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Defense Acquisition Regulations System
Attn: Ms. Amy Williams (DARC Deputy Director)
OUSD (AT&L) DPAP/DARS

Re: DFARS Case 2012-D055
Public Meeting – Detection & Avoidance of Counterfeit Electronic Parts – Further
Implementation

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I offer this written statement for the record of presentations made at the Public Meeting, 49 Fed. Reg. 11747 (Mar. 3, 2014), to solicit further views on implementation of Section 818 of the FY 2012 National Defense Authorization Act (the "Act"). My comments concentrate on the identification of "trusted suppliers" as required by section 818(c)(3) of the Act.

I. Industry's Frustration

Section 818 was enacted into law on December 31, 2011. The statute directed DoD to issue new regulations governing contractors before the end of September 2012. The proposed DFARS, from Case 2012-D055, emerged on May 16, 2013, seventeen months after enactment and nearly eight months later than Congress intended. Ten further months have passed between the proposed rule and the date of the latest public hearing. But no final rule has emerged.

I have written previously about the importance of proceeding carefully so as to recognize the complexity of supply chain issues and the risks of unknown but dysfunctional consequences. I also have urged DoD to adopt an approach that is adaptive rather than prescriptive. The long delay in production of regulations, however, has its own negative consequences. Industry continues to struggle with questions of what will constitute acceptable systems to detect and avoid counterfeit electronic parts. Considerable friction has been produced between the higher tier purchasers of electronic parts, who expect they will be subject to the final regulations, and the various lower tiers that supply those parts. Resolution of that friction is very difficult, if not impossible, until the requirements and applicability of the regulations are known.

DoD, I presume, recognizes that the language of Section 818, as drafted, applies specifically to "covered contractors" and these are entities that are subject to the Cost Accounting Standards. Moreover, because Section 818 is not a self-executing regulation, it does not appear to have a present binding effect – notwithstanding its most important purposes – and will not be enforceable until such time as binding regulations are in place. These conditions alone leave the status of Section 818 very much in "limbo" – surely not the result that the Congress intended.

II. The Hard Point Between Demand and Supply

Section 818(c)(3) zeroes in at the point of intersection between those companies subject to the law (the “covered contractors”) and those outside its coverage who are relied upon to supply electronic parts. Highest tier companies naturally seek to flow down requirements, and terms and conditions, which would “guarantee” against the presence of counterfeits, or cause sources to shoulder risk of loss and liability should a counterfeit “escape” occur. These demands often are rejected by the lower tier suppliers, however, because they cannot make such assurances or assume such risks, especially where the parts required are no longer available from original sources or their authorized distributors.

It is a virtually inarguable proposition – all things being equal – that DoD contractors should purchase from original sources (OCMs, OEMs) and their authorized distributors. But *not* all things *are* equal. Sometimes, price alone will discourage purchases from original sources even when they are available.¹ But the bigger flaw in the premise is that DoD can satisfy its needs largely by reliance upon original sources. It cannot, at least for the foreseeable future. The present public meeting is an important opportunity to clarify how DoD and its supply chain should deal with the conflict between statutory insistence upon parts with no counterfeit risk, on the one hand, and market requirements for parts available only from sources with imperfect assurance, on the other.

Demand remains and will continue for the supply of electronic parts that are no longer available from the original sources. Such parts may be obsolescent or no longer in production. They may be available only from independent distributors, if they happen to hold such parts in inventory, or from brokers, who may find such parts in the “open market.”

III. “Primary” and “Secondary” Sources for Electronic Parts

Section 818(c)(3) expresses a relatively simple concept, favoring “trusted suppliers.” In this key area, unfortunately, the law’s language is tortured. At the outset, 818(c)(3)(A)(i) tells DoD that its regulations should require, “whenever possible,” its contractors and subcontractors to purchase electronic parts that are “in production” or “currently available in stock” from OEMs or their authorized dealers. Equally favored are “trusted suppliers who obtain such parts exclusively from” the OEMs or their authorized distributors.² For purposes of this document, I shall refer to this preferred class of sources as **primary sources**.

¹ A continuing emphasis upon paying the lowest price for electronic components is directly contrary to the purposes of Section 818 to avoid counterfeit parts. In 2012, I wrote that “a low-cost purchasing approach penalizes those companies that invest the most in securing their supply chains. Simply put, contractors that invest the most will be unable to compete on price with companies that shirk their responsibilities.” “Legislating Supply Chain Assurance: An Examination of Section 818 of the FY 2012 NDAA,” *The Procurement Lawyer*, Vol. 47, No. 4 (Summer 2012) (Jeffery M. Chiow, co-author).

² In 2012, I asked “what a contractor is to do, and at whose ultimate expense, where no ‘genuine’ part is available from an original component manufacturer, authorized distributor or other ‘trusted source.’” “Counterfeit Electronic Parts: What to Do Before the Regulations (and Regulators) Come?,” *Bloomberg BNA Federal Contracts Report*, 97 FCR (Jun. 21, 2012) (Jeffery M. Chiow, co-author).

