THE NORTH AMERICAN FREE TRADE AGREEMENT IMPLEMENTATION ACT

STATEMENT OF ADMINISTRATIVE ACTION

This Statement of Administrative Action is submitted to the Congress in compliance with section 1103 of the Omnibus Trade and Competitiveness Act of 1988 ("1988 Act") and accompanies the implementing bill for the North American Free Trade Agreement ("NAFTA" or "Agreement"). The bill approves and makes statutory changes required or appropriate to implement the Agreement, which the President signed on December 17, 1992, on behalf of the United States under the authority of section 1102 of the 1988 Act.

This Statement describes significant administrative actions proposed to implement the NAFTA. In addition, incorporated into this Statement are two other statements required under section 1103: (1) an explanation of how the implementing bill and proposed administrative action will change or affect existing law; and (2) a statement setting forth the reasons why the implementing bill and proposed administrative action are necessary or appropriate to carry out the Agreement.

For ease of reference, this Statement generally follows the organization of the NAFTA, with the exception of grouping the general provisions of the Agreement (*i.e.*, Chapters One, Two and Twenty-Two of the Agreement) at the beginning of the discussion.

For each chapter of the NAFTA, the Statement first briefly summarizes the most important provisions of the Agreement. Next, the Statement describes the pertinent provisions of the implementing bill, explaining how the bill changes or affects existing law and stating why those provisions are required or appropriate to implement the NAFTA. Finally, the Statement describes the administrative action proposed to implement the particular chapter of the NAFTA, explaining how the proposed action changes existing administrative practice and stating why the changes are required or appropriate to implement the Agreement.

The Statement addresses certain provisions of Title V as well as Title VI of the implementing bill -- which make various changes in U.S. law that are appropriate (rather than required) to implement the NAFTA -- following the discussion of NAFTA Chapter Twenty-One.

It should be noted that this Statement does not, for the most part, discuss those many instances in which U.S. law or administrative practice will remain unchanged under the NAFTA. In many cases, U.S. laws and regulations are already in conformity with the obligations imposed by the Agreement. In other cases, U.S. laws and regulations are "grandfathered" (*i.e.*, exempted) from the obligations of the NAFTA. In addition, some provisions of the NAFTA impose obligations only on Canada or Mexico.

In a few instances where there have been frequent questions from the public or the Congress, the Statement notes examples of specific statutes, regulations or practices that do *not* have to be changed as a result of the Agreement. Because this Statement is designed to describe *changes* in U.S. laws and regulations proposed to implement the NAFTA, however, the Statement concentrates on those changes and generally does not attempt to enumerate instances in which no change in existing law or practice will be required.

Although the implementing bill is voluminous, a careful reading of this Statement makes clear that the NAFTA requires comparatively few significant changes in U.S. law or regulation. Much of the bulk of the legislation is taken up with amendments or additions to U.S. law -- such as Title VI, the "Customs Modernization Act," -- that the Administration, working with the Congress, considered to be desirable, rather than necessary, to implement the NAFTA. Other parts of the bill -- such those establishing NAFTA's "rules of origin" for goods -- set out certain parts of the NAFTA itself. Still other bill provisions, simply extend to Mexico treatment currently enjoyed by Canada under the United States - Canada Free-Trade Agreement Implementation Act of 1988.

Finally, references in this Statement to particular sections of U.S. statutes are based on those statutes in effect as of the date this Statement was submitted to the Congress.

CHAPTER ELEVEN: INVESTMENT

A. SUMMARY OF NAFTA PROVISIONS

Chapter Eleven comprises two parts. Part A sets out each government's obligations with respect to investors from other NAFTA countries and their investments in its territory. Part B affords investors the right to seek compensation through international arbitration for a violation of the provisions of Part A or of certain provisions of Chapter Fifteen, governing the behavior of government monopolies and state enterprises.

1. Section A - Investment

a. Scope and Coverage

Part A provides four basic protections to "investors of other Parties": non-discriminatory treatment; freedom from "performance requirements;" free transfer of funds related to an investment; and expropriation only in conformity with international law.

"Investment" is broadly defined in Article 1139, and both existing and future investments are covered. "Investor of a Party" is defined to encompass both firms (including branches) established in a NAFTA country, without distinction as to nationality of ownership, and NAFTA-country nationals. The chapter applies where such firms or nationals make or seek to make investments in another NAFTA country.

