



# Whom Can You Trust?

## Mitigating Security Risk in Industrial Base Investments

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**U**.S. COMPANIES INCREASINGLY FACE CHALLENGES FROM STATE ACTORS SEEKING TO LEVERAGE the companies to the states' advantage. The U.S. Government repeatedly has emphasized concerns about "economic aggression" against U.S. businesses carried out by potentially adverse states (and even non-state actors). These concerns are referenced in both last year's U.S. National Security Strategy and the National Defense Strategy, as well as other recent high-level government publications and announcements.

Furthermore, media reports frequently carry stories about how U.S. companies often face an uneven playing field in which other nations seek to improve their domestic firms' capabilities at the expense of U.S. businesses. Such activities include providing government subsidies that promote domestic firms, imposing market and investment barriers on foreign firms, supporting targeted overseas investments and acquisitions and even conducting industrial espionage and intellectual property theft. Both U.S. Government and news media reports most often point to China as the primary culprit for these activities, but there are others, such as Russia.

Of concern to the U.S. defense community is the impact such aggressive economic and trade policies could have on the U.S. defense industrial base. For example, last year a U.S. interagency task force produced a report on the state of the U.S.

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manufacturing and defense industrial base that highlighted the deleterious effect that opportunistic states are having on the U.S. defense industry. One area of concern stems from the rapidly increasing military potential of cutting-edge technologies, often developed by small and medium enterprises, and possibly even startups—all of them dependent upon external investments to continue operations. There are resultant concerns that adversarial states might seek to leverage investments in such companies to acquire key defense technologies critical to U.S. military capabilities, the same technologies that would otherwise be denied to the state. The state need not directly own the targeted company, either, for this potential to exist. Rather, it could exert control through several layers of ownership, in effect obscuring the true ownership and control of the company.

### **A Possible Solution: The Trusted Capital Marketplace**

To mitigate some of the risk that adversarial states pose to the U.S. defense industry, the Pentagon is launching the Trusted Capital Marketplace (TCM) project. The stated objective of this program is to connect innovative defense and technology companies with trusted investors. Doing so would help companies working on key defense or dual-use technologies find necessary capital and funding to continue to carry out research and development or conduct additional operations. The TCM project could also help minimize the risk that an investor—be it a company or individual—would be susceptible to leverage by adverse actors. Notably, the TCM is intended not just for U.S. companies but defense and technology companies of the greater National Technology Industrial Base (NTIB), which currently also includes Canada, the United Kingdom and Australia.

The TCM project includes three lines of effort to achieve this goal. First, it seeks to identify sources of innovation within the NTIB defense and technology community that are of value to the Department of Defense (DoD). Second, the program aims to develop a pool of investors that have been sufficiently screened to ensure that they are likely free of adverse foreign influence. Third, TCM seeks to provide a platform so that the identified innovative companies and the vetted investors can more readily financially engage with each other. By doing so, TCM will ostensibly allow companies to more easily identify

sources of necessary funding without the corresponding concern of wondering about the ultimate source of the funding. In addition, TCM could minimize concerns within the defense community that adverse actors are leveraging financial investments to acquire prohibited technologies.

### **Undergirding With Due Diligence Best Practices**

Due diligence has long been a standard practice within the financial and business communities, where it is used to investigate a potential investor or future business partner to confirm facts or identify possible red flags. For example, finding out later that a major investor in your firm has breached a sanctions regulation, such as by exporting goods to a sanctioned foreign entity, could lead not only to significant legal repercussions but also potentially impact the company's bottom line due to any associated reputational risks and lost business. Therefore, undertaking proper due diligence prior to an engagement not only helps companies comply with the law but also makes good business sense.

For the TCM project to succeed, the Pentagon will need to ensure that approved investors are properly screened and vetted. Drawing upon some due diligence best practices could help the program achieve its stated goals. At a minimum, the Pentagon should consider the following for its trusted investors screening program.

**Create a risk assessment.** This is a critical first step and will guide subsequent steps. The TCM project needs to ensure that it clearly identifies the potential risks it is concerned about. It also needs to characterize the identified hazards, to include likelihood of occurring, potential severity and possible impact. Categorizing the risks into risk buckets—such as low, medium and high—will help later determine how best to implement controls and where to devote resources and effort. The final risk assessment periodically should be reviewed and revised as necessary to ensure it remains relevant to evolving risk concerns.

**Develop an objective due diligence program.** Using the risk assessment developed in the previous step, identify the appropriate level of investigation into potential investors. Prioritization of resources and efforts should be on

investigating those subjects that fall into higher-risk categories. However, given the objective of the TCM project, identification of key pieces of information should be required for all potential TCM funding pool participants. These key components should include checks into the following:

- Adverse media
- Sanctions, watch lists and other enforcements
- State ownership
- Beneficial ownership (discussed more fully below)
- Corporate registration and corporate affiliations
- Regulatory and litigation fines and other enforcements

**Conduct the appropriate due diligence on potential investors.** All potential investors should undergo the prescribed level of due diligence prior to consideration for inclusion in the pool of trusted investors. The outcome of the due diligence investigation into the potential investor

consider additional due diligence on the identified beneficial owner(s) as well.

**Identify important third-party relationships.** Who else does the investor fund? With what other organizations does the funder engage? Casting a wide net to clarify important business relationships that the potential investor currently has would help provide a better understanding of any possible hazards. For investments considered particularly high-risk due to sensitive defense technologies or large sums of money involved, additional due diligence into key third-party relationships should be conducted.

**Monitor and routinely rescreen.** Investment into and ownership of firms changes frequently, as do any associated risks. Appropriate monitoring should occur at least monthly to quickly capture any newly emerging adverse information that could potentially disqualify a trusted



should be a key determinant when considering whether to approve an investor's application. At the same time, however, to safeguard a funder's wellbeing and not scare off potential investors, any information gleaned during the due diligence process should be considered sensitive, and not used other than to decide whether to approve the investor's application.

**Establish ultimate beneficial ownership.** Understanding the ownership of important partners has always been a sound business practice. However, while many due diligence programs often stop at identifying immediate ownership only, the TCM project should, where relevant, seek to identify the ultimate beneficial owner(s) of any potential investor. Beneficial ownership, different than legal ownership, refers to anyone who enjoy the benefits of ownership without being on the record as the owner. In effect, the beneficial owner(s) would have ultimate effective control. Identifying who truly controls a company is not always easy, as the information may be hidden behind opaque ownership and control structures. But it is crucial to understanding with whom one is really doing business. Depending upon the outcome, it may be worthwhile to

investor. In addition, continued status as a trusted investor should be contingent upon an annual rescreening to ensure risk profiles remain accurate with the current situation.

### **Conclusion**

The TCM project seeks to provide the DoD with an important tool to ensure that key innovative companies can continue to research and develop cutting-edge defense technologies without fear of undue influence by adversarial states. To help achieve this goal, the DoD should draw upon due diligence best practices. Financial institutions and corporations have long used due diligence screening to help identify any potential red flags in a financial or business engagement prior to finalizing the engagement, thus avoiding what could be significant legal or financial problems later. The same procedures could be used to help screen potential investors in key defense and technology companies. Doing so would help to ensure that innovative defense and technology companies maintain access to capital critical for continued operations, while minimizing their exposure to adverse foreign influence.

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