U.S., Mexico, Canada Agree to Update NAFTA

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After more than a year of sometimes contentious negotiations, the United States, Mexico, and Canada (the "Parties") reached an agreement late Sunday night to revise the North American Free Trade Agreement ("NAFTA")—renaming it the U.S.-Mexico-Canada Agreement ("USMCA"). The new agreement has many points of continuity with prior U.S. FTAs. For example, it incorporates important disciplines on digital trade from the Trans-Pacific Partnership ("TPP") Agreement, and it eliminates certain foreign market access barriers (e.g., dairy) faced by U.S. exporters, in line with the traditional market-opening objective of U.S. FTAs. But the USMCA also departs significantly from past U.S. FTAs in other ways, e.g., by establishing stricter and more complex rules of origin for vehicles and vehicle parts, drastically reducing the scope of investor-state dispute settlement, and introducing a sunset provision. These elements of the agreement reflect the Trump Administration's skepticism of globalism, and its belief that NAFTA and other FTAs have undermined the U.S. industrial base by overexposing U.S. companies and workers to international competition. As the Administration's first major attempt to translate this outlook into detailed, concrete international rules, the USMCA provides an important signal of the Administration's likely negotiating stance in potential future FTAs and FTA renegotiations.

It is important to recognize that the USMCA still has to clear major hurdles, as the U.S., Canada, and Mexico must each ratify the agreement in their domestic legal systems before it can enter into force. In the U.S., that will require Congress to pass implementing legislation. Under Trade Promotion Authority ("TPA") legislation enacted in 2015, the Administration can secure an up-or-down vote on the USMCA implementing bill, but a statutorily-mandated period of time must pass (in order to allow for full Congressional and public consideration of the agreement) before the Administration may submit a draft bill and supporting materials to Congress. As a result, the President will not be able to enter into (i.e., sign) the USMCA until November 29, 2018, and the earliest that the Administration may submit the draft bill is 30 days thereafter (i.e., December 29, 2018). Once the bill is introduced, Congress will have a maximum of 90 days to vote on it, without amendments.

The updated USMCA is extremely lengthy and contains many new chapters and provisions. Some of the key outcomes include the following:

- **Vehicles and vehicle parts**: One of the Trump Administration's chief objectives in the negotiations was to modify the NAFTA rules of origin for vehicles and vehicle parts (including passenger cars, light trucks, heavy trucks, and parts thereof) in order to increase North American production in general, and U.S. production in particular. The new agreement seeks to achieve this objective by changing the criteria that these products must meet in order to qualify as "originating" in the USMCA countries, and therefore to become eligible for duty-free treatment. Under the new rules, a vehicle or vehicle part must satisfy, first of all, a regional value content ("RVC") requirement, meaning that a certain proportion of the item's value must come from inputs that are themselves originating in the USMCA countries. Although NAFTA also had an RVC requirement, the USMCA's is stricter (with the precise percentages escalating over time after the USMCA enters into force, and also varying for different types of vehicles and vehicle parts).

In addition to the RVC requirement, the USMCA imposes three new rules-of-origin requirements for vehicles and vehicle parts, which have no precedent in NAFTA or any other U.S. free trade agreement. These are: (1) a labor value content ("LVC") requirement, which requires producers to certify that their annual production achieves a certain level of expenditures on labor and certain types of high-wage activity (defined in terms of a $16 per hour average production wage); (2) a steel/aluminum content requirement, which requires that at least 70% of the vehicle producer's purchases of both steel and aluminum in North America originate in USMCA countries; and (3) a regional part requirement (applicable to passenger vehicles and light trucks only), requiring that certain principal vehicle parts originate in the USMCA countries.[1] The agreement permits the Parties to temporarily relax these requirements under an "alternative staging regime," which will be permitted until January 1, 2025, or 5 years after the entry into force of the agreement, whichever is later.

Overall, these new requirements may cause some companies to shift portions of their production chains to USMCA countries, and otherwise boost investment in USMCA countries, to obtain USMCA certification for vehicles and vehicle parts. By the same token, other companies may decide that complying with the USMCA's stricter rules of origin is too costly or cumbersome, leading them to shift production to third countries and import vehicles into the U.S. subject to the existing 2.5% MFN tariff that applies to imports of passenger cars. This strategy may not be viable, however, if the Trump Administration uses Section 232 (the national security provision that it has already used to impose steel and aluminum tariffs) to impose restrictions on imports of autos and auto parts, as is currently under consideration.

- **Investor-state dispute settlement (ISDS)**: NAFTA included a broad ISDS mechanism that enabled investors to sue NAFTA parties directly in the event of expropriation, discrimination, or unfair and inequitable treatment. Since then, every U.S. FTA (including TPP) has included an ISDS mechanism with only modest limitations. However, the USMCA departs from past practice by drastically reducing the scope of ISDS, in three important ways. First, except for Legacy Claims (e.g., investment arbitrations that are ongoing under the NAFTA), the provision will be phased out as between the U.S. and Canada. Second, the U.S. and Mexico agreed to limit the scope of potential investor-state claims under the USMCA to claims for discrimination and direct expropriation. Only parties to covered government contracts in certain industries (oil and natural gas, power generation services, telecommunications services, transportation services, and ownership or management of infrastructure) can bring claims for breach of the other substantive obligations in Chapter 14 (including fair and equitable treatment and indirect expropriation). Third, for disputes not involving covered government contracts, the USMCA requires that a would-be claimant first litigate the challenged measure in domestic courts until it receives a final judgment or 30 months have passed. Overall, these changes reflect the Trump Administration's skepticism about ISDS, based on a view that it reduces the political risk associated with offshoring U.S. jobs.

