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Good News For Foreign Investors In US Defense Industry

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Foreign ownership will bar a U.S. facility security clearance ("FCL") unless foreign ownership, control or influence ("FOCI") is mitigated in accordance with federal law. Though companies holding FCLs may play out their classified U.S. government contracts after being acquired by a foreign owner (if the government customer agrees), they may not receive or perform on new classified contracts. This can decimate the value of a company that draws a significant portion of its revenue from classified work, and frustrate the efforts of foreign-controlled companies to obtain FCLs and compete for classified contracts.

The key reference is the U.S. Department of Defense National Industrial Security Program Operating Manual. For foreign-controlled companies, the most common form of FOCI mitigation is the special security agreement. The SSA imposes a series of corporate governance constraints (including the appointment of independent, U.S. citizen outside directors), together with other extraordinary measures (such as restrictions on visits and electronic communications), to protect classified and controlled unclassified information, and to prevent undue foreign influence in the performance of classified contracts.

Importantly, companies operating under SSAs (as opposed to more stringent forms of mitigation) may not be awarded contracts that require access to highly classified ("proscribed") information[1] without a national interest determination ("NID") by the government contracting activity ("GCA"). The NID requires the GCA

[1] Proscribed Information is defined as Top Secret ("TS"); Communications Security ("COMSEC") material, excluding Controlled Cryptographic Items when unkeyed or utilized with unclassified keys; Restricted Data ("RD"); Special Access Program ("SAP") information; and Sensitive Compartmented Information ("SCI").

to confirm that disclosure of proscribed information is consistent with the national security interests of the United States. DOD Manual 5220.22, Volume 3 "National Industrial Security Program: Procedures for Government Activities Relating to Foreign Ownership, Control, or Influence ("FOCI")," Enclosure 3 3.d.(3)(c)1.

The process and agreements that the DOD uses to mitigate FOCI of cleared U.S. government contractors have evolved since SSAs were introduced some 30 years ago. Over the past few years, the Defense Security Service has adopted a "risk-based approach" to mitigation, recognizing that all contractors are not alike and that some foreign owners present greater risk than others.

In 2015, in a move that promised greater efficiency, the director of the DSS won back authority to establish and revise the templates that govern FOCI mitigation and negation agreements and related implementation documents. In addition, changes are also trickling into the recently modified NID process. If all goes well, these changes will allow for quicker and more predictable NID determinations. All of these changes should be welcome news to foreign investors in the U.S. defense sector.

The Modernized Approach to FOCI Mitigation

For years, government regulators treated any foreign ownership as a threat, regardless of its source. The regulatory scheme continues to require mitigation in all cases where companies are subject to FOCI, but the form of mitigation is now more closely tied to risk. This risk-based approach to FOCI mitigation[2] involves three principal considerations:

1. First, the DSS determines the policy requirements. For example, if a contractor is foreign-government-controlled, there are distinct statutory, regulatory and policy guidelines that apply to FOCI mitigation and access to proscribed information. Similarly, the level of FOCI (e.g., minority versus majority ownership) has implications for FOCI mitigation.

2. Second, the DSS takes into account factors other than ownership and control that could affect security, including security risks attendant to the products and services that a contractor provides to the U.S. government. These factors include, but are not limited to:

[2] The SSA is only one of several FOCI mitigation tools employed by the government. FOCI mitigation varies, depending on the level of foreign control and the information at risk. This assessment could therefore involve decisions about the form of mitigation, *e.g.*, Board Resolution (generally for foreign investment that does not involve a board presence), Security Control Agreement (for minority foreign investment that entails board representation or minority veto rights), Special Security Agreement (for foreign majority control), or Proxy Agreement (typically for foreign majority or foreign government-control cases, especially cases involving highly sensitive data or technology) – or about specific case-by-case departures from the template agreements.

- counterintelligence concerns,
- the perceived value of the technology to adversaries (particularly where relationships may exist between the adversary and the foreign investor), and
- security concerns about the contractor's supply chain.

Though never formally acknowledged, the reality is that foreign parent companies headquartered in countries that are strongly allied with the United States are treated more favorably than companies whose parents are located in less reliable countries, for the simple reason that strongly allied countries pose less of a threat to the United States. Treating foreign interests in the same way never made sense, and runs contrary to fundamental principles of risk allocation.[3]

Finally, the DSS assesses the views of other stakeholders — namely, U.S. government customers — regarding the appropriate form of FOCI mitigation. On rare occasions, the DSS and a contractor's government customer may disagree about the appropriate form of FOCI mitigation. Under the risk-based approach, the DSS will consider the concerns and interests of a customer, which may result in different FOCI mitigation than originally contemplated.

