NEW PENTAGON DIRECTIVE ON FOREIGN-OWNED CONTRACTORS INCLUDES SOME NOTABLE SURPRISES

By law, companies under foreign ownership, control or influence ("FOCI") cannot hold facility security clearances unless measures are taken that effectively negate or mitigate FOCI. The Under Secretary of Defense (Intelligence) (USD(I)) recently issued a directive entitled "Policy Guidance for Foreign Ownership, Control, or Influence (FOCI)." Although it largely affirms current practice, the directive includes some notable surprises. Effective on its release in early September, the directive will be published no later than March 2010 in the new National Industrial Security Program Operating Manual ("NISPOM").

The directive supplants prior guidance in the NISPOM. It applies to the Department of Defense ("DoD") as well as all agencies for which the Pentagon provides industrial security services. This group includes (among others) the National Aeronautics and Space Administration, the Departments of Justice and Homeland Security, and the Federal Communications Commission. Notably, the group does not include the Department of Energy ("DoE"), which has its own industrial security regulations that closely track the NISPOM. DoE reportedly plans to update its regulations along the lines of the new DoD guidance, but there is no timetable for DoE action. The directive does not affect current FOCI arrangements, nor does it apply to companies that were well in process for facility security clearances when the directive was issued. (It could be applied, however, when currently cleared companies are required to renew their FOCI mitigation agreements or if they seek to upgrade their clearances.)

The directive reaffirms DoD policy to "allow foreign investment consistent with the national security interests of the United States" and underscores the purpose of the industrial security regulations: namely, "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."

Under the NISPOM, a U.S. company is deemed under FOCI "whenever 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 arrangements 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." (Emphasis supplied.)

Once a company is determined to be under FOCI, the Defense Security Service ("DSS"), as the executive agent of the NISPOM, must determine the appropriate form of FOCI mitigation. Although the government has the authority to impose unilaterally ***any*** security requirement it believes necessary to protect classified information and programs, the principal forms of FOCI mitigation are:

- Special Security Agreement ("SSA"), when a foreign interest effectively owns or controls a company or corporate family. Under an SSA, U.S. citizens must serve as independent Outside Directors on the board of the SSA company. Under the directive, however, the number of Outside Directors must now ***exceed*** the number of "Inside Directors"-- (the directors who represent the shareholder). The directive further states that DSS ***may*** require a majority of the board to be Outside Directors. All of this is new. Although the composition of the board has always been a matter of negotiation, the

NISPOM was silent on the number of Outside Directors and, with rare exception, DSS was satisfied if the Outside Directors, when combined with the Officer-Directors, collectively equaled or (more commonly) outnumbered the Inside Directors. The directive assigns no apparent weight to the Officer-Directors and instead focuses attention exclusively on the balance between the Outside Directors and Inside Directors.

- Voting Trust or Proxy Agreement, when a foreign interest effectively owns or controls a company or corporate family. Under either arrangement, the foreign owner relinquishes most rights associated with ownership to cleared U.S. citizens approved by DSS. Under a Voting Trust, the foreign owner transfers legal title to the trustees. Under a Proxy Agreement, only voting rights are conveyed to the proxy holders. Both arrangements involve significant restrictions on the foreign owner, but impose no restrictions on the company's eligibility to access classified information and compete for classified contracts. The directive makes clear, however, that DSS need not accept a proposed Voting Trust or Proxy Agreement -- *i.e.,* in some cases the government may hold that there is *no* acceptable means of FOCI mitigation, even if the owner is willing to accept significant restrictions on ownership.
- Security Control Agreement ("SCA"), when a foreign interest does not effectively own or control a company but as an investor is nevertheless entitled to representation on the board. In such cases, one (or more, depending on security risk factors) independent U.S. citizen(s), approved by the government, must serve as Outside Director(s).

Under the directive, DoD makes clear, for the first time, that a Voting Trust or a Proxy Agreement can "effectively negate foreign government control," thereby avoiding the statutory ban on award of a contract to a foreign government-controlled corporation that requires access to highly classified information. This is a significant development. Although, on a case-by-case basis, the DoD has held that a Proxy or Voting Trust Agreement avoids the statutory ban, the policy had never been published.

FOCI is readily determined when ownership translates to board representation. The NISPOM recognizes, however, that foreign ownership concerns can arise in a variety of circumstances, and requires DSS to consult with the appropriate Government Contracting Agencies ("GCA") regarding the required mitigation method. (The directive makes clear that secrecy has a price. DSS may decide that a company is ineligible for a clearance if the foreign owner cannot be determined because, for example, investors in a foreign investment or hedge fund cannot or will not be identified.) Even when foreign ownership does not entitle the investor to a seat on the board, DSS may require the company to adopt mitigation measures, such as a board resolution acknowledging FOCI and barring foreign control of classified contracts or programs, assigning oversight duties and responsibilities to independent board members, modifying or terminating loan agreements, contracts, and other understandings with foreign interests, physical or organizational separation of the component performing on classified contracts, and similar, targeted constraints on FOCI. All of this is consistent with prior policy.

