# THE PUBLICLY TRADED SSA COMPANY – CAN FOCI AND PUBLIC COMPANY REQUIREMENTS BE RECONCILED?

Under the National Industrial Security Program ("NISP"), U.S. Government contracts requiring access to classified information may not be awarded to U.S. firms under foreign ownership, control, or influence ("FOCI") unless adequate safeguards are in place to mitigate the risks associated with FOCI and protect the national security. The National Industrial Security Program Operating Manual ("NISPOM") provides government-wide guidance for determining whether U.S. companies are under FOCI, and prescribes requirements, restrictions, and other safeguards that are necessary to prevent unauthorized disclosure of classified information released by U.S. Government executive branch departments and agencies to their contractors.

Under the NISPOM, there are several FOCI mitigation measures available in cases of majority foreign ownership. The most common measure used is the Special Security Agreement ("SSA"). The SSA is a security arrangement which imposes a series of industrial security and export-control measures on a foreign-owned U.S. company by means of an institutionalized set of corporate practices and procedures, thus allowing the U.S. company to obtain and maintain the appropriate level of facility security clearance ("FCL") to allow it to receive access to classified information. The SSA preserves the foreign owner's right to be represented on the U.S. company's Board of Directors with a direct voice in the Board's management of the company, while denying to the foreign owner any unauthorized access to the classified or export-controlled information in the U.S. company's possession, interference in its daily management affairs, and involvement in its performance of classified contracts or participation in classified programs. While an SSA is typically used when non-U.S. persons own a majority of the economic or voting interests in a U.S. company, it may also be used when non-U.S. persons own a significant stake, although less than a majority.

The SSA typically provides that the Board of Directors of the cleared U.S. company is comprised of three types of directors – Outside Directors, Officer/Directors and Inside Directors.

- The Outside Directors must be completely disinterested individuals who have had no prior relationship with the cleared company, the foreign owner or any company affiliated with either. These individuals also must be resident U.S. citizens who either have or are eligible to possess personnel security clearances ("PCL") at the level of the cleared company's FCL. The initial Outside Directors must be approved by the Department of Defense ("DoD") (or the Department of Energy ("DoE") if the company is predominantly engaged in classified work for the DoE) prior to establishment of the SSA. Any new Outside Directors must be approved by the DoD or the DoE, as applicable, before they begin to serve as directors. Appointment of potential Outside Director candidates to the Board of an SSA company before they have been approved by the Government will compromise their ability to serve as Outside Directors for that company (or for any other company owned by the foreign entity that controls the SSA company).

- The Officer/Directors serve as liaisons between the cleared U.S. company and its Board of Directors. Like the Outside Directors, these individuals must be resident U.S. citizens who either have or are eligible to possess PCLs at the level of the cleared company's FCL. Officer/Directors cannot hold interlocking positions with entities that own, or are affiliated with the owners of, the SSA company.

- The Inside Directors serve as minority representatives of the foreign owner on the cleared company's Board of Directors. They need not be U.S. residents or citizens. They are the means by which the foreign owner maintains a role in management of the cleared company without the ability to directly control or influence the actions of the cleared company. The Inside Directors are excluded from access to the classified and export-controlled information in the possession of the cleared company. An Inside Director may not be elected Chairman of the Board or serve as an officer or employee of the cleared company. However, the Inside Directors are the only people in the SSA company who are permitted to hold interlocking positions at the foreign parent company or its affiliates, absent the approval of the Government.

Generally, the DoD and DoE require the appointment of at least three Outside Directors to the SSA company's Board. Pursuant to a Directive-Type Memorandum issued by the Under Secretary of Defense (Intelligence) in September 2009, in an SSA company monitored by the DoD, the number of Outside Directors must now exceed the number of Inside Directors on the cleared company's Board and the DoD may require that a majority of the Board be Outside Directors. The DoE is not governed by the directive.

