



**Partnering With Outside Directors & Proxy Holders
To Strengthen FOCI Boards:
A White Paper**

AUGUST 2018

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Executive Summary

The Defense Security Service (DSS) is exploring more effective approaches to familiar topics. As one initiative, DSS has focused on strengthening the framework governing appointment of, and partnership with, Outside Directors and Proxy Holders (OD/PH) who serve with DSS approval on the Boards of Directors (BoD) for cleared companies under Foreign Ownership, Control, or Influence (FOCI) which are operating under DSS-approved FOCI mitigation or negotiation agreements.

This document captures DSS insights after more than a year of research and collaboration with government and industry personnel, and is meant to provide information on the best practices and factors DSS intends to consider when approving OD/PH nominations. DSS will develop concrete measures that define roles and responsibilities and evaluate and educate board members for companies under FOCI (i.e., FOCI Boards).

Several observations have emerged after extensive conversations with experts in industry and government, the most common being that FOCI Boards are generally more complex and demanding than non-FOCI Boards. That is because the intensity of managing both the security and business oversight roles of OD/PH requires more proactive and diversified roles.

Furthermore, DSS research indicates that BoD evaluation is now the norm. Evaluating FOCI Boards will provide crucial insight into the cleared contractor's ability to safeguard national security interests. DSS has also learned that training for OD/PH on subjects related to the protection of sensitive information, corporate governance, and business/financial management would greatly benefit OD/PH and the companies they oversee. Based on these observations, DSS expects that it will implement the following reforms and best practices consistent with the National Industrial Security Program (NISP). Specifically, DSS will:

- Consider the balance of skills across a FOCI Board in the aggregate when reviewing and approving nominations of OD/PH;
- Decline or rescind approval for an individual to serve as OD/PH if DSS determines that the individual is no longer able to discharge his/her responsibilities as OD/PH effectively;
- Require FOCI Boards to implement an evaluation process that regularly assesses the performance and effectiveness of OD/PH and the FOCI Board in the aggregate related to their NISP responsibilities; and
- Develop training and other guidelines to help OD/PH nominees better hone their skills, and make successful completion of such training a condition of approval.

DSS undertakes these best practices and reforms in the spirit of the NISP partnership. DSS looks forward to further collaboration with cleared contractors to identify opportunities for further improvement, and welcomes comment on this important initiative.

I. Introduction

DSS oversees the protection of classified information and technologies in the hands of cleared contractors by providing NISP risk management services on behalf of the Department of Defense (DoD) and the 32 federal departments, agencies, and offices that have entered into agreements with the Secretary of Defense to receive NISP services from DoD. The Undersecretary of Defense for Intelligence has directed that DSS provide oversight, advice, and assistance to Government Security Committees (GSCs) to ensure they maintain policies and procedures to safeguard classified information and to prevent adverse impact on performance of classified contracts. DSS also requires GSCs to verify their companies' compliance with FOCI mitigation agreements, contractual security requirements and applicable provisions of the NISP Operating Manual (NISPOM), DoD 5220-22-M.

To fulfill its oversight mission, DSS is reorienting priorities based on risk analysis and mitigation. Key to that process is examining OD/PH responsibilities given the critical role those individuals play in mitigating risk of loss, compromise or suspected compromise of classified information and adverse impacts on performance of classified contracts associated with cleared contractors operating under FOCI mitigation agreements. To meet its commitment to partner with industry, DSS engages with select industry representatives to gather views of extant requirements and guidelines for OD/PH. DSS concludes the roles of OD/PH can be significantly strengthened to further minimize risks to classified and sensitive information and technology.

DSS will develop and implement a new oversight framework for FOCI Boards that establishes a relationship between DSS and OD/PH that is sensitive to the importance of the overall health—including financial—of cleared contractors in the NISP. This framework must protect classified information and technology and thereby serve the interests of both the United States Government (USG) and cleared contractors, thereby reinforcing the importance of continued collaboration between DSS and industry in support of national security.

