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National Security Alert

Department of Defense Updates the National Industrial Security Program's FOCI Regulations

The US Department of Defense (DoD) recently amended the Code of Federal Regulations (CFR) to codify DoD policies regarding contractors under foreign ownership, control or influence (FOCI) and that possess, or are in process to obtain, a facility security clearance (FCL). The codification of the FOCI policies serves to increase uniformity and effectiveness of the policies as applied by DoD, its components and the non-components for which DoD's Defense Security Service (DSS) provides industrial security services (e.g., the Departments of State and Justice). The interim final rule, which is effective as of April 9, 2014, and is subject to comment until June 9, 2014, incorporates policies into the CFR that DSS has previously informally observed or that have been promulgated through less formal means. While the rule does not appear to substantively alter the requirements for companies under FOCI, it standardizes procedures and can assist companies in gauging the timing and steps of the FOCI process. By assigning a timeline to the key steps, companies can better assess the flow of transactions involving FOCI, as the FOCI-mitigation process often impacts deal timing.

The interim final rule provides requirements related to the National Industrial Security Program, which was established by executive order in 1993. The rule will be added at 32 CFR Part 117 and addresses the following general areas: the initial FCL eligibility of US companies under FOCI and continued FCL eligibility for contractors subject to FOCI; criteria for determining whether contractors are under FOCI; responsibilities in FOCI matters; and FOCI-mitigation agreements. The interim final rule does not apply to companies that are currently in process for an FCL. Although the rule does not define criteria by which entities are considered "in process," a company has likely achieved such status once it has been sponsored for an FCL.

In issuing the interim final rule, DoD emphasized long-standing US policy recognizing the value of—and encouraging—foreign direct investment in the US defense industry. In the Federal Register notice, DoD stated, "By maintaining the capability for foreign-owned U.S. contractors to compete for classified contracts with FOCI mitigation, DoD . . . enhances competition and realizes cost savings through that competition." It further noted the value of making innovative technologies developed by foreign-owned US companies available to the US government.

While the interim final rule does not mark a significant departure from current policy, potential foreign investors in cleared US businesses should benefit from increased transparency regarding the FOCI-mitigation process. The following are some of the interim final rule's most notable provisions:

- Although it does not use the specific terminology, the interim final rule discusses the concept of a commitment letter, which is a tool used by DSS to mitigate FOCI between the completion of a transaction and the establishment of a FOCI-mitigation agreement. The commitment letter allows foreign-owned companies to maintain their FCLs during this interim period. *See* 32 C.F.R. § 117.56(b)(2)(iv).

- A company has 30 days to appeal DSS's determination that the company is under FOCI. DSS then has 30 days to respond to the appeal. *See* 32 C.F.R. § 117.56(b)(3)(iii).

- If DSS cannot sufficiently identify the foreign owner of a five-percent-or-greater interest in a company, DSS may deny the company an FCL. This provision could be of particular relevance to contractors owned by private equity groups (even US-owned and -controlled organizations), as such ownership structures commonly involve foreign-owned limited partnerships with beneficial owners that may not be readily identifiable. *See* 32 C.F.R. § 117.56(b)(3)(v).

- For a company under foreign control or influence unrelated to foreign ownership (e.g., as might result from foreign debt or revenue), DSS may require measures other than FOCI-mitigation agreements (e.g., an oversight committee for classified business). *See* 32 C.F.R. § 117.56(b)(4)(ii).

- If a subsidiary of a FOCI-mitigated parent company requires a Top Secret FCL but the parent's FCL is at a lower level, the parent and any intermediate entities must be formally excluded from Top Secret access. *See* 32 C.F.R. § 117.56(b)(4)(iv).

- DSS must maintain templates for FOCI-mitigation agreements and supporting documents, which must have been approved by the Under Secretary of Defense for Intelligence (USD(I)). The regulations imply that substantive deviations from these templates must be approved by the USD(I). *See* 32 C.F.R. § 117.56(b)(4)(vi).

- The office of the USD(I) will become actively involved in the processing of National Interest Determinations (which are necessary for companies operating under a Special Security Agreement (SSA) to access proscribed classified information) that exceed certain timing thresholds. *See* 32 C.F.R. § 117.56(b)(5)(ii)(B).

- DSS may determine that the Outside Directors of a company under an SSA must constitute a majority of the company's board of directors. *See* 32 C.F.R. § 117.56(b)(6)(iii).

- Companies under FOCI mitigation must, if applicable, implement an "Administrative Support Agreement." It is not clear if this provision reflects DSS's current requirement for an Affiliated Operations Plan, or if it predates or modifies that requirement. *See* 32 C.F.R. § 117.56(b)(9).

- For transactions that are reviewed by the Committee on Foreign Investment in the United States (CFIUS), DSS may advise CFIUS that DSS needs more time to evaluate a proposed FOCI action plan. If so, the additional time could cause CFIUS to initiate a 45-day investigation. This underscores the importance of engaging DSS early in the process of a foreign person investing in a US business that holds an FCL. *See* 32 C.F.R. § 117.56(b)(14)(iv)(B)(*5*).

We intend to submit comments on the interim final rule to DoD. We encourage you to contact us with any feedback you have that could be incorporated into such comments. Comments must be submitted by June 9, 2014.

Contact Us

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