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## The USMCA Enters Into Force: Five Things to Know About the Trade Agreement

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On July 1, the United States–Canada–Mexico Agreement (“USMCA”) entered into force. Negotiation of this “new” North American Free Trade Agreement (“NAFTA”) was several years in the making and reflects an effort to modernize the original hemispheric free trade agreement from a generation ago and adapt it to reflect current times and economic priorities. Now, with COVID-19 and U.S.–China tensions both creating an impetus for reshoring manufacturing capacity, the USMCA contains key features for companies and their sponsors to be aware of.

### 1. Qualifying for Tariff-Free Trade

The USMCA largely preserves tariff-free trade among the U.S., Canada and Mexico, though revamping the “rules of origin” in certain key areas for how products qualify. For example, in the automotive sector, Chapter 4 of the USMCA generally requires that for most vehicles the percentage of parts required to be made in North America increase in phases over a three-to-five-year period, from 62.5 percent to 75 percent.

On June 30, U.S. Customs and Border Protection (“CBP”) issued Implementing Instructions for the USMCA, providing guidance on making and evaluating claims for tariff-free treatment. In doing so, given the complexities involved in getting supply chains into compliance with the agreement’s requirements, CBP indicated that it might “show restraint in enforcement during the six-month period after USMCA’s entry-into-force.”

### 2. Enforcing Cross-Border Labor Standards

The USMCA contains mechanisms to incentivize manufacturing in the U.S. by gradually making U.S. labor more cost-competitive. For example, in the automotive sector, there are requirements that a certain percentage of a vehicle's value be made by workers earning at least \$16 an hour, 30 percent and later 40 percent for passenger vehicles, and 45 percent for certain trucks.

Chapter 31 provides for enforcement of labor standards in the three countries through a system of consultations and government-to-government dispute settlement panels, with a focus on implementation of Mexico's new labor law reforms. In particular, as between the U.S. and Mexico, there is a "Rapid Response" mechanism to monitor compliance and more quickly enforce non-compliance, with respect to labor rights at particular facilities in Mexico. The U.S. Trade Representative recently testified in Congress that, as needed to address legitimate concerns, the U.S. was prepared to "take action early and often."

### 3. Developing Digital Trade

When the NAFTA entered into force in 1994, the commercial Internet barely existed. Now, it is estimated that in the last ten years, the U.S. surplus in digital trade with Canada and Mexico has grown by approximately 65%, contributing almost \$20 billion annually to the U.S. economy.

Chapter 19 of the USMCA prohibits customs duties on certain digital products distributed electronically; limits the authority of governments to require disclosure of proprietary source code and algorithms; and encourages collaboration in addressing cybersecurity challenges. It also protects Internet platforms from liability for third-party content they host or process, except regarding intellectual property enforcement. In addition, it bans data transfer restrictions and does not impose data localization requirements, enabling companies to tap into the consumers of other countries, but without having to store data on those customers locally. Combined, the provisions provide companies wide latitude in setting up and managing their North American data infrastructure to leverage the power of digital trade.

### 4. Protecting Foreign Investments

The NAFTA conferred upon private parties the right to bring arbitration claims for mistreatment of their foreign investments against the host country directly, without needing to go to domestic court or be aided by their own government. Some viewed this investor-state dispute settlement system ("ISDS") as interfering with the right of

governments to regulate and for providing companies with “political risk insurance” to invest abroad rather than in their own country.

Chapter 14 of the USMCA generally eliminates such ISDS, but preserves one as between the U.S. and Mexico with respect to five sectors: oil and gas, power generation, telecommunications, transportation, and infrastructure, particularly with respect to government contracts. In 2013, Mexico announced reforms opening its energy sector to foreign investment, including with respect to joint ventures with state-owned oil and gas company, Petróleos Mexicanos (“PEMEX”). For U.S. investors in Mexico’s energy sector, it is viewed that ISDS “locks in” the benefit of those reforms.

## 5. Keeping an Eye on China

One reason for tightening the agreement’s rules of origin was the concern that China was sending products to Mexico for assembly and then using it as an export platform to enter products into the U.S. market, “free riding” under the benefits of the NAFTA. More recently, with U.S.-China tensions rising and the countries engaged in a strategic competition over leading-edge technologies, the Trump administration appears to be using the benefits of free trade with the U.S. as a lever to apply against China.

Chapter 32 of the USMCA contains a provision Commerce Secretary Ross termed a “poison pill,” that provides that a party to the agreement can terminate it if either of the other two parties enters into a free trade agreement with a country any one of them considers to be a “non-market economy,” as the U.S. has designated China. This effectively acts as a block on Canada or Mexico entering into a trade agreement with China without the U.S. first having a say. With reference to this provision, in June 2020, Mexico’s Economy Minister took back comments that Mexico would seek a trade agreement with China, instead clarifying it had no intention of doing so.

## Key Takeaways

- The USMCA contains involved rules of origin to qualify for tariff-free trade, though the U.S. government may allow companies additional time to implement their compliance programs.
- There is a special monitoring and enforcement mechanism to quickly pressure test Mexico’s adherence to its labor law reforms.
- Companies will be able to engage in cross-border digital trade largely without constraints.

- Investor-state dispute settlement remains available between the U.S. and Mexico in the energy and other select sectors, providing protection mechanisms for foreign investments.
- The USMCA may serve as a template for how the U.S. may use trade agreements to try to align trading partners against China.

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