



**Counterfeit Parts in DoD's Supply Chain:  
TechAmerica Webinar on Section 818 of 2012 NDAA**  
April 16, 2012

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EXPERIENCE TIPS THE BALANCE

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# What is the problem?

- Components and systems entering the DoD supply chain contain counterfeit parts that make it impossible to predict when or how the systems may fail.
- The failure or threat of failure due to counterfeit parts reduces reliability of weapons and systems.
- Reliance on potentially compromised systems risks loss of life and property and may cause mission failure.
- The incentives for counterfeiters and the often faceless global nature of the supply chain for electronic parts makes fixing the problem difficult.
- Supply chain integrity is necessary, but expensive.

# Counterfeit Parts Awareness Timeline

- 2008
  - INSIDE THE AIR FORCE
  - BUSINESS WEEK
  - DoJ Prosecutions
  - PRO IP Act
- 2009
  - NASA comments to HEC
  - DoJ Prosecutions
- 2010
  - Dept. of Commerce, BIS Study
  - IPEC Working Group Formed
  - Boeing/L-3 Comm./Raytheon
- 2011
  - GAO Report: DoD Leverage
  - DoJ Prosecutions
- 2011
  - Dept. of Commerce, Survey of telecom company hardware
  - DoD MIBP S2T2 Review
  - SASC Investigation & Hearing
  - 2012 NDAA
- 2012
  - GAO Report: Internet Fakes
  - AT&L “Overarching” Memo
  - Deadlines for DoD Action
    - June 28, 2012
    - September 26, 2012

# What is the Government's responsibility, culpability?

- Trade policies, export/import
- Bilateral relations, e.g. with China
- Acquisition policies and preferences
  - Commercial item
  - Lowest price technically acceptable
  - Small business preference
  - Acquisition workforce
- Enforcement by DoJ, CBP and others

## What has Congress done to date to address the problem?

- Pro-IP Act formed IPEC Working Group
- Section 806 of 2011 NDAA
- SASC Investigation and Hearing on Counterfeit Electronic Parts in Military Equipment
- Section 818 of 2012 NDAA

# SASC Hearing and Legislative History

- Feb - Nov 2011 SASC Investigation
- Nov 8 SASC Hearing
  - DoD, MDA & GAO
  - Boeing/L-3 Comm./Raytheon
  - SIA/SMT Corp.
- Nov 17, S. 1092 introduced
- Nov 29, S. 1092 passed
- 2012 NDAA signed Dec 31, 2011

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## Part of a larger picture...

- Government-wide anti-counterfeiting initiative
  - Cybersecurity legislation
  - Pharmaceuticals
- DoD examination of DIB issues
  - S2T2 surveys
  - Cyber Threat
- Administration policy goals

# What are IPEC's government supply chain objectives?

- Develop procedures for PMs to identify counterfeit risk consistent with industry standards
- Consider regulations to mandate stronger industry anti-counterfeiting measures
- Examine package and product traceability and marking
- Improve capability of government and industry evaluation
- Anti-counterfeit training and outreach for Federal workforce
- Consider additional measures to protect rights and interests of the U.S. to recoup costs and prosecute counterfeiters

<http://www.gpo.gov/fdsys/pkg/FR-2011-08-09/pdf/2011-20204.pdf>



# What regulations are in play?

- DFARS
- FAR
- Cost Principles
- Changes (Fixed & Reimbursable)

## What the law requires (DoD internal)

- Define “counterfeit electronic part” and “suspect counterfeit electronic part”
- Implement a risk-based approach for DoD procurement personnel to minimize impact of counterfeit electronic parts
- Issue or revise guidance to recommend suspension and debarment for lack of supply chain integrity
- Establish a system for reporting counterfeit parts
- Develop a process to act on such reports

