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DOD ISSUES INTERIM FINAL RULE REGARDING PROCEDURES FOR CLEARED CONTRACTORS UNDER FOREIGN OWNERSHIP, CONTROL, OR INFLUENCE

On April 9, 2014, the Department of Defense ("DoD") issued an interim final rule (79 Fed. Reg. 19467) codifying U.S. industrial security policies and procedures relating to safeguarding classified information in the context of U.S. contractors under foreign ownership, control, or influence ("FOCI"). The issuance of the interim final rule follows efforts, which remain ongoing, by DoD to revise the National Industrial Security Program Operating Manual, DoD 5220.22-M, and to clarify and make more consistent requirements and procedures concerning the eligibility of U.S. contractors under FOCI for facility clearances ("FCLs"); criteria for determining whether contractors are under FOCI; and security mechanisms that may be used to mitigate or negate FOCI.

Notably, while the interim final rule provides more comprehensive guidance to DoD Components and contractors, it does not reflect a policy change. The FOCI rules are still grounded in the principle that the United States benefits from the prospect of introducing foreign investment and technology into the defense industrial base, provided certain fundamental protections are in place. For that matter, the interim final rule also does not mark a significant change in practices; rather, the interim rule largely codifies the practices and procedures that DoD has developed and applied in the FOCI context over the last few years. Some of these, such as requiring FOCI mitigation and related implementation procedures to be in place before executing FCLs, are practices that have emerged in the last year and are now being reflected in the interim final rule but other requirements have been reflected in memoranda that have been published for several years.

As a general matter, the publication of the procedures and criteria used by DoD to evaluate and mitigate FOCI should provide greater clarity to DoD Components, U.S. government agencies that use industrial security services provided by the Defense Security Service ("non-DoD Components") and the defense industrial base. We also expect that there will be follow on guidance and, possibly, rulemakings from DoD to provide further organizational and substantive guidance on facility clearance and FOCI matters — which likewise should be welcomed by most contractors. Nevertheless, there are some aspects of the FOCI process that may remain challenging, especially from a planning and predictability standpoint:

- First, the interim final rule only applies to agencies and components under DoD cognizance. This includes non-DoD Components that rely on the Defense Security Service ("DSS") for FOCI mitigation, but the rule lacks a strong enforcement mechanism to ensure those other agencies fall in line with the requirements of the rule. Likewise, other agencies with cognizance over FOCI, such as the Department of Energy, may apply their own processes, which may vary from the DoD processes. Thus, the rule may bring greater consistency to part of the government's FOCI process, but it will not ensure consistency across the government.
- Second, the interim final rule itself has an exception for DoD and non-DoD Components to allow them to exercise "discretionary authority" to impose any security requirement they deem necessary to protect classified information. Such "discretionary authority" has arguably been the

basis for variance in practices, particularly in procurements, among DoD components in the past, and the rule could provide additional justification for such variances to continue.

- Third, with respect to the issuance of National Interest Determinations, or "NIDs," the interim final rule formalizes a number of process improvements that DoD has implemented in an effort to improve the response time for obtaining NIDs, however the rule would not solve the major challenges with NIDs. This is because the ultimate decision regarding whether to approve NIDs remains with the Government Contracting Activity ("GCA"), a structure that can contribute to significant delays and unpredictable results. We expect that DoD recognizes the limitations in the rule on this front, and may pursue additional policy directives to help clarify and improve the NID process.

Importantly, DoD will be accepting comments on the interim final rule through June 9, 2014, so there is an opportunity for interested parties to provide feedback and potentially help shape a final rule on these and other points.

