

APPLIED SIGNAL TECHNOLOGY INC  
Form DEF 14A  
February 11, 2008

**Schedule 14A**

Schedule 14A Information  
Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

Preliminary Proxy Statement

Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

Definitive Proxy Statement

Definitive Additional Materials

Soliciting Material Pursuant to § 240.14a-11(c) or § 240.14a-12

.....

Applied Signal Technology, Inc.  
(Name of Registrant as Specified in its Charter)

Applied Signal Technology, Inc.  
James E. Doyle  
Vice President-Finance, CFO  
400 West California Avenue  
Sunnyvale, CA 94086

.....

Payment of Filing Fee (Check the appropriate box):

No fee required.

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(1) Amount Previously Paid:

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February 15, 2008

Dear Shareholder:

The Applied Signal Technology, Inc. Annual Meeting of Shareholders will be held on March 18, 2008, 4:00 p.m. Pacific Time, at the Sheraton Hotel, located at 1100 N. Mathilda Avenue, Sunnyvale, California 94086. You are cordially invited to attend.

The Notice of Annual Meeting of Shareholders and a Proxy Statement, which describe the formal business to be conducted at the meeting, follow this letter.

It is important that you use this opportunity to take part in the affairs of Applied Signal Technology by voting on the business to come before this meeting. After reading the Proxy Statement, please promptly mark, sign, date, and return the enclosed proxy card in the postage-paid envelope to ensure that your shares will be represented. Regardless of the number of shares you own, your careful consideration of, and vote on, the matters before our shareholders is important.

A copy of our Annual Report to Shareholders for the fiscal year ended October 31, 2007, is also enclosed for your information. At the Annual Meeting, we will review our activities over the past fiscal year and our plans for the future. The Board of Directors and management look forward to seeing you at the Annual Meeting.

Sincerely yours,

Gary L. Yancey, Chief Executive Officer

**Applied Signal Technology, Inc.**

**Notice of Annual Meeting of Shareholders to be Held on Tuesday, March 18, 2008**

**To the Shareholders:**

Notice is hereby given that the 2008 Annual Meeting of the Shareholders of Applied Signal Technology, Inc., a California corporation, will be held on March 18, 2008, 4:00 p.m. Pacific Time, at the Sheraton Hotel, located at 1100 N. Mathilda Avenue, Sunnyvale, California 94086, for the following purposes:

- 1. To elect three Class II directors to hold office for a two-year term ending at our Annual Meeting to be held in 2010 and until their respective successors are elected and qualified.

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2. To approve the amendment of the 2004 Stock Incentive Plan to increase the number of shares authorized under the 2004 Stock Incentive Plan by 500,000 additional shares.
3. To consider a proposal to ratify the appointment of Ernst & Young LLP as the independent accountants of Applied Signal Technology, Inc. for the fiscal year ending October 31, 2008.
4. To transact such other business as may properly come before the meeting.

Shareholders of record at the close of business on January 29, 2008, are entitled to notice of, and to vote at, this meeting and any adjournment or postponement thereof. For ten days prior to the meeting, a complete list of shareholders entitled to vote at the meeting will be available for examination by any shareholder, for any purpose relating to the meeting, during ordinary business hours at our principal offices located at 400 West California Avenue, Sunnyvale, California 94086.

By order of the Board of Directors,

Sunnyvale, California  
February 15, 2008

Gary L. Yancey, Chief Executive Officer

IMPORTANT: Please complete, date, sign, and promptly mail the enclosed proxy card in the accompanying postage-paid envelope to ensure that your shares are represented at the meeting. If you attend the meeting, you may choose to vote in person even if you have previously sent in your proxy card.

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## Proxy Statement 2008 Annual Meeting of Shareholders

The enclosed proxy is solicited on behalf of the Board of Directors of Applied Signal Technology, Inc., a California corporation, for use at our 2008 Annual Meeting of Shareholders to be held on Tuesday, March 18, 2008, and at any adjournment or postponement thereof, referred to in this proxy statement as the Annual Meeting. The Annual Meeting will be held at 4:00 p.m. Pacific Time at the Sheraton Hotel, located at 1100 N. Mathilda Avenue, Sunnyvale, California 94086. The proxy solicitation materials were first mailed on or about February 15, 2008, to all shareholders entitled to vote at the Annual Meeting.

### Information about the Annual Meeting and Voting

#### Why am I receiving these proxy materials?

We sent you this proxy statement and the accompanying proxy card because the Board of Directors of Applied Signal Technology, Inc. is soliciting your proxy to vote at the Annual Meeting. You are invited to attend the Annual Meeting to vote on the proposals described in this proxy statement. However, you do not need to attend the meeting to vote your shares. Instead, you may simply complete, sign, and return the accompanying proxy card.

We mailed this proxy statement, the accompanying proxy card, and our Annual Report for the fiscal year ended October 31, 2007, on or about February 15, 2008, to all shareholders of record entitled to vote at the Annual Meeting.

#### Who is entitled to vote at the Annual Meeting?

To be able to vote, you must have been a shareholder on January 29, 2008, the record date for determination of shareholders entitled to notice of, and to vote at, the Annual Meeting (the "Record Date"). As of the Record Date, 12,589,317 shares of our common stock were issued and outstanding.

Our stock transfer books will remain open between the Record Date and the date of the Annual Meeting. A list of shareholders entitled to vote at the Annual Meeting will be available for inspection at our offices located at 400 West California Avenue, Sunnyvale, California 94086.

*Shareholder of Record: Shares Registered in Your Name.* If at the close of business on the Record Date, your shares were registered directly in your name with our transfer agent, BNY Mellon Shareowner Services, or Mellon, then you are a shareholder of record. As a shareholder of record, you may vote in person at the meeting or vote by proxy. Whether or not you plan to attend the meeting, we urge you to complete and

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return the accompanying proxy card to ensure your vote is counted.

*Beneficial Owner: Shares Registered in the Name of a Broker, Bank, or Other Agent.* If, at the close of business on the Record Date, your shares were not issued directly in your name, but rather were held in an account at a brokerage firm, bank, or other agent, you are the beneficial owner of shares held in “street name” and these proxy materials are being forwarded to you by your broker, bank, or other agent. The broker, bank, or other agent holding your shares in that account is considered to be the shareholder of record for purposes of voting at the Annual Meeting.

As a beneficial owner, you have the right to direct your broker, bank, or other agent on how to vote the shares in your account. You are also invited to attend the Annual Meeting. However, since you are not the shareholder of record, you may not vote your shares in person at the meeting unless you request and obtain a valid proxy issued in your name from your broker, bank or other agent.

### **What am I being asked to vote on?**

There are three matters scheduled for a vote at the Annual Meeting:

1. The election of three Class II members of the Board of Directors to hold office until our 2010 Annual Meeting of Shareholders
2. The amendment of our 2004 Stock Incentive Plan to increase the number of shares authorized under the 2004 Stock Incentive Plan by 500,000 additional shares
3. The ratification of the selection by the Audit Committee of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending October 31, 2008

### **How many votes do I have?**

Each holder of common stock is entitled to one vote per share held. As of the Record Date, a total of 12,589,317 votes may be cast on each matter at the Annual Meeting.

### **What is a quorum?**

For business to be conducted at the Annual Meeting, a quorum must be present. The presence at the Annual Meeting, either in person or by proxy, of holders of shares of outstanding common stock entitled to vote and representing a majority of the voting power of such shares will constitute a quorum for the transaction of business. At the close of business on the Record Date, there were 12,589,317 shares outstanding and entitled to vote.