# What the law requires (DoD and Contractors)

- Whenever possible DoD and contractors shall obtain parts from OEMs, authorized dealers or “trusted suppliers”
  - When parts are no longer available, they must be obtained from “trusted suppliers”
  - If not possible, contractor must notify DoD and parts must be inspected, tested and authenticated
- DoD must establish qualification requirements to identify trusted suppliers and contractors may identify their own
  - Contractor trusted supplier programs must be consistent with industry standards, subject to DoD audit and contractors “assume the responsibility”

## What the law requires (Contractors)

- Responsible for detecting and avoiding counterfeit electronic parts and all costs of any associated rework or corrective action
- With knowledge of or reason to suspect counterfeit electronic parts, must give written notice to government authorities and GIDEP w/in 60 days
- Immune from civil liability for reporting after a “reasonable effort” to determine whether counterfeit
- Must establish policies and procedures to “eliminate” counterfeit electronic parts

# What the law requires (Contractor Systems)

- Need to address specific areas:
  - Train personnel
  - Inspect and test electronic parts
  - “Abolish counterfeit parts proliferation”
  - Enable parts traceability
  - Use trusted suppliers
  - Report and quarantine counterfeit (and suspect) parts
  - Identify and rapidly confirm or deny suspect counterfeit parts
  - Design, operate and maintain systems to detect and avoid counterfeit (and suspect) parts
  - Flow down detection and avoidance requirements
- DoD must approve or disapprove like business systems rule

# What are DOD, contractors and suppliers doing?

- DoD
  - DLA questionnaire
  - DUSD Kendall 3.16.12 Memo – “Overarching DoD Counterfeit Prevention Guidance”
  - Cooperative Working Group
- Contractors
  - Develop/Review Policy and Procedure to detect and avoid
  - Monitor and seek to participate in rulemaking
- Suppliers
  - AS 5553 Standard (or others)

# How can DoD minimize DIB impacts?

- Dialogue with industry – notice and comment
- Cost benefit analysis and risk-based approach
- Provide safe harbor when contractor has implemented and maintained a robust system
- Draw the proper line between detection and avoidance inspections (allowable costs) and corrective action or rework (unallowable costs)
- Account for supply chain integrity in procurements – low cost is counter-productive

# What legislative fixes have been advocated?

- Exception to strict liability consistent with MDA clause, that provides safe harbor if—
  - Contractor has detection and avoidance system
  - Parts procured from reliable source, or provided as GFP
  - With timely notice
- Exception to strict liability for maintenance or refurb if—
  - DoD elects not to fund proposal to eliminate obsolete parts, and
  - Contractor complies with sourcing requirements
- Amend CICA to expressly allow DoD to:
  - Limit procurements of electronics to OEMs and authorized dealers unless electronic components are not available from reliable sources



# What does the 3.16.12 DoD Memo portend?

- Defines counterfeit part as:
  - “an item that is an unauthorized copy or substitute that has been identified, marked, and/or altered by a source other than the item’s legally authorized source and has been misrepresented to be an authorized item of legally authorized source.”
- Points to 7.18.11 AT&L Memo “Program Protection Plan,” DFARS 252.246-7003 and PGI 246.371 as existing guidance
- Indicates likely policy direction for:
  - Expanding beyond electronic parts
  - Handling notifications
  - Using GIDEP

## Some questions to consider

- How prescriptive will or should the rule be?
- How long will contractors have to implement?
- Who in DoD can or will audit compliance?
- Can and will DoD engineer out obsolescence?
- Can one rule fit the entire supply chain?
- Will the rule be influenced by DoJ?
- How does the rule interact with Section 806?
- Can there be gradual or pilot implementation?

