Hogan Lovells

AFTA NAFTA: USMCA and the path forward

25 October 2018

The good news: U.S., Mexico, and Canada strike USMCA deal

On 30 September, after an intensive, last-minute flurry of negotiations, Canada joined the United States and Mexico in a new trilateral agreement to replace the original North American Free Trade Agreement (NAFTA 1.0). The new agreement, now renamed the "U.S.-Mexico-Canada Agreement" (USMCA), will replace NAFTA 1.0 if and when it is approved by the U.S. Congress, Canadian Parliament, and Mexico's Congress of the Union.

The USMCA brought a sigh of relief from U.S. business and agriculture, which feared a precipitous and damaging U.S. withdrawal from NAFTA 1.0. U.S. companies, trade associations, and farm groups were concerned that an abrupt NAFTA 1.0 breakup would seriously disrupt existing supply chains and sourcing arrangements and potentially cost U.S. farmers, service providers, and manufacturers access to their top two export markets.

Like every serious trade negotiation, the USMCA endgame required compromises from all parties. The Trump administration backed away from earlier demands to terminate NAFTA 1.0's binational dispute settlement mechanism for anti-dumping (AD)/countervailing duties (CVD) cases, abolish Canada's "cultural exception," and settled for more limited market access improvements under Canada's dairy supply management regime. There was no agreement to eliminate U.S. Section 232 tariffs on Canadian and Mexican steel and aluminum imports and Canadian and Mexican retaliatory measures, all of which remain in effect, although negotiations will continue. For their part, Mexico and Canada acceded to tougher auto rules of origin and limits on certain provisions of NAFTA 1.0, e.g., investor-state arbitration.

With days to go before the 1 October target date specified by the Office of the United States Trade Representative (USTR) for notifying Congress of the text of a Mexico-only agreement and the talks at an apparent impasse, the United States and Canada entered into round-the-clock negotiations in an effort to resolve their remaining issues in time for Mexican President Enrique Peña Nieto to sign the agreement by 30 November before leaving office.

As anticipated, the last issue to be resolved was NAFTA 1.0's binational panel review mechanism for anti-dumping and countervailing duty orders, which Ambassador Lighthizer has long wanted to eliminate, but has been a top priority for Canada dating back to the 1988 U.S.-Canada Free Trade Agreement. In the end, the two sides compromised on minor procedural tweaks to the panel review process. The dairy issue was largely settled on the basis of Canada's Trans-Pacific Partnership (TPP-12) market access commitments, which open 3.5 percent of the Canadian dairy

market to U.S. dairy products. In addition, Canada agreed to phase out its Class 7 milk-pricing scheme, which was adopted in 2017 and has the effect of limiting imports of U.S. ultra-filtered milk.

The final deal includes the following:

- Auto rules of origin – The agreement raises the rules of origin from 62.5 to 75 percent for passenger vehicles and light trucks over a three-year period, including requirements that 70 percent of steel and aluminum content originate in North America and that 40-45 percent of a vehicle be produced by workers paid US$16 or more. The wage provisions, in effect, require that part of the vehicle must originate in the United States or Canada. In an important shift, the current draft appears to eliminate NAFTA 1.0's automotive tracing requirements, which date back to the U.S.-Canada FTA. Instead, the USMCA substitutes specific regional value content (RVC) requirements for key parts and components. This should simplify rule of origin calculations somewhat, although the impact on the origin of specific vehicles is likely to vary. The draft agreement includes side letters that exempt 2.6 million Mexican passenger vehicles and light trucks and US$108 billion of auto parts from future U.S. tariffs imposed under Section 232 of the Trade Expansion Act of 1962. Likewise, Canada received an exemption for 2.6 million vehicles and US$32.3 billion of auto parts. Both figures are well above current trade levels and thus unlikely to bite for some time.

- ISDS – The investor-state dispute settlement (ISDS) mechanism was eliminated for Canada and is now limited to Mexico only. Legacy claims involving U.S. investors in Canada and Canadian investors in the United States may proceed under the terms of NAFTA 1.0, and new claims may be presented for three years after the USMCA enters into force. These transition provisions are necessary because, unlike most U.S. bilateral investment treaties (BITs), NAFTA 1.0 does not contain a clause permitting claims after its termination.

