
Secretary

May 8, 2007
Palo Alto, California

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PROXY STATEMENT

ANNUAL MEETING OF STOCKHOLDERS
OF
STEMCELLS, INC.

The enclosed form of proxy is solicited on behalf of the Board of Directors of StemCells, Inc. (the company) for use at the Annual Meeting of Stockholders (the Annual Meeting) to be held on June 12, 2007 at 2 P.M., local time, at the company s headquarters at 3155 Porter Drive, Palo Alto, California 94304. The cost of solicitation of proxies will be borne by the company. Directors, officers and employees of the company may solicit proxies by telephone, facsimile or in person for no additional compensation. The company will reimburse banks, brokerage firms, and other custodians, nominees and fiduciaries for reasonable expenses incurred by them in sending proxy materials to the beneficial owners of shares.

The Board has fixed the close of business on April 26, 2007 as the record date for determining stockholders entitled to notice of and to vote at the Annual Meeting or any adjournment thereof. There were 79,468,911 shares of our Common Stock, $.01 par value (the Common Stock), outstanding on April 26, 2007, each of which is entitled to one vote for each share on the matters to be voted upon.

Shares of our Common Stock represented by proxies in the form enclosed that are properly executed and returned to us and not revoked will be voted as specified therein by the stockholder. In the absence of contrary instructions, or in instances where no specification is made, the shares will be voted:

(i) FOR the election as directors of the nominees as described herein under Proposal Number 1 Election of Directors,

(ii) FOR ratification of the selection of accountants as described herein under Proposal Number 2 Ratification of Selection of Independent Public Accountants,

(iii) FOR adoption of the proposed amendment to the 2006 Equity Incentive Plan as described herein under Proposal 3 Amendment of the 2006 Equity Incentive Plan, and

(iv) in the discretion of the named proxies, as to any other matter that may properly come before the Annual Meeting.

Any stockholder signing and delivering a proxy may revoke it at any time before it is voted by delivering to the Secretary of the company a written revocation or a duly executed proxy bearing a date later than the date of the proxy being revoked. Any stockholder attending the Annual Meeting in person may revoke his or her proxy and vote his or her shares at the Annual Meeting.

A copy of the company s Annual Report to Stockholders for the fiscal year ended December 31, 2006 will be mailed, along with this Proxy Statement, on or about May 8, 2007 to all stockholders entitled to vote at the Annual Meeting.

QUORUM, REQUIRED VOTES, AND METHOD OF TABULATION

Consistent with Delaware law and under the company s Amended and Restated By-laws, a majority of the shares entitled to be cast on a particular matter, present in person or represented by proxy, constitutes a quorum as to such matter. The company will appoint election inspectors for the meeting to count votes cast by proxy or in person at the Annual Meeting.

Election of directors by stockholders will be determined by a plurality of the votes cast by the stockholders entitled to vote at the election that are present in person or represented by proxy. The approval of the proposals to ratify the selection of accountants and to amend the company s 2006 Equity Incentive Plan each requires a majority of the votes properly cast to be affirmative. The election inspectors will count shares represented by proxies that withhold authority to vote for a nominee for election as a director or that reflect abstentions and broker non-votes (i.e., shares represented at the meeting held by brokers or nominees as to which (i) instructions have not been received from the beneficial owners or persons entitled to vote and (ii) the broker or nominee does not have discretionary voting power on a particular matter) only as shares that are present and entitled to vote on the matter for purposes of determining the presence of a quorum, but neither abstentions nor broker non-votes have any effect

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on the outcome of voting on the election of directors, the selection of accountants or the amendment to the 2006 Equity Incentive Plan.

Management does not know of any matters to be presented at this Annual Meeting other than those set forth in this Proxy Statement and in the Notice accompanying this Proxy Statement. If other matters should properly come before the meeting, the proxy holders will vote such matters in their discretion. Any stockholder has the right to revoke his or her proxy at any time before it is voted.

