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DOD POLICY GUIDANCE FOR FOREIGN OWNERSHIP, CONTROL OR INFLUENCE ("FOCI")

This memorandum summarizes Directive-Type Memorandum 09-019 - "Policy Guidance for Foreign Ownership, Control, or Influence (FOCI)" (hereinafter, the "DTM"), which was recently issued by the Under Secretary of Defense for Intelligence's ("USD(I)"). The DTM now comprises the official policy and procedures of the Department of Defense ("DOD") for the determination and mitigation of FOCI with respect to U.S. companies that hold, or are under consideration for, a facility security clearance ("FCL"). To this end, the DTM:

- reiterates DOD policy to "allow foreign investment consistent with the national security interests of the United States" and to utilize FOCI mitigation procedures "to protect against foreign interests gaining unauthorized access to classified information, adversely affecting the performance of classified contracts, or undermining U.S. security and export controls";
- largely summarizes and provides greater transparency regarding long-standing existing DOD policy and practices with respect to FOCI determination and mitigation; and
- nevertheless, also includes several subtle distinctions in practice and a marginal narrowing of the discretion of the Defense Security Service ("DSS") in the mitigation of FOCI, such as in connection with the number of independent Outside Directors that may be required for companies subject to Special Security Agreements ("SSA").

The DTM states that this policy guidance will be re-issued as part of the new National Industrial Security Policy Operating Manual ("NISPOM") no later than March 10, 2010. That date, however, should be understood as approximate; the updated NISPOM will be issued only after a USD(I)-led coordination process, and the ultimate timing for the new release of the NISPOM, in turn, depends on that coordination process. In the interim, the DTM will be the governing policy applicable to all FOCI matters apart from those falling under the purview of the Department of Energy.

With that background, the following are the principal points contained in the DTM.

FOCI DETERMINATION

The DTM reconfirms existing policy with respect to the existence of FOCI, stating that FOCI is present when a foreign interest has "the power, direct or indirect (whether or not exercised, and whether or not exercisable through the ownership of the U.S. company's securities, by contractual arrangement or other means), to direct or decide matters affecting the management or operations of the company in a manner that may result in unauthorized access to classified information or may adversely affect the performance of classified contracts."[1]

The DTM further reiterates that the FOCI analysis formally begins with submission of a Standard Form 328 "Certificate Pertaining to Foreign Interests" ("SF 328") by either the cleared company or its parent to DSS. The DTM

[1] *See* DTM at 5. These criteria also generally align with the elements of foreign "control" under the applicable regulations of the Committee on Foreign Investment in the United States at 31 C.F.R. Part 800.

clarifies, however, that DSS may request that one or more of the entities in a corporate family submit individual SF 328s. Although DSS occasionally has requested individual SF 328s, until now DOD guidance provided solely for a single, consolidated SF 328. Also, while not stated in the DTM, DSS will accept informal or draft notices of a foreign interest from either party to a transaction (*i.e.*, a foreign party may itself advise DSS of the pendency of a transaction), enabling DSS then to solicit submission of the formal SF 328.

The DTM provides that a company may appeal a FOCI determination in writing to the Director of DSS within 30 days after receipt of DSS's written decision. DSS, in turn, may request additional information from the company and must respond within 30 days with a decision or an estimate as to when a decision will be rendered.

One subtle but notable distinction in the policy expressed in the DTM is that, when new transactions arise presenting FOCI, DOD no longer will uphold the validity of a FCL simply on the basis that an acceptable FOCI mitigation instrument is being *negotiated*. Rather, as a matter of policy, DSS will continue to maintain the validity of a FCL only in those circumstances where an acceptable FOCI action plan has been presented and agreed upon. While this will not result in a significant practical difference for most transactions that involve foreign control — an acceptable FOCI action plan typically must be in place in any event for DOD to provide its consent in the parallel review process administered by the Committee on Foreign Investment in the United States ("CFIUS") — the new language does narrow somewhat DSS's discretion to maintain the validity of a FCL if an acceptable FOCI mitigation plan has not been agreed upon. This new language, in turn, places an even greater emphasis on early engagement with DSS to avoid the risk of invalidation to the FCL or, in cases that involve CFIUS approval, any undue delay in that process.[2]

FOCI Mitigation

The DTM largely summarizes existing practice with respect to acceptable mitigation of FOCI.

