

A closer look at the USTR Summary of Objectives for the NAFTA Renegotiation

On July 17, 2017, the Office of the United States Trade Representative (USTR) issued a Summary of Objectives for the NAFTA Renegotiation (the Summary). The Summary, required to be published under US law before formally commencing the renegotiation, identifies the objectives of the Trump Administration (the Administration) regarding the North American Free Trade Agreement (NAFTA), and provides an insight into the issues that will be on the table in upcoming negotiations.

One of the fundamental objectives of the Administration in the negotiations is the reduction of the US trade deficits with its NAFTA partners. In the Administration's view, there is a causal connection between the NAFTA and trade deficits, which the Administration views as inherently negative. The Summary also signals the Administration's belief that trade agreements have the ability to resolve trade imbalances. While these propositions are controversial among economists and trade specialists, they provide an insight into how the Administration will measure success and how it will seek to advance its negotiating priorities.

Overall, the Summary did not cause excessive alarm in Canada and Mexico. Many of the elements restate the fundamental purposes of the NAFTA and nothing suggests a rejection of free trade per se. For example, the Summary reaffirms the maintaining of duty-free access and promotes regional integration. Many of the items proposed for renegotiation offer an opportunity for the parties to improve trade across the continent, and to modernize the NAFTA to reflect current economic and trade priorities.

The Summary sets out in significant detail the items on which the US will be pressing Canada and Mexico. Beyond the headlines, this alert takes a closer look at some of the highlights that are most likely to be of interest to our clients.

Trade in goods

Fundamentally, the Administration has affirmed its desire to maintain existing reciprocal duty-free market access for industrial goods and to strengthen disciplines on non-tariff barriers. Even in the historically sensitive area of textiles and apparel, the objective is to maintain existing duty-free access "while taking into account US import sensitivities".

On agricultural goods, the US wants to maintain current duty-free access but will seek an elimination of non-tariff barriers for American agricultural exports, including tariff rate quotas. The Summary thus squarely takes aim at Canada's supply-management system for dairy,

eggs and poultry. Making any concessions on supply management will be very challenging for the Government of Canada. Canada was able to make some concessions acceptable to its trading partners in the recently-concluded Canada Europe Comprehensive Economic and Trade Agreement (CETA) and in the Trans-Pacific Partnership Agreement (TPP). These concessions involved primarily the increase in duty-free quota available for exporters in the signatory states.

In Mexico, the objective to "[i]mprove the US trade balance and reduce trade deficit with NAFTA countries" has raised concerns and created uncertainty. While the USTR clearly states its intention to maintain duty-free access for industrial and agricultural goods, if addressing trade deficits is the measure of success, the US may seek to impose trade barriers or tariffs, particularly in the manufacturing sector, in order to "correct" such deficits. This would be completely unacceptable for Mexico.

A large part of Mexico-US trade is in manufacturing inputs that are part of established North American supply chains. In fact, across all three countries, it is not uncommon for intermediate inputs to cross the border several times before being incorporated into finished goods. These supply chains could be disrupted by either tariff or non-tariff barriers. There are no modern precedents for trade agreement negotiations to directly address trade deficits. On the contrary, the economic forces of comparative advantage underpinning free trade agreements may well produce trade deficits. In any case, Mexico has made it clear that new tariffs are not acceptable.

Mexico's Secretary of Economy has clearly stated that Mexico is willing to review the trade deficit with the US, but as a side issue to the NAFTA renegotiation. This position is coherent with the current text of NAFTA, which does not deal with trade deficit reduction.

Also of concern to Mexico, on agricultural goods, the Summary includes the elimination of cross subsidization, price discrimination and price undercutting as an important goal. This is significant, for example, in the context of Mexican sugar exports to the US.

Customs and trade facilitation

The Summary aims to facilitate transparency for importers and exporters by requiring member states to make laws and regulations easily accessible, and to increase standards for the implementation of World Trade Organization (WTO) agreements that deal with trade facilitation and customs valuation. Canada's regulatory framework is already highly transparent; this position will, therefore, not likely be a topic of significant debate.