Abstentions and “broker non-votes” (that is, shares held by a broker or nominee that are represented at the meeting, but with respect to which such broker or nominee is not instructed to vote on a particular proposal and does not have discretionary voting power) will be counted for the purpose of determining whether a quorum is present for the transaction of business.

Your shares will be counted toward the quorum only if you submit a valid proxy (or one is submitted on your behalf by your broker, bank, or other agent) or if you vote in person at the meeting. Abstentions and broker non-votes will be counted toward the quorum requirement. If there is no quorum, the chairperson of the meeting, or a majority of the votes present at the meeting, may adjourn the meeting to another date.

### **What vote is required for each item?**

- For the election of directors, the three nominees in Class II receiving the most “For” votes (among votes properly cast in person or by proxy) will be elected.

- To be approved, the amendment of our 2004 Stock Incentive Plan to increase the number of shares authorized under the 2004 Stock Incentive Plan by 500,000 additional shares must receive a “For” vote from a majority of shares present and entitled to vote either in person or by proxy.

- To be approved, the ratification of the selection of Ernst & Young LLP as our independent registered public accounting firm must receive a “For” vote from a majority of shares present and entitled to vote either in person or by proxy.

### **How do I vote?**

For the election of directors, you may either vote “For” each of the three nominees or you may “Withhold” your vote for any nominee you specify. For any other matter to be voted on, you may vote “For” or “Against” or abstain from voting. The procedures for voting are as follows.

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*Shareholder of Record: Shares Registered in Your Name.* If you are a shareholder of record, you may vote in person at the Annual Meeting. Alternatively, you may vote by proxy by using the accompanying proxy card. Whether or not you plan to attend the meeting, we urge you to vote by proxy to ensure your vote is counted. You may still attend the meeting and vote in person if you have already voted by proxy.

To vote in person, come to the Annual Meeting and we will give you a ballot when you arrive.

To vote by proxy, simply complete, sign, and date the accompanying proxy card and return it promptly in the envelope provided. If you return your signed proxy card to us before the Annual Meeting, we will vote your shares as you direct.

*Beneficial Owner: Shares Registered in the Name of Broker, Bank, or Other Agent.* If your shares are held in “street name,” that is, your shares are held in the name of a brokerage firm, bank, or other nominee, in lieu of a proxy card you should receive a *voting instruction form* from that institution by mail. Simply complete and mail the voting instruction card to ensure that your vote is counted. The voting instruction form should indicate whether the institution has a process for beneficial holders to vote over the Internet or by telephone. A large number of banks and brokerage firms participate in the Broadridge Financial Solutions, Inc. online program, which provides eligible shareholders the opportunity to vote over the Internet or by telephone (see [www.broadridge.com](http://www.broadridge.com).) *The Internet and telephone voting facilities will close at 11:59 p.m. Eastern Time, March 17, 2008.*

If your voting instruction form does not reference Internet or telephone information, please complete and return the paper voting instruction form in the postage-paid envelope provided. Shareholders who vote over the Internet or by telephone need not return a proxy card or voting instruction form by mail, but may incur costs, such as usage charges, from telephone companies or Internet service providers.

If you are a registered holder, you may also vote your shares in person at the Annual Meeting. If your shares are held in street name and you wish to vote in person at the meeting, you must obtain a proxy issued in your name from the record holder (for example, your broker) and bring it with you to the Annual Meeting. We recommend that you vote your shares in advance as described above so that your vote will be counted if you later decide not to attend the Annual Meeting.

### **What if I return a proxy card but do not make specific choices?**

If you return a signed and dated proxy card without marking any voting selections, your shares will be voted “For” the election of the three nominees for director in Class II, “For” the amendment of our 2004 Stock Incentive Plan to increase the number of shares authorized under the 2004 Stock Incentive Plan by 500,000 additional shares, and “For” the ratification of the selection of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending October 31, 2008. If any other matter is properly presented at the meeting, then one of the individuals named on your proxy card as your proxy will vote your shares using his or her best judgment.

### **What if I receive more than one proxy card or voting instruction form?**

If you receive more than one proxy card or voting instruction form because your shares are held in multiple accounts or registered in different names or addresses, please be sure to complete, sign, date, and return *each* proxy card or voting instruction form to ensure that all of your shares will be voted. Only proxy cards and voting instruction forms that have been signed, dated, and timely returned will be counted in the quorum and voted.

If you registered more than one account for online access of shareholder communications, you will receive more than one email notice with voting instructions. Please follow the electronic voting instructions for *each* email notice you receive to ensure that all of your shares will be voted.

### **Who will count the votes and how will my vote(s) be counted?**

Votes will be counted by the inspector of elections appointed for the Annual Meeting, who will separately count “For” and “Withhold” votes with respect to the election of directors and, with respect to any proposals other than the election of directors, “For” and “Against” votes, abstentions, and broker non-votes. A “broker non-vote” occurs when a nominee holding shares for a beneficial owner does not vote on a particular proposal because the nominee does not have discretionary voting power with respect to that proposal and has not received instructions with respect to that proposal from the beneficial owner, despite voting on at least one other proposal for which it does have discretionary authority or for which it has received instructions. Abstentions will have no effect on the outcome of the election of directors but will be counted as “Against” votes with respect to any proposals other than the election of directors. Broker non-votes have no effect and will not be counted toward the vote total for any proposal.

If your shares are held by your broker, bank, or other agent as your nominee (that is, in “street name”), you will need to obtain a proxy form from the institution that holds your shares and follow the instructions included on that form regarding how to instruct your broker, bank, or other agent to vote your shares. If you do not give instructions, your broker, bank, or other agent may vote your shares with respect to “discretionary”

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items, but not with respect to “non-discretionary” items. Discretionary items are proposals considered routine under the rules of the NASDAQ Global Select Market, such as the vote for directors and ratification of our independent registered public accounting firm.

### **Can I change my vote after I have voted?**

Yes. You can revoke your proxy at any time before the applicable vote at the meeting. If you are the record holder of your shares, you may revoke your proxy in any one of three ways:

1. You may submit another properly completed proxy with a later date
2. You may send a written notice that you are revoking your proxy to our Corporate Secretary at 400 West California Avenue, Sunnyvale, California 94086
3. You may attend the Annual Meeting and vote in person (however, simply attending the meeting will not, by itself, revoke your proxy)

If your shares are held by your broker, bank, or other agent, you should follow the instructions provided by them.

### **How and when may I submit a shareholder proposal for the 2009 Annual Meeting of Shareholders?**

In the event that a shareholder desires to have a proposal considered for presentation at our 2009 Annual Meeting of Shareholders, and included in our proxy statement and form of proxy card used in connection with that meeting, the proposal must be forwarded in writing to our Corporate Secretary so that it is received no later than October 17, 2008. Any such proposal must comply with the requirements of Rule 14a-8 promulgated under the Securities Exchange Act of 1934, as amended, referred to in this proxy statement as the Exchange Act.

If a shareholder, rather than seeking to include a proposal in the proxy statement and proxy card as discussed above, commences his or her own proxy solicitation for the 2009 Annual Meeting of Shareholders or seeks to nominate a candidate for election as a director or to propose business for consideration at that meeting, we must receive notice of the proposal no later than October 17, 2008. If the notice is not received by October 17, 2008, it will be considered untimely under Rule 14a-4(c)(1) promulgated under the Exchange Act and the proxy holders designated by Applied Signal Technology will have discretionary voting authority under proxies solicited for the 2009 Annual Meeting of Shareholders with respect to such proposal, if properly presented at the meeting.

Please address any shareholder proposals or notices of proposals to our Corporate Secretary at Applied Signal Technology, Inc., 400 West California Avenue, Sunnyvale, California 94086.