This framework seeks to strengthen FOCI Boards. OD/PH serve a critical role in safeguarding information that supports the national security interests of the United States. DSS recognizes that most OD/PH share distinguished career backgrounds and a firm commitment to doing what is best for the country. DSS also recognizes, however, that their roles cannot remain static in the face of ever-evolving challenges and threats to classified national security information.

II. General Requirements

a. Purpose of the Board

A company BoD performs many functions, including, but not limited to, providing oversight of and strategic direction for management; ensuring compliance with applicable law; instituting an enterprise risk management and compliance framework; and maximizing shareholder value. The role of a FOCI Board, however, includes two critically important, additional responsibilities: preventing the cleared contractor's foreign parent (the foreign shareholder) and affiliates from unauthorized access to classified and other sensitive information; and precluding the foreign shareholder from adversely affecting performance on classified contracts. FOCI Boards must

remain cognizant of their obligations not only to the company they lead, but also of their fiduciary duties to shareholders and their continuing duty to see that the cleared contractor protects the critical information and assets entrusted to it by the USG. As a practical matter, FOCI Boards must be prepared to serve multiple masters. These obligations require diverse skills among FOCI Board members, which DSS plans to consider when exercising its authorities.

b. A Strong FOCI Board

Striking the right balance between commercial and governmental interests is essential to the effectiveness of any FOCI Board. A FOCI Board composed entirely of national security experts with little or no experience in business might enforce the FOCI mitigation agreement to the letter, but might also increase the risk of the business failing to achieve reasonable financial objectives, thereby depriving the foreign shareholder of its investment and the USG of the technology and/or services provided by the cleared contractor. Likewise, a FOCI Board composed entirely of seasoned business executives but with little or no expertise in national security requirements might ensure great profitability, but at the expense of increased risks to the company's technology and USG classified information. Indeed, unauthorized transfers, theft, cyber compromises or other activities harm both USG national security interests and a company's ability to remain competitive in the marketplace. As a result, FOCI Boards must reconcile the foreign shareholder's financial interests with USG national security interests while ensuring both the foreign shareholder and the cleared contractor comply with the FOCI mitigation agreement and the NISPOM. A strong FOCI Board will demonstrate that, in the aggregate, its members can enforce the FOCI mitigation agreement while also focusing on the cleared contractor's commercial success and protecting USG's critical assets.

c. OD/PH Qualifications

While DSS cannot approve or disapprove appointment of non-OD/PH board members, DSS intends to consider the composition of a given FOCI Board in the aggregate as a factor in the DSS evaluation of OD/PH nominees. DSS expects it will examine the background, skills, and experience of the entire FOCI Board to recommend sufficient diversity in experience and expertise to gain a balance of strengths and skillsets.

Section 2-305(a) of the NISPOM requires that persons who serve as OD/PH be "U.S. citizens who can exercise management prerogatives relating to their position in a way that ensures that the foreign owner can be effectively insulated from the company." DSS will continue to scrutinize the qualifications of OD/PH nominees carefully, to ensure they can "exercise management prerogatives" effectively, while including a holistic consideration of how "management prerogatives" may be brought to bear on a FOCI Board in particular. Some of the pertinent traits the shareholder should consider when making nominations, and which DSS will subsequently review, include, in no particular order:

- **Government experience.** Has the nominee served in any roles within Federal or State government? If so, when, and for how long? Did the nominee acquire any pertinent expertise as a result of such service, and if so, is it current? Did the nominee work in the Intelligence Community or another national security sector?