That said, the US is likely to push Canada to raise its "low value" threshold for duty-free shipments. Currently, Canada's duty-free, low value shipment threshold is CA\$20, while the US level is US\$800. The US position on this will be highly contentious for Canadian bricks and mortar retailers. A major concession on this front by Canada would also be complicated by the Canadian Goods and Services Tax, which applies to all merchandise sales, whether domestic or import. Allowing a CA\$800 tax and duty-free threshold would tilt the playing field in favour of imports over locally-sourced goods. Of course, the US position could be that the current divergence in threshold levels favours Canadian exporters to the US. This issue may likely receive significant attention because the Administration has consistently expressed concerns about lack of "reciprocity" in many US FTAs. Reducing the value threshold would also facilitate e-commerce, which we address further below.

Mexico is in a similar situation as Canada, since Mexico's low-value shipment threshold is US\$50; although, to date, the focus has been primarily on the Canadian thresholds.

Trade facilitation is an essential area for Mexico, which has made significant progress in reforming its domestic legislation to reduce burdens associated with the clearance of goods, customs procedures and border requirements. However, more progress remains to be made. For Mexico, the most important objective on customs and trade facilitation is the implementation of the WTO Trade Facilitation Agreement (TFA) (which the three countries have accepted), including:

- provisions to facilitate the more rapid movement of goods across the borders even before the final determination of customs duties, prioritizing perishable goods, and expediting certain air cargo;
- using modern technology and infrastructure at the Mexican Customs offices (Aduanas) to practice inspections;
- using digital and electronic procedures instead of paper documents for customs clearance;
- implementing procedures to modernize the NAFTA origin verifications by, among other things, moving to digital audits and improving coordination between customs authorities;
- publishing online information on exporting and importing, customs law and regulations, and establishing points of contact to respond to queries;
- enforcing provisions on border agency cooperation and customs cooperation establishing a single window to participating agencies; and
- establishing administrative and judicial appeal mechanisms for customs decisions.

Since the three countries have accepted the TFA, we do not expect difficult negotiations on this topic.

Rules of origin

The rules of origin in the NAFTA set out the local content requirement for goods to qualify for the NAFTA duty treatment. The Administration has signalled that it believes these rules need to be stricter, and reduce the amount of non-US and non-NAFTA content that will be allowed. The Summary calls for a strengthening of the rules of origin and restates the original intent of the NAFTA: to provide benefits to those products that

are made in North America. The Summary is short on specifics, but it is likely that changes will be proposed to local content requirements for certain sectors, which could have a significant impact on supply chains throughout North America.

For example, the rules of origin for automotive products are based on tariff shift and/or value-content requirements. The NAFTA requires manufacturers to track the regional value content of the major components of automobiles, light trucks, engines, transmissions, other heavy duty trucks and other parts. The current regional value content for autos, light vehicles, engines and transmissions is 62.5 percent and for other vehicles (trucks, vehicles for the transportation of more than 16 persons and others) is 60 percent. If the rules of origin were to be tightened, the most likely outcome will be the increase of the value-content requirement (although other requirements could also be modified, such as the inclusion in the prescribed origin tracking method of components that were not yet widely used when the NAFTA was negotiated).

In Mexico, trade authorities and stakeholders in specific sectors have raised the possibility of negotiating changes in the rules of origin as a strategy to avoid tariffs. For changes to be acceptable to Mexico: (i) the rules of origin must be based on the concept of NAFTA-produced materials (not US-made, as the document seems to suggest); and (ii) any increase in origin requirements must be sectorial and provide for a phase-out period. Likewise, the Summary is silent in relation to the use of invoices with exporter certification to get preferential treatment at time of importation (as contemplated in the Free Trade Agreement between Mexico and the European Union, and the TPP). This could be incorporated as part of the renegotiation of the NAFTA.