Background to the Interim Final Rule

The interim final rule reflects a more comprehensive effort by DoD to provide guidance to its various Components, as well as to the defense industrial base, on the procedures and criteria for determining FOCI, and how such determinations intersect with other processes, including the issuance of NIDs and the national security reviews undertaken by the Committee on Foreign Investment in the United States ("CFIUS") when they involve FOCI matters. Previously, the primary "regulations" governing FOCI mitigation matters were:

- The National Industrial Security Program Operating Manual ("NISPOM");
- Directive-Type Memorandum 09-019 - "Policy Guidance for Foreign Ownership, Control, or Influence (FOCI)" (hereinafter "DTM"); and
- The 2010 rule promulgated by the Information Security Oversight Office ("ISOO") of the National Archives and Records Administration Amendment to address NIDs, which is codified at 32 C.F.R. 2004.22(c).

The interim final rule largely codifies the FOCI policy and procedures found in the DTM, which provided formal policy guidance and procedures concerning the FCL eligibility of U.S. companies with foreign involvement; criteria for determining whether U.S. companies are under FOCI; responsibilities in FOCI matters; and the security measures that may be employed to mitigate the effects of FOCI.

The DTM was an interim policy measure that was intended eventually to be re-issued as part of a future revision of the NISPOM. While DoD has not yet issued a revised NISPOM, the interim final rule now essentially re-issues the DTM in the Code of Federal Regulations ("C.F.R."), with various changes and additions, as discussed below. The interim rule creates a new Part 117 to Title 32 of the C.F.R., which is dedicated to the NISP, and places the new FOCI regulations in Subpart C of Part 117, reserving Subparts A and B for future use, presumably for codification of other NISP-related policies.

Key Provisions of the Interim Final Rule

The interim final rule codifies a number of other existing DoD policies and practices concerning FOCI and also includes a number of clarifications to DoD policies and procedures that likely will smooth the process for GCAs and contractors involved in FOCI mitigation determinations. Below we analyze some key provisions in the rule:

General Responsibilities and Procedures

- The rule confirms that the Components retain "discretionary authority" to impose any security procedure or restriction they deem necessary to protect classified information and performance on classified contracts. Despite the stated purpose of the new rule to maximize uniformity and effectiveness, this broad discretionary authority leaves room for significant departures from normal DSS processes and can result in significant delays and uncertainty when a Component exercises this authority. [117.56(a)(2)]
- The rule reiterates DoD policy that DSS will administratively terminate an FCL where it determines that a contractor does not possess classified material and does not have a current or pending requirement for access to classified information. In practice, however, DSS has exercised some flexibility in determining whether a requirement to access classified information is "pending," particularly when there is GCA support for issuing or continuing the FCL. [117.56(b)(2)(vi)]

FOCI Determination

- The rule provides that, in the context of reviewing changes submitted by a contractor in an updated Certificate Pertaining to Foreign Interests (SF-328) to determine whether a change is material, DSS will periodically review the definition of "material change" and will publish updated guidance as to what constitutes a reportable material change with regard to FOCI. [117.56(b)(12)(ii)]
- The rule confirms DSS's existing practice of evaluating a company's Securities and Exchange Commission filings, articles of incorporation, by-laws, loan and shareholder agreements, and other publicly available information in making a FOCI determination. [117.56(b)(2)(ii)]
- While the rule largely codifies the DTM's list of factors for determining FOCI, the interim rule notes that DSS will consider "prior relationships" between the U.S. company and a foreign party that holds an interest in the company. [117.56(b)(3)(i)(E)]
- While it is not new, it may be of particular interest to hedge fund and private equity investors that DSS may deny an FCL if investors that own five percent or more of the U.S. company cannot be identified (e.g., participating investors in a hedge fund that own five percent of the company). [117.56(b)(3)(v)]
- While the DTM provided that DSS will advise and consult with GCAs regarding the required FOCI mitigation method, the rule clarifies that DSS additionally will "provide those GCAs with the details of the FOCI factors and any associated risk assessments" and "will meet to discuss the FOCI action plan, when determined necessary by either DSS or the applicable GCAs." That said, DSS retains discretion to accept a FOCI action plan in the absence of written objections from the GCA. [117.56(b)(3)(iv); 117.56(b)(4)(v)]