- **Business experience.** Has the nominee worked in the private sector before? If so, when, for which company/companies, and for how long? What were the nominee's responsibilities, and what expertise did the nominee bring to each position or acquire while in that position? How familiar is the nominee with business finance and Generally Accepted Accounting Practices? Does the nominee have a proven track record of working collaboratively with corporate executives in developing and implementing business practices? Is the candidate familiar with and experienced in the specific strategic and operating issues of the cleared contractor and corresponding industry sector(s)?
- **FOCI experience.** Has the nominee served as an OD/PH before? If so, for which company, and for how long? Did the nominee chair the GSC, and if not, how did he/she support the GSC? What was the company's record of FOCI mitigation and NISP compliance during the nominee's time on the GSC, and to what extent did the nominee contribute to it?
- **Leadership experience.** Has the nominee served in a senior leadership role, such as Chair, Director, President, CEO, or Senior Executive, in either the private or public sector, or both? Is the nominee a recognized leader in his or her field(s)? Does the nominee have the capacity to think strategically about the company as a whole and its competitive position?
- **Industry and technology expertise.** Has the nominee worked in the industry of the cleared contractor before? If so, for how long, and in what capacity? Does the nominee understand how that industry, and the cleared contractor, serves the USG and operates profitably to obtain an adequate risk-adjusted return on investment? Does the nominee have knowledge or experience with the specific technology or service the cleared contractor provides to USG?
- **Security expertise.** Does the nominee have any specialized knowledge in security, risk management, counterintelligence, and related fields? Is the nominee experienced with safeguarding classified and company proprietary information, particularly intellectual property, from cyber threats?
- **Availability.** Does the nominee serve on any additional boards? If so, how many? Does the nominee serve, or intend to serve, on any of those boards' committees? If so, which ones? Does the nominee have any other positions or responsibilities that might draw substantial attention from his/her work on the FOCI Board?
 - DSS found that many companies, both public and private, limit the number of boards on which their directors may serve. In light of the heightened demands of serving as an OD/PH, DSS expects that it will not approve any nominee who serves on more than three other Boards of Directors or similar governing bodies as of the date of nomination, subject to exceptions for good cause shown. DSS will weigh whether other substantial time commitments may affect an OD/PH's ability to discharge his/her responsibilities. DSS expects the nominee will notify DSS if he/she assumes another role requiring a time commitment of more than 250 hours per year after being approved as OD/PH.

Again, there is no NISPOM or DSS requirement for OD/PH to have any one set of skills and experience. DSS intends to assess the composition of the FOCI Board in the aggregate and consider how a nominee's background will contribute to the balance and strength of the FOCI

Board, while recognizing that cleared contractors and foreign shareholders may have nominated an individual based on important business considerations. The goal is to create a FOCI Board that is more proactive, informed and independent, and capable of leading FOCI- and security-related oversight.

d. Governance & Operations

Finally, DSS will bring the agency's interests in a strong FOCI Board to bear when reviewing the governance and operations of a cleared contractor. Those interests are particularly acute when considering term limits, staggered board schedules, and the policy-based presumption that OD/PH be completely disinterested, as that term is used in the NISPOM.

Adding Directors to a FOCI Board should introduce new and valuable skills, perspectives and energy to both the NISP and cleared contractors. Moreover, the duties, experience, and leadership demands of serving on a given BoD will evolve over time as the company evolves. DSS found that most U.S. public companies, and many private companies, impose term limits on their Directors or else require staggered appointment terms for board members for those very reasons. Under most FOCI mitigation agreements OD/PH serve a term of five years, or the duration of the agreement, and then must be re-nominated for additional terms. As a best practice, however, in light of the strong interest in rotating board membership, companies under FOCI may propose a term not to exceed five years for each Director and then set term limits through the company's by-laws, which could result in staggered board member terms. DSS has approved such arrangements in the past. Staggered terms may be beneficial since they allow the cleared contractor to evaluate each OD/PH individually, rather than all at once, as may be necessary if every OD/PH's term expires simultaneously.

DSS recognizes that some Directors serve multiple terms for several reasons, such as specialized knowledge or exceptional skill, and that imposing firm requirements in this area may precipitate the very sort of rigid decision making that a risk-based approach seeks to avoid. Accordingly, DSS will evaluate proposals for term limits or for staggered board member terms on a case-by-case basis, and will maintain discretion to require FOCI Boards to adopt term limits.

As for disinterestedness, section 2-305(b) of the NISPOM provides that OD/PH must be "completely disinterested individuals with no prior involvement with the [FOCI-mitigated] company, the entities with which it is affiliated, or the foreign owner." The same section, however, allows DSS to approve the nominee "in advance and in writing" even if he/she is not "completely disinterested." DSS recognizes the presumption in favor of nominees who are completely disinterested, but also understands that in some circumstances an appropriate nominee may not be completely disinterested, such as an individual whose prior involvement with the cleared contractor or its affiliates is dated or otherwise attenuated. DSS will carefully scrutinize nominees who are not completely disinterested, but with an eye to the overall risk of approval, incorporating the factors discussed elsewhere in this Paper.