- **Dairy**: Canada's dairy supply management system was a key flashpoint in USMCA negotiations. The supply management system includes tariff rate quotas ("TRQs") on a variety of imported dairy products, with tariffs for products outside the quota generally exceeding 200% (as President Trump has noted in public comments). Furthermore, in 2017, Canada adopted a new "Class 7" pricing scheme to boost domestic supplies of Canadian skim milk components, which reduced U.S. exports of high protein ultra-filtered (UF) milk.

  When NAFTA was concluded, it generally left Canada's dairy protections unaddressed. However, in the USMCA, Canada agreed to establish new TRQs exclusively for the United States, effectively guaranteeing U.S. exports certain (albeit limited) market access. Furthermore, Canada agreed to eliminate Class 7 pricing (as well as Class 6 pricing, a similar scheme specific to Ontario), which will modestly expand additional opportunities for U.S. exporters of UF milk.

  That said, Canada and Mexico have imposed tariffs on certain U.S. dairy products in retaliation for U.S. tariffs on Canadian and Mexican steel and aluminum, imposed pursuant to Section 232. The Parties have not yet resolved the Section 232 tariffs issue (as discussed below). Accordingly, it remains unclear to what extent the USMCA's dairy outcomes will translate into increased market access for U.S. dairy exporters.
- **Digital Trade**: USMCA contains a digital trade chapter that largely tracks TPP's e-commerce chapter. For example, the chapter prohibits Parties from applying customs duties to digital products distributed electronically; prohibits restrictions on cross-border data flows and requirements to store or process data in-country (data localization requirements); limits Parties' ability to require disclosure of proprietary computer source code and algorithms; and provides for safe harbors against intermediary liability for Internet platforms.
- **De Minimis**: Canada agreed to raise the "de minimis" thresholds for express shipments – i.e., the minimum value of imported goods not subject to customs duties and sales taxes – to C$150 (US$117) for customs duties and C$40 (US$31) for sales taxes (currently the limit is C$20 for both customs duties and sales taxes). Higher de minimis thresholds tend to boost e-commerce, which often involves cross-border shipments of lower-value goods.
- **Sunset**: During the negotiations, the Trump Administration insisted on a sunset provision that would provide for the updated agreement to terminate automatically in 5 years, absent

an affirmative agreement between the Parties to extend it. The USMCA provides instead that the agreement will terminate in 16 years, unless all Parties confirm in writing their wish to extend the agreement for another 16 years. Required joint reviews (beginning 6 years after entry into force, and potentially repeating annually in the absence of an agreement to extend the USMCA) will provide periodic opportunities to negotiate such an extension. Thus, while Canada and Mexico appear to have accommodated the U.S. demand for a sunset provision, the USMCA's distant expiration date and the required joint reviews should significantly reduce the risk that termination would actually occur.

- **Trade Remedies Dispute Settlement**: Another flashpoint in the negotiations was NAFTA Chapter 19, which allows binational panels of trade lawyers to substitute for domestic courts in reviewing domestic antidumping and countervailing duty determinations. The Administration called for the elimination of Chapter 19, due to concerns that it impinged U.S. sovereign rights to impose trade remedies in accordance with domestic U.S. laws. However, Canada and Mexico support Chapter 19, because they view it as a more favorable forum for litigating U.S. trade remedy determinations than U.S. federal courts. In a concession to Canada, the USMCA retains Chapter 19 (now renumbered as Chapter 10) largely unchanged, though with some technical adjustments and procedural enhancements.
- **Currency Manipulation**: No U.S. FTA has ever established disciplines on competitive devaluation of exchange rates. Although the Administration attempted to strike a deal with Korea on currency manipulation as part of the renegotiation of KORUS, thus far no such agreement has materialized.

  For the first time, the USMCA addresses currency manipulation through a dedicated chapter on macroeconomic policies and exchange rate matters. Each party confirmed that it is bound by International Monetary Fund rules to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage." The Parties agreed that they "should" achieve and maintain a market-determined exchange rate regime; refrain from competitive devaluation, including through intervention in the foreign exchange market; and strengthen underlying economic fundamentals, which reinforces the conditions for macroeconomic and exchange rate stability. The chapter also sets out certain transparency and reporting requirements, which will be subject to the agreement's dispute settlement provisions. These provisions are likely aimed at countries outside the USMCA, representing a new international legal benchmark for exchange rate practices that certain countries (e.g., China) have violated in the past.
- **Non-Market Country FTA**: In a move likely intended to prevent any future FTAs between USMCA countries and China, the Parties included a provision (another first in any U.S. FTA) requiring a Party to notify the others of its intention to begin free trade agreement negotiations with a non-market country at least three months prior to commencing the negotiations. Should a Party enter into a trade agreement with such a country, the other two parties would have the right to terminate the USMCA on six-months' notice and replace it

with a bilateral agreement.

