

# THE GOVERNMENT CONTRACTOR®



THOMSON REUTERS

Information and Analysis on Legal Aspects of Procurement

Vol. 58, No. 34

September 14, 2016

## FOCUS

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### FEATURE COMMENT: The Latest Chapter In Counterfeit Parts Regulations—Sources Of Electronic Parts

The regulatory requirements governing counterfeit electronic parts and suspect counterfeit electronic parts since their Defense Federal Acquisition Regulation Supplement introduction in May 2014 continue to evolve. DFARS 252.246-7007 establishes the system criteria for contractor counterfeit electronic part detection and avoidance systems. See Vanek & Tibbets, “Counterfeit Electronic Parts—The DFARS Final Rule And The Expanded Reporting Requirements For Nonconforming Items,” BRIEFING PAPERS No. 14-11 (Oct. 2014). The latest chapter is the Department of Defense’s publication of a final rule under DFARS Case 2015-D005 governing the sources of electronic parts. See 81 Fed. Reg. 50635–50 (Aug. 2, 2016). The final rule became effective upon publication and is promulgated at DFARS 252.246-7008. It is designed to implement the requirements codified in § 818 of the National Defense Authorization Act for Fiscal Year 2012, as modified by § 817 of the FY 2015 NDAA.

In accordance with § 818, contractors and subcontractors are required to procure electronic parts from trusted suppliers to mitigate the risk to the DOD supply chain resulting from counterfeit and suspect counterfeit electronic parts. Contractors and subcontractors who are not the original component manufacturer must timely notify the contracting officer if they cannot obtain an electronic part from a trusted supplier. If a contractor or subcontractor procures electronic parts from a source other than a trusted supplier, it is now required to inspect, test and

authenticate the parts in accordance with applicable industry standards.

The final rule enhances DOD’s ability to strengthen the integrity of the electronic parts acquisition process in a manner that benefits both the Government and the contractor. The careful selection of suppliers in accordance with the process set forth in this final rule, and the inspection, testing and authentication of electronic parts not traceable back to the original manufacturer (OM), further mitigate supply chain risk. The rule complements DFARS 252.246-7007, which requires Cost Accounting Standards-covered contractors to have an approved counterfeit and suspect counterfeit electronic parts detection and avoidance system. The final rule amends one of the 12 system criteria regarding use of suppliers codified at DFARS 246.870-2(b)(v); creates additional terms in DFARS 246.870-2 cross-referenced to DFARS 252.246-7008 (related to the sources of electronic parts); adds consistency in the requirements for traceability and sources of electronic parts; and extends the requirements from CAS-covered contractors and their subcontractors at any tier to all DOD contractors and subcontractors supplying electronic parts or items containing electronic parts, including commercial items, and regardless of business size or CAS coverage.

The final rule amends DFARS 212.301 to direct the use of the clause 252.246-7008 in solicitations and contracts for commercial-item acquisitions. The final rule amends and adds a number of definitions to DFARS 202.101, and makes a number of other conforming changes to 246.870-2 and 252.246-7007. The final rule also applies to DOD’s procurement of medical devices, even though the Food and Drug Administration is charged with protecting public health and regulating medical devices.

The final rule does not cover raw materials or minerals. Similarly, the final rule does not address part obsolescence or diminishing manufacturing sources of supply. A future rule will address obsolescence and diminishing manufacturing sources.

**Definitions**—The final rule adds many new definitions, identified below, to the clause at 252.246-7008. It also amends 252.246-7007 for consistency, removes embedded software or firmware from the electronic part definition, and revises the definition of obsolete electronic part.