SHARE OWNERSHIP OF CERTAIN BENEFICIAL OWNERS

The following table sets forth certain information regarding the beneficial ownership of our Common Stock as of April 5, 2007 by (i) each person known by us to be the beneficial owner of more than 5% of our outstanding Common Stock, (ii) each director and nominee for director, (iii) each executive officer named in the Summary Compensation Table and (iv) all executive officers and directors of the company as a group. Except as otherwise indicated, we believe that the beneficial owners of the Common Stock listed below, based on information furnished by such owners, have sole investment and voting power with respect to such shares, subject to community property laws where applicable, and that there are no other affiliations among the stockholders listed in the table.

Name and Address of Beneficial Owner*	Shares Beneficially Owned	Percentage of Class Beneficially Owned
Eric H. Bjerkholt(1)	33,333	**
Ricardo Levy(2)	92,165	**
Martin McGlynn(3)	832,441	1.0%
Desmond O Connell(4)	10,500	**
Roger M. Perlmutter(5)	113,503	**
John J. Schwartz(6)	275,958	**
Ann Tsukamoto(7)	413,778	**
Irving Weissman(8)	1,797,465	2.2%
Rodney K.B. Young(9)	183,364	**
All directors and executive officers as a group	3,752,507	4.6%

* The address of all persons listed in the table is c/o StemCells, Inc., 3155 Porter Drive, Palo Alto, California 94304.

** Less than 1%.

(1) Includes 33,333 shares issuable upon exercise of stock options exercisable within 60 days.

(2) Includes 92,165 shares issuable upon exercise of stock options exercisable within 60 days.

(3) Includes 808,041 shares issuable upon exercise of stock options exercisable within 60 days. Includes 24,400 shares included in Mr. McGlynn s 401(k) plan.

(4) Includes 500 shares owned by a family member, as to which Mr. O Connell disclaims beneficial ownership.

(5) Includes 113,503 shares issuable upon exercise of stock options exercisable within 60 days.

(6) Includes 275,958 shares issuable upon exercise of stock options exercisable within 60 days.

(7) Includes 358,562 shares issuable upon exercise of stock options exercisable within 60 days. Includes 28,382 shares included in Dr. Tsukamoto s 401(k) plan. Includes a total of 26,834 shares held in trusts for the benefit of Dr. Tsukamoto and her family members, including 4,000 shares owned by Dr. Tsukamoto s parents as to which she disclaims beneficial ownership.

(8) Includes 690,292 shares issuable upon exercise of stock options exercisable within 60 days. Includes 14,511 shares held in trust for Dr. Weissman s children as to which he disclaims beneficial ownership.

(9) Includes 178,124 shares issuable upon exercise of stock options exercisable within 60 days. Includes 5,240 shares included in Mr. Young s 401(k) plan.

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SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires our executive officers, directors, and any persons who beneficially own more than 10% of our common stock to file initial reports of ownership and reports of changes in ownership with the SEC. For the convenience of our executive officers and directors, we prepare and file the reports for them pursuant to a power of attorney that each of them has given to us.

We believe that our executive officers and directors complied with all filing requirements related to Section 16(a), except for the following:

We filed a late report related to our award of stock options and stock appreciation rights to each of the following persons: Mr. George Koshy, Mr. Martin McGlynn and Dr. Ann Tsukamoto.

We filed a late report related to our award of stock options to Mr. Rodney K.B. Young.

INFORMATION CONCERNING THE BOARD AND ITS COMMITTEES

During 2006, the Board of Directors was composed of Messrs. McGlynn and Bjerkholt and Drs. Levy, Perlmutter, Schwartz, and Weissman for the entire year. In January 2007, Mr. Desmond O Connell was elected to the Board. The independent members of the Board, as determined by the Board of Directors in accordance with NASD rules, are Mr. Bjerkholt and Drs. Levy, Perlmutter and Schwartz and, since January 2007, Mr. O Connell. The Board of Directors of StemCells held four regular meetings during the fiscal year ended December 31, 2006; a meeting of the outside directors without the Chief Executive Officer present was held at each of the regular meetings of the Board. Each of the directors attended more than 75% of the meetings of the Board of Directors and of the committees on which they served.

