Foreign Fund Investors in Defense and National Security Businesses Subject to New Regulations Imposing 30-Day Advance Review

The Defense Security Service ("DSS") imposes ownership and control restrictions on a U.S. business with access to classified information under national security clearances if its parent entity or investors pose concerns regarding Foreign Ownership, Control or Influence ("FOCI"). For a transaction involving a private fund buyer, DSS reviews the participation of "foreign interests" — e.g., foreign limited partners, non-U.S. fund entities or foreign lenders — when analyzing FOCI risks.

DSS recently published its first set of regulations governing the process for reviewing and approving foreign investment in U.S. businesses that hold Facility Security Clearances ("FCLs").[1] The new DSS rules update a process more than 20 years old for reviewing proposed transactions that pose potential FOCI concerns.

DSS oversees special restrictions on hundreds of U.S. businesses that hold FCLs because of such FOCI concerns. In 2011, DSS reviewed many transactions and imposed "FOCI Mitigation Agreements" on 21 companies and required the appointment of Independent Directors approved by DSS. In nine transactions, DSS imposed "Proxy Agreements" that forced foreign investors to relinquish control of the U.S. business holding an FCL in order to ensure protection of classified information.[2]

The DSS regulations provide that a U.S. company "determined to be under FOCI is ineligible for an FCL unless and until security measures have been put in place to mitigate FOCI."[3] Thus, DSS "will invalidate any existing FCL" upon closing on a sale, merger or other transaction involving significant foreign participation unless (1) the buyer has submitted to DSS a proposed "FOCI Action Plan" and DSS has found the Action Plan acceptable and (2) the company agrees to adequate interim protections.[4] Previously, DSS would allow a target company to keep its FCL after closing if its buyer submitted a "Commitment Letter" and was "negotiating" a FOCI Mitigation Plan "in a timely manner" after closing. DSS is now ending that practice.

DSS will invalidate a security clearance on closing a sale, merger or other transaction involving significant foreign participation unless (1) the buyer has submitted to DSS a proposed "FOCI Action Plan" and DSS has found the Action Plan acceptable and (2) the company agrees to adequate interim protections.

Under the new rules, a proposed FOCI Action Plan must be submitted before closing. DSS commits to provide "feedback" within 30 days.[5] When planning an acquisition, a buyer will need additional time to develop its Action Plan and to negotiate adjustments in response to DSS feedback. Without adequate time to resolve issues, a target could lose its FCL, preventing it from receiving classified information, working on classified matters, or obtaining new classified contracts after closing.

The new rules also formalize the relationship between DSS reviews and reviews by the Committee on Foreign Investment in the United States ("CFIUS").[6] The new DSS process now officially overlaps with the CFIUS process, which can take up to 90 days, and the 60-day period for Export Control notices that may be required by

the Department of State under the International Traffic in Arms Regulations ("ITAR").

The table below summarizes reviews and time periods for acquisitions of defense and national security businesses.

Requirement Pertaining to Foreign Investment	Pre-Closing Review Period
CFIUS	
Initial Review upon filing	30 days
CFIUS may require additional period of investigation	45 days
Possible review by President	15 days
ITAR	
Notice of foreign ownership or control in advance of sale or transfer of company holding Export Control licenses or registrations	60 days
DSS — new FOCI Rules	
Submission and negotiation of "FOCI Action Plan" and proposed "FOCI Mitigation" instruments and formalities	At least 30 days to receive "feedback" from DSS after submission.

As a practical matter, the new 30-day DSS timeline should be considered the minimum for planning purposes.

As a practical matter, the new 30-day DSS timeline should be considered the minimum for planning purposes. Additional time may be needed to prepare and make adjustments for the FOCI Action Plan and to confirm DSS approval before closing.

While some practitioners have assumed that these procedures are essentially unchanged, the new regulations make clear that advance approval and an affirmative determination by DSS are mandated. Closing may be delayed if filings with DSS are not made far enough in advance. Appropriate terms should be included in the transactional documents to address these risks and to allocate responsibilities to prepare and complete the FOCI Action Plan. A FOCI Action Plan includes:

- Disclosure of possible FOCI, including total foreign investment, identification of individual investors in excess of 5%, as well as personal details concerning company management, foreign business relationships, loans, etc.[7]

- "FOCI Mitigation" instruments that range from Board Resolutions (formalizing exclusion from access to classified data) to Proxy or Trust arrangements that leave control of the company in the hands of trusted U.S. citizens who have the necessary security clearances to manage the business.
- The selection and appointment of Independent Directors, subject to DSS approval.
- Creation of a Government Security Committee of the Board to oversee classified matters.
- Designation of U.S. citizens with appropriate clearances as Key Management Personnel.
- Adoption of a Technology Control Plan, Electronic Communications Plan, Visitation Plan and Facilities Location Plan to protect and control access to classified data.
- Adoption of an Administrative Support Agreement or Affiliated Operations Plan that discloses and restricts support provided by foreign affiliates.

DSS reviews have expanded in recent years as foreign investment in U.S. businesses has been increasing.

FOCI reviews by DSS are highly discretionary. Not surprisingly, the new rules restate long-standing policy that DSS will "make FOCI determinations on a case-by-case basis"[8] on the basis of a variety of factors, including the identity and origin of the foreign investors, "record of … espionage" or "unauthorized technology transfer" as well as the "sensitivity of information" and "[a]ny other factor that indicates or demonstrates a capability on the part of foreign interests to control or influence the operations or management of the business."[9] The new rules provide that DSS staff will make a FOCI determination that can be appealed to the DSS Director, and that appeals should be decided within 30 days.[10] Thus, the rules confirm that a limited degree of due process is afforded.

DSS reviews have expanded in recent years as foreign investment in U.S. businesses has been increasing. At the same time, DSS has been facing heightened pressure to tighten access to classified information and the granting of security clearances. The new rules, therefore, impose stricter protections and new timelines, and are designed to provide more consistent procedures and timelines and to permit more uniform treatment of foreign investment. The new rules follow several years of improvements in DSS staffing, training and processing of notices of proposed transactions.

It should also be mentioned that DSS issued its regulations without notice as an Interim Final Rule. Thus, the regulations had immediate effect but are subject to modification after a period for public comment. While the Final Rule may not be published for some time, and it is unclear how lenient DSS may be in implementing the new standards, it is likely that the DSS review process will become only more formalized and that the new timelines will be enforced more strictly in the future.

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1 See 79 Fed. Reg. 19467 (Apr. 9, 2014), codified at 32 C.F.R. § 117.51-56.

2 Id., 79 Fed. Reg. at 19468.

3 32 C.F.R. § 117.56(b)(2)(i)

4 Id. § 117.56(b)(2)(iv)

5 Id. § 117.56(b)(3)(vi)

6 Id. § 117.56(b)(14)

7 Id. § 117.56(b)(3)(v).

8 Id. § 117.55(b)(2).

9 Id. § 117.56(a)(3)(i).

10 Id. § 117.56(b)(3)(iii).

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