But electronic parts must be supplied that are not in production or currently in stock. The statute, at 818(c)(3)(A)(ii), says that “trusted suppliers” should be used in this situation. It does not define who these are or how their trustworthiness is to be determined. The statute further recognizes, at 818(c)(3)(B), that parts also will be obtained from sources “other than” those described in subparagraph (A). Parts not acquired from 818’s primary sources are referenced here as being supplied by **secondary sources**.

The statute is clear that it prefers parts from primary sources. Beyond that, however, it is opaque. It suffers from indifferent use of the same term – “trusted supplier” – to apply to very different sources presenting different risks and mitigation challenges. DoD’s challenge is to sort this out and offer practical guidance to its suppliers and their supply chain. The focus of the rule should be to inform industry on when they should use, how they should select and how they can mitigate the risk of parts purchased from secondary sources.

IV. A Market-Driven Analysis of Secondary Sources

The objective of Section 818 is to reduce the risk and, if possible, eliminate counterfeits from the entire universe of electronic parts that DoD (or its contractors) may require. Parts from primary sources present the least risk. What remains are all other required parts that, by definition, must be acquired from secondary sources. Secondary sources can vary widely, but it serves to classify them into several “tiers” of progressively greater risk:

- *Tier 1:* From suppliers who only deal in parts that are originals but not presently in production, and who possess documentation to establish an unbroken chain-of-custody from the OEM or authorized distributor;
- *Tier 2:* From independent distributors who maintain an inventory of parts of varying degrees of assurance (measured by documentation, pedigree, provenance, etc.); and
- *Tier 3:* From brokers who do not maintain an inventory but who acquire parts on the open market in response to specific demand.

(This is an oversimplification but it will serve to illustrate the point.) Section 818 struggles with how to qualify suppliers who operate at each of these tiers. All represent sources that, in the real world markets, remain essential (even if not preferred) to supply parts that are required to sustain and support defense equipment. To conform to 818(c)(3), the regulation must accommodate all these tiers of secondary sources, though it also must make the qualification demands more rigorous at the lower tiers where the risk is greatest.

V. Statutory Tools Available to Qualify Secondary Sources

Section 818 provides something of a toolkit to apply to the qualification of *all* secondary sources. Since they are not from the primary or “preferred” original source(s), 818(c)(3)(B) obligates DoD to establish requirements for **notification** of the Department, and **inspection, testing**, and

authentication.³ Also, 818(c)(3)(C) mandates that DoD establish “**qualification requirements**” that it can use – and upon which, by extension, its contractors can rely – to identify suppliers that have “appropriate **policies** and **procedures** in place.” Further, when DoD authorizes the use of such secondary sources (which I equate to “additional trusted suppliers”), 818(c)(3)(D)(i) requires that these suppliers comply with **established industry standards**. Section 818(c)(3)(D)(ii) says that a contractor who purchases from these “additional trusted suppliers” must assume **responsibility** for their “**authenticity**.” Section 818(c)(3)(D)(iii) obligates DoD retain oversight over the selection of such suppliers through “**review and audit**.”

Accordingly, the toolkit for qualification of secondary sources includes:

Notification of DoD (or higher tier customer)	Qualification requirements
Inspection	Established industry standards
Testing	Legal responsibility for authenticity
Authentication	Oversight by review and audit

Each of these tools will be used by purchasers, both to qualify certain sources and to mitigate the counterfeit risk by active measures such as additional inspection, testing and authentication. Similarly, these tools also inform suppliers as to what they should do, e.g., to have in place policies and procedures and to follow industry standards. At the same time, the selection among the tools and the details of their use will vary. Burdens are less where purchases are to be made from secondary sources at the higher reliability tiers. Relative risk should drive the use of these tools and corresponding obligations.

VI. A Risk-Based Hierarchy of Obligations

The circumstances of demand and supply are almost infinitely variable for the systems that DoD procures and sustains. Similarly diverse are the possibilities of “threat” of counterfeit insertion, “vulnerability” of systems to counterfeit attack and the potential “consequence” or harm from a counterfeit escape. Accordingly, rules for qualification and use of “trusted suppliers” cannot seek to impose a static orthodoxy. Necessarily, the “trusted supplier” qualification regime must be context-driven. Industry should be informed of principles to apply and encouraged to adopt known standards. The ultimate measure of compliance will depend upon the facts and circumstances of implementation by each contractor covered by the regulation.

“Risk-based methods” are used to address the threat of counterfeit electronic parts and the response.⁴ Qualification of secondary sources should employ a simplified subset of the methods

³ DoD has not yet established notification requirements. For the rule to be coherent and complete, the customer must be involved and informed, not ignorant.