During 2006, the Board had three standing committees the Compensation and Stock Option Committee (the Compensation Committee), the Corporate Governance and Nominating Committee (the Corporate Governance Committee) and the Audit Committee as well as a single-member committee established under the company s 2001, 2004 and 2006 Equity Incentive Plans. All members of the Compensation Committee, the Audit Committee and the Corporate Governance Committee are, and are required by the charters of the respective committees to be, independent as determined pursuant to NASD rules.

The Corporate Governance Committee operates pursuant to a written charter, a copy of which is available through the company s website at www.stemcellsinc.com. It is composed of Drs. Levy, Perlmutter and Schwartz. The Corporate Governance Committee held one meeting in 2006. It oversees nominations to the Board and considers the experience, ability and character of potential nominees to serve as directors, as well as particular skills or knowledge that may be desirable in light of the company s position at any time. The Corporate Governance Committee may identify potential candidates through any reliable means available, including identification by a search firm and recommendations of past or current members of the Board from their knowledge of the industry and of the company. Potential candidates recommended by security holders will be considered as provided in the company s Policy Regarding Shareholder Candidates for Nomination as a director, which sets forth the procedures and conditions for such recommendations. This Policy is also available through the company s website at www.stemcellsinc.com.

The Compensation Committee was composed of Dr. Schwartz and Mr. Bjerkholt throughout 2006; Mr. O Connell joined the Committee in January 2007. The Compensation Committee held five meetings in 2006. The Compensation Committee makes recommendations to the Board and the company s management concerning salaries in general, determines executive compensation and, except to the extent that such decisions have been delegated to and made by the single-member Committee, approves incentive compensation for company employees and consultants. The Compensation Committee acts pursuant to a charter which is available through the company s website at www.stemcellsinc.com.

The Audit Committee is composed of Mr. Bjerkholt and Drs. Schwartz and Levy. The Audit Committee held five meetings during 2006. The primary function of the Audit Committee is to assist the Board of Directors in fulfilling its oversight responsibilities by reviewing financial reports and other financial information provided by the company to any governmental body or the public, the company s systems of internal controls regarding finance, accounting, legal compliance, and ethics that management and the Board have established, and the company s auditing, accounting and financial processes generally. The Audit Committee meets quarterly, and at such other times as it finds it necessary. It recommends to the Board of Directors the appointment of a firm of independent auditors to audit the financial statements of the company and meets with such personnel of the company to review the scope and the results of the annual audit, the amount of audit fees, the company s internal accounting controls, the company s financial statements contained in the company s Annual Report to Stockholders and other related matters. Each of the members of the Audit Committee is independent, and the Board has determined that Mr. Bjerkholt is an audit committee financial expert, as defined in SEC and NASD rules. The Audit Committee acts pursuant to a charter which is available through the company s website at www.stemcellsinc.com.

Stockholders who wish to communicate with the Board of Directors or with a particular director may send a letter to the Secretary of the company at StemCells, Inc., 3155 Porter Drive, Palo Alto, California 94304. Any communication should clearly specify that it is intended to be made to the entire Board of Directors or to one or more particular director(s). The Secretary of the company will review all such correspondence and forward to the Board of Directors a summary of all such correspondence and copies of all correspondence that, in the opinion of the Secretary, deals with the functions of the Board of Directors or committees thereof or that he otherwise determines requires their attention. The Secretary maintains a log of all correspondence received by the company that is addressed to members of the Board of Directors, and any director may at any time review and request copies of any such correspondence.