An *electronic part* under this final rule means an integrated circuit, a discrete electronic component (including, but not limited to, a transistor, capacitor, resistor or diode) or a circuit assembly. As in 252.246-7007, a *counterfeit electronic part* is an unlawful or unauthorized reproduction, substitution or alteration that has been knowingly mismarked, misidentified or otherwise misrepresented to be an authentic, unmodified electronic part from the OM, or a source with the express written authority of the OM or current design activity, including authorized aftermarket manufacturer. Unlawful or unauthorized substitution includes used electronic parts represented as new, and the false identification of grade, serial number, lot number, date code or performance characteristics. *Suspect counterfeit electronic part* means an electronic part for which credible evidence (including, but not limited to, visual inspection or testing) provides reasonable doubt that the electronic part is authentic.

*Authorized aftermarket manufacturer* means an organization that fabricates an electronic part under a contract with, or with the express written authority of, the original component manufacturer based on the original component manufacturer’s designs, formulas or specifications.

*Contract manufacturer* means a company that produces goods under contract for another company under the label or brand name of that company.

*Contractor-approved supplier* means a supplier that does not have a contractual agreement with the original component manufacturer for a transaction, but has been identified as trustworthy by a contractor or subcontractor.

*Obsolete electronic part* means an electronic part that is no longer available from the OM or an authorized aftermarket manufacturer.

*Original component manufacturer* means an organization that designs or engineers a part and is entitled to any intellectual property rights to that part.

*Original equipment manufacturer* means a company that manufactures products that it has designed from purchased components and sells those products under the company’s brand name.

*Original manufacturer* means the original component manufacturer, the original equipment manufacturer or the contract manufacturer.

**A Three-Tiered Approach**—This final rule creates a three-tiered hierarchical approach for the supply of electronic parts. The preamble identifies this approach as categories 1–3.

Category 1 includes electronic parts that are in production or currently available in stock. If an electronic part is in production or currently available in stock, the contractor or subcontractor must obtain such parts from (a) the OM, (b) its authorized suppliers, or (c) suppliers that obtain such parts exclusively from the original manufacturers of the parts or its authorized suppliers. These sources include authorized aftermarket manufacturers. If the electronic part is available from any category 1 supplier, the contractor or subcontractor must purchase the part from those suppliers. Such mandate is without regard to lead times. If the part is in production or available, and even if there is a demonstrated immediate need for the part in production with a lead time, contractors and subcontractors do not have the option to purchase the part from any source other than a category 1 source. Although the final rule does not explicitly discuss the consequences that lead times may have on delivery times, contractors must know their lower-tier supply chain and consider the lead times in delivery schedules to the next higher tier.

Category 2 sources are suppliers of electronic parts not in production and not currently available in stock. Purchases of electronic parts from category 2 sources are permissible only if the electronic part is not in production and not currently available in stock in accordance with category 1. Subject to certain conditions, contractors must obtain parts from suppliers identified by the contractor as contractor-approved suppliers. A contractor-approved supplier is defined as a supplier that does not have a contractual commitment with the OM for a transaction, but has been identified as trustworthy by a contractor or subcontractor. DOD does not use the phrase “trusted supplier,” which has caused considerable confusion since its first use in § 818.

Contractors must identify and approve category 2 sources. As part of the identification and approval process, contractors must follow existing applicable industry standards to inspect, test and authenticate the electronic part prior to supplying it to the Government. Current industry standards adopted

by DOD to satisfy these category 2 requirements include ISO9001, AS9100, AS5553A, AS6462, AS6081, AS6174, etc. DOD-adopted industry standards can be found at <https://assist.dla.mil>.

Under category 2 purchases, the contractor or subcontractor assumes all responsibility for the selection and approval of contractor-approved sources, for adequate testing and inspection of the parts, and for the authenticity of the parts. The selection of a contractor-approved supplier is subject to review and audit by the CO. As contractors and subcontractors are now required to inspect, test and authenticate sources, they must develop and implement risk-based approaches considering all pertinent factors, including, without limitation, criticality of the part, its use, the consequences of the part's failure and the supplier itself.

While not final, a further DOD proposed rule explicitly states that the contractor may proceed with the acquisition of electronic parts from the contractor-approved supplier unless notified otherwise by DOD. See 81 Fed. Reg. 50680–81 (Aug. 2, 2016). Comments on the proposed rule are due by October 3.