### **Who will bear the cost of soliciting proxies?**

We will bear the entire cost of the solicitation of proxies for the Annual Meeting, including the preparation, assembly, printing, and distribution of this proxy statement, the proxy card, and any additional solicitation materials furnished to shareholders. Copies of solicitation materials will be furnished to brokerage houses, fiduciaries, and custodians holding shares in their names that are beneficially owned by others so that they may forward the solicitation materials to the beneficial owners. We may reimburse such persons for their reasonable expenses in forwarding solicitation materials to beneficial owners. The original solicitation of proxies may be supplemented by solicitation by personal contact, telephone, facsimile, email, or any other means by our directors, officers, or employees. No additional compensation will be paid to those individuals for any such services.

### **How can I find out the results of the voting at the Annual Meeting?**

Preliminary voting results will be announced at the Annual Meeting. Final voting results will be published in our Quarterly Report on Form 10-Q for the quarter ending May 2, 2008.

## **Matters to be Considered at the Annual Meeting**

### **Information about our Board of Directors**

We have a classified Board of Directors consisting of four Class I directors (John P. Devine, David D. Elliman, Robert J. Richardson, and Gary L. Yancey), and three Class II directors (Milton E. Cooper, Marie S. Minton, and John R. Treichler). Stuart G. Whittelsey, Jr. resigned as a member of the Board of Directors and of all committees of the Board, effective November 15, 2007, to pursue his retirement.

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Effective August 28, 2007, our Board of Directors set the number of directors at eight, and elected Marie S. Minton to the Board of Directors as a Class II director with a term expiring at this Annual Meeting of Shareholders to fill the vacancy created by setting the number of directors at eight. Following Mr. Whittelsey's retirement effective November 15, 2007, the Board reduced the size of the Board to seven members, which is the current size of our Board of Directors.

At each annual meeting of shareholders, directors are elected for a term of two years to succeed those directors whose terms expire at the Annual Meeting date and serve until their respective successors are duly elected and qualified. The term of our Class I directors expires at the Annual Meeting to be held in 2009. The term of our Class II directors expires at this 2008 Annual Meeting, and successors to the directors in Class II will be elected for a two-year term expiring at the 2010 Annual Meeting.

The following table sets forth, for our current directors, including the nominees to be elected as Class II directors at this meeting, information with respect to their ages and background.

Name	Principal Occupation	Age	Director Since
<i>Class I directors:</i>			
John P. Devine	Director	70	1995
David D. Elliman	Director	57	1991
Robert J. Richardson	Director	61	2003
Gary L. Yancey	Chief Executive Officer	62	1984
<i>Class II directors:</i>			
Milton E. Cooper	Director	69	2004
Marie S. Minton	Director	46	2007
Dr. John R. Treichler	Chief Technical Officer	60	1984

### Nominees for Election for a Two-Year Term Expiring at the 2010 Annual Meeting

#### Milton E. Cooper

Milton E. Cooper has been a director of the Company since March 2004. Mr. Cooper was the President of the Federal Sector of Computer Sciences Corporation from January 1992 through February 2001. Prior to that time, he also served in marketing and general management positions with IBM Corporation, Telex Corporation, and Raytheon Company. Mr. Cooper currently serves as a director of L-1 Identity Solutions, Inc., a provider of biometric recognition technology and services for identification of individuals, and EPlus, Inc., a business selling, leasing, and managing information technology and other assets.

#### Marie S. Minton

Marie S. Minton has been a director of the Company since August 2007. Ms. Minton is the founder and Managing Director of Transition Finance Strategies, LLC, an investment holding company formed in 2003 that owns and manages small businesses. From 1994 to 2003, Ms. Minton was a Managing Director and the Chief Financial Officer of Global Environment Fund, an international private equity investment management firm. Before joining GEF, Ms. Minton was the Vice President of Finance for Clean Air Capital Markets Corporation, a boutique investment banking firm. From 1986 through 1993, Ms. Minton was an Audit Manager in the Entrepreneurial Services Division of Ernst & Young. She served as a director, member of the Audit and Executive Committees, and Chair of the Compensation Committee of Essex Corporation from 2000 through 2006. Ms. Minton is a Certified Public Accountant and a Chartered Financial Analyst. She is a member of the American Institute of CPAs, the Virginia Society of CPAs, the CFA Institute, and the CFA Society of Washington, D.C.

#### Dr. John R. Treichler

Dr. John R. Treichler, a co-founder of the Company, has been a director and employee of the Company since its incorporation in 1984. He has served in the position of Senior Scientist since 1984 and as Chief Technical Officer since 1999. Prior to co-founding the Company, he worked at ARGOSystems, Inc. for seven years, most recently serving as a senior scientist in the Strategic Systems Division, and at Stanford University for

three years in the Information Systems Laboratory. Prior to working at Stanford University, Dr. Treichler served for four years as an officer in the United States Navy.

## **Directors Continuing in Office until the 2009 Annual Meeting**

### **John P. Devine**

John P. Devine has been a director of the Company since May 1995. Mr. Devine served as Deputy Director, National Security Agency (NSA) for Technology and Systems from 1992 to 1995 and as Deputy Director, NSA for Research and Engineering from 1990 to 1992. From 1989 to 1990, Mr. Devine served as NSA Chief of Staff. Mr. Devine has been a consultant to the defense industry since his retirement from the NSA. Mr. Devine serves on the board of Ericsson Federal, Inc. and Spirent Federal Systems.

### **David D. Elliman**

David D. Elliman has been a director of the Company since 1991. Mr. Elliman is a professional investor. He is a founding partner of Elmrock Partners, which, along with affiliates, specializes in private equity, marketable equity, structured finance, and asset securitization investments. Elmrock Partners was founded in 1982. Mr. Elliman serves on the boards of a number of private companies.

### **Robert J. Richardson**

Robert J. Richardson has been a director of the Company since February 2003. From November 1997 to January 2000, Mr. Richardson was Chairman and Chief Executive Officer of Unitrode Corporation, a publicly traded semiconductor company, which was acquired by Texas Instruments, Inc. in 2000. From June 1992 to November 1997, Mr. Richardson was President of SVG Lithography (formerly Perkin-Elmer) in Connecticut, and then Vice President, New Business Development and Corporate Marketing for Silicon Valley Group. From 1988 to 1992, Mr. Richardson was the President and General Manager for the Santa Cruz Division of Plantronics, Inc., a manufacturer of communications equipment, and from 1985 to 1988, he was Director, Motorola New Enterprises. Mr. Richardson currently serves as director for a number of private technology companies.

### **Gary L. Yancey**

Gary L. Yancey, a co-founder of the Company, has served the Company as President, Chief Executive Officer, and Chairman of the Board since the Company's incorporation in January 1984. Prior to co-founding the Company, he was employed for ten years by ARGOSystems Inc., a manufacturer of electronic reconnaissance systems, most recently serving as Director of the Strategic Systems Division; and for seven years prior to that time, as an engineer with GTE Sylvania, Inc., a defense electronics company.

## **Proposal One: Election of Class II Directors**

Three persons are to be elected to serve as Class II directors of the Board of Directors at this 2008 Annual Meeting. Management's nominees for election by the shareholders to those positions are the current Class II members of the Board of Directors, Milton E. Cooper, Marie S. Minton, and John R. Treichler. If elected, the nominees for election as Class II directors will serve as directors until our Annual Meeting of shareholders in 2010, and until their successors are elected and qualified.