Concerns relating to accounting, internal controls or auditing matters will immediately be brought to the attention of the Chairman of the Audit Committee and handled in accordance with established procedures, which are set out in the Audit Committee s Policy on Receipt, Retention and Treatment of Complaints Regarding Accounting, Internal Controls and Auditing Matters. A copy of this policy is available on the company s website, www.stemcellsinc.com.

The company does not have a policy on director attendance at Annual Meetings of shareholders. At the 2006 Annual Meeting, director Martin McGlynn, President and Chief Executive Officer of the company, was present and presided.

Prior to September 20, 2004, non-employee directors received an annual retainer of $18,000 ($35,000 for the Chairman), payable quarterly, in addition to $1,500 for each Board meeting attended ($500 for each meeting attended by telephone) and $500 for each committee meeting attended if not contemporaneous with a Board meeting. In addition, upon election, each such director also received an initial option to purchase 20,000 shares of our Common Stock, and upon re-election after his initial three-year term, each such director received an additional option to purchase 15,000 shares of our Common Stock. Each of these options was exercisable at the fair market value of the Common Stock at the time of grant, and the shares vested in equal portions over three years on the anniversaries of the respective grant dates.

Effective September 20, 2004, non-employee directors receive quarterly retainers of $4,500 ($8,750 for the Chairman); the chairs of the standing committees receive quarterly stipends of $1,000 (Audit Committee) or $500 (Compensation and Corporate Governance Committees). Non-employee directors also receive $1,500 for each Board meeting, and $1,000 for each standing committee meeting, attended in person or by videoconference ($500 for each meeting attended by telephone). All dollar amounts are paid in cash. Non-employee directors now receive an initial option of 20,000 shares at market value, vesting ratably over three years, and an option for 10,000 shares on each anniversary of their appointments, vesting one year after issuance, each exercisable at the fair market value of the stock on the date of the respective grant. Directors are reimbursed for their expenses in attending meetings of the Board of Directors and meetings of committees of the Board of Directors.

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Director Compensation Table

The following table sets forth information with respect to the compensation of the non-employee directors for the year ended December 31, 2006.

Name	Fees Earned or Paid in Cash ($)	Stock Option Awards(1) ($)	All Other Compensation ($)	Total ($)
Eric Bjerkholt	35,500(2)	44,384(3)		79,384
Ricardo Levy, Ph.D.	30,500	33,287(4)		$ 63,787
Roger Perlmutter, M.D., Ph.D.	25,500	36,595(5)		$ 62,095
John Schwartz, Ph.D.	51,000(6)	30,861(7)		$ 81,861
Irving Weissman, M.D.	24,000	40,418(8)	50,000(9)	$ 114,418

(1) After an initial grant of an option to purchase 20,000 shares upon appointment, each director is granted an option for 10,000 shares on the anniversary of his or her appointment. The exercise price is the closing price of the stock on the grant date or, if the NASDAQ market is not open on that date, the closing price on the last preceding market day. The value of the option awards is determined using the fair value recognition provisions of SFAS 123(R), which was effective January 1, 2006. Because it reflects the dollar amount recognized for financial statement reporting purposes for the fiscal year ended December 31, 2006 in accordance with FAS 123(R), value may include amounts from awards granted in and prior to 2006.

(2) Includes $500 earned in 2006 but paid in 2007.

(3) As of December 31, 2006, Mr. Bjerkholt had options outstanding for 40,000 shares.

(4) As of December 31, 2006, Dr. Levy had options outstanding for 102,165 shares.

(5) As of December 31, 2006, Dr. Perlmutter had options outstanding for 123,503 shares.

(6) Includes $500 earned in 2006 but paid in 2007.

(7) As of December 31, 2006, Dr. Schwartz had options outstanding for 280,958 shares.

(8) As of December 31, 2006, Dr. Weissman had options outstanding for 700,292 shares.