Contractors and subcontractors who purchase electronic parts from another vendor, such as under the Federal Supply Schedule, from suppliers accredited by the Defense Microelectronics Activity, or from Government inventory or stock under the authority of DFARS 252.251-7000, Ordering from Government Supply Sources, are still obligated to comply with the requirements of 252.246-7008(b) and (c), selecting suppliers and traceability, respectively. If an electronic part is procured from these sources, the Government is responsible for the authenticity of the part. If the part is subsequently determined to be counterfeit or is suspected of being counterfeit, the Government will promptly replace the part at no charge to the contractor or subcontractor. The Government will also consider an adjustment to the performance schedule resulting from the delays caused by the counterfeit or suspect counterfeit part replacement.

The costs incurred by the contractor or subcontractor as a result of inspection, testing and authentication from contractor-approved suppliers may be charged as a direct cost under the contract.

Category 3 suppliers are sources of supply other than category 1 or 2 sources. Category 3 suppliers may be utilized if category 1 parts are not available, the contractor or subcontractor cannot approve a supplier in accordance with the procedures of category

2, a subcontractor other than the OM refuses to accept the flowdown of this clause, or the contractor or subcontractor cannot confirm that an electronic part is new or previously unused and has not been commingled in supplier new production or stock with used, refurbished, reclaimed or returned parts. In such a case, the contractor must promptly notify the CO in writing. Subcontractors should promptly notify in writing the next higher-tier contractor. In the event the electronic part is to be used in many assemblies, the contractor may submit one notification for the entire lot identifying the assemblies containing parts, including serial numbers, etc.

The contractor and subcontractor remain responsible for the inspection, testing and authentication of the electronic parts utilizing the DOD-approved industry standards discussed above. Furthermore, the contractor and subcontractor shall document the inspection, testing and authentication, and make such documentation available to the Government upon request.

**Traceability**—If a contractor or subcontractor is not the OM or an authorized supplier, it shall implement a risk-based process that tracks the electronic part from its origins at the OM, through and inclusive of the Government's acceptance. Traceability is applicable whether the part being supplied is a discrete part or part of an assembly. When implementing the risk-based approach, contractors and subcontractors must consider the consequences of failure of an electronic part. If the contractor or subcontractor cannot trace the electronic part through the entire supply chain, then it is responsible for inspection, testing and authentication in accordance with the existing DOD-approved industry standards. Contractors and subcontractors are obligated to document traceability and inspection, testing and authentication activities, and to maintain that documentation and provide it to the Government upon request.

Contractor risk-based processes required by this final rule are complementary to the risk-based approaches that covered contractors currently have under their approved counterfeit detection and avoidance systems pursuant to DFARS 252.246-7007. The final rule again states that contractors shall have risk-based processes that consider the consequences of part failure and enable part tracking from the OM up through the supply chain.

Summarizing the documentation requirements, the final rule does not require documentation if an

electronic part is in production. For parts not in production and purchased from a contractor-approved supplier with traceability to the OM, there is only the need to provide documentation upon request. If traceability cannot be supported, then documentation of the contractor's inspection, testing and authentication must be maintained and provided to the Government upon request.

**Cost Allowability**—The implementation costs of compliance with DFARS 252.246-7008 are not unlike any other costs incurred by the contractor or subcontractor in contract performance. Whether a cost is allowable and allocable to a contract is governed by the rules in FAR pt. 31. Unless a cost is explicitly unallowable, allowability depends on a number of factors, including reasonableness, allocability, CAS applicability, and generally accepted accounting practices. The final rule's preamble reiterates that costs are allocable if they are incurred specifically for the contract, benefit both the contract and other work, can be distributed in reasonable proportion to the benefits received, or are necessary to the overall operation of the business, regardless of whether a direct relationship to a specific cost objective can be shown. Therefore, the costs incurred for establishing and maintaining the risk-based processes, traceability, inspection, testing, authentication, etc. are all allowable unless specifically deemed unallowable under FAR pt. 31. Likewise, as the costs of compliance are not unlike other costs associated with performance under a Government contract, the preamble to the final rule expressly notes that such costs should not create an undue burden for small and medium-sized contractors.