As a starting point, the factors DSS considers when determining the existence and extent of FOCI largely remain the same in the DTM (*e.g.*, record of economic and government espionage against U.S. targets, record of compliance with pertinent U.S. laws, regulations and contracts, the type and sensitivity of the information at issue, and the presence of foreign government ownership or control). The DTM also adds a "catch-all" statement that DSS will consider "any other factor" indicating that a foreign interest has the ability to control or influence the operations or management of the U.S. company. The DTM clarifies that DSS will consider these factors with regard (i) to the foreign interest that is the source of the FOCI as well as (ii) *any* country or countries in which the foreign interest is domiciled, has its principal place of business, is identified by DSS as a substantial source of revenue for the foreign interest, or otherwise has significant ties to the foreign interest. In addition, the DTM makes explicit that DSS will consider counterintelligence and technology transfer risk assessments for the U.S. company and all entities in the ownership chain.

If an entity is subject to FOCI, the following mitigation instruments may apply:

- Board Resolutions, which may apply when a foreign interest does not own voting interests sufficient to elect or is not entitled to representation on the company's board.

[2] The requirement to have an acceptable FOCI action plan in place, however, still does not mean that the FOCI mitigation instrument must be executed and implemented prior to the consummation of a transaction; parties still may consummate transactions prior to the execution of the agreed-upon mitigation instrument, provided that there is no risk to the classified information.

- Security Control Agreements ("SCA"), which may apply when a foreign interest does not effectively own or control a company or corporate family but is entitled to representation on the company's board.
- SSAs, which may apply when a foreign interest effectively owns or controls a company or corporate family.
- In lieu of a SSA, passive mitigation instruments — namely, a Voting Trust or Proxy Agreement — may also apply when a foreign interest effectively owns or controls a company or corporate family, depending on DSS's consideration of the FOCI factors listed above. For example, these corporate structures can effectively negate FOCI both for foreign government control and for purposes of access to proscribed information (*e.g.*, Top Secret, communications security, or Restricted Data).
- Certain more limited forms of mitigation may be implemented when there is foreign control or influence without ownership (*e.g.*, specific board resolutions, assignment of responsibilities to certain board members, diversification or reduction of foreign-source income, or appointment of a technology control officer).

The DTM also formalizes the process for the precise terms of mitigation instruments. The USD(I) specifically will approve new templates for the FOCI mitigation agreements. DSS may then propose changes to the templates in individual cases. However, DSS's discretion to depart from the template agreements without prior approval of the USD(I) extends only to *non-substantive* provisions in the agreements.

One anticipated change in the new template SSA relates to the number of Outside Directors. The DTM provides that the number of Outside Directors must *exceed* the number of Inside Directors for an SSA, and that "DSS shall determine if the number of Outside Directors should be a majority of the Board of Directors based on an assessment of security risk factors pertaining to the company's access to classified information." By comparison, the current template for the SSA provides simply that "the number of Inside Directors shall not exceed the combined total of Outside Directors and Officer/Directors." For example, under the current SSA template, a company subject to a SSA could have four Inside Directors and four total Outside Directors and Officer/Directors. Under the new template, the same company would require at least four and, possibly, five Outside Directors. For companies that already have a SSA, this change will be implemented when the SSA comes up for renewal.

ADDITIONAL CLARIFICATIONS

There are several other notable confirmations of existing practice and public clarifications in the DTM, including:

- The DTM confirms that the statutory prohibition against a foreign government controlled entity receiving access to proscribed information, in the absence of a waiver, does not apply if the entity is subject to a Proxy Agreement or Voting Trust.
- The DTM confirms that DSS may rule a U.S. company ineligible for a FCL if the identity of a foreign owner cannot be adequately determined.
- The DTM provides additional guidance regarding the content of the Electronic Communication Plans ("ECP") that companies are required to adopt under the SCA, SSA, Voting Trust or Proxy Agreement. ECPs should include detailed network descriptions and configuration diagrams delineating which networks will be shared and which will be protected from foreign access, while also addressing firewalls, remote administration, monitoring, and separate e-mail servers, as applicable.
- The DTM confirms that the requirement for a National Interest Determination ("NID") to ascertain that access to proscribed information by a company under a SSA will not harm the national security interests of the United States "applies equally to new

contracts to be issued to companies already cleared under SSAs as well as existing contracts when cleared companies are acquired by foreign interests and an SSA is the proposed mitigation."

If you have any questions concerning the material discussed in this memorandum, please contact the following members of our international trade group:

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