Ideally, moving to a risk-based approach allows the DSS to tailor FOCI mitigation to the realities of a changing business environment and the globalization of the defense market. Initially, efforts at structuring risk-based arrangements appeared hampered by 32 C.F.R. Part 117 (the "FOCI regulation"), an interim rule that requires that templates for FOCI mitigation agreements be approved by the undersecretary of defense for intelligence and places limits on the ability of the DSS to alter those templates.

In January 2015, however, the undersecretary of defense for intelligence delegated authority to the director of the DSS to establish and revise mitigation agreement templates and supplemental documents for each type of mitigation agreement, including the most restrictive agreements.[4] Notably, the delegation is not permanent; it remains in effect only until a final FOCI regulation is published and standards for FOCI agreements and related documents are developed and reissued by the DSS.

The delegation undoubtedly stemmed from concern that the FOCI regulation, if applied as written, could make it difficult to tailor agreements to meet unique security or business needs. Further, requiring the undersecretary of defense for intelligence approval for templates and

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[3] Companies that are owned by investors or other companies in countries that are hostile to the United States generally do not get security clearances at all. Among countries allied with the United States, however, the truth is that some are more equal than others.

[4] The typical form of FOCI negation agreement is the Proxy Agreement, wherein voting control of the Contractor is vested in independent, cleared U.S. citizen proxy holders (generally three).

revisions to templates introduced delays and entangled the undersecretary in the "weeds" of FOCI mitigation. The delegation provides the DSS with the authority not only to make changes to template agreements, but also to approve the model agreements themselves. Further, the scope of the delegation reaches ancillary documents, including the Electronic Communications Plan,[5] the Technology Control Plan,[6] the Facility Location Plan,[7] and the Affiliated Operations Plan.[8] (Nevertheless, we note that the DSS website has not yet caught up with the model agreements currently in use; templates posted on the website are often out of date.)

Although the working assumption may be that contractors are the principal advocates for changes to FOCI templates, the truth is that government customers sometimes find standard agreements an impediment to contract performance. In such cases, it can be useful to enlist the customer in support of changes to the standard agreement. The DSS is often receptive to arguments for change that are made by agencies, which are, in many respects, the clients that the DSS serves.

The delegation and the risk-based approach to FOCI mitigation are simple, common-sense policies. Nevertheless, changes in FOCI mitigation plans are incremental, not radical. The DSS continues to hold to the tried and true templates — not only because they are well known, but also because they know that change can reverberate across the 100-plus contractors that operate under FOCI mitigation plans. Foreign owners entering into FOCI mitigation plans should set their expectations accordingly. Departures from the templates will be modest.

National Interest Determinations

The NID process was overhauled in February of 2015 under Directive Type Memorandum 15-002 "Policy Guidance for the Processing of National Interest Determinations (NIDs) in Connection with Foreign Ownership, Control, or Influence (FOCI)." The memo gave the DSS more control over the NID process, but it was limited to DOD components.[9] The DSS has begun developing a standardized process for completing its NID responsibilities under the memo. The focus of this effort has been to create uniformity in (1) the process that notifies the DSS about

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5 A series of procedures that give the Facility Security Officer authority to monitor electronic communications between the Contractor and its affiliates to identify undue FOCI and to protect against unauthorized disclosure of classified and controlled unclassified information.

6 A formal compliance plan to protect against unauthorized disclosure of classified and controlled unclassified information.

7 A formal plan governing shared facilities between the Contractor and its affiliates.

8 A formal policy governing shared services between the Contractor and its affiliates.

9 See *Stroock Special Bulletin* "New DOD Policy Seeks to Streamline National Interest Determination Process," (February 12, 2015), by Chris Griner, Christopher R. Brewster, Shannon Reaves, and Erin Bruce Iacobucci, at www.stroock.com/siteFiles/Publications/NewDoDPolicySeekstoStreamlineNationalInterestDeterminationProcess.pdf. One significant change made by the DTM is that DSS now writes the proposed NID for GCAs, which is intended to speed up the process. (Although, some GCAs continue to write their own NIDs.)

the requirement for a NID and (2) the process by which the DSS then proposes a NID to the GCA.

Despite the memo, the NID decision-making process still varies from customer to customer. The DSS is also looking at the way NID notifications are provided (or not provided) to contractors. (Notice of the NID approval does not always make it back to the contractor in a timely way, if at all.) Help may be found in the rollout of the National Industrial Security Program Contracts Classification System (essentially a database for all Contract Security Classification Specifications ("DD 254s")). Though not yet mandatory, this system will automate the transmission of DD 254s from customers directly to the DSS and increase the speed of NID approvals.

Finally, the FOCI regulation provides that "[i]f a GCA requires a contractor cleared under [an SSA] to have access to proscribed information, the GCA will initiate action to consider a NID at the pre-contract phase." The DSS recently noted, however, that starting the NID process during the pre-contract phase is only available if the solicitation itself requires access to classified information. Absent a classified solicitation, the NID process will begin only when a DD 254 is issued.

In short, we see modest progress for the NID process, which is better than none at all.

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