Regarding cost allowability of contractor and subcontractor incurred costs for rework and remediation of counterfeit or suspect counterfeit parts, on August 30 DOD published a final rule expanding the safe harbor currently applicable to covered contractors under DFARS 252.246-7007. See 81 Fed. Reg. 59510–15 (Aug. 30, 2016). Effective upon the rule's publication, the costs of counterfeit electronic parts and suspect electronic counterfeit parts and the associated costs of rework or corrective action required to remedy the inclusion of such parts are unallowable *unless* (1) the contractor has an operational system to detect and avoid counterfeit and suspect counterfeit electronic parts (252.246-7007) that has been reviewed and approved by DOD pursuant to DFARS 244.303(b); (2) the counterfeit or suspect counterfeit electronic parts are Government-furnished property as defined in FAR 45.101, or were obtained by the contractor in ac-

cordance with the clause at 252.246-7008, Sources of Electronic Parts; (3) the contractor becomes aware of the counterfeit or suspect counterfeit electronic parts through its own or its subcontractor's inspection, testing and authentication efforts, through a Government-Industry Data Exchange Program (GIDEP) alert or any other means; and (4) the contractor provides timely notice to the cognizant CO(s) and GIDEP. Timely notice is defined as 60 days. Contractors must notify the COs of each contract under which the counterfeit or suspect counterfeit electronic part is a deliverable, whether as a discrete part or part of an assembly. For the safe harbor to apply, the contractor or subcontractor must meet all elements. Costs related to rework or corrective action remain unallowable if it is the Government that discovers the counterfeit nature of the electronic part.

**Applicability**—The final rule applies to all contractors and subcontractors regardless of CAS coverage or size, and regardless of whether the electronic part is a commercial or noncommercial item. Additionally, the final rule applies to acquisitions at or below the simplified acquisition threshold (SAT).

Regarding *commercial items*, the Federal Acquisition Streamlining Act, codified at 41 USCA § 1906, exempts the application of various laws for the acquisition of commercial items unless the law (a) imposes criminal or civil liability or (b) specifically refers to § 1906; or (c) the FAR Council makes a written determination and finding that it is not in the Government's best interest to exempt commercial-item acquisition contracts from the provision of the law. Similarly, commercial off-the-shelf (COTS) items are exempt under 41 USCA § 1907 unless the law (1) contains criminal or civil liabilities; (2) specifically refers to § 1907; (3) concerns authorities or responsibilities under the Small Business Act or bid protest procedures; or (4) the Office of Federal Procurement Policy administrator makes a written determination that it would not be in the Government's best interest to exempt acquisitions of COTS items from the provision of law. The director for Defense Procurement and Acquisition Policy is the appropriate authority to make such a determination. The DPAP director has determined it is in the Government's best interests to apply the requirements of § 818(c)(3) to commercial and COTS items.

Furthermore, the DPAP director determined that the final rule applies to acquisitions at or below the SAT. Section 1905, title 41 U.S. Code governs the applicability of laws to contracts or subcontracts in



amounts at or below the SAT, and is intended to limit applicability of such laws to contracts or subcontracts if the contract amount is below the SAT threshold. Like §§ 1906 and 1907, § 1905 provides that if a provision of law contains criminal or civil penalties, or if the FAR Council makes a written determination that it is not in the Government's best interest to exempt contracts or subcontracts at or below the SAT, the law will apply. As the DFARS is part of the FAR system of regulations, the DPAP director has the authority to make such a determination.