Trade in services

The Summary largely restates existing provisions that prohibit discrimination and marketplace restrictions between the NAFTA members. The Summary also provides for increased protection for American delivery services. This appears to target long-standing complaints about the differential treatment between postal and commercial carrier imports by the Canada Border Services Agency. The Summary also aims to include all services on a "negative list" basis, meaning that all services are covered except as specifically negotiated and expressly stated. We do not anticipate these demands to be deal-breakers.

Telecommunications and financial services

The Summary calls for increased market access for US telecommunications companies. If this objective is met, Canada's big three telecommunications companies may face increased competition from American suppliers of such services.

Largely, the Summary calls for this chapter of the NAFTA to be updated in line with current practices: (i) transparent regulation and independent regulators; (ii) network access for suppliers through interconnection; and (iii) protecting suppliers' choice of technology. Mexico has recently met these standards as part of the telecommunications reform it enacted in 2014. We do not anticipate major problems in the negotiations in this area.

The Summary also calls for increased market access for American financial services suppliers, but remains unclear which specific sector will be targeted. In Canada, foreign institutions already have significant access to the main financial services markets but there are limits on foreign ownership of Canada's large banks.

One item that is likely to be highly controversial in Canada and Mexico is the objective to limit measures that restrict cross-border data flows in the financial services sector. Any limit on the ability of Canadian or Mexican regulators to control cross-border flow of private customer data will likely meet with very stiff opposition in both countries.

Besides the issues of the liberalization of cross-border data for financial services, Mexico will be open to establish high standards in this chapter, mainly because US and Canadian financial institutions (including, but not only banks) operate in Mexico without major restrictions. However, the improvement of the transparency and predictability of its regulatory procedures may remain problematic for Mexico.

Digital trade in goods and services, and cross-border data flows

The US will seek to constrain the ability of the NAFTA countries to limit cross-border data flows, or to require the use or installation of local computing facilities. Although Canada has few statutes that require data to remain in Canada, these few statutes combined with governmental policies (such as the Canadian government's 2016 cloud computing strategy) create significant barriers to cross-border data flows. For example, the Income Tax Act requires companies to retain business records in Canada. The Canada Revenue Agency has long considered records kept on servers hosted in the US not to be kept in Canada for the purposes of satisfying these provisions, even if the records can be retrieved from within Canada at any time. In addition, British Columbia and Nova Scotia prohibit public bodies (including municipalities, universities, schools and hospitals) from storing personal information outside of Canada. New Brunswick has a more limited version of this prohibition for health information.

Public interest advocacy groups may support data localization laws on the basis that Canadians do not enjoy the same procedural protections for data stored in the US as in Canada, and that these laws can also provide Canada with the room necessary to establish its own approach to privacy. Moreover, Canada may need just this type of flexibility in order to continue to enjoy free movement of data from Europe under the EU General Data Protection Regulation. However, the US position may find support from multinational companies and even Canadian businesses seeking to take advantage of cloud-based services hosted in the US.

The US is also seeking commitments not to impose customs duties on digital products (such as software, music, video and e-books). The US appears to be concerned that Canada may attempt to use these measures to advance its cultural policies, such as through a Netflix tariff to fund Canadian cultural content. Canadian consumers may cheer for the US on this point, but the Canadian cultural industries will not. Finally, the US is seeking to establish rules restricting the right of governments to require disclosure of computer source code. Privacy and security advocates argue that this could limit the government's ability to protect itself from vulnerabilities or spyware by making such code available to security researchers or auditors. Requirements for source code disclosure are often included in Government of Canada software development contracts.

With respect to e-commerce and data flows, Mexico and Canada are likely to be willing to make the same commitments as those included in the TPP, while the US is seeking stronger commitments. If the parties do agree on digital trade beyond the scope of existing TPP provisions, Mexico and Canada may need to amend their legal frameworks.

Investment

The Summary calls for a general reduction of investment barriers across all sectors. Many Canadian industries, including aviation, rail transportation, and financial services, have long-standing legacy ownership limitations which may be on the table. While Canada has eliminated or reduced many such limitations over the past several decades, a number of sensitive restrictions remain. Reducing or eliminating these investment restrictions may require legislative changes and be politically controversial. If the US is determined to see remaining investment restrictions eliminated or reduced, we anticipate challenging negotiations for this chapter.