Each of Mr. Cooper and Dr. Treichler is standing for re-election by the shareholders. Ms. Minton is standing for election by the shareholders for the first time. During fiscal year 2007, the Nominating and Governance Committee evaluated possible candidates, including Ms. Minton. Based on the Nominating and Governance Committee's evaluation of the candidates and its recommendation to the Board, the Board elected Ms. Minton in August 2007.

Unless instructed otherwise, the persons named in the accompanying proxy will vote the shares represented by such proxy for the election of the three nominees for Class II director. Each of the three nominees has consented to serve, and the Board does not know of any reason why any of them would be unable to serve. If a nominee becomes unavailable or unable to serve before the Annual Meeting (for example, due to serious illness), the Board can either reduce its size or designate a substitute nominee. If any nominee becomes unavailable for election to the Board of Directors, an event which is not anticipated, the persons named as proxies have full discretion and authority to vote or refrain from voting for any other nominee in accordance with their judgment.

### **Required Vote**

If a quorum is present and voting, the three nominees for Class II director receiving the highest number of votes will be elected as Class II directors. Abstentions and broker non-votes have no effect on the vote.



## Recommendation of the Board of Directors

**THE BOARD OF DIRECTORS RECOMMENDS A VOTE “FOR” THE NOMINEES FOR CLASS II DIRECTOR NAMED ABOVE. UNLESS AUTHORITY TO DO SO IS WITHHELD, THE PROXY HOLDERS NAMED IN EACH PROXY WILL VOTE THE SHARES REPRESENTED THEREBY FOR THE ELECTION OF THE NOMINEES LISTED ABOVE.**

## Corporate Governance

### Independence of the Board of Directors

The Board of Directors determines the independence of directors annually based on a review by the directors and the Nominating and Governance Committee. No director is considered independent unless the Board of Directors has determined that he or she has no material relationship with us, either directly or as a partner, shareholder, or officer of an organization that has a material relationship with us. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable, and familial relationships, among others. The standards relied upon by the Board of Directors in affirmatively determining whether a director is independent are comprised of those objective standards set forth in the NASDAQ rules, which generally provide that an “Independent director” means a person other than an executive officer or employee of the company or any other individual having a relationship which, in the opinion of the issuer’s board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. The following persons shall not be considered independent:

- A director who is, or at any time during the past three years was, employed by Applied Signal Technology
  - A director who accepted or who has a family member who accepted any compensation from Applied Signal Technology or its subsidiaries in excess of \$100,000 during any period of twelve consecutive months within the three years preceding the determination of independence, other than the following:
    - Compensation for board or board committee service
    - Compensation paid to a family member who is an employee (other than an executive officer) of the company
    - Benefits under a tax-qualified retirement plan, or non-discretionary compensation
  - A director who is a family member of an individual who is, or at any time during the past three years was, employed by Applied Signal Technology as an executive officer
    - A director who is, or has a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which Applied Signal Technology received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient’s consolidated gross revenues for that year, or \$200,000, whichever is more, other than the following:
      - Payments arising solely from investments in the company’s securities
      - Payments under non-discretionary charitable contribution matching programs
    - A director who is, or has a family member who is, employed as an executive officer of another entity where at any time during the past three years any of the executive officers serve on the compensation committee of such other entity
      - A director who is, or has a family member who is, a current partner of Ernst & Young LLP, or was a partner or employee of Ernst & Young LLP who worked on our audit at any time during any of the past three years

In addition, members of the Audit Committee must (i) meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Securities Act of 1933, as amended, (ii) not have participated in the preparation of our financial statements or those of any of our current subsidiaries at any time during the past three years, and (iii) be able to read and understand fundamental financial statements, including a company’s balance sheet, income statement, and cash flow statement. Additionally, at least one member of the Audit Committee must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual’s financial sophistication, including being or having been a chief executive officer, chief financial officer, or other senior officer with financial oversight responsibilities.

In November 2007, the directors and the Nominating and Governance Committee reviewed directors’ responses to a questionnaire asking about the relationships with the Company (and those of their immediate family members) and other potential conflicts of interest, as well as material

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provided by management related to transactions, relationships, or arrangements between us and the directors or parties related to the directors. The Nominating and Governance Committee reported its conclusions to the Board of Directors, and the Board of Directors then considered each director individually and determined that none of the directors has had during the last three years (i) any of the relationships listed above or (ii) any other material relationship with us that would compromise his or her independence; provided, however, that as Chief Executive Officer, Mr. Yancey, and as Chief Technical Officer, Dr. Treichler, do not meet the definition of independence. The Nominating and Governance Committee also determined that the members of the Audit, Compensation, and Nominating and Governance Committees also meet the independence tests of NASDAQ.

### Executive Sessions

Our independent directors meet in regularly scheduled executive sessions at which only independent directors are present. No single director has been designated by the Board to act as the presiding director for such executive sessions.

### Meetings of the Board of Directors and Committees

During the fiscal year ended October 31, 2007, the Board of Directors held 22 meetings. All directors attended at least 75% of the aggregate of the number of meetings of the Board of Directors and of the committees of the Board of Directors on which such director served during fiscal year 2007.

### Committees of the Board of Directors

The Board of Directors currently has three regular committees: Audit Committee, Compensation Committee, and Nominating and Governance Committee. Each of these committees operates under a written charter adopted by the Board. Copies of these charters are available on our website at [www.appsig.com/investors](http://www.appsig.com/investors). The following table provides membership information for fiscal year 2007 for each of the committees of the Board of Directors.

Name	Audit	Compensation	Nominating and Governance
Milton E. Cooper	X	X	X
John P. Devine		X	X*
David D. Elliman	X	X*	
Marie S. Minton <sup>(1)</sup>	X		
Robert J. Richardson	X	X	X
Stuart G. Whittelsey, Jr. <sup>(2)</sup>	X*	X	

\* Committee Chairperson

(1) Ms. Minton joined the Board in August 2007, and became a member of the Audit Committee at that time.

(2) Mr. Whittelsey resigned as a member of the Board of Directors and of all committees of the Board effective November 15, 2007.

Effective November 15, 2007, the Board of Directors approved changes to the committee memberships, and the following table provides membership information for fiscal year 2008 for each of the committees of the Board of Directors.

Name	Audit	Compensation	Nominating and Governance
Milton E. Cooper		X*	
John P. Devine		X	X
David D. Elliman	X*	X	
Marie S. Minton <sup>(1)</sup>	X		X

Robert J. Richardson	X	X*
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\* Committee Chairperson

### The Audit Committee

The Audit Committee of the Board of Directors oversees our accounting and financial reporting processes and the audits of our financial statements. For this purpose, the Audit Committee performs several functions:

- Maintains responsibility for the appointment, compensation, retention, and oversight of our independent registered public accounting firm and evaluates the qualifications, performance, and independence of the independent auditor
- Approves in advance the engagement of the independent registered public accounting firm for all audit and non-audit services, and approves the fees and other terms of the engagement
- Reviews, with our independent registered public accounting firm, any significant difficulties, disagreements, or restrictions encountered during the course of the audit, and reviews any management letters issued by the independent registered public accounting firm
- Reviews the critical accounting policies and all alternative treatments of financial information discussed by the independent registered public accounting firm with management, and reviews with management significant judgments made in the preparation of financial statements
- Reviews, with management and our independent registered public accounting firm, our financial reporting processes and internal financial controls
- Reviews the annual audited financial statements and recommends to the Board of Directors their inclusion in our annual report
- Reviews the quarterly financial statements and earnings press releases
- Reviews with management its assessment of the effectiveness and adequacy of our internal controls and procedures for financial reporting, and any significant deficiencies in the design or operation of our internal controls, and reviews with the independent registered public accounting firm their report on our internal controls
- Reviews and approves any related party transactions
- Establishes and oversees procedures for the receipt, retention, and treatment of complaints received regarding accounting, internal controls or auditing matters; reviews changes in, or waivers of, our Code of Conduct, and as requested by the Board, reviews and investigates any conduct alleged to be in violation of the Code of Conduct
- Periodically reviews and discusses with the independent registered public accounting firm the matters required to be discussed by Statement on Accounting Standards 61 (Codification of Statements on Auditory Standards No. 380) and any formal written statements received from the registered independent

The Audit Committee held ten meetings during the fiscal year ended October 31, 2007.