FOCI Mitigation

- While DSS typically requires a company to appoint one outside director when it adopts a Security Control Agreement to mitigate FOCI, the interim rule clarifies that DSS may determine that more than one outside director is necessary. [117.56(b)(4)(iii)(B)]
- The rule reaffirms the availability of limited mitigation measures to address FOCI that is unrelated to foreign ownership, providing a "non-exclusive" list of examples: execution of a special board resolution; assignment of specific oversight duties to independent board members; formulation of special executive-level security committees to oversee the performance of classified contracts; appointment of a technology control officer; modification or termination of

loan agreements, contracts, and other understandings with foreign interests; diversification or reduction of foreign-source income; demonstration of financial viability independent of foreign interests; elimination or resolution of problem debt; physical or organizational separation of the business unit performing on classified contracts; and other actions that negate or mitigate foreign control or influence. [117.56(b)(4)(ii)]

- The rule provides useful clarification regarding four circumstances in which a limited FCL may be awarded — formalizing DSS's practice of allowing limited FCLs where a contractor has a single classified contract — and enhanced guidance regarding DSS's procedures for issuing a limited FCL. The rule newly clarifies that that a limited FCL, which effectively operates as an exception from FOCI mitigation, is an option for a "single, narrowly defined purpose." Further, while the DTM previously provided that a limited FCL may be issued "when FOCI mitigation is not feasible," the rule provides that one may be issued where "the company is either unable or unwilling to implement FOCI negation or mitigation." [117.56(b)(13)]
    - Three of the four permissible circumstances relate to activities that also will involve interests of foreign governments. The fourth is a broader exception that allows a GCA senior official to sponsor a U.S. company under FOCI, describing the compelling need for the limited FCL and certifying that the GCA accepts the risk inherent in not negating or mitigating the FOCI. Whereas the DTM provided that a limited FCL permits performance only on "classified contracts issued by the GCA," the new rule formalizes existing DSS practice that a limited FCL under these circumstances permits performance only on "a" classified contract issued by that GCA.
- The rule reviews supplemental FOCI mitigation measures that often are required under FOCI mitigation agreements, including Technology Control Plans ("TCPs") and Electronic Communications Plans ("ECPs"), and notes that templates for these plans will be submitted to the USD(I) for approval. [117.56(b)(7)-(8); 117.56(b)(4)(vi)]
- While the descriptions of the TCP and ECP reflect DSS's existing practices, notably absent from the rule is any mention of DSS's new requirement for an "Affiliated Operations Plan" ("AOP"). Over the past two years, DSS has begun requiring companies operating under a FOCI mitigation agreement to document and submit for DSS pre-approval an AOP that describes shared ("affiliated") services and cooperative commercial arrangements with non-mitigated affiliates, along with associated risks and mitigation procedures. Instead of codifying the new AOP requirement, the new rule refers to an "Administrative Support Agreement," ("ASA") which is the format that contractors typically used prior to DSS's shift to the AOP. [117.56(b)(9] The reference to the ASA rather than the AOP model is puzzling given DSS's emphasis on having all companies that operate under FOCI mitigation agreements develop an AOP, and it will be interesting to see how DSS responds to this point in a final rulemaking.

Timelines and Interaction with other Regulatory Reviews

- The rule clarifies that DSS must evaluate a contractor's proposed FOCI action plan and provide written feedback within 30 calendar days. [117.56(b)(3)(vi)] In addition, GCAs will be given up to 30 calendar days (absent shorter regulatory review deadlines, such as CFIUS) to provide objections to a FOCI action plan. [117.56(b)(4)(v)]
- The rule separately outlines DSS's procedures and timeframes for evaluating FOCI in the context of review of a foreign acquisition by CFIUS. [117.56(b)(14)]
- In addition to reiterating long-standing policy that DSS will invalidate an existing FCL in the context of a foreign acquisition until the contractor submits an acceptable FOCI mitigation plan, the rule clarifies that the contractor also may have to agree to interim measures to address FOCI until a FOCI mitigation or negation agreement is executed. [117.56(b)(2)(iv)]