Since 1994, Mexico has reformed its Foreign Investment Law on several occasions, opening new sectors or industries to foreign investment. For example, the telecommunications and hydrocarbon sectors were

opened to foreign investment (although some restrictions still apply). Other sensitive restrictions still apply (e.g., up to 49 percent of foreign investment is allowed in manufacturing and commercialization of firearms, newspapers, port administration, maritime carriers, among others). As well, maritime cabotage, i.e. the carriage of goods between two Mexican ports, is an area where the US may well press for 100 percent foreign investment participation. These issues will not be easy to negotiate for Mexico. That said, the US Jones Act, which requires US flagged carriers to transport goods between US ports, could limit the ability of the US to push hard in this area for fear that Canada and Mexico will seek reciprocity.

Intellectual property

The Summary calls for increased protection of intellectual property rights under the NAFTA. The objectives in relation to patents and trademarks are worded broadly and, in large measure, are similar to the IP objectives negotiated as part of the TPP. Though the Summary does not suggest a significant deviation from current intellectual property law in Canada, the Summary does hint at some changes that will be sought in relation to trademarks in Canada.

As an example, the 2014 Combating Counterfeit Products Act gave border services agents the power to seize counterfeit and pirated goods, in addition to adding criminal offence provisions to the Trademarks Act. Under a new NAFTA agreement, the US may seek provisions to further expand the power of customs officials. Based on previous lobbying during the TPP negotiations, this could include the seizure of goods at the border, even for in-transit shipments which would not stay in Canada. Also, the US may seek stronger enforcement by allowing detention of goods with marks that are not only identical, but "confusingly similar" to registered trademarks.

Furthermore, Canada recently implemented amendments to the Trademarks Act (via Bill C-10) that were designed to implement Canadian commitments in the CETA. Among other things, the CETA expanded the protection of Geographical Indication (GI) which needed to be reflected in Canadian legislation. Some commentary from the US indicates that the provisions of the CETA are viewed as an attempt by the EU to restrict the use of common food names without due process. The US will likely seek to restrict the recognition of GIs for common food names.

With respect to patents, the Summary does not appear to deviate significantly from the provisions of Annex C of the Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement, as they currently exist, but we note that the US has long complained that Canada has been slow to fully implement its commitments under that agreement. The protection of inventions through patents issued in Canada, and their enforcement via Canada's legal system, does not differ significantly from the US. While the patent litigation process does tend to move faster in the US, the procedure along with the available rights and remedies is, generally, the same in Canada. One possible change that the US could seek to increase in the enforcement of patent rights in Canada is in the addition of contributory patent infringement as a cause of action whereas, currently in Canada, only direct patent infringement and induced patent infringement are possible causes of action.

With respect to the protection of new and emerging technologies, this aspect of the Summary is somewhat confusing, as doing so requires those technologies to be first patented. Much of these technologies are computer-based and, as such, face additional hurdles to patentability as a result of jurisprudence arising from both within and outside of the US. The test for patentability is, generally, the same worldwide, including Canada and the US. Accordingly, we would not expect any significant impact in this regard for Canada unless the US amended its patent legislation or adopted new legislation regarding the patentability and protection of such technologies, and then pressed Canada and Mexico to adopt similar legislation.

In relation to Mexico, the Summary's key points are: (i) improving IP enforcement through the full implementation of the TRIPS Agreement (a long-standing complaint against Mexico), including the Declaration

of the Doha Round and (ii) including measures that protects generic terms and prevent the reduction of market access to US products through the protection of geographical indications. The second point is closely related to the geographical indications system that the EU seeks to include in its free trade agreements with other nations, which has caused the loss of market access to some US products (mainly cheese and wine products). In this regard, Mexico will be required to protect European geographical indications without reducing market access to US products (e.g., brie cheese). Canada's recent experience on this issue with the CETA could help the parties find common ground.