# Where are costs likely to be generated from 818?

- Direct costs
  - Specific assurance/corrective actions on contract
  - Higher purchase price for components
- Increased contractor overhead
  - Compliance costs
  - Establishing DoD-unique process
- Decreased competition
  - Risk-avoidance decision for commercial companies
  - Small businesses' inability to comply
- Companies pricing to cover risk

# What specifically can or should “industry” do?

- Internal conversation about Section 818
  - Legal/Contracts/Procurement/Quality
    - What are we already doing?
    - What do we need to do?
    - What can't we do?
  - Identify risky contracts and risky suppliers
  - Develop or hire supply chain & contracts expertise
  - How do you measure up to likely standards?
- Communicate with and leverage associations

# Was 818 Necessary?

- 818 follows several years of incomplete efforts by Gov't and industry to address counterfeit parts
- The 2011 SASC hearings vividly demonstrated the reality and pervasiveness of the threat posed
- Congress determined that protection of the DoD supply chain was important to national security
- Efforts previously “recommended” and “studied” (e.g., by GAO, Commerce, AIA, etc.) now are being acted upon.

No one can argue with the purposes of 818. Action to address counterfeit parts was overdue.

# The Good, The Bad and the Unknown(s)

- 818 should be credited with strengths
  - Direction to DoD to assess and improves its practices
  - Clear statement that contractors are responsible
  - Emphasis on purchases from OCMs and Trusted Suppliers
  - Insistence on GIDEP reporting and after-action
  - Strengthened Customs & Enforcement
- But there are serious problems and unknowns
  - Only DoD is allowed to use a “risk based approach”
  - Shift of detection/correction expense is unreasonable
  - Uncertain industrial base impact – but little flexibility

# Prospects and Concerns Vary “Tier by Tier”

- Compliance is least a concern for Tier 1 suppliers for whom the DoD is a dominant customer.
  - Many already subject to AS5553 and working to respond to DCMC reviews of current standards and practices
  - Already rely on OCMs and other Trusted Suppliers
- Compliance is a great concern for lower tier suppliers (and where DoD is a less significant buyer)
  - Costs / process may not be feasible for small business
  - Commercial parts sources may exit

**Section 818 applies at all tiers – no distinction for commercial sources, commercial suppliers**

# Is There an “Iceberg” or Just Surface Ice?

- ARWG criticizes 818 as “focused on punitive solutions” that could “undermine compliance”
- ARWG suggests small and non-traditional federal contractors will be “discouraged”
- DoD however, already has “moved out” (by the 16 March memo) to respond to a “serious threat”
- *It is known that Congress and DoD have acted to address counterfeit parts*
- *Adverse impacts on the industrial base and supply chain participants, in contrast, are speculative*



# Prudent Implementation

## Industry

- Anticipate requirements
- Identify current practices
- Perform risk-assessment
- Adopt best practices / Stds
- Validate suppliers
- Document policies
- Improve training

## • Government

- Solicit broad industry input
- Consider pilot or sequential implementation
- Avoid “single prescription”
- Emphasize incentives
- Admit and act on issues as arise through experience

**DoD Should Involve Industry in 818 Assessment & Rulemaking**

# Acting on 818 at the 1<sup>st</sup> and 2<sup>nd</sup> Tier

- Self-Evaluation
  - Design and specification (part life cycle)
  - Supplier management
  - Component management
  - Procurement
  - Inspection
  - Test / evaluation
  - Reporting
  - Response
  - System and process documentation

## Small business response to 818

- Assess current products, customers, requirements
- Evaluate supply chain sources, record & risk
- Eliminate sources of uncertain pedigree
- Notify customers if parts unavailable
- Identify potential standards and best practices
- Examine cost impact (recurring, non-recurring)
- Advise Gov't customers and primes of impact
- Coordinate with other businesses similarly situated

## Concluding Observation

Supply chain assurance is a very complex problem. Solutions require interdependent action of many domestic and international actors. Congress has spoken, however. Section 818 requires DoD to issue regulations that will cause contractors to “eliminate” counterfeit electronic parts from the DoD supply chain and to “abolish” counterfeit parts proliferation. Industry should do its best to comply, while collecting evidence to support changes as may be necessary to the statute or implementing regulations.

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