(9) Dr. Weissman receives $50,000 per year for his services as a consultant and member of the company s Scientific Advisory Board.

EXECUTIVE OFFICERS

The current executive officers of the company who are not also directors of the company are:

Name	Age	Position
Ann Tsukamoto, Ph.D.	54	Chief Operating Officer
Rodney K.B. Young	44	Chief Financial Officer and Vice President, Finance and Administration

Ann Tsukamoto, Ph.D., joined the company in November 1997 as Senior Director of Scientific Operations; was appointed Vice President, Scientific Operations in June 1998 and Vice President, Research and Development in February 2002. In November 2006, she was promoted to the newly-created position of Chief Operating Officer, in which role she retains responsibility for the company s research and development efforts. From 1989 until she joined StemCells, Dr. Tsukamoto was employed at SyStemix, Inc., where she served in various research capacities before transitioning to the position of Director of Clinical Science. At SyStemix, Inc., Dr. Tsukamoto assisted in the launch of its clinical research program for the hematopoietic stem cell. She received her Ph.D. degree from the University of California, Los Angeles and did postdoctoral research with Dr. Harold Varmus at the University of California, San Francisco. Dr. Tsukamoto is an inventor on six issued U.S. Patents related to the human hematopoietic stem cell.

Rodney K.B. Young joined the company in September 2005 as Chief Financial Officer and Vice President, Finance. In November 2006 he became CFO and Vice President, Finance and Administration, with responsibilities for administrative functions including Human Resources and Information Technology in addition to Finance. From 2003 to 2005, Mr. Young was Chief Financial Officer and a director of Extropy Pharmaceuticals, Inc., a private biopharmaceutical company focused on developing drugs for pediatric indications. From 2000 to 2002, Mr. Young was Managing Director, Healthcare Corporate Finance, and head of healthcare investment banking for Europe at SG Cowen Securities Corp. From 1999 to 2000, Mr. Young was Executive Director, Global Mergers & Acquisitions and head of the healthcare mergers & acquisition team for Europe at Lehman Brothers Inc. From 1989 to 1999, Mr. Young was an investment banker in the Global Healthcare group at Lehman Brothers Inc. Mr. Young received both his BA and MBA degrees from the University of Chicago.

Martin McGlynn, President and Chief Executive Officer of the company, is its other executive officer; Mr. McGlynn is a member of the Board of Directors.

All executive officers of the company are elected annually and serve at the discretion of the Board of Directors.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

During 2006, none of our executive officers served on the board of directors of any entities that had one or more executive officers serve on our Compensation Committee. No current or past executive officers or employees of the company serve on our Compensation Committee. The following directors served on the Compensation Committee in 2006: Dr. Schwartz and Mr. Bjerkholt.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Related parties can include any of our directors or executive officers, certain of our stockholders and their immediate family members. In order to identify related party transactions, each year, we prepare and require our directors and executive officers to complete Director and Officer Questionnaires identifying any transactions with us in which the officer or director or their family members have an interest. A conflict of interest occurs when an individual s private interest interferes, or appears to interfere, in any way with the interests of the company as a whole. Our code of ethics requires all directors, officers and employees who may have a potential or apparent conflict of interest to immediately notify our Compliance Officer; in addition, the Corporate Governance Committee of the Board of Directors is responsible for considering and reporting to the Board any questions of possible conflicts of interest of Board members. Copies of our code of ethics and the Corporate Governance Committee charter are posted on the corporate governance section of our website at www.stemcellsinc.com.

The independent members of the Board of Directors are responsible for reviewing and approving all potential conflicts of interest and all material transactions with any related party on a continuing basis. In evaluating related party transactions and potential conflicts of interest, our independent directors apply the same standards of good faith and fiduciary duty they apply to their general responsibilities. They will approve a related party transaction only when, in their good faith judgment, the transaction is in the best interest of the company.