III. Expectations and Evaluation

Based on the experience and observations of DSS in administering FOCI mitigation under the NISP, and based on extensive discussions with managers and directors of cleared companies, DSS has concluded that the work of building and maintaining a strong FOCI Board starts with approval of OD/PH nominees but continues long after. DSS therefore expects that it will require FOCI Boards to implement mechanisms to assess the performance and effectiveness of OD/PH and the FOCI Board in the aggregate. DSS anticipates leveraging existing processes, such as the DSS Security Vulnerability Assessment (SVA), to assist with that evaluation, and DSS also will help cleared contractors develop and implement new processes to identify challenges and help OD/PH better understand what is expected of them.

Board evaluation has become standard across U.S. companies, which regularly evaluate their Directors either internally, through self-assessments and “360 degree review” exercises, or externally, through third-party assessments and reports. (Many companies use more than one of these mechanisms to evaluate Directors.) To ensure that OD/PH are fulfilling their NISP-related obligations to the USG, DSS will rely on credible assessments of OD/PH and FOCI Boards as one factor in its oversight. DSS and FOCI Boards will benefit from the best practice of implementing an evaluation process that regularly assesses the performance and effectiveness of OD/PH and the FOCI Board in the aggregate. DSS intends to use the results of that process to develop training and guidance for OD/PH, to review future OD/PH nominations, and to address issues involving an OD/PH that give DSS cause for concern.

DSS has identified examples of specific variables that should help identify those OD/PH who are appropriately engaged on a FOCI Board:

- **Company Engagement.** An OD/PH should be actively engaged with the cleared contractor beyond his/her minimum responsibility to attend quarterly board meetings. Such involvement includes, but is not limited, to: communicating with the Facility Security Officer (FSO) and other company personnel (e.g. management and security teams); insider threat program management; site visits; helping to develop and implement FOCI and risk mitigation measures; consulting with the BoD and management in between meetings on security, strategic, financial, and program-related matters; responding timely to cleared contractor or FOCI Board Member requests for input regarding risks or issues facing the cleared contractor or FOCI Board; and participating in SVAs.
- **Communication with DSS.** OD/PH should consistently, timely and proactively engage with DSS on company issues and the security environment. For example, OD/PH can reach out to DSS if the company is considering a complex affiliated operation, or if there are concerns about the foreign shareholder. DSS expects the GSC to include its views in any proposal submitted by the cleared contractor or its parent companies regarding the company’s NISP compliance or the terms of the FOCI mitigation agreement and associated supplements.
- **Meeting attendance.** OD/PH should attend, and prepare adequately for, every board meeting, particularly when classified matters will be discussed. OD/PH should also attend every GSC meeting.

- **Training.** OD/PH will likely be required to take annual training, encompassing both a Director's oversight duties as an OD/PH and other skillsets that will enhance success on the FOCI Board. For further discussion on this point, please see Section V below.

DSS expects to weigh the variables discussed above at least annually during the SVA and review all corresponding company records (e.g. the Annual Implementation and Compliance Report (AICR), the FOCI Board's Standard Operating Procedures and rules of engagement, related corporate governance plans, etc.). OD/PH will define how they address these, and related, issues, at least annually in the AICR required by paragraph 2-308(b), NISPOM, submitted to DSS. DSS also anticipates requiring OD/PH to explain, as part of the AICR, how they have acted to identify and mitigate security, insider threat, counterintelligence and cyber threats facing the cleared contractor. (By way of example, DSS notes that the Securities and Exchange Commission requires public companies to disclose "material cybersecurity risks and incidents" to investors). Each FOCI Board is unique, so processes and procedures will vary, and the FOCI Board should work closely with DSS in formulating them. DSS will expect each OD/PH individually to articulate how he/she is fulfilling his/her roles and responsibilities to provide effective leadership and oversight of the cleared contractor.