The SSA requires the establishment of a permanent compensation committee of the Board of Directors, which oversees the salary determinations and performance appraisals of the cleared company's key management personnel, including, among others, the company's chairman and CEO, and any other official as determined by the DoD or DoE. The compensation committee is required to be comprised of at least one Outside Director and one Inside Director. In addition, the SSA typically requires that any other committee of the Board be comprised of at least one Outside Director and one Inside Director, except for the mandated Government Security Committee, which monitors the company's operations for compliance with the SSA and is comprised solely of Outside Directors and Officer/Directors.

In the event an SSA company becomes a public company and lists its common stock for trading on a national securities exchange such as the New York Stock Exchange ("NYSE") or the Nasdaq Stock Market ("Nasdaq"), it will need to be mindful of certain rules and regulations of the U.S. Securities and Exchange Commission ("SEC") and of the exchange on which it lists its stock, which may conflict with its SSA. Each of the exchanges requires that the Board of Directors of a listed company be comprised of a majority of "independent directors." There are some differences in the definitions of "independent director" under NYSE and Nasdaq rules, but generally, in order for a director to be considered independent, the Board is required to make a determination that he or she does not have a material relationship with the company. Both the NYSE and Nasdaq list criteria which would disqualify a director from being independent, including if he or she:

- is or has been an employee of the listed company within the past three years or has an immediate family member who is or has been an executive officer of the company within the past three years;

- has received payment from the listed company in excess of a specified amount during any 12-month period within the past three years;

- is employed by another company that has made payments to, or received payments from, the listed company for property or services in excess of a specified amount in any of the past three fiscal years; or

- is an executive officer of another company where any executive officer of the listed company serves on the compensation committee of the Board of such other company.

Under both NYSE and Nasdaq rules, ownership of even a significant amount of stock by itself does not disqualify a director from being independent. However, references to the listed company in the independence criteria set forth above include any parent or subsidiary of the listed company so, for example, a person employed by a foreign parent of the listed company would not be independent. In addition, the independence requirements for directors serving on an audit committee (described below) are more stringent, and an employee or executive officer of an affiliate of the listed company would not qualify as independent for this purpose.

The NYSE also generally requires a listed company to maintain the following Board committees composed entirely of independent directors:[1]

- a compensation committee that, among other things, determines the compensation of the CEO and makes recommendations to the Board with respect to the compensation of the other executive officers;

- a nominating/corporate governance committee that, among other things, identifies individuals qualified to become Board members and develops and recommends to the Board a set of corporate governance guidelines applicable to the company; and

- an audit committee that, among other things, assists Board oversight of (1) the integrity of the company's financial statements, (2) the company's compliance with legal and regulatory requirements, (3) the qualifications and independence of the company's auditors, and (4) the performance of the company's internal audit function and independent auditors.

Each of the NYSE and Nasdaq have exceptions from most of these requirements for a "controlled company," or a listed company of which more than 50% of the voting power is held by an individual, a group or another company, although there is no exemption from the requirement to maintain a fully independent audit committee.[2] In many cases, a public company that is party to an SSA will be a controlled company; however, in certain instances a foreign owner may choose or be required to maintain an SSA as the cleared company's FOCI mitigation measure even if the foreign entity's ownership level drops below 50%.

In many cases, the Board committee independence requirements of the national securities exchanges will conflict with the cleared company's obligations under the SSA to include an Inside Director on each Board committee other than the Government Security Committee. While an employee of a foreign owner that holds less than a majority of the voting power of the company could satisfy the independence requirements of the exchanges, there may be other factors which would disqualify him or her from being independent.[3] In addition, he or she would almost certainly not meet the more stringent independence requirements for directors serving on the audit committee. While a company could find a director who

---

1 Nasdaq has similar requirements, although the functions of the compensation committee and the nominating committee may be performed by a separate vote of a majority of the listed company's independent directors instead of by a separate independent committee.

2 Some versions of legislation proposed in Congress would also impose requirements on compensation committees similar to those currently imposed on audit committees.