The chapter applies to all governmental measures relating to investment, with the exception of measures governing financial services, which are treated in Chapter Fourteen. Under Article 1112, in the event of any inconsistency between Chapter Eleven and another chapter, the other chapter will prevail.

b. Non-discrimination and Minimum Treatment Standards

Articles 1102 and 1103 set out the basic non-discrimination rules of "national treatment" and "most-favored-nation treatment." These rules require, respectively, each government to treat NAFTA investors and their investments:

- no less favorably than its own investors and their investments, and
- no less favorably than investors of other countries and their investments.

Article 1102 makes clear that the "national treatment" rule prohibits governments from imposing local equity requirements or requiring an investor from another NAFTA country, by reason of its nationality, to sell an investment. Furthermore, Article 1102 provides that the treatment provided by state and provincial governments to investors from other NAFTA

countries and their investments must be no less favorable than the most favorable treatment they provide to domestic investors and their investments.

Article 1104 specifies that investors and their investments are to be accorded the better of national or most-favored-nation treatment. Article 1105 provides that each country must also accord NAFTA investors treatment in accordance with international law.

c. Performance Requirements

Article 1106 imposes disciplines on seven types of "performance requirements." Under Article 1106, a government may not, as a condition for the establishment or operation of an investment, require a firm to:

- limit its sales in the domestic market by conditioning such sales on exports or foreign exchange earnings;
- buy or use components from a local supplier or accord a preference to domestic goods or services;
- achieve a minimum level of "domestic content;"
- limit its imports to a certain percentage of exports or foreign exchange inflows associated with the investment;
- transfer technology to any domestic entity, except to remedy an alleged violation of competition law;
- export a specified level of goods or services; or
- supply designated regional or world markets solely from its local production.

A government generally may not use the first four of the requirements listed above as a condition for receiving an advantage, such as a tax holiday. NAFTA's treatment of taxation measures is addressed in Article 2103.

The rules prohibiting performance requirements apply with respect to all investments, whether by non-NAFTA investors, domestic investors, or investors from another NAFTA country. For example, under Article 1106, the Mexican Government may not require a Japanese-owned (or Mexican-owned) firm in its territory to export to the United States.

By virtue of Article 1108(8), NAFTA's disciplines on the second, third and sixth type of performance requirement listed above do not apply to a NAFTA government's export promotion programs or foreign aid activities. In addition, the prohibition against the second,

third, fifth and seventh type of performance requirement does not apply in connection with government procurement. Finally, under Article 1106(6), the disciplines on the second and third category of performance requirements do not affect a government's ability to apply nondiscriminatory environmental measures.

d. Management

Article 1107 prohibits NAFTA governments from requiring local firms owned by investors from other NAFTA countries to fill senior management positions with local nationals. A government may require a simple majority of the board of directors to be local nationals, however, as long as the requirement does not materially impair the investor's control over its investment.

e. Reservations and Exceptions

Article 1108 creates a system of limited "reservations" and "grandfathering" to exempt certain laws and regulations that are not in conformity with the non-discrimination, performance requirement and senior management obligations described above.

The NAFTA governments have recorded in their schedules to Annexes I, II, and III a specific "reservation" for all federal-level measures inconsistent with those obligations that they wish to maintain. (These annexes appear in Volume II of the 1993 *Government Printing Office* reprint.)

(1) Reservations for Existing Measures

Annex I sets out each government's reservations for existing, inconsistent measures at the federal government level. Existing non-conforming measures at the state or provincial level are automatically "grandfathered" for two years. By the end of that period, any such measure must have been listed as a "reservation" in Annex I in order for the exemption to remain in effect. The two-year period was negotiated in order to allow time for the states and the federal government to identify all such measures and to include them in the Annex, if desired.

Existing measures at the local level that are inconsistent with Chapter Eleven rules are automatically "grandfathered" on a permanent basis.

Laws and regulations that are "grandfathered" or listed as a reservation in Annex I are exempt from challenge under the NAFTA, even if they are amended or renewed, so long as they are not made more inconsistent with the Agreement. If a measure is liberalized, however, any such liberalization may not be reversed by a subsequent amendment.

Canada took various reservations in Annex I based on its exceptions under the CFTA. Such reservations include the right to review direct acquisitions of C$150 million or

more, restrictions in the oil and gas sectors, and limitations in connection with the ownership and privatization of certain state enterprises.