- Moreover, under Annex 14-D, the scope of U.S.-Mexico ISDS is limited to national treatment, most-favored nation (MFN), and expropriation, omitting other investment obligations, e.g., minimum standards of treatment (MST). In addition, the USMCA incorporates language from the TPP-12 that limits the definition of indirect expropriations to situations "in which an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure" and clarifies that "[n]on-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriations, except in rare circumstances." This language limits the scope of ISDS claims and aims to curb some of the most vociferous criticisms of NAFTA 1.0, as several controversial NAFTA 1.0 ISDS cases involved challenges to various environmental measures as regulatory takings or indirect expropriations. Under the USMCA, U.S.-Mexico ISDS disputes involving government contracts are limited to specific sectors, e.g., energy, telecommunications, power generation, etc. This limitation does not apply to ISDS claims not involving government contracts.

- Currency manipulation – While the Trump administration has touted its enforceable new rules regarding currency manipulation, the final USMCA provisions are limited and underscore the U.S. Department of Treasury's continued skepticism about allowing free trade agreement (FTA) arbitral panels to delve too deeply into currency issues. Enforcement is limited to certain transparency and notification obligations, which require a party to disclose certain International Monetary Fund (IMF) reports and quarterly data on official reserves,

currency interventions, capital flows, imports, and exports. There is no authority for USMCA panels to examine the legitimacy of a party's currency practices or find that it has engaged in "currency manipulation." Moreover, any sanctions are limited to the adverse impact of failing to comply with the transparency rules and thus are unlikely to amount to much.

- Non-market economies – The USMCA contains a new provision that allows a party, e.g., the United States, to terminate the agreement if another party enters into an FTA with a non-market economy, e.g., China.

- Labor/environment – The agreement builds on the Bush 43 administration's "May 10" framework for enforceable labor and environmental rules. This framework was adopted in the U.S.-Korea, U.S.-Peru, U.S.-Colombia, and U.S.-Panama FTAs and in TPP-12. It adds an "Annex on Worker Representation in Collective Bargaining in Mexico," which requires Mexico to amend its labor laws to better protect the right of workers to organize unions, a priority for many congressional Democrats. With respect to the environment, the USMCA incorporates TPP-12's provisions on various aspects of environmental conservation (e.g., fisheries subsidies, shark finning, and invasive alien species) and adds new provisions for cooperation on air quality and marine litter.

- Pharmaceuticals/biologics – The USTR secured 10 years of protection for biologic medicines, which was a top priority for Senate Finance Committee Chairman Hatch (R-UT), and includes traditional provisions regarding data exclusivity, linkage, and patent term extension. Both the U.S.-Korea and U.S.-Australia FTAs contained provisions requiring greater transparency of pharmaceutical pricing and reimbursement procedures, an important consideration in single-payer health care systems where the government is the main purchaser. This included a right of independent review of government pricing decisions. These protections were rolled back in TPP-12 and dropped entirely from the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP-11), but have resurfaced in the USMCA. Certain provisions that were discretionary in TPP-12 have been restored to "shall," but the USMCA retains TPP-12's exclusion of the med-pharm transparency rules from dispute settlement.

- Intellectual property – The intellectual property chapter of the USMCA provides for a minimum copyright term of life of the author plus 70 years. It seeks to limit the scope for geographic indications that could affect existing trademarks (e.g., Budweiser) and generic product names, particularly ones that are commonly used for U.S. cheese (e.g., parmesan) and food products. The USMCA includes a safe harbor for internet service providers modeled on the U.S. Digital Millennium Copyright Act, which requires the timely take down of infringing material. In return, the USMCA protects internet service providers (ISPs) from copyright and criminal liability for the unauthorized actions of their users under a provision drawn from Section 230 of the Communications Decency Act (47 U.S.C. § 230).

- Digital trade – Like TPP-12, the USMCA prohibits data localization requirements and restrictions on cross-border data flows.

- Agriculture – Apart from the dairy issues, the USMCA ends Canada's grain grading system, which designated U.S. wheat and other foreign grains as low-grade. Canada will provide limited improvements in U.S. market access through new tariff rate quotas for chicken, eggs, turkey, and broiler hatching eggs.

- Financial services – Much of the USMCA's financial services chapter tracks TPP-12. In addition, the USMCA chapter incorporates new language governing digital commerce, which

prohibits any party from preventing a financial institution from transferring information, including personal information, into and out of its territory by electronic or other means or restricting a financial institution from locating computing facilities abroad, as long as regulatory authorities have immediate, direct, complete, and ongoing access to information for regulatory and supervisory purposes. While the agreement allows cross-border transfers of personal data, it now requires each party "shall adopt or maintain a legal framework that provides for the protection of personal information." The national treatment and MFN provisions of the USMCA's financial services chapter carry forward TPP-12's language regarding "like circumstances," which is a departure from the General Agreement on Trade in Services (GATS) and narrows the application of both obligations. While the financial services chapter is subject to ISDS, the procedure is now limited to the United States and Mexico, limits expropriation claims somewhat, and imposes additional procedural hurdles.