### The Compensation Committee

The Compensation Committee of the Board of Directors:

- Periodically reviews and advises the Board concerning both regional and industry-wide compensation practices and trends in order to assess the adequacy and competitiveness of our compensation programs for executive officers and directors relative to comparable companies in our industry
- Reviews and approves corporate and personal performance goals and objectives relevant to the compensation of all executive officers, and sets all executive compensation
- Makes recommendations to the Board regarding the establishment and terms of our incentive compensation plans and equity compensation plans, and administers such plans
- Approves grants of options, restricted stock, and other awards to all executive officers and directors
- Approves compensation-related matters outside the ordinary course to executive officers and directors, including but not limited to employment contracts, change-in-control provisions, severance arrangements, and material amendments thereto

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- Reviews and approves for filing the disclosures in our “Compensation Discussion and Analysis” and any other disclosures regarding executive compensation to be included in our public filings or shareholder reports
- Makes recommendations to the Board regarding director compensation

The Compensation Committee is responsible for all grants of equity awards. Equity awards to executive officers of Applied Signal Technology are made at meetings of the Compensation Committee, and not by unanimous written consent. All awards approved for grant at a regularly scheduled meeting are granted effective as of the date of the meeting. The Compensation Committee has delegated authority to make equity awards to newly-hired employees, other than to an individual who, at the time of grant, is or is expected to become, an executive officer of Applied Signal Technology, a member of the Board of Directors or any other person whose transactions in our equity securities are subject to Section 16 of the Securities Exchange Act of 1934 and any other person who reasonably may be expected to become a “covered employee” within the meaning of Section 162(m) of the Internal Revenue Code, to the Chief Executive Officer, pursuant to parameters established by the Compensation Committee concerning total number of shares to be issued.

The Compensation Committee held four meetings during the fiscal year ended October 31, 2007.

### **The Nominating and Governance Committee**

The Nominating and Governance Committee of the Board of Directors:

- Evaluates and selects nominees for each election of directors
  - Determines criteria for selecting new directors, including desired board skills and attributes, and identifies and actively seeks individuals qualified to become directors
- Considers any nominations of director candidates validly made by shareholders
  - Reviews and makes recommendations to the Board of Directors concerning qualifications, appointment, and removal of committee members
- Reviews the Code of Business Conduct and Ethics from time to time and recommends such changes to the Code as the Committee shall deem appropriate
- Reviews our compliance with corporate governance listing requirements established by The NASDAQ Stock Market
- Assists the Board in developing criteria for the evaluation of Board and committee performance
  - Assists the Board in the orientation of new directors and in the development of corporate governance-related continuing education for all Board members

The Nominating and Governance Committee held four meetings during the fiscal year ended October 31, 2007.

### **Director Nominations**

Our bylaws contain provisions that address the process by which a shareholder may nominate an individual to stand for election to the Board of Directors at the Company’s Annual Meeting. The Nominating and Governance Committee has adopted a policy regarding director nominations and regarding communications by shareholders with directors, including the process for evaluating director nominees proposed by shareholders. To date, we have not received any recommendations from shareholders requesting that the Nominating and Governance Committee (or any predecessor) consider a candidate for inclusion among the Committee’s slate of nominees in our proxy statement.

In evaluating director nominees, the Nominating and Governance Committee considers the following factors:

- The appropriate size of our Board of Directors and its Committees
- The perceived needs of the Board for particular skills, background, and business experience
  - The skills, background, reputation, and business experience of nominees compared to the skills, background, reputation, and business experience already possessed by other members of the Board
- The nominees’ independence from management
-

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The applicable regulatory and listing requirements, including independence requirements and legal considerations, such as antitrust compliance

- The benefits of a constructive working relationship among directors
- The desire to balance the considerable benefit of continuity with the periodic injection of the fresh perspective provided by new members

Other than the foregoing, there are no stated minimum criteria for director nominees, and the Nominating and Governance Committee may also consider such other factors as it may deem are in our best interests and the interests of our shareholders. The Nominating and Governance Committee does, however, believe it appropriate for at least one member of the Board to meet the criteria for an “audit committee financial expert,” that a majority of the members of the Board meet the definition of “independent director” under NASDAQ rules, and that one or more key members of management participate as members of the Board.

The Nominating and Governance Committee identifies nominees by first evaluating the current members of the Board of Directors willing to continue in service. Current members of the Board with skills and experience that are relevant to the Company’s business and who are willing to continue in service are considered for re-nomination, balancing the value of continuity of service by existing members of the Board with that of obtaining a new perspective. If any member of the Board does not wish to continue in service or if the Nominating and Governance Committee or the Board decides not to re-nominate a member for re-election, the Nominating and Governance Committee identifies the desired skills and experience of a new nominee, and discusses with the Board suggestions as to individuals that meet the criteria. In addition, the Committee has in the past engaged third parties to identify, evaluate, or assist in identifying potential nominees.

The Nominating and Governance Committee will evaluate any recommendation for director nominee proposed by a stockholder. In order to be evaluated in connection with the Nominating and Governance Committee’s established procedures for evaluating potential director nominees, any recommendation for director nominee submitted by a stockholder must be sent in writing to the Corporate Secretary, 400 West California Avenue, Sunnyvale, California 94086, 120 days prior to the anniversary of the date proxy statements were mailed to stockholders in connection with the prior year’s Annual Meeting of Stockholders and must contain the following information:

- The candidate’s name, age, contact information, and present principal occupation or employment
- A description of the candidate’s qualifications, skills, background, and business experience during, at a minimum, the last five years, including his or her principal occupation and employment and the name and principal business of any corporation or other organization in
- which the candidate was employed or served as a director

### **Communication with Directors**

Shareholders who wish to communicate with the Board of Directors may do so by writing to: Applied Signal Technology, Inc., Attention: Board of Directors, 400 West California Avenue, Sunnyvale, California 94086. The Corporate Secretary shall maintain a log of such communications and transmit as soon as practicable such communications to the identified director addressee(s), unless there are safety or security concerns that mitigate against further transmission of the communication or the communication contains commercial matters not related to the stockholder’s stock ownership, as determined by the Corporate Secretary in consultation with the Chief Executive Officer and legal counsel. The Board of Directors or individual directors so addressed shall be advised of any communication withheld for any reason as soon as practicable.

### **Director Attendance at Annual Meetings**

We make every effort to schedule our Annual Meeting at a time and date to maximize attendance by directors taking into account the directors’ schedules. We believe that annual meetings provide an opportunity for shareholders to communicate with directors and have adopted a policy requesting that all directors make every effort to attend the Company’s Annual Meeting. Historically, more than a majority of the directors have done so; for example, 100% of the directors attended the 2007 Annual Meeting.

### **Committee Charters and Other Corporate Governance Materials**

The Board has adopted a charter for each of the committees described above, as well as a Code of Business Conduct and Ethics that applies to all of our employees, officers, and directors. Links to these materials are available on our website at [www.appsig.com/investor](http://www.appsig.com/investor). To date, there have not been any waivers by the Company of compliance with the code of ethics by any executive officer or director. Any amendments to, or waivers under, the code of ethics that are required to be disclosed by the rules of the SEC will be disclosed on the Company’s website.