- **Government Procurement**: The Trump Administration sought during the negotiations to revise the NAFTA procurement chapter through a so-called “dollar for dollar” approach that would have reduced Canadian and Mexican access to the U.S. market. The USMCA goes even further by eliminating the chapter altogether as between the United States and Canada. Going forward, the two countries will address government procurement issues solely under the WTO Agreement on Government Procurement. This change presumably reflects the Administration’s broader focus on strengthening “Buy America” policies.
- **Intellectual Property**: The intellectual property chapter is similar to the equivalent chapter in the TPP Agreement, but it does include some important differences. For example, the agreement provides for a minimum of 10 years of biologic drugs patent protection; under TPP, this period was five to eight years. It will also require a copyright term of the life of the author plus 70 years (the TPP Agreement had included a similar provision, but it was dropped when the U.S. withdrew). Currently, in Canada, the copyright term is the life of the author plus 50 years. In a nod to advocates of stronger IP protection for content, the USMCA dropped language on so-called “fair use” exceptions to copyright law that had been included in TPP.
- **Financial Services**: The financial services chapter breaks new ground by expanding the list of financial services that may be supplied on a cross-border basis to include investment advice and portfolio management for collective investment schemes; electronic payment services; and (in the case of Mexico) insurance services that are not being supplied by home country suppliers. In another first, the chapter prohibits data localization requirements as they pertain to financial institutions and certain other regulated financial services suppliers. The TPP Agreement excluded the financial services sector from the equivalent provision in that agreement.
- **Labor**: The USMCA includes an enforceable (through state-to-state dispute settlement) chapter on labor – in contrast to NAFTA, which addressed labor issues in an unenforceable side agreement. An annex to the labor chapter contains commitments by Mexico to adopt, by January 1, 2019, legislation establishing “(i) an independent entity for conciliation and union collective bargaining agreement registration and (ii) independent Labor Courts for the adjudication of labor disputes.” In combination with the $16 production wage rate for vehicles and vehicle parts (discussed above), these provisions represent significant steps by the Trump Administration to address concerns that NAFTA contributed to a “race to the bottom” through low-wage competition with Mexico.

- **Environment**: As with the labor chapter, the USMCA replaces NAFTA’s unenforceable side agreement on the environment with a dedicated chapter that is subject to the agreement’s dispute settlement provisions. Although parts of the chapter are aspirational – encouraging Parties to “consult” and “cooperate” in areas such as air pollution, marine debris and sustainable forestry – other areas are prescriptive. For example, it contains strong language prohibiting any Party from failing to “effectively enforce its environmental laws” in a manner that affects trade between the Parties, and requires Parties to provide access to domestic venues for enforcement of that Party’s environmental laws. It prohibits certain fisheries subsidies, and it contains strong provisions intended to combat wildlife trafficking and unregulated fishing. The environment provisions also place greater emphasis on public participation. Notably, the USMCA maintains NAFTA's Commission for Environmental Cooperation ("CEC"), an international tribunal where any "person" may submit an enforcement matter asserting that a Party is failing to enforce its environmental laws. The CEC, however, has no power to order remedial actions, and its effectiveness has been met with mixed reviews.

The Trump Administration described the USMCA as containing "the most comprehensive" set of enforceable environmental obligations of any U.S. trade agreement. Environmental groups may not share that view, especially in light of the agreement's omission of the term "climate change."

In addition to the agreement itself, the Parties also negotiated several side letters, including four (two with Canada, and two with Mexico) regarding potential future U.S. import restrictions imposed pursuant to Section 232 of the Trade Preferences Extension Act of 1962 (as amended) (i.e., the national security provision that the Administration has already used to impose steel and aluminum tariffs, and pursuant to which the Administration is considering restrictions on imports of autos and auto parts). Two of the side letters stated that if the U.S. imposes Section 232 import restrictions on autos, light trucks, or auto parts, the U.S. will exclude:

- 2.6 million passenger vehicles imported from Canada/2.6 million passenger vehicles imported from Mexico on an annual basis;
- Light trucks imported from Canada/Mexico; and
- Such quantity of auto parts amounting to $32.4 billion for Canada/$108 billion for Mexico in declared customs value in any calendar year.

The other two side letters state that the U.S. shall not adopt or maintain a measure imposing import restrictions on Canadian goods or services under Section 232 "for at least 60 days after imposition of a measure. During that 60-day period, the United States and Canada shall seek to negotiate an appropriate outcome based on industry dynamics and historical trading patterns."

The USMCA does not contain an agreement on the existing steel and aluminum tariffs, which Administration officials have stated are being negotiated on a separate track.

We will continue to assess the agreement and monitor related developments. Please contact us if you have any questions.

1. Article 4-B.3(7).

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