- Finally, in a major breakthrough, for U.S.-Mexico ISDS disputes, the ad ref agreement expands the range of permissible financial services claims to cover core investment obligations, including national treatment, MFN, and expropriation. In contrast, TPP-12 and most past U.S. FTAs limited financial services ISDS claims to expropriation, minimum standard of treatment, and an assortment of secondary obligations.

- Energy – NAFTA 1.0's energy chapter was dropped, apart from a new provision recognizing that control over hydrocarbon resources is a matter of Mexican sovereignty. Limiting foreign participation in Mexico's energy sector has been a priority for the incoming Mexican President Andrés Manuel López Obrador. This could open the door for Mexico to roll back some of the liberalization of the energy sector implemented under Mexican President Enrique Peña Nieto. Ensuring a continued supply of Mexico's energy products was a key goal of NAFTA 1.0 in the wake of the Organization of the Petroleum Exporting Countries (OPEC) oil crisis, although the need for energy in the United States has been mitigated somewhat by the fracking revolution.

- Rights of indigenous peoples – In an apparent bow to Canada, the agreement recognizes the rights of indigenous peoples.

- TPP-12 chapters – One of the top upsides of the draft agreement is that it updates NAFTA 1.0 by incorporating TPP-12's chapters regarding state-owned enterprises, good regulatory practices, small and medium enterprises, anti-corruption, and various sectoral annexes involving industry standards. Reflecting ongoing improvements in U.S. FTAs over the past two decades, the USMCA incorporates important improvements from TPP-12 to NAFTA 1.0's chapters regarding e-commerce, sanitary and phytosanitary procedures (SPS), technical barriers to trade (TBT), customs, and customs procedures.

As noted, the United States dropped controversial proposals to eliminate Chapter 19's binational panel mechanism for review of AD/CVD decisions and abolish Canada's cultural exception. Other controversial poison pills that were dropped include:

- NAFTA Chapter 20 – The Trump administration originally proposed making NAFTA 1.0's government-to-government dispute settlement provisions advisory. This would have gutted the agreement by making it unenforceable. While there have been very few Chapter 20 disputes, it is the mechanism for enforcing a party's rights if another party violates the FTA. The Chapter 20 mechanism has been moved to Chapter 31 but remains largely intact.

- Sunset – The U.S. dropped its demands for a five-year sunset clause. Instead, the USMCA agreement terminates 16 years after the date of its entry into force unless each party confirms it wishes to continue the agreement for a new 16-year term. As under NAFTA 1.0, any party can withdraw on six-month notice; as a result, it was never clear why a sunset clause was necessary.
- Government procurement – The United States backed away from controversial proposals that would have severely restricted Canadian and Mexican access to the U.S. government procurement market.
- Section 201 – The United States backed away from proposals to abolish a NAFTA 1.0 provision requiring that the inclusion of Canadian or Mexican products in a global safeguard (Section 201 of the Trade Act of 1974) requires a finding that they account for a "substantial share" of imports and "contribute importantly" to serious injury to the U.S. domestic industry. These NAFTA 1.0 exceptions were maintained in the final text. However, certain procedural protections contained in the NAFTA 1.0 have been significantly weakened.

In sum, the changes to NAFTA 1.0 were limited and, apart from the auto and dairy sectors, are unlikely to significantly alter existing trade and investment flows. Much of the original NAFTA 1.0 remains intact or survived with minor or cosmetic updating. The addition of new TPP-12 chapters updates the agreement to reflect new development in U.S. trade since the original NAFTA 1.0's entry into force in 1994. Despite the chaotic negotiating process to date and the legislative uncertainties that lie ahead, credit goes to Ambassador Lighthizer, Canadian Minister Freeland, Mexico's Economy Minister Guajardo, and President-elect Andrés Manuel López Obrador's designated negotiator Seade for steering the NAFTA 1.0 renegotiation to a final deal that improves and updates certain NAFTA provisions, avoids major damage, and most importantly, appears to be something President Trump apparently can live with. Given President Trump's harsh rhetoric during the 2016 campaign, the outcome could have been much worse. In that sense, this is a good outcome that many considered almost impossible considering the parties' original positions and the accompanying obstacles to a successful negotiation.

Now the bad news: USMCA still needs congressional approval

Despite the glow of the administration's successful USMCA deal, the agreement will not enter into force unless approved by Congress. Until then, like other trade agreements, the USMCA is just a piece of paper. As with other recent trade votes, congressional approval is likely to represent a difficult, uncertain, tortuous, and politically fraught process.