DOD notes in the preamble that counterfeit electronic parts, regardless of dollar value, can seriously disrupt the DOD supply chain, harm weapon system integrity and endanger the warfighter. Even low-value items can cause critical failure of fielded systems, including aircraft, ships and other weapon systems. As first reported in the congressional investigation precipitating § 818 and found in studies that have followed, a large proportion of counterfeit electronic parts were initially purchased as commercial or COTS items. Consequently, exempting contracts and subcontracts below the SAT, or acquisitions for commercial and COTS items, would, as DOD notes, severely decrease the intended effect of the statute and increase the risk of receiving counterfeit parts, thereby presenting a significant mission, security or safety risk.

**Small Businesses**—Small businesses are not exempt from compliance with the sources of supply requirements. Referring to § 818, DOD states in the rule's preamble that the law does not exempt small businesses from the statutory requirements. The rationale for not exempting small businesses is the same rationale used for the final rule's applicability to all DOD contractors: The risk to the DOD supply chain far outweighs the burden to small businesses. A low-dollar-value undetected counterfeit part or a COTS item procured from a small business can have the same disastrous consequences as a high-dollar item supplied by any other business regardless of size. It is further noted that small businesses supply a large portion of the counterfeit parts directly threatening the DOD supply chain.

DOD also refuted concerns, including from the Small Business Administration Office of Advocacy, that mandating small business compliance with the final rule would impose undue burdens, including the costs of compliance. Industry concern is that many small and medium-sized businesses will not have the

expertise, resources and infrastructure necessary to maintain the database of information required for compliance with the final rule. Therefore the cost impacts of compliance will deter small businesses from participating as prime and subcontractors in the Government procurement process.

Relying on FY 2015 Federal Procurement Data System data, DOD estimated there are approximately 52,168 small businesses that have DOD prime or subcontracts for the supply of electronic parts. DOD could not identify any significant alternatives that would reduce the economic impact on small businesses while maintaining the objective of the final rule. Although DOD recognized that the cost of compliance with the DFARS requirement may deter some small businesses and commercial suppliers from participating in Government procurements, DOD noted that the risks associated with counterfeit electronic parts is unacceptable. Furthermore, the implementation costs associated with DFARS 252.246-7008 are not unlike any other costs incurred when performing as a contractor or subcontractor under a Government contract. With the publication of the final rule, safe harbor for cost allowability for counterfeit and suspect counterfeit electronic parts, and the cost of rework and corrective action, will help ensure that small businesses will not be disproportionately impacted *if* the electronic parts are procured in accordance with this clause.

**Flowdowns**—This DFARS clause requires mandatory flowdown to subcontractors at any tier, regardless of size and commercial-item status. Contractors are required to flow down the substance of this clause to subcontractors at any tier. Although DFARS 252.244-7000 states that a contractor is not required to flow down any DFARS clause to any subcontractor for commercial items *unless so specified in a particular clause* like 252.246-7007, this new DFARS clause specifies the flowdown of the substance of the clauses to subcontracts for commercial-item procurements of electronic parts, components and assemblies.

The final rule does not require the flowdown of this clause to the OM of electronic parts.

**What this Means for DOD Contractors and Subcontractors**—The final rule on sources of electronic parts is the latest chapter in DOD counterfeit parts mitigation that dramatically expands procurement compliance requirements to all contractors and subcontractors performing under DOD contracts. Electronic parts must be procured in strict conformance with the hierarchical order of categories 1–3. There is

no longer a distinction between CAS-covered and non-CAS-covered contractors, prime or subcontractor tiers, noncommercial or commercial-item procurements, nor procurement values above or below the SAT. All contractors and subcontractors performing under DOD contracts for the supply of electronic parts and assemblies will need to assess and audit their supply chains, and develop and implement comprehensive risk-based approaches for the procurement of electronic parts. The careful selection of suppliers, and the inspection, testing and authentication of electronic parts that are not traceable to the OM, are consistent with industry

risk-based approaches that any prudent contractor should follow. While this final rule is the latest chapter in DOD's actions to strengthen the integrity of the electronic parts supply chain, it will likely not be the last.



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