Trading Among Farmers

Blueprint

22 May 2012

This is a condensed version of the Trading Among Farmers Blueprint, provided for shareholders' information. It contains all relevant aspects of the design of Trading Among Farmers but omits some information that is commercially sensitive. The full version, including detailed term sheets for all relevant contracts was provided to the Fonterra Board, the Fonterra Shareholders' Council and the advisors of the Due Diligence Committee.

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CONTENTS

1. INTRODUCTION

Outline and Purpose of this Document

This Blueprint sets out the main features concerning "Trading Among Farmers" ("TAF").

The objectives of TAF reflect Fonterra's unique capital structure under which open entry and exit at a fair price (or a 'well discovered' price in a deep and liquid market if Shares are tradable) are important features to be retained, not only from the perspective of our farmer shareholders but also under the public policy objectives of the Dairy Industry Restructuring Act 2001 (DIRA).

This Blueprint is in six sections. These sections are:

Section 1. The objectives of TAF;

Section 2. A general overview of TAF, including the distinct roles of the Fonterra Shareholders' Market and the Fonterra Shareholders' Fund;

Section 3. A general description of the operation of the Fonterra Shareholders' Market;

Section 4. A general description of the role and functions of the Fonterra Shareholders' Fund; and

Section 5. An explanation as to how the size of the Fonterra Shareholders' Fund will be managed within policy targets and constitutional thresholds.

Section 6. A glossary of terms used in this Blueprint.

1.1. Document Purpose

In June 2010, Fonterra's farmer shareholders voted in changes to the Fonterra Constitution that enable the Board to put in place a regime for Trading Among Farmers ("TAF") before the end of December 2013 (or a later date specified by the Board). To do so, the design of TAF must meet certain pre-conditions set out in the Constitution, including support from the Shareholders' Council.

This document describes the essential structural features of TAF sufficient to support detailed market rules and facilitate the development and consideration of necessary legislation.

Capitalised terms used in this document are defined in the Glossary which appears in Section 6.

1.2. Objectives of Trading Among Farmers

In order to deliver TAF in a manner consistent with the resolution of shareholders in June 2010 when they approved the Form B Constitution, the following objectives have guided the development of TAF:

- Maintain Fonterra as a sustainable co-operative with voting rights linked to milk supplied to Fonterra;
- Remove Fonterra's obligation under DIRA to redeem Shares. This would then provide a permanent share capital on which Fonterra's business can operate and invest. Fonterra will have the ability to issue and buy-back shares in appropriate circumstances;
- Ensure Fonterra has sufficient permanent share capital to give the Co-operative the funding needed to continue to have the ability to drive the highest sustainable returns to farmers;
- Ensure that the arrangements enable farmer shareholders to buy and sell Shares when they wish at prices that reflect a well-informed and liquid market;

- Ensure the arrangements produce a stable market outcome, in the sense that they will meet the above objectives for the foreseeable future;
- Ensure that the arrangements appropriately reflect Co-operative principles in that they do not create advantages or disadvantages for any farmer shareholder or group of farmer shareholders in relation to any other farmer shareholder or group of farmer shareholders;
- Ensure that the arrangements appropriately meet the needs of farmers as shareholders of Fonterra. The Fonterra Shareholders' Market will be the primary focus and any supporting structure must be consistent with this objective;
- Ensure that the arrangements can be communicated and understood by farmer shareholders in an effective and straight-forward manner;
- Ensure that the arrangements meet with the Government's competition policy requirements.

Over and above these objectives, there is a clear commitment to farmer shareholders that, in the design and implementation of TAF, 100% farmer control and ownership of the Co-operative must be maintained.

There are also a number of key design principles that have been applied in designing TAF:

Principle	All decisions taken will need to…	Rationale
1 Liquid	…support creation of a well-informed and liquid market in Shares	Required to meet farmer shareholders' open entry and exit, the government's competition policy objectives and therefore remove redemption obligations under DIRA
2 Trusted	…encourage farmer shareholders and other stakeholders to have confidence in the FSM	Required to secure sufficient investment and trading to support a deep and liquid market
3 Fungible	…encourage price convergence between the FSM and the Units of the FSF trading on the NZSX	Required to ensure that the FSF increases liquidity and price discovery in the FSM
4 Straight-forward	…enable all farmer shareholders to understand and use the FSM	Required to reflect co-operative principles where one group of farmer shareholders is not advantaged over another
5 Ready	…enable the FSM to be operational by late 2012	Required to meet initial target implementation date mandated by the Board and communicated to farmer shareholders
6 Contestable	… demonstrate that farmer shareholders and Fonterra are receiving best possible value from market participants	Required to ensure that the market operations are sustainable

1.3. Pre-conditions to launch

The five pre-conditions[1] to a launch of TAF are, in summary:

- The establishment of the Fonterra Shareholders' Fund with the necessary features and size;
- The establishment of the Fonterra Shareholders' Market as a reliable and