If DSS concludes that an OD/PH is not fulfilling his or her NISP responsibilities, then DSS will rescind approval of that OD/PH if the national security interests of the United States dictate that action. Rescission of approval of appointment will be considered as a potential remedy on a case-by-case basis, with full review of all pertinent information, consideration of other remedial actions, and advance notice to the OD/PH, the cleared contractor, and the foreign shareholder, with an opportunity to respond. Rescission will not be undertaken lightly, but rather only when DSS determines the individual is no longer able to discharge his or her responsibilities effectively. Furthermore, consistent communication among all stakeholders should ensure that the existence of serious performance issues and the need for rescission of DSS approval of a OD/PH's appointment would ever come as a surprise to any of the parties involved. The OD/PH role is crucial to a FOCI Board's success, and so DSS will contemplate rescission only when necessary to ensure FOCI Board effectiveness.

DSS recognizes that Board member performance is dynamic, and that a one-size-fits-all approach to evaluations is inappropriate. For example, metrics relating to the dynamics of a FOCI Board, such as interpersonal and critical thinking skills, or the ability to create value, are difficult to measure and evaluate. Board members' compatibility varies greatly and there is no rigid formula that makes a FOCI Board successful. DSS will therefore likely require that FOCI Board evaluations include a survey of board members. Survey questions may include whether the OD/PH: brings useful skills and expertise to the board and the company; understands the company's strategy, business, products, and programs; understands and exercises board governance duties responsibly; and, helps the company understand and mitigate FOCI- and security-related risks.

This survey can be conducted internally (e.g. through the FSO or GSC Chair), through a third party, or by other means. DSS research suggests that charging a board committee with assessing the BoD's overall performance elicits information needed to assess performance. DSS is exploring potential frameworks or even templates for surveys by and for FOCI Boards that

identify the evaluation criteria to assess, such as attendance, participation, responsiveness, and issues both substantive and qualitative. Regardless of the precise mechanism, however, DSS plans to review BoD assessment(s) as part of its FOCI board evaluation.

Additionally, the OD/PH will likely be required to address how he/she is managing the challenge of balancing the traditional board role with the national security duty to the USG. For example, one area DSS has identified as significant in OD/PH effectiveness is a thorough orientation of new OD/PH onto the FOCI Board. DSS will develop training courses and other guidelines to help OD/PH make that transition, in order to ensure that individual is able to discharge important responsibilities more effectively.

IV. Implementation

To meet the qualifications and expectations discussed above, DSS plans to reform its OD/PH nomination review and evaluation process. It is not always easy to predict whether an OD/PH nominee will succeed as a FOCI Board member until actual board service begins, but DSS believes the nomination and evaluation processes can and should more effectively ensure that nominees understand and fulfill their obligations.

DSS review of OD/PH nominees previously focused primarily on responses to a questionnaire, and a resume provided by the nominee. Moving forward, however, DSS plans to focus more broadly on the nominee's professional experience and background, as well as other obligations held by the nominee that may affect his/her availability to serve on a FOCI Board, when evaluating OD/PH nominees. For example, DSS must know how many other Boards the nominee serves on and his/her obligations to them, since availability and engagement by OD/PH are essential to the success of a FOCI Board. An OD/PH nominee should not hold so many positions and roles that he/she is not able to devote sufficient time to oversight of the cleared contractor and its security program, because, as discussed above, FOCI Boards are generally more demanding than non-FOCI boards. Furthermore, as a condition of approval, an OD/PH will likely be required to notify DSS if he/she assumes another position, including Director or a different senior management role, at a different company.

DSS also plans to review past performance of an OD/PH nominee with a cleared contractor. For example, if a nominee is an OD/PH on another FOCI Board or serves in another role at a cleared contractors, DSS may review the results of the SVAs and assessment/survey results of that company. DSS also anticipates reviewing the nominee's involvement and engagement with both DSS and any cleared contractor. For example, if a nominee is already an OD/PH, DSS expects that it will consider his/her attendance record at board and committee meetings, DSS annual meetings, and other available data in the course of exercising its approval authority.