One of the big wild cards is whether the Democrats will take the House of Representatives or Senate. Democratic control of the House, in particular, would be a major challenge. Recent House trade votes have been cliffhangers, including the Dominican Republic–Central America Free Trade Agreement (CAFTA–DR) (217-215), the Trade Act of 2002 (215-212), and the Bipartisan Congressional Trade Priorities and Consultation Act of 2015 (218-208). Most Democrats have opposed these efforts at trade liberalization. While Lighthizer made a major effort to court congressional Democrats and the unions, both Republican and Democratic congressional staffers have been uniformly skeptical that at the end of the day a significant number of House Democrats will support a major USMCA bill or give President Trump a big win. NAFTA remains controversial and deeply unpopular, and it seems doubtful that Trump's changes will alter this equation.

Under the Bipartisan Congressional Trade Priorities and Accountability Act of 2015, 19 U.S.C. 4021 note, the congressional approval process will be subject to the Trade Promotion Authority (TPA) procedures. Under TPA procedures,

- the administration has up to 60 days after the agreement is signed to submit a list of changes to U.S. law that will be needed for the deal to take effect;
- the U.S. International Trade Commission must prepare a report assessing the agreement's potential economic impact 105 days after the agreement is signed;
- the administration must submit to Congress the final text of the implementing legislation and a draft statement of administrative action (SAA) 30 days before the bill is formally introduced;
- the Senate Finance Committee and House Ways and Means Committee will review the draft implementing bill, hold hearings, a mock mark-up, and if necessary a mock conference on the draft implementing bill. While the administration is not required to accept the committees' changes, it normally tries to do so;
- the House Ways and Means Committee can take up to 45 days in session to consider and report the bill back to the floor. If they do not report the bill after 45 session days, it is automatically discharged;
- the Constitution and TPA rules mandate the House must vote first with debate limited to 20 hours. The bill is non-amendable under the TPA and needs enough votes to pass in a straight up-and-down vote, at which point it will be reported to the Senate;
- the Senate Finance Committee will have up to 15 session days to consider the House bill before it is discharged;
- the Senate has 30 session days to vote. Debate is again limited to 20 hours, and the bill can pass with support from a majority of members voting;
- the president signs the implementing bill into law. The bill gives the president and USTR authority to implement the agreement by proclamation; and
- the USTR will monitor the implementation of Canada's and Mexico's commitments. When the USTR is satisfied, it will tell the White House to put the agreement into force through a presidential proclamation.

The fun should start next year.

Contacts

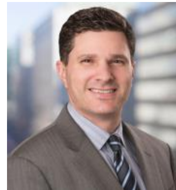
Warren H. Maruyama
Partner, Washington, D.C.
T +1 202 637 5716
warren.maruyama@hoganlovells.com

H. Deen Kaplan
Partner, Washington, D.C.
T +1 202 637 5799
deen.kaplan@hoganlovells.com

Robert D. Kyle
Partner, Washington, D.C.
T +1 202 637 5494
robert.kyle@hoganlovells.com

Craig A. Lewis
Partner, Washington, D.C.
T +1 202 637 8613
craig.lewis@hoganlovells.com

Chandri Navarro
Partner, Washington, D.C.
T +1 202 637 5640
chandri.navarro@hoganlovells.com



Jonathan T. Stoel
Partner, Washington, D.C.
T +1 202 637 6634
jonathan.stoel@hoganlovells.com

Juan Francisco Torres Landa Ruffo
Office Managing Partner, Mexico City
T +52 55 5091 0157
juanf.torreslanda@hoganlovells.com

M. Jorge Yáñez V.
Partner, Monterrey, Mexico City
T +52 81 8220 1528 (Monterrey)
T +52 55 5091 0165 (Mexico City)
jorge.yanez@hoganlovells.com

Jared R. Wessel
Counsel, Washington, D.C.
T +1 202 637 6472
jared.wessel@hoganlovells.com

www.hoganlovells.com

"Hogan Lovells" or the "firm" is an international legal practice that includes Hogan Lovells International LLP, Hogan Lovells US LLP and their affiliated businesses.
The word "partner" is used to describe a partner or member of Hogan Lovells International LLP, Hogan Lovells US LLP or any of their affiliated entities or any employee or consultant with equivalent standing. Certain individuals, who are designated as partners, but who are not members of Hogan Lovells International LLP, do not hold qualifications equivalent to members.
For more information about Hogan Lovells, the partners and their qualifications, see www. hoganlovells.com.
Where case studies are included, results achieved do not guarantee similar outcomes for other clients. Attorney advertising. Images of people may feature current or former lawyers and employees at Hogan Lovells or models not connected with the firm.
© Hogan Lovells 2018. All rights reserved.