Mexico retained the right under Annex I to review large acquisitions. The initial threshold for review, $25 million, will increase to $150 million in the tenth year after entry into force of the Agreement. The $150 million threshold will be adjusted annually for inflation and later for economic growth as well, but the amount can never be higher than the Canadian threshold. Other principal Mexican exceptions in Annex I are reservations on the ownership of land, for cable television, air and land transportation, and retail sales of certain petrochemical products. Outside of previously state-monopolized sectors, the privatization of Mexican state enterprises will generally be open to U.S. bidders.

For its part, the United States took reservations for existing, non-conforming legislation in respect of such matters as nuclear power, broadcasting, mining, customs brokers and air transportation.

In addition to "grandfathering" specified government measures, some Annex I reservations set forth schedules for liberalizing investment restrictions, such as the phase-out of Mexican performance requirements and equity limitations in the mining, construction and auto parts sectors.

(2) Reservations for Future Measures

The three governments have also recorded a limited number of broader exemptions for measures falling into certain sectors, such as basic telecommunications, broadcasting, and maritime trade. Those exemptions, listed as reservations in Annex II, allow a government to maintain existing and adopt new laws and regulations that vary from Chapter Eleven's rules regarding non-discrimination, performance requirements and senior management.

(3) Mexican Exception for Reserved Sectors

Annex III sets out several Mexican reservations reflecting Mexican constitutional provisions making certain commercial activities the exclusive domain of the Mexican Government. These include satellite and telegraphic communications, railroad transportation, nuclear power generation, the production and distribution of electricity as a public service, and activities related to the production, distribution and sale of energy products and primary petrochemicals.

As with Annex I, Annex III measures cannot be changed in the future to be made more inconsistent with the chapter's rules, and if liberalized in the future cannot be subsequently be made more restrictive. Further, any investments (including service contracts) that Mexico permits in these sectors must be accorded the post-establishment protections of Chapter Eleven. (NAFTA Note 40, which is appended to Annex 602.3 and Article 1101(2), confirms these post-establishment protections.) Finally, although Annex III permits Mexico to restrict to Mexican nationals any sale of government assets in the sectors listed in the Annex,

government assets in recently de-monopolized sectors must be opened to purchase by U.S. bidders within three years of their initial sale.

(4) Transfers

Article 1109 requires each NAFTA government to permit transfers relating to an investment covered by Chapter Eleven to be made freely and without delay, including transfers of profits, royalties, sales proceeds and other remittances relating to an investment. Further, no government may require its own investors to repatriate profits generated by their investments in another NAFTA country. Exceptions permit a government to prevent transfers under certain laws of general application, such as bankruptcy laws. Article 2104, which is applicable to trade and investment, permits the establishment of multiple exchange rates in narrowly-defined circumstances, under IMF discipline, to address balance-of-payments difficulties.

(5) Expropriation and Compensation

Under Article 1110, a NAFTA government may not expropriate an investment made by an investor from other NAFTA countries other than for a public purpose, on a non-discriminatory basis and in accordance with due process of law. Compensation must be paid without delay at the fair market value of the expropriated investment, plus any applicable interest, and must be freely realizable and transferable.

(6) Special Formalities

Article 1111 permits a NAFTA government to adopt or maintain "special formalities" in connection with the establishment of an investment, so long as such requirements do not materially impair the substance of any right accorded by Chapter Eleven. Special formalities include requirements such as typical state incorporation requirements. Article 1111 also permits a government to seek routine information and data from investments covered by the chapter.

(7) Denial of Benefits

Article 1113 describes those circumstances under which a NAFTA government may refuse to apply the protection of Chapter Eleven to firms, or their investments, that otherwise qualify for coverage under the chapter, where the firms are owned or controlled by investors from a non-NAFTA country.

The article preserves the foreign policy prerogative of each government to deny benefits to firms owned or controlled by nationals of a non-NAFTA country with which it does not have diplomatic relations or to which it is applying economic sanctions.

It also permits each government to deny benefits to such firms if they have no substantial business activities in the NAFTA country where they are established. Thus shell companies could be denied benefits but not, for example, firms that maintain their central administration or principal place of business in the territory of, or have a real and continuous link with, the country where they are established. This provision requires the denying government to give prior notification, and to consult, in accordance with Articles 1803 and 2006.