Dr. Weissman, a member of the Board of Directors, was retained in September 1997 to serve as a consultant to us. Pursuant to his Consulting Agreement, Dr. Weissman provides consulting services to us and serves on our Scientific Advisory Board. In return, we pay Dr. Weissman $50,000 per year for his services and granted him an option to purchase 500,000 shares of Common Stock for $5.25 per share. The option was fully vested as of September 25, 2005, remains exercisable, and has been expensed in full. Based on the fair value of this option (which was determined using the Black-Scholes method) and its vesting schedule, we recorded a total expense of $1,262,443. We also agreed to nominate Dr. Weissman for a position on the Board of Directors, and he agreed to serve if elected. Since October 1, 2000, he has been compensated for this service in the same manner and amount as other non-employee members of the Board. The Consulting Agreement contains confidentiality, non-competition, and assignment of invention provisions and is for a term of fifteen years, subject to earlier termination by either party.

Dr. Weissman is a member of the Board of Directors and co-chairman of the Scientific Advisory Board of Cellerant Therapeutics, Inc., a privately-owned biotechnology company that was a tenant in the building in which we are located. (Cellerant was formerly known as Celtrans, LLC, and Dr. Weissman was at one time its interim

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Chief Executive Officer and a member of its Board of Managers.) We have also provided Cellerant use of part of our animal facility and access to our irradiator under space-sharing and other agreements. The last of these agreements expired as of June 30, 2006.

EMPLOYMENT AND SEVERANCE AGREEMENTS

Employment agreements: Martin McGlynn joined the company as President and Chief Executive Officer on January 15, 2001. Under the terms of an agreement between Mr. McGlynn and the company, Mr. McGlynn is entitled to an annual base salary of $275,000 per year, reviewable annually by the Board of Directors, and a bonus, in the Board s sole discretion, of up to 25% of his base salary. (Over time, the Board increased Mr. McGlynn s base salary and target bonus so that they are, respectively, $385,000 and 40% of his base salary effective March 2007.) By virtue of the agreement, Mr. McGlynn was granted an option to purchase 400,000 shares of our Common Stock with an exercise price equal to the fair market value of the Common Stock on the date of his employment, one fourth to vest on the first anniversary of his employment and the remaining three-fourths to vest in equal monthly installments during his second through fourth years of employment. The agreement provided that the Board could, in its sole discretion, grant Mr. McGlynn a bonus option to purchase up to an additional 25,000 shares, which it did. The company also agreed to pay Mr. McGlynn a $50,000 relocation bonus and to reimburse him for relocation expenses, and have done so.

Dr. Ann Tsukamoto, Ph.D., joined the company in November 1997 and has served as our Chief Operating Officer since November 2006. Under her employment agreement, the company provides Dr. Tsukamoto with $750,000 of term life insurance during her employment. Dr. Tsukamoto s base salary is no longer controlled by a formal agreement. In December 2003, the Board set Dr. Tsukamoto s target bonus at 25% of her base salary effective January 1, 2004.

Rodney K.B. Young joined the company in September 2005 as Chief Financial Officer and Vice President, Finance. Under the terms of his agreement with the company, Mr. Young s base salary is $250,000 per year, with a target cash bonus of up to 25% of his base salary. Any bonus is in the Board s sole discretion. Mr. Young was also granted options to purchase 450,000 shares of the company s Common Stock. The options will vest over 48 months; one-quarter of the shares vested on the first anniversary of the date on which Mr. Young s employment began and the remaining shares vest, subject to his continued employment by the company, at the rate of 1/48th per month on the last day of each month during the ensuing 36 months. In addition, the agreement provided for an option to acquire no less than 25,000 shares of the Common Stock of the company at the closing price of the stock on the date of grant, the first anniversary of his employment. The grant of 25,000 shares was duly made, and will vest in the same manner as his earlier option grant over 48 months, subject to his continued employment by the company.