### **Shareholder Proposals**

Shareholders may nominate one or more persons for election as directors at a meeting only if timely notice of such nomination(s) has been given in writing to our Corporate Secretary in accordance with our Bylaws. The complete description of the requirements for shareholder nomination of director candidates is contained in the Bylaws. In summary, assuming (i) we held an annual meeting the previous year and (ii) the date of the

next meeting is within 30 days of the anniversary date of the meeting for the previous year, a shareholder desiring to nominate one or more candidates for election at the next annual meeting must submit written notice of such nomination to the Corporate Secretary at least 120 days in advance of the one year anniversary of the date that we released our proxy statement in connection with the annual meeting held in the previous year. You can obtain a copy of the full text of the Bylaws provision by writing to the Corporate Secretary, 400 West California Avenue, Sunnyvale, California 94086.

## Compensation Committee Interlocks and Insider Participation

None of the members of the Compensation Committee are or have been an officer or employee of Applied Signal Technology. During fiscal year 2007, no member of the Compensation Committee had any relationship with Applied Signal Technology requiring disclosure under Item 404 of Regulation S-K. During fiscal year 2007, none of our executive officers served on the compensation committee (or its equivalent) or board of directors of another entity any of whose executive officers served on our Compensation Committee or Board of Directors.

## Compensation of Directors

The Compensation Committee reviews and recommends to the Board non-employee director compensation. We use a combination of cash and stock-based compensation to attract and retain qualified candidates to serve on our Board of Directors. In setting the compensation of non-employee directors, we consider the significant amount of time that the Board members expend in fulfilling their duties to us as well as the experience level we require to serve on the Board. The Compensation Committee annually reviews the compensation and compensation policies for non-employee members of the Board of Directors.

**Cash Compensation.** Directors who are also our employees are not compensated by us for services provided as a member of the Board of Directors. During fiscal year 2007, non-employee directors were paid an annual retainer of \$40,250 for their services as members of the Board of Directors, plus an annual fee of \$2,875 to each chairperson of a committee of the Board of Directors. We reimburse out-of-pocket travel expenses of non-employee directors not residing in the San Francisco Bay area in accordance with our travel policy.

**Equity Compensation.** Non-employee directors are eligible to participate in the 2001 Stock Option Plan and 2004 Stock Incentive Plan, and employee-directors are able to participate in the 1993 Employee Stock Purchase Plan, 2001 Stock Option Plan, 2004 Stock Incentive Plan, and 401(k) Plan. Options granted to non-employee directors are not intended to qualify as incentive stock options under the Internal Revenue Code. The initial and any annual options granted to non-executive directors vest annually in three equal annual installments on the anniversary date of such grant. A director who ceases to be a director for any reason may exercise the vested portion of his or her options within 12 months following such termination, to the extent not previously exercised. All options granted to non-employee directors under the 2001 Stock Option Plan expire ten years following the date of grant, and under the 2004 Stock Incentive Plan, expire eight years following the date of grant.

During fiscal year 2007, we made grants of restricted stock to non-employee directors rather than stock option grants, and expect to continue to award restricted stock to directors rather than grant stock options. In fiscal year 2007, after our Annual Meeting of Shareholders, we awarded 1,875 shares of restricted stock to each of our non-employee directors. These shares each vest over three years at the rate of one-third on each anniversary of the date of grant, and vesting of such shares accelerates in full upon a change in control of the Company. The Board awarded to Ms. Minton 4,688 shares of restricted stock effective upon her appointment as a member of the Board on August 28, 2007. This restricted stock award becomes exercisable as to 938 shares on March 14, 2008, 1,875 shares on March 14, 2009, and as to the final 1,875 shares on March 14, 2010, subject to Ms. Minton's continued service as a member of the Board of Directors, and vest in full upon a change of control of the Company.

Options to purchase our common stock and restricted stock granted to our non-employee directors provide that in the event of a change in control of the Company, each outstanding option, and each share of restricted stock, held by a non-employee whose service as a director has not terminated prior to such date shall be vested in full, and in the case of stock options, immediately exercisable and vested in full as of the date ten days prior to the change in control.

The following table sets forth information concerning the compensation earned during the fiscal year ended October 31, 2007, by each individual who served as a director at any time during the fiscal year.

## 2007 Director Compensation

Name	Fees Earned or Paid in Cash (\$) <sup>(1)</sup>	Option Awards (\$) <sup>(2)</sup>	Stock Awards (\$) <sup>(2)</sup>	Other Compensation(\$) <sup>(3)</sup>	Total (\$)
Milton E. Cooper	\$40,250	\$66,932	\$10,715	\$1,172	\$119,069

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John P. Devine	\$43,125	\$42,111	\$10,715	\$1,172	\$97,123
David D. Elliman	\$43,125	\$42,111	\$10,715	\$1,172	\$97,123
Marie S. Minton	\$10,063	—	\$4,332	\$586	\$14,981
Robert J. Richardson	\$40,250	\$42,111	\$10,715	\$1,172	\$94,248
Stuart G. Whittelsey	\$43,125	\$42,111	\$10,715	\$1,172	\$97,123
John R. Treichler <sup>(4)</sup>					
Gary L. Yancey <sup>(4)</sup>					

(1) For a description of annual non-employee director fees, see the disclosure above under “Cash Compensation.”

(2) The amounts shown are the compensation costs recognized in our financial statements for fiscal year 2007 related to grants of stock options and awards of restricted stock to our non-employee directors in fiscal year 2007 and prior years, to the extent we recognized compensation costs in fiscal year 2007 for such awards in accordance with the provisions of SFAS 123R. For a discussion of the valuation assumptions used in the SFAS 123R calculations, see Note 1 of Notes to Consolidated Financial Statements, “Organization and Summary of Significant Accounting Policies—Stock-Based Compensation” included in Part IV, Item 15 of our Annual Report on Form 10-K for the year ended October 31, 2007, referred to in this proxy statement as our 2007 Form 10-K. The grant date fair value of the options was estimated by using the Black Scholes option pricing model, in accordance with the provisions of SFAS 123R. The actual value, if any, that a director may realize on each option will depend on the excess of the stock price over the exercise price on the date the option is exercised and the shares underlying such option are sold. There is no assurance that the actual value realized by a director will be at or near the value estimated by the Black Scholes model.

(3) The amounts shown represent the dividend payments received during fiscal year 2007, associated with restricted stock awards.

(4) Mr. Yancey and Dr. Treichler received no compensation for their service on the Board of Directors. Compensation paid to each of them as Chief Executive Officer and Chief Technical Officer, respectively, is disclosed in the Summary Compensation Table.

## Proposal Two: Amendment of the Applied Signal Technology, Inc. 2004 Stock Incentive Plan

### Amendment of 2004 Stock Incentive Plan

At the Annual Meeting, the stockholders will be asked to approve an amendment to the Applied Signal Technology, Inc. 2004 Stock Incentive Plan (the “2004 Plan”) to increase by 500,000 the maximum number of shares of our common stock that may be issued under the 2004 Plan. The Board of Directors believes that in order to successfully attract and retain the best possible candidates for positions of responsibility, we must continue to offer a competitive equity incentive program. As of January 29, 2008, approximately 48,171 shares remained available for the future grant of awards under the 2004 Plan. The Board of Directors has unanimously adopted, subject to stockholder approval, an amendment to increase the maximum number of shares of common stock issuable under the 2004 Plan by 500,000 shares to a total of 1,100,000 shares to ensure that we will continue to have available a reasonable number of shares for our 2004 Plan equity incentive program. In addition to the 2004 Plan, as of October 31, 2007, there remained available for future grant a total of 357,557 shares under our 2000 Stock Option Plan, and 35,635 shares under our 2001 Stock Option Plan. Unlike the 2004 Plan, however, these two plans authorize only the grant of stock options, and eligibility under the 2000 Stock Option Plan is limited to our non-officer employees, and is not available for grant of options to our executive officers or directors. Furthermore, our Board of Directors terminated the 2000 Stock Option Plan. All shares remaining available for grant under the 2000 Stock Option Plan ceased to be reserved, provided that the provisions of the 2000 Plan shall continue to govern outstanding options previously granted pursuant to the 2000 Stock Option Plan.