(8) Environmental Measures

Article 1114 affirms that Chapter Eleven does not preclude a NAFTA government from adopting, maintaining or enforcing measures otherwise consistent with the chapter to ensure investment is consistent with its environmental protection goals. The article also provides that no government should waive or relax its environmental measures in order to attract or retain an investment. Derogations from this provision are subject to compulsory consultations if requested by a NAFTA government but are not subject to formal dispute settlement under Chapter 20. The Commission on Environmental Cooperation, created by the supplemental agreement on environmental cooperation, may assist in such consultations.

2. Section B - Investor - State Dispute Settlement

Section B of Chapter Eleven provides a mechanism for an investor to pursue a claim against a host government that it has breached its obligations under Section A. This mechanism is patterned after the investor-State dispute settlement mechanism of the standard U.S. bilateral investment treaty and permits an investor to submit its claim to binding arbitration under internationally-accepted rules.

a. Nature of Claims

Articles 1116 and 1117 set forth the kinds of claims that may be submitted to arbitration: respectively, allegations of direct injury to an investor, and allegations of indirect injury to an investor caused by injury to a firm in the host country that is owned or controlled by the investor. In both cases, investors may bring claims where the injury results from an alleged breach of Section A or of certain provisions governing the behavior of government monopolies in Chapter Fifteen.

All claims must be brought within three years. Article 1117(3) provides that if claims arising out of the same events are brought under both Articles 1116 and 1117, the claims should be heard together by a tribunal under Article 1126.

Article 1138(1) excludes from investor-State dispute settlement decisions to prohibit or limit investment on national security grounds. Read together with Annex 1138(2), Article 1138(2) also excludes from investor-State dispute settlement, and from government-to-government dispute settlement under Chapter Twenty, decisions taken by Canada or Mexico to prohibit or restrict an acquisition under their laws providing for screening of foreign investment.

b. Initiation of Dispute Settlement Proceedings

Article 1118 encourages the settlement of claims through consultation or negotiation. Articles 1119 and 1120 set forth the process leading up to the submission of a dispute to an arbitral panel.

Article 1119 provides that an investor must provide notice of its intention to submit a claim to arbitration at least 90 days before doing so, and specifies the content of such notice. Article 1120 provides that once six months have elapsed from the events giving rise to a claim, the investor may submit the claim for arbitration to:

- the International Centre for the Settlement of Investment Disputes (ICSID), provided both the country of the investor and the host country are parties to the ICSID Convention (neither Canada nor Mexico currently is);

- ICSID's "Additional Facility," in the event one such country is not a party to the Convention; or

- an *ad hoc* arbitral tribunal established under the arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL).

Because the NAFTA will give rise to private rights of action under Mexican law, Annex 1120.1 avoids subjecting the Mexican Government to possible "double exposure" by providing that a claim cannot be submitted to Chapter Eleven arbitration where the same claim has been made before a Mexican court or administrative tribunal.

Article 1137(1) describes the actions by which claims are considered to have been submitted to arbitration.

c. Jurisdictional Requirements

Articles 1121 and 1122 set out rules for establishing the requisite mutual consent for arbitration. Article 1121 requires the investor (and, in certain cases, the enterprise that is owned or controlled by the investor) to consent in writing to arbitration, and to waive the right to initiate or continue any actions in local courts or other *fora* relating to the disputed measure, except for actions for injunctive or other extraordinary relief. To ensure that a host country cannot frustrate an arbitration by withholding its own consent, Article 1122 itself constitutes advance consent by the three NAFTA governments to arbitration.

d. Appointment of Arbitrators

Article 1123 provides generally for the establishment of three-member arbitral tribunals, one member to be appointed by each of the disputants, and the presiding arbitrator to be appointed by agreement between the disputants. If, within ninety days of the submission of the claim to arbitration, a disputant fails to appoint an arbitrator, or the two disputants fail to agree on a presiding arbitrator, Article 1124 provides for arbitrators to be named by the ICSID Secretary-General.

The Secretary-General may use his discretion in making appointments. However, with respect to the appointment of the presiding arbitrator, he must choose first from a roster of 45 qualified individuals agreed upon by the three NAFTA governments. The Secretary-General may select from ICSID's standing Panel of Arbitrators only in the event that no person on the roster is available and may choose only non-NAFTA nationals.

Article 1125 is intended to satisfy the rules for appointing a national of a disputing party to an arbitral tribunal established under ICSID or the ICSID Additional Facility.