Severance arrangements: Each of the executive officers would receive payments on termination of his or her employment by the company without fault[1] or consequent to a change of control or, in one case, by virtue of disability. In the case of Mr. McGlynn, on termination without cause, the company would continue to pay salary and provide benefits for one year, at the rate then in effect. If the termination were associated with a change of control, the company would pay (in a lump sum) two years of salary and benefits (grossing up healthcare costs), as well as a bonus with respect to the termination year at 25% of the base salary, pro-rated for the portion of the year served; in addition, all unvested stock options would vest and all stock options would be exercisable for two years after termination. If Mr. McGlynn s employment were terminated on account of disability, the company would continue to pay his salary for up to six months (or until he obtained other employment or became eligible for disability income under a company plan, if sooner).

In the case of Mr. Young, on termination without cause, the company would continue to pay salary and provide benefits for six months, at the rate then in effect. If the termination were associated with a change of control, the company would continue to pay Mr. Young s salary and provide benefits (including his share of COBRA, grossing up for the tax effects, if any) for 12 months; in this event, any unvested options would vest on termination. (Under all stock option plans pursuant to which Mr. Young holds options, all employee options vest on a change in control.)

[1] Or termination by the executive officer for Good Reason as defined in the agreement.

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In the case of Dr. Tsukamoto, on termination without cause whether or not associated with a change of control, the company would continue to pay salary and provide benefits for 12 months, at the rate then in effect. Dr. Tsukamoto s agreement provides that if the termination were associated with a change of control, any unvested options granted pursuant to the company s 1992 Equity Incentive Plan would vest on termination; all such options have, however, now vested.

If we terminate the employment of any executive officer for cause or the officer resigns without good cause, he or she will not be entitled to any severance or other benefits. All bonus awards are in the Board s sole discretion.

The following table displays the value of what the executive officers would have received from the company had their employment been terminated on December 31, 2006:

Officer	Salary	Bonus	Health	Early Vesting of Options	Total
CEO					
Terminated without cause	$ 364,000	0	$ 15,407	0	$ 379,407
Terminated, change of control	$ 728,000	$ 91,000	$ 56,800(1)	$ 1,138,972(2)	$ 1,957,972
Disability(3)	$ 182,000	0	0	0	$ 182,000
Other	0	0	0	0	0
COO					
Terminated without cause	$ 275,000	0	$ 10,092		$ 285,092
Terminated, change of control	$ 275,000	0	$ 10,092	$ 245,402(4)	$ 530,494
Other	0	0	0		0
CFO					
Terminated without cause	$ 125,000	0	$ 5,482		$ 130,482
Terminated, change of control	$ 250,000	0	$ 10,964	$ 79,881(5)	$ 340,845
Other	0	0	0		0

(1) Includes tax gross-up on 2 years of healthcare costs.

(2) By agreement, all options vest and remain exercisable for 2 years.

(3) Payments stop before 6 months if individual obtains other full-time employment or qualifies for payments under any disability income plan provided by the company.

(4) An agreement with Dr. Tsukamoto provided for vesting of her options issued under a Plan that did not provide for 100% automatic vesting on change of control, but those options have all vested. All of her unvested options were issued pursuant to Plans that do so provide.

(5) All unvested options issued under the applicable Equity Incentive Plans vest on change of control under the terms of those Plans.

REPORT OF THE AUDIT COMMITTEE

The Audit Committee oversees our accounting and financial reporting processes and the audits of our financial statements on behalf of the Board, and selects an independent public accounting firm to perform those audits. Management has the primary responsibility for establishing and maintaining adequate internal control over financial reporting, preparing the financial statements, and establishing and maintaining adequate controls over public reporting. Our independent registered public accounting firm for fiscal 2006, Grant Thornton LLP, had responsibility for conducting an audit of our annual financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States) and expressing an opinion on the conformity of those audited financial statements with generally accepted accounting principles.