- The rule also assigns responsibilities to the DoD Special Access Program Central Office ("SAPCO") and establishes procedures to ensure that "black programs" — i.e., unacknowledged Special Access Programs that could pose a concern for mergers and acquisitions involving foreign buyers or other FOCI matters — are identified early in the process instead of surprising the parties with a late-arising, inexplicable and insurmountable bar to the transaction. [117.55(e); 117.56(b)(5)]

Procedures for National Interest Determinations

The interim final rule also codifies DoD policies and practices related to the issuance of so-called National Interest Determinations or "NIDs," which are required to permit certain cleared contractors — specifically, those operating under a Special Security Agreement ("SSA") for the purpose of mitigating FOCI — to access proscribed categories of classified information (i.e., Top Secret, classified Communications Security ("COMSEC"), Restricted Data, Sensitive Compartmented Information, and Special Access Program ("SAP") information).

In April 2010, the 2010 ISOO rule (32 C.F.R. 2004.22(c)) formalized certain rules governing the issuance of NIDs, including a soft 30-day timeframe for NID decisions by a GCA, following notice of the request for a NID to the GCA. If no interagency coordination is required, the GCA is supposed to provide a final documented decision on a NID, with a copy to the contractor, within 30 days. If the proscribed information is owned by or under the control of another agency (e.g., the Department of Energy for Restricted Data), the GCA has 30 days to notify the other agency that its concurrence will be required for the NID, and then another 30 days (for 60 days total) to provide the final documented and concurred upon NID.

Despite the ISOO rule, contractors have continued to struggle with the NID approval process. In some cases obtaining NID decisions can take a year or more, and DSS consistently has reported a significant backlog of NID cases. GCAs often appear confused by the NID requirement, and the inconsistency in the issuance of NIDs has created significant uncertainty for industry. The new Part 117 formalizes a number of process improvements that DoD has implemented since the ISOO rule in an effort to improve the response time for obtaining NIDs, as follows.

1. All Components served by DSS are required to designate an individual who is authorized to make decisions and provide a coordinated GCA position on FOCI matters within the established timelines.
2. DSS will provide GCAs a guide to clarify their roles and responsibilities with respect to the FOCI process and NIDs, in particular.
3. DSS will notify the designated individual for the applicable GCA within 30 calendar days of identifying the requirement for a NID. DSS also will ask the GCA to identify all relevant GCA contracts that require a NID decision.
4. DSS will notify SAPCO of NID requirements to allow the SAPCO to advise of awareness of unacknowledged SAPs or any SAP for which DSS responsibility has been carved out.
5. DSS provides a monthly report on pending NID decisions that exceed 30 days, or 60 days if interagency coordination is required, to the Office of the Under Secretary of Defense for Intelligence (OUSD(I)) Security Directorate and the Office of the Under Secretary of Defense for Acquisition, Technology and Logistics (OUSD(AT&L)).
6. OUSD(I) will intervene, as warranted, when NID decisions are pending beyond the 30- and 60-day deadlines.

7. Finally, OUSD(AT&L) will confer, as warranted with the applicable DoD Service Acquisition Executive or Component equivalent about unresolved NID decisions.

While these steps — in particular, the guide from DSS — may help at the margins, in the end, the decision regarding whether to approve NIDs remains with the GCAs, and there is no effective enforcement mechanism to ensure a consistent timeline and application of the NID process. As a result, we expect that there will continue to be inconsistency and delays in NIDs, and this is an area that will continue to merit attention from DoD and industry to ensure that NIDs do not result in discrimination against foreign-owned contractors.

If you have any questions concerning the material discussed in this client alert or would like to discuss the potential submission of comments to DoD on this interim final rule, please contact the following members of our cross-border investment practice group:

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