Since the USTR proposes to liberalize cross-border data for several areas, Mexico will be required to greatly improve the enforcement of IP rights, not only related to counterfeiting and piracy, but also in relation to cyber theft. In this sense, Mexico will feel significant pressure to more meaningfully commit to the rule of law on IP rights.

Transparency, competition and State-Owned and Controlled Enterprises (SOE)

The position of the US with respect to increased transparency, competition policy and SOEs should not be difficult for Canada, as many of the negotiating positions outlined in the Summary are already firmly in place in Canada.

The Summary seeks to define SOEs based on government ownership or control. One of the goals of such a definition is likely to include entities that are incorporated through trusts, Public-Private Partnerships or other means in order to curb what the US perceives as unfair competition by the SOEs. This may involve major changes in Mexico where SOEs remain dominant in a few strategic sectors, like energy and the operation of ports. For Canada, it is difficult to anticipate whether this will be challenging. While there remains a number of SOEs playing significant roles in the economy, it is not clear how their activities are trade distorting or whether the US intends to target Canadian SOEs in the negotiations.

Labour and the environment

The US will look to bring labour protection measures to the forefront of the NAFTA by requiring countries to adhere to international labour standards. Increased labour protections will not likely be a point of issue for Canada at the negotiation, as Canada is already committed to and meeting international labour standards, and its employment standards are either on par with or superior to those prevailing in the US.

The proposal states that the NAFTA countries are required to "take initiatives to prohibit trade in goods produced by forced labour, regardless of whether the source country is a NAFTA country". This may imply that if a NAFTA country is not complying with labor standards or fails to take adequate steps to prohibit trade with a third country that is failing to comply, the other NAFTA countries could apply measures to imports from the offending country. The position of Mexico in past trade agreements is not to go this far, but rather to incorporate by reference the provisions of labour-related international agreements into its free trade agreements.

The Summary seeks to ensure that labour obligations under the NAFTA (or other labour agreements) are subject to the dispute settlement mechanism that applies to other parts of the NAFTA. Additionally, the USTR proposes to allow the participation of stakeholders in dispute settlement and for the public to be able to raise directly with the NAFTA governments alleged violations of the labour-related obligations.

Although the Administration has rejected the TPP, we note that many of its stated objectives for the NAFTA in relation to labour, environment and other matters, align with TPP provisions.

Similar to labour matters, on the environment, the Summary includes rules ensuring that environmental obligations become subject to the dispute settlement mechanism that applies to other parts of the NAFTA. The Summary does not clearly articulate the consequences for breaching environmental obligations, but if they involve limiting imports from the offending country, Mexico will likely oppose such an approach.

The Summary also sets out that the NAFTA countries should adopt rules implementing their obligations under the Multilateral Environment Agreements (e.g., the Convention on International Trade in Endangered Species of Wild Fauna and Flora). The US is calling for rules that prevent signatories from deviating from environmental commitments as a way to increase trade and investment, and from failing to enforce their own environmental laws. While few details are available, global warming and greenhouse gas emissions are likely to be on the table.

Anti-corruption

The US position on anti-corruption is largely in line with the provisions that were incorporated into the TPP. These focus on the criminalization of corruption and increased enforcement mechanisms. The Summary demonstrates that the US will ask for more transparent record-keeping by companies, an increase in the use of codes of conduct to promote higher ethical standards among public officials, and a prohibition on tax deductions for corruption payments.

None of these are likely to be problematic for Canada (for example, bribes are already non-deductible under our tax laws). However, the issue is sensitive for Mexico and may have political consequences beyond the scope of the NAFTA. The outcome will largely depend on the political skill of the Mexican negotiators, particularly in light of the upcoming 2018 presidential elections, in which corruption is likely to be one of the key political issues.

Mexico may object if the anti-corruption demands go beyond the new legal framework on anti-corruption recently adopted by Mexico. The new anti-corruption regime involves constitutional and legislative provisions that are still being implemented. Recently, two new federal statutes were enacted, and already impose new, severe sanctions in cases of corruption in government procurement. While we anticipate that this will be one of the challenging negotiating areas for Mexico, it may also provide an opportunity for the current government to demonstrate its commitment to fighting corruption.