Article 1126 addresses the possibility that more than one investor might submit to arbitration claims arising out of the same event. It provides for the appointment by the ICSID Secretary-General of a special three-member tribunal to consider whether such multiple claims have questions of fact or law in common, in which case that tribunal may assume jurisdiction over, and decide, all or part of any such claims.

e. Arbitral Proceedings

Articles 1127 through 1129 enable a NAFTA government that is not involved in the arbitration to be apprised of relevant facts and other information and, if it wishes, to submit views to the tribunal on questions of NAFTA interpretation. To help ensure the enforceability of an award, Article 1130 provides that unless otherwise agreed, the arbitration must take place in a country that is a party to the New York Convention on the Recognition and Enforcement of Arbitral Awards ("New York Convention").

Articles 1131 and 1132 address the substantive law to be applied in arbitral proceedings. Article 1131(1) provides that arbitral tribunals are to decide questions in accordance with the NAFTA and applicable international law rules. Article 1131(2) makes binding on NAFTA arbitration tribunals any interpretation of the Agreement by the Free Trade Commission established under Article 2001.

Under Article 1132, a Party's defense that an alleged breach falls within the scope of a reservation set forth in a NAFTA annex must be referred to the Commission, and any decision it makes on the issue will be binding on the tribunal. If the Commission does not make a decision within sixty days, however, the question is referred back to the tribunal.

Under Article 1133, a tribunal may seek advice from experts on environmental, health, safety or other scientific matters under certain conditions. Article 1137(3) provides that

a country cannot assert, as a defense or set-off, that the investor has been compensated for its losses by insurance or similar means.

Article 1137(2), read together with Annex 1137.2, requires each NAFTA government to designate in its official register the agency to which notices and other arbitration documents are to be delivered. For the United States, this will be the Department of State.

f. Nature of Relief

Under Article 1134, a tribunal may order interim protective measures to preserve existing rights of the disputants, including the preservation of evidence. A tribunal cannot, however, order attachment of assets or enjoin the government from applying any measure that is the subject of the dispute.

Article 1135 limits a final award to money damages or restitution, or a combination of both; awards of restitution must offer the alternative of paying damages. No punitive damages may be awarded.

g. Enforcement of Arbitral Awards

Article 1136 sets forth rules governing enforcement of final awards. Paragraph one restates the traditional rule that an arbitral award has no precedential effect and is binding only on the particular disputants in the matter. Paragraph two obliges a disputant to abide by and comply with the award. Paragraph three provides a disputant the opportunity to seek revision or annulment of the award before enforcement may be sought.

Paragraph four requires each Party to provide for enforcement of an award in its territory. The Federal Arbitration Act (9 U.S.C. 1 *et seq*.) satisfies the requirement for the enforcement of non-ICSID awards in the United States. The Convention on the Settlement of Investment Disputes Act of 1966 (22 U.S.C. 1650, 1650a) provides for the enforcement of ICSID awards.

In the event that a country does not comply with an award, paragraphs five and six provide that the investor's government may request a government-to-government arbitration panel under Article 2008 to consider the matter. The initiation of such proceedings would not prevent the investor from seeking enforcement of the award.

By declaring that claims submitted to NAFTA arbitration will be considered to arise out of a commercial relationship or transaction, paragraph seven satisfies prerequisites of the New York Convention and the Inter-American Convention on International Commercial Arbitration for the enforcement of awards under those agreements.

h. Publication of Awards

Article 1137(4) and Annex 1137(4) govern the publication of awards. For arbitrations involving the United States or Canada, either disputant may make the award public; for arbitral proceedings involving Mexico, the applicable arbitration rules will govern.

B. ACTION REQUIRED OR APPROPRIATE TO IMPLEMENT THE NAFTA

1. Implementing Bill

No change in statute will be required to implement the provisions of Chapter Eleven.

2. Administrative Action

Article 1108 permits the United States to exempt existing, non-conforming state government measures by including them in Annex I within two years after entry into force of the Agreement.

Under Article 1124, the three NAFTA governments must establish a 45-member roster of potential presiding arbitrators on the date of entry into force of the Agreement. The Administration will begin consulting with Canada and Mexico shortly on the development of the 45-member roster, and anticipates soliciting the advice of groups such as the American Arbitration Association and the International Chamber of Commerce.