3 For example, if the foreign owner held a majority of the voting power of the listed company within the previous three years or received in excess of a specified amount of payments for property or services in any of the previous three years, such individual would not qualify as independent.

qualifies as independent and would also be categorized as an Inside Director,[4] this may not be a practical solution. If the classified work is performed at a subsidiary level, the SSA could be established at that level so that the public company wouldn't be subject to the corporate governance requirements of the SSA. However, this would require the listed company to find a new group of directors to serve on its or the subsidiary's Board, as the Outside Directors and Officer/Directors of the subsidiary would generally not be permitted to serve on the parent company's Board. An alternative approach would be to seek a waiver from the DoD or DoE of the requirement to include an Inside Director on Board committees or a related amendment to the cleared company's SSA. Since the purpose of the requirement to include an Inside Director on committees is to benefit the foreign owner by allowing it to maintain an interest in the management of the cleared company, and not to serve a national security concern, the Government will likely accommodate any such request.

Both NYSE and Nasdaq rules generally provide for a phase-in period for newly public companies. A listed company is permitted to have only one independent member of the applicable committees at the time of listing, a majority of independent members within 90 days of listing and fully independent committees within one year of listing. Accordingly, a newly listed company will have some time to approach the DoD or DoE, or take other corrective measures, after listing its stock on a national securities exchange before it is in violation of its SSA. Similar phase-in periods are available for companies that cease to be "controlled companies."

A company with stock listed on a national securities exchange that is party to an SSA also needs to be mindful of the requirement under the SSA that Outside Director candidates be approved by the DoD or DoE before they are appointed to the cleared company's Board. A listed company is subject to the SEC's proxy rules, which require the company to send to its shareholders, or make available on a free, publicly available Internet website, a proxy statement setting forth information on director nominees before soliciting votes for such nominees. In the event the company chooses to make the proxy statement available on the Internet without sending copies to its shareholders, it must be made available at least 40 days prior to the shareholder meeting at which the election of directors will be held. If the company opts to send copies of the proxy statement to its shareholders, it is not required to send the materials by any specific date; however, proxy statements typically are prepared and provided to shareholders well in advance of shareholder meetings in order to provide sufficient time to solicit the requisite number of votes in favor of nominees.

When looking to add new Outside Directors, listed companies that are parties to SSAs will need to begin their nomination and Government approval process early. Nominees for the Board of a company with stock listed on the NYSE or Nasdaq typically must be recommended by a nominating committee, which often undertakes an extensive search to find candidates who meet the criteria for directors established by the Board. This process should be completed as early as practicable to allow the company sufficient time to obtain DoD or DoE approval of the nominees, which could take up to two or three months. If possible, nominees intended to qualify as Outside Directors should be pre-approved by the Government before the proxy materials are provided to shareholders.[5] If this is not possible, the proxy materials should state that even if a nominee is elected by shareholders, his or her appointment to the Board will be subject to approval by the DoD or DoE, as applicable, and formal appointment should not be made until such

[4] For example, a non-U.S. resident with no relationship to the listed company may qualify as an independent director but will not meet the criteria for an Outside Director, and will therefore be an Inside Director.

[5] The SEC has proposed proxy access rules that would mandate inclusion of directors nominated by shareholders in a company's proxy materials. If these rules are adopted, it could become more challenging to get director nominees pre-approved by the Government before proxy materials are finalized or even before the date of the shareholder meeting.

approval is obtained. If the nominee begins serving on the Board before being approved by the Government, he or she will not qualify as an Outside Director without a waiver from the Government reviewer, which could result in a failure of the cleared company to have a sufficient number of Outside Directors.

If a cleared company that goes public is mindful of the issues raised above, they can be easily handled with some careful advance planning. However, the failure to pay attention to potential conflicts between the requirements of an SSA and the rules and regulations of the SEC and national securities exchanges may lead to some problems that could otherwise be avoided.

Kaye Scholer's National Security Practice Group has advised on numerous foreign acquisitions of government contractors, both on corporate and regulatory matters. For additional information, please contact any of the following members of the practice group:

National Security

Farhad Jalinous
+1 202 682 3581
farhad.jalinous@kayescholer.com

Karalyn Meany
+1 202 682 3547
karalyn.meany@kayescholer.com

Keith Schomig
+1 202 682 3522
keith.schomig@kayescholer.com

Norman Pashoian
+1 202 682 3562
norman.pashoian@kayescholer.com

Corporate

Mark S. Kingsley
+1 212 836 7092
mark.kingsley@kayescholer.com