Trade remedies and Chapter 19 dispute settlement mechanism

Perhaps most difficult for Canada, the Summary calls for the outright elimination of the Chapter 19 dispute settlement mechanism for countervailing and antidumping decisions made by regulatory authorities in the NAFTA countries. This mechanism provides an alternative to contesting the decisions before the local courts. Chapter 19 dispute settlement is considered a very hard-fought negotiating victory for Canada. In fact, Canada pulled out of the initial Canada-US free trade negotiations in 1987 over the Chapter and it is widely considered one of the fundamental quid pro quo concessions that secured the Canada-US FTA and then the NAFTA. Abandoning this prize will not be easy, and Canada would likely demand significant concessions to eliminate this alternative dispute settlement process.

This objective also came as a surprise to Mexico, since the US has resorted to the Chapter 19 dispute settlement mechanism on a greater number of occasions than Mexico. Mexican officials have expressed their intention to insist on maintaining the dispute settlement mechanism. Interestingly, some Mexican congressmen have already exhorted the Mexican Ministry of Economy to reject the US proposal.

It is not clear whether Chapter 19 is a deal-breaker for Mexico. Notably, Mexico has made significant progress recently in implementing specialized trade courts as part of the reform of the Federal Tribunal of Administrative Justice. That said, Chapter 19 will likely be an area where both Mexico and Canada present a consistent position, if for no other reason than this is one of the top priorities for USTR, and they may be able to obtain significant concessions in other topics if they agree to eliminate Chapter 19.

The US also wishes to eliminate the NAFTA global safeguard exclusion. This means that the NAFTA countries would no longer be excluded from global safeguards measures imposed by other NAFTA countries.

Government procurement, energy, dispute settlement and currency

The remainder of the objectives provide for provisions calling for transparent government procurement policies, increased market access for the energy sector, and early identification and settlement of disputes which are not at odds with Canada's current framework. Although the USTR does not specify how it will increase opportunities in government procurement, it is reasonable to assume that it will seek to reduce the thresholds established under the NAFTA. On this, Mexico is not likely to go beyond the thresholds negotiated in the TPP.

With respect to energy, as a result of sweeping energy reforms, Mexico will likely be open to further integration of the North American market. The Mexican government may well consider that further NAFTA commitments in this area would help protect the hard-fought reforms against attempts to reverse them following the next election.

The Summary concludes with a call for the NAFTA signatories to avoid currency manipulation. While none of the parties to the agreement have been accused of using currency manipulation to gain trade advantages, this may be more of a forward-looking inclusion meant to influence the content of future trade agreements.

Final thoughts

The Summary raises several issues that will be very challenging to negotiate, notably on the Chapter 19 panels. Both Mexico and Canada have signalled that they consider Chapter 19 to be a crucial element of the NAFTA. Overall, however, the Summary provides reason for optimism that the NAFTA parties will be able to renegotiate the NAFTA to modernize the agreement. In many respects, the Summary reaffirms basic principles of the NAFTA and raises issues that have been successfully addressed in other trade agreements (like the TPP and CETA). To the extent the Summary takes aim at specific existing controversial measures, the negotiating goals are largely set out in sufficiently general language that the negotiators will have some flexibility and the parties should be able to arrive at an acceptable compromise.

The Summary is ambitious and sets out numerous complex negotiation priorities for the US. This suggests that the negotiations will not be completed quickly. Some of the issues that have already been worked through in other negotiations, like the TPP, or the Mexican and Canadian agreements with the EU, could be resolved swiftly, but others deal with sensitive national interests that will be difficult to resolve. In all three countries, the NAFTA has a complex political dynamic. Elections and other domestic political forces will play a significant role in the negotiations. It will not be easy to truly modernize the NAFTA and arrive at a workable compromise for all three parties. The process may take longer than most observers currently anticipate.

As the negotiations progress, Dentons' International Trade group will continue to keep clients informed and help them to understand how either a failure in the negotiations or a successful renewal of the NAFTA, may impact their businesses.

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