OD/PH must exercise independent judgment. As previously discussed, the NISPOM generally requires that nominees be completely disinterested, and DSS will continuously assess an OD/PH's independence. DSS will likely also take into account potential conflicts created by other Board or business-related associations. For further discussion on this point, see Section II(D) above. DSS must ensure OD/PH nominees are able protect the national security interests of the United States by maintaining policies and procedures to safeguard classified information

and preventing adverse impact on performance on contracts requiring access to classified information. Compliance with the FOCI mitigation agreement, related documents and the NISP, and disinterestedness are significant considerations in that evaluation. A rapidly changing security environment requires these reforms to ensure continued OD/PH effectiveness on FOCI Boards.

V. Training

Industry feedback has identified training as critical when it comes to strengthening OD/PH. DSS agrees, and has concluded that training OD/PH on subjects related to national security would greatly benefit OD/PH nominees by empowering them to safeguard national security interests more effectively. DSS has also concluded that OD/PH approval should be conditioned upon a nominee's completion of baseline training. DSS therefore expects that it will require OD/PH, as a condition of approval, to satisfy discrete training requirements within 45 days of the DSS approval date; if the nominee fails to do so without an extension or exemption being granted, DSS expects that it will rescind its conditional approval of the nomination. Following completion of that initial training, OD/PH should work with their boards to devise and complete individualized training regimes tailored to the individual circumstances of each OD/PH. This allows OD/PH to better hone their skills to meet necessary national security, corporate governance, and fiduciary responsibilities.

Baseline training requirements will likely include the training courses on FOCI Outside Directors, Proxy Holders, and Voting Trustees, as well as Insider Threat Awareness, both offered by the DSS Center for Development of Security Excellence (CDSE). OD/PH will also likely be required to review *Navigating the Affiliated Operations Plan: A Guide for Industry* and *Targeting U.S. Technologies: A Trend Analysis of Cleared Industry Reporting*, both published by DSS and available on DSS's public website. DSS expects to phase in additional requirements over time, such as training in shareholder engagement, boardroom fundamentals, cybersecurity, and insider threat.

After completing the baseline requirements, OD/PH will likely be required to maintain their awareness of those requirements by completing periodic refresher training, to include:

- CDSE online course for FOCI Outside Director, Proxy Holders, and Voting Trustees
 - OD/PH will likely be expected to complete this course every five years.
- CDSE online course: Insider Threat Awareness
 - OD/PH will likely be expected to complete this course every two years.
- *Targeting U.S. Technologies: A Trend Analysis of Cleared Industry Reporting*
 - OD/PH will likely be expected to review the document as it is published annually.

To ensure proper balance of the financial health of cleared contractors with national security requirements, DSS will encourage cleared contractors to tailor individual training requirements for OD/PH. Those requirements should be crafted to meet the cleared contractor's business governance and operations, and should take into account the results of the annual OD/PH effectiveness assessment/survey. Doing so will help OD/PH protect national security interests

even more effectively, and also assist cleared contractors by enhancing OD/PH knowledge in areas such as corporate governance, finance and accounting, and program management. DSS will assist industry with these tailored training strategies by leveraging not only internal government resources (e.g. CDSE), but also identifying resources offered by non-Federal entities (e.g., professional and business associations and trade groups, academic institutions, etc.) where annual assessment/survey results identify high demand.

VI. Conclusion

DSS's transition to a risk-based enterprise is driven by the rapidly evolving threat landscape confronting the United States and the Defense Industrial Base. As America's adversaries prove ever more elusive and flexible, DSS too must adapt and become more flexible in fulfilling its mission to protect classified or critical assets and technologies. The reforms projected herein will be implemented consistent with DSS's existing authorities, but with an eye to the flexibility and risk-based approach inherent to DSS's transition.

DSS undertook to examine the OD/PH framework after years of continuous feedback from industry and government personnel about the need for reforming that framework, and has elicited continuous feedback over the course of its review. That feedback does not end with the implementation of these reforms. DSS welcomes further suggestions and collaboration in order to continuously improve our performance; please feel free to send questions and comments to dss.quantico.dss-hq.mbx.foci-operations@mail.mil.