The directive assigns a greater role to the contracting agency in FOCI mitigation, requiring that DSS provide the FOCI assessment and proposed mitigation plan to agencies with an interest in the company or corporate family. In the absence of written objections, however, DSS may implement what it deems to be an acceptable FOCI mitigation plan based on available information.

The directive asserts a leadership role for USD(I) in FOCI mitigation policies, stating that USD(I) will even approve templates for FOCI mitigation agreements. Further, although DSS may propose changes to the contents of these template FOCI mitigation agreements, and may tailor non-substantive provisions of the template agreement for any particular FOCI case without further approval from USD(I), notification is required to USD(I) for any deviation from the template. It remains to be seen how this policy will play

out in practice. While it may assure a greater degree of predictability in FOCI mitigation plans, it also implies a greater degree of rigidity.

Although DSS policy has long required a Technology Control Plan and an Electronic Communications Plan ("ECP") to guard against unauthorized release of classified and export-controlled information, the directive codifies these requirements, specifying in particular that the ECP must include "a detailed network description and configuration diagram that clearly delineates which [electronic] networks will be shared and which will be protected from foreign access," including firewalls, remote administration, monitoring, maintenance, and separate e-mail servers.

Mergers and acquisitions that may affect U.S. national security are reviewed by the multi-agency Committee on Foreign Investment in the United States ("CFIUS"). The directive devotes considerable attention to the CFIUS review process. Following CFIUS review, the President can block transactions that present a threat to the national security. If the transaction involves the acquisition of a cleared company, mitigation of FOCI is required for the transaction to pass muster, and if the acquisition is finalized without an acceptable FOCI mitigation action plan, the DSS is required to invalidate the company's clearance until the company has submitted an acceptable plan. While invalidated, a company generally cannot receive new classified material or bid on new classified contracts. Moreover, if there is any concern that classified information is at risk and security measures are inadequate to remove the possibility of unauthorized access, DSS must terminate the clearance. For this reason, it is critically important to address FOCI considerations as part of the acquisition process.

CFIUS review and the DSS FOCI review are carried out in parallel but separate processes with different time constraints and considerations. The directive requires DSS to review, adjudicate, and mitigate FOCI for companies under CFIUS review on a priority basis, with "all relevant information" forwarded to the USD(I) Security Directorate for a consolidated reply to DoD's CFIUS representative. If DSS recommends further investigation, the recommendation must be stated in a signed memorandum with supporting rationale. The directive identifies "known security issues" that must be addressed in the review, highlighting concerns that should be considered by the parties as they prepare their CFIUS filing -- a "marginal or unsatisfactory security rating," "unresolved counterintelligence concerns," and "alleged export violations."

The directive makes clear that foreign acquisitions of defense contractors ***must*** address FOCI mitigation. If agreement cannot be reached on material terms of a FOCI action plan, or if the U.S. party to the proposed transaction fails to comply with the FOCI reporting requirements of DoD regulations, DSS may recommend full investigation of the transaction "to determine the effects on national security *and to decide whether to recommend that the President take any action.*" (Emphasis supplied.)

A company under an SSA may only access highly classified information (*e.g.*, "Top Secret") following a National Interest Determination ("NID") -- a finding by the contracting agency that disclosure of the classified information will not harm the national security interests of the United States. If the information at risk is under the classification or control jurisdiction of an agency other than the contracting agency (for example, the National Security Agency for COMSEC, or the Department of Energy for Restricted Data), the written concurrence of the agency must be obtained before the contracting agency can issue an NID. If there is no indication that an NID will be denied, however, DSS may not delay implementation of the action plan, although the company may not access additional proscribed information until the NID is issued.

The directive squarely addresses an issue that has troubled foreign acquisitions, noting that the requirement for NIDs "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.*" (Emphasis supplied.) In the latter cases, the relevant GCAs will be called upon to review proposed SSAs and determine whether favorable NIDs will be issued. If a GCA will not support an NID, it must consult with DSS concerning the acceptability of mitigating FOCI through an SSA, the clear implication being that more restrictive measures may be explored if the contracts at issue cannot be redirected. If, however, the GCAs do not respond to DSS, DSS can proceed with implementation of a FOCI action plan pending completion of the GCAs' NID reviews as long as there is no indication that the NID will be turned down. This is an important development. By making clear that DSS can proceed without NIDs, the directive appears to be intended as an action-forcing mechanism to encourage GCAs to do the hard work that evaluating NIDs can entail. (Access to highly classified information will be denied, however, until the NID is issued.)

Although the directive breaks some new ground -- most notably in requiring that Outside Directors outnumber Inside Directors -- it chiefly ratifies current practice. Even so, the directive is welcome because it provides firm underpinning for policies and practices that heretofore lacked any written foundation accessible outside the Pentagon.

Kaye Scholer's National Security Practice Group provides guidance on numerous issues involved in the acquisition of cleared defense contractors, from antitrust concerns to CFIUS reviews. For additional information, please contact any of the following members of the practice group.

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