The Audit Committee oversaw the independent public accounting firm s qualifications and independence, as well as its performance. The Audit Committee assisted the Board in overseeing the preparation of the company s financial statements, the company s compliance with legal and regulatory requirements, and the performance of the

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company s internal audit function. The Audit Committee met with personnel of the company and Grant Thornton LLP to review the scope and the results of the annual audit, the amount of audit fees, the company s internal accounting controls, the company s financial statements contained in the company s Annual Report to Stockholders and other related matters.

The Audit Committee has reviewed and discussed with management the financial statements for fiscal year 2006 audited by Grant Thornton LLP, as well as management s report on internal control over financial reporting, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control Integrated Framework. The Audit Committee has discussed with Grant Thornton LLP various matters related to the financial statements, including those matters required to be discussed by SAS 61 (Codification of Statements on Auditing Standards, AU 380). The Audit Committee has also discussed with Grant Thornton LLP its report on internal control over financial reporting and its report on management s assessment of internal control over financial reporting, has received the written disclosures and the letter from Grant Thornton LLP required by Independence Standards Board Standard No. 1 (Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees), and has discussed with Grant Thornton LLP its independence.

Based upon such review and discussions, the Audit Committee recommended to the Board of Directors, and the Board approved the recommendation, that the audited financial statements be included in the company s Annual Report on Form 10-K for the fiscal year ending December 31, 2006 for filing with the SEC.

AUDIT COMMITTEE
Eric Bjerkholt, Chairman
Ricardo B. Levy, Ph.D.
John J. Schwartz, Ph.D.

Compensation Discussion and Analysis

Overview of Program

The Compensation and Stock Option Committee is responsible, among other things, for the evaluation of the performance of the company s executive officers in light of relevant corporate goals and objectives and the determination and approval of their compensation. The Compensation Committee is composed of independent directors of the company. Its charter, which describes more fully its responsibilities, is available on the company s website at www.stemcellsinc.com.

In 2006, the Compensation Committee consisted of John Schwartz and Eric Bjerkholt. In January 2007, Desmond O Connell, a newly elected director, was added to the Committee.

Compensation Objectives

The objectives of our compensation policy are to attract, retain and reward the individuals best able to meet the company s needs, lead it toward profitability, and develop shareholder value. To do this, we believe we need to provide overall compensation packages competitive with comparable companies that is, companies with whom we compete for high-level scientific and executive personnel.

In seeking to accomplish the objectives of our compensation policy, the Compensation Committee follows a compensation program designed, ultimately, to reward increasing stockholder value. Because achievement of the company s mission the use of stem cell technology for the treatment and possible cure of intractable diseases is a long and slow process, we use the following as, in effect, surrogate endpoints:

the achievement of stated annual corporate goals; these goals are designed to be challenging, so that one would not expect consistent achievement of 100% of the goals. The Board may grant more than 100% of the target bonus in exceptional circumstances;

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the effectiveness of leadership an executive officer has shown in inspiring and marshalling excellent performances in his or her direct reports;

the anticipation, identification and successful disposition of issues and problems that, if not addressed timely and effectively, might have a deleterious effect on the company; and

the speed and effectiveness with which an executive officer discovers, assesses and, where appropriate, pursues promising opportunities for the company.

Implementing our Objectives

Compensation elements: StemCells, like most biotechnology companies, uses a combination of base salary, cash bonus and equity awards to compensate its employees, including senior management. As a very small company we have about 50 employees in total and only three executive officers we feel that having so few people in each cohort makes it inefficient to establish a formulaic allocation of total compensation among its various elements; we rely, instead, on our experience and judgment.

In exercising this judgment, we evaluate the range of each element paid by comparable companies for each position. Each year, the Compensation Committee considers the performance of the executive officers during the prior year, and determines their salary and target bonus. Equity compensation is generally determined by the Board on the recommendation of the Compensation Committee and awarded at one of the company s