⁴ At 818(b)(2), the statute encourages DoD to implement a “risk-based approach to minimize the impact of counterfeit electronic parts or suspect counterfeit electronic parts.”

that are used to manage counterfeit risk at the enterprise level.⁵ Specifically, every time a part must be purchased from a secondary source, it is possible to evaluate what I will call “authenticity risk” and “failure risk.”

- Authenticity risk can be discerned by the presence or absence of knowledge as to the source (pedigree), history (provenance) and documentation of a particular part. It also can be informed by such data as date of fabrication, years out of production, etc. The supplier possesses the most relevant knowledge to this inquiry.
- Failure risk relates to the adverse consequences should a part prove to be counterfeit. The purchaser will have the most knowledge of this.
- These factors are linked. A part with a high authenticity risk should not be procured (if at all) except when there is negligible or no failure risk. A part with less than ideal authenticity risk should never be procured when the failure risk is high. Contractor systems will emerge (or are in the works now) that will take available source data and automate this kind of risk analysis. For purposes of determining whether a contractor has a compliant purchasing system, DoD should write regulations that encourage such informed, data-driven judgments on the part of its suppliers. It should not attempt to “prescribe” narrow solutions to supply chain challenges.
- Certain classes of devices, even if not purchased from the OCM, OEM or authorized distributor, have such inherently low risk of being counterfeit that they should be excluded from the final 818 rules. The qualification rigors for “trusted suppliers” should not apply to electronic parts purchased as “Commercial Off The Shelf” (COTS) items or off a GSA Schedule.

Mitigation also is to be considered in source qualification. The “product” of authenticity risk and failure risk may be reduced by the ability of supply chain actors to take measures that will mitigate the risk of a counterfeit. These could be as simple as a higher level of testing, a change in sampling ratio, or additional inspection. They could be quite complex (and costly), such as advanced diagnostic measures, destructive tests, or comparison to “gold standard” examples. Qualification goes not just to the source but to the part, what is known about it, its function, and what measures can be taken (by seller, buyer or intermediary) to provide authentication.

VII. DoD Should Rely on “Covered Contractors” to Qualify Secondary Sources

The supply chain is most vulnerable where demand exists for parts that cannot be satisfied by primary sources. Qualification of secondary sources imposes obligations both on the source and the purchaser. Indeed, this must occur to respect the requirements of 818(c)(3)(B), (C) and (D). In light of the obligations that both buyer and seller must fulfill whenever electronic parts are purchased from secondary sources, DoD should employ a flexible, rather than rule-based

⁵ I wrote in 2013 how “Risk” can be seen as a function of “Threat,” “Vulnerability” and “Consequences.” See “New DoD Counterfeit Prevention Policy: Resolves Responsibilities Within DoD But Leaves Many Contractor Questions Unresolved,” *Bloomberg BNA Federal Contracts Report*, 99 FCR (Jun. 21, 2013).

approach to supplier qualification. Strictly speaking, only a small number of large defense contractors are “covered contractors” subject to the full requirements of Section 818. These companies already are subject to extensive business systems regulation – and the proposed DFARS to implement Section 818 would add counterfeit parts detection and avoidance to the criteria used to evaluate their purchasing systems. (Quality systems also are implicated.)

Therefore, given a pervasive oversight regime already is in place, DoD should refrain from adding additional burdens and instead defer to the judgment of its contractors to develop and operate compliant systems. DoD should evaluate and verify those systems, but that will require expertise and resources that are now in very short supply. Because its principal contractors must be able to purchase from secondary sources, DoD should use 818(c)(3)(D) to delegate to them the authority to define and impose qualification standards. Practically, if DoD were to insert itself into this process at the operating level, the result would be delays and obstacles to the purchasing process. Such an intrusive role is not necessary; 818(c)(3)(D)(ii) requires the contractors who approve secondary sources to “assume responsibility” for parts authenticity. This, along with other sanctions of 818, including the disallowance of costs of rework and corrective action, at 818(c)(2)(B), protect the Government’s interests sufficiently.

VIII. Use of Industry Standards

The final 818 regulations should encourage contractors to adopt and conform to industry standards as they evolve, e.g., SAE AS5553a, AS6081, AS6174, AS6301. They apply both to purchasers of electronic parts and to their sources (primary or secondary). This decision will impose additional responsibilities and costs, especially on candidate secondary sources. Such are necessary costs of avoidance of counterfeits. Already, some secondary sources at the higher risk tiers (small businesses, stocking distributors and brokers) have invested to implement these standards (and to qualify under DLA programs such as QSLD and QTSL). Forward-acting companies should be favored in qualification as “additional trusted suppliers” and in real world purchasing preferences. The final DFARS should incentivize companies to make a comparable investment and commit to the highest level of commercial product assurance practices. Secondary sources cannot adopt best practices for “free.” Customers using secondary sources – whether the Government (when buying for its own account) or its large contractors – must be prepared to pay the incremental price necessary to justify these additional assurance measures.

Respectfully submitted:

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