We are asking our stockholders to approve the proposed amendment to the 2004 Plan so that we will have a sufficient number of shares available for alternatives to stock options, including stock appreciation rights, restricted stock and restricted stock unit awards, performance share and performance unit awards, deferred compensation awards, and other stock-based or cash-based awards. Our Board of Directors believes that the ability of the Company to grant incentive awards other than stock options is important in enabling us to offer competitive compensation packages and to make the most effective use of the shares our stockholders authorize for incentive purposes. Therefore, the Board of Directors urges you to vote to approve the proposed amendment to the 2004 Plan.

The 2004 Plan is also designed to preserve the Company’s ability to deduct in full for federal income tax purposes the compensation recognized by its executive officers in connection with certain awards granted under the 2004 Plan. Section 162(m) of the Internal Revenue Code of 1986, as amended (the “Code”), generally denies a corporate tax deduction for annual compensation exceeding \$1 million paid to the chief executive officer or to any of the four other most highly compensated officers of a publicly held company. However, certain types of compensation, including performance-based compensation, are generally excluded from this limit. To enable compensation in connection with stock option awards granted under the 2004 Plan to qualify as “performance-based” within the meaning of Section 162(m), the grant of such awards must be

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made by a compensation committee of the Board comprised solely of two or more “outside directors,” as defined by Section 162(m). The compensation an employee could receive in connection with such awards must be based solely on an increase in the value of the common stock after the date of grant, and the plan must state the maximum number of shares for which such awards may be granted to any employee during a specified period. The compensation related to such awards will qualify as performance-based only if the shareholders approve the class of employees eligible to receive such awards and the limit on the maximum number of shares for which such awards may be granted to an employee.

The Board of Directors believes that it is in the best interests of the Company and its shareholders to preserve the ability of the Company to deduct in full, compensation related to stock option awards granted under the 2004 Plan. Therefore, for the purpose of qualifying such compensation as performance-based under Section 162(m) of the Code, the shareholders are asked to approve the following provisions of the 2004 Plan:

- All employees of the Company or any parent or subsidiary corporation of the Company are eligible to be granted stock option awards under the 2004 Plan

- No participant may receive under the 2004 Plan stock options for more than 400,000 shares of common stock in the aggregate per calendar year, provided that this limit will be appropriately adjusted for stock splits, stock dividends, and similar changes to the Company’s capital structure

### Summary of the Plan

The following summary of the 2004 Plan is qualified in its entirety by the specific language of the 2004 Plan, a copy of which is available to any stockholder upon request.

**General.** The purpose of the 2004 Plan is to advance the interests of the Company by providing an incentive program that will enable the Company to attract, retain, and reward employees, consultants, and directors, and to motivate such persons to contribute to the growth and profitability of the Company. These incentives are provided through the grant of stock option, restricted stock, and restricted stock unit awards.

**Shares Subject to Plan.** The maximum aggregate number of authorized shares of the common stock of the Company under the Plan is 600,000. Upon approval of this proposal, the maximum aggregate number of authorized shares of the common stock of the Company under the 2004 Plan will be 1,100,000. Appropriate adjustments will be made to the foregoing limit and to outstanding awards upon any merger, consolidation, reorganization, reincorporation, recapitalization, reclassification, stock dividend, stock split, reverse stock split, split-up, split-off, spin-off, combination of shares, exchange of shares, or similar change in the capital structure of the Company. If any award expires, lapses, or otherwise terminates for any reason without having been exercised or settled in full, if shares are reacquired pursuant to withholding, or if shares subject to forfeiture or repurchase are forfeited or repurchased by the Company, any such shares reacquired or subject to a terminated award will again become available for issuance under the Plan. The shares available will not be reduced by shares withheld to satisfy tax withholding obligations. Only the net number of shares issued upon the exercise of options exercised by tender of previously owned shares will be deducted from the shares available under the 2004 Plan.

**Administration.** The 2004 Plan will be administered by the Board of Directors. In the case of awards intended to qualify for the performance-based compensation exemption under Section 162(m) of the Code, administration must be by a compensation committee comprised solely of two or more “outside directors” within the meaning of Section 162(m). (For purposes of this summary, the term “Board” will refer to either such duly appointed committee or the Board of Directors.) Subject to the provisions of the 2004 Plan, the Board determines in its discretion the persons to whom and the times at which awards are granted, the types and sizes of such awards, and all of their terms and conditions. The Board may, subject to certain limitations required by Section 162(m), amend, cancel or renew, waive any restrictions or conditions applicable to any award, and accelerate, continue, extend, or defer the vesting of any award. The 2004 Plan provides, subject to certain limitations, for indemnification by the Company of any director, officer, or employee against all reasonable expenses, including attorneys’ fees, incurred in connection with any legal action arising from such person’s action or failure to act in administering the 2004 Plan. The Board will interpret the 2004 Plan and awards granted thereunder, and all determinations of the Board will be final and binding on all persons having an interest in the 2004 Plan or any award.

**Prohibition of Option Repricing.** The 2004 Plan expressly provides that, without the approval of a majority of votes cast in person or by proxy at a meeting of the Company’s shareholders, the Board may not provide for either the cancellation of outstanding options in exchange for the grant of new options at a lower exercise price or the amendment of outstanding options to reduce the exercise price.

**Eligibility.** Awards may be granted to employees, consultants, directors, and officers of the Company or of any present or future parent or subsidiary corporations of the Company. In addition, awards may be granted to prospective service providers in connection with written employment offers, provided that no shares subject to any such award may vest, become exercisable, or be issued prior to such person’s commencement of service. Incentive stock options may be granted only to employees.



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**Stock Options.** The Board may grant nonstatutory stock options, incentive stock options within the meaning of Section 422 of the Code, or any combination of these. To enable compensation received in connection with stock options granted under the 2004 Plan to qualify as “performance-based,” within the meaning of Section 162(m) of the Code, the 2004 Plan limits the size of such awards. Under this limit, no participant may receive under the 2004 Plan in any calendar year stock options for more than 400,000 shares of common stock in the aggregate. Appropriate adjustment will be made to such 400,000 share limit in the event of any change in the capital structure of the Company.

Each option granted under the 2004 Plan must be evidenced by a written agreement between the Company and the optionee specifying the number of shares subject to the option and the other terms and conditions of the option, consistent with the requirements of the 2004 Plan. The exercise price of each option may not be less than the fair market value of a share of common stock on the date of grant. However, any incentive stock option granted to a person who at the time of grant owns stock possessing more than 10% of the total combined voting power of all classes of stock of the Company or any parent or subsidiary corporation of the Company (a “Ten-percent Stockholder”) must have an exercise price equal to at least 110% of the fair market value of a share of common stock on the date of grant.

The 2004 Plan provides that the option exercise price may be paid in cash, by check, or in cash equivalent; by the assignment of the proceeds of a sale or loan with respect to some or all of the shares being acquired upon the exercise of the option; to the extent legally permitted, by tender of shares of common stock owned by the optionee having a fair market value not less than the exercise price; by such other lawful consideration as approved by the Board; or by any combination of these. Nevertheless, the Board may restrict the forms of payment permitted in connection with any option grant. No option may be exercised unless the optionee has made adequate provision for federal, state, local, and foreign taxes, if any, relating to the exercise of the option, including, if permitted by the Company, through the optionee’s surrender of a portion of the option shares to the Company.

Options will become vested and exercisable at such times or upon such events and subject to such terms, conditions, performance criteria, or restrictions as specified by the Board. The maximum term of any option granted under the 2004 Plan is eight years, provided that an incentive stock option granted to a ten-percent stockholder must have a term not exceeding five years. Subject to the term of the option, an option generally will remain exercisable for three months following the optionee’s termination of service, provided that if service terminates as a result of the optionee’s death or disability, the option generally will remain exercisable for twelve months. The Board, in its discretion, may provide longer post-termination exercise periods, but in any event, the option must be exercised no later than its expiration date.

Incentive stock options are nontransferable by the optionee other than by will or by the laws of descent and distribution, and are exercisable during the optionee’s lifetime only by the optionee. Nonstatutory stock options granted under the 2004 Plan may be assigned or transferred to the extent permitted by the Board and set forth in the option agreement.

**Outside Director Options.** An outside director is a director of the Company who is not an employee or consultant. Each option granted to an outside director under the 2004 Plan, in addition to satisfying the general requirements for stock options described above, will generally vest and become exercisable in three substantially equal installments on each of the first three anniversaries of the date of grant of such option. If the outside director’s service terminates for any reason, including death or disability, the option may be exercised by the outside director, or his or her representative, at any time prior to the expiration of twelve months after the date on which the outside director’s service terminated.

**Restricted Stock.** Awards of restricted stock may be granted by the Board subject to such restrictions for such periods as determined by the Board and set forth in a written agreement between the Company and the participant. No monetary payment is required for receipt of shares of restricted stock, the consideration for which is furnished in the form of the participant’s services to the Company. Restricted stock may not be sold or otherwise transferred or pledged until the restrictions lapse or are terminated. Restrictions may lapse in full or in installments on the basis of the participant’s continued service or other factors, such as performance criteria established by the Board. Unless otherwise provided by the Board, a participant will forfeit any shares of restricted stock as to which the restrictions have not lapsed prior to the participant’s termination of service. Participants holding restricted stock will have the right to vote the shares and to receive all dividends and other distributions, except that any dividends or other distributions in shares will be subject to the same restrictions on transferability as the original award.

**Restricted Stock Units.** Restricted stock units granted under the 2004 Plan represent a right to receive shares of Company common stock at a future date determined in accordance with the terms and conditions set forth in a written agreement between the Company and the participant. No monetary payment is required for receipt of restricted stock units or the shares issued in settlement of the award, the consideration for which is furnished in the form of the participant’s services to the Company. The Board may grant restricted stock unit awards subject to vesting conditions similar to those applicable to restricted stock awards. Restricted stock units may not be sold or otherwise transferred or pledged. Unless otherwise provided by the Board, a participant will forfeit any shares of restricted stock as to which the restrictions have not lapsed prior to the participant’s termination of service. Participants have no voting rights or rights to receive cash dividends with respect to restricted stock unit awards until shares of common stock are issued in settlement of such awards. However, the Board may grant restricted stock units that entitle their holders to receive dividend equivalents, which are rights to receive additional restricted stock units for a number of shares whose value is equal to any cash dividends paid by the Company.

**Change in Control.** The 2004 Plan defines a “change in control” of the Company as any of the following events (or series of related events) in which the stockholders of the Company immediately prior to the event do not retain immediately after the event direct or indirect beneficial

ownership of more than 50% of the total combined voting power of the outstanding voting securities of the Company or the entity to which the assets of the Company were transferred: (i) the direct or indirect sale or exchange by the stockholders of all or substantially all of the voting stock of the Company; (ii) a merger or consolidation in which the Company is a party; (iii) the sale, exchange, or transfer of all or substantially all of the assets of the Company; or (iv) a liquidation or dissolution of the Company. Additionally, a change in control will occur if there is a change in the composition of the Board within any consecutive two-year period as a result of which fewer than a majority of the directors are incumbent directors. An "incumbent director" means a member of the Board who either (1) is a member of the Board as of the date of the approval of the 2004 Plan by the shareholders of the Company, or (2) is elected, or nominated for election, to the Board with the affirmative votes of at least a majority of the incumbent directors at the time of such election or nomination, but (3) was not elected or nominated in connection with an actual or threatened proxy contest relating to the election of the directors of the Company. In the event of a change in control of the Company, the acquiring or successor entity may assume all stock options outstanding under the Equity Plan or substitute substantially equivalent options. If the outstanding stock options are not assumed by the acquiring or successor entity, the Board may accelerate the vesting and exercisability of the options. Any options that are not assumed in connection with the change in control nor exercised as of the time of consummation of the change in control will terminate and cease to be outstanding as of the effective time of the change in control. In addition, the Board may, at its discretion, provide for the acceleration of vesting of any stock option, restricted stock award, or restricted stock unit award. Finally, in the event of change of control, the vesting of each outstanding outside director option will accelerate in full as of the date ten days prior to the change in control.

**Termination or Amendment.** The 2004 Plan will continue in effect until the first to occur of (i) its termination by the Board, (ii) the date on which all shares available for issuance under the 2004 Plan have been issued and all restrictions on such shares under the terms of the 2004 Plan and the agreements evidencing awards granted under the 2004 Plan have lapsed, or (iii) the eighth anniversary of its approval by the Company's shareholders. The Board may terminate or amend the 2004 Plan at any time, provided that no amendment may be made without shareholder approval if the Board deems such approval necessary for compliance with any applicable tax or securities law or other regulatory requirements, including the requirements of any stock exchange or market system on which the common stock of the Company is then listed. No termination or amendment may affect any outstanding award unless expressly provided by the Board, and, in any event, may not adversely affect an outstanding award without the consent of the participant unless necessary to comply with any applicable law, regulation, or rule.

#### **Summary of U.S. Federal Income Tax Consequences**

The following summary is intended only as a general guide to the U.S. federal income tax consequences under current law of participation in the 2004 Plan and does not attempt to describe all possible federal or other tax consequences of such participation or tax consequences based on particular circumstances.

**Incentive Stock Options.** An optionee recognizes no taxable income for regular income tax purposes as a result of the grant or exercise of an incentive stock option qualifying under Section 422 of the Code. Optionees who neither dispose of their shares within two years following the date the option was granted nor within one year following the exercise of the option will normally recognize a capital gain or loss upon a sale of the shares equal to the difference, if any, between the sale price and the purchase price of the shares. If an optionee satisfies such holding periods upon a sale of the shares, the Company will not be entitled to any deduction for federal income tax purposes. If an optionee disposes of shares within two years after the date of grant or within one year after the date of exercise (a "disqualifying disposition"), the difference between the fair market value of the shares on the exercise date and the option exercise price (not to exceed the gain realized on the sale if the disposition is a transaction with respect to which a loss, if sustained, would be recognized) will be taxed as ordinary income at the time of disposition. Any gain in excess of that amount will be a capital gain. If a loss is recognized, there will be no ordinary income, and such loss will be a capital loss. Any ordinary income recognized by the optionee upon the disqualifying disposition of the shares generally should be deductible by the Company for federal income tax purposes, except to the extent such deduction is limited by applicable provisions of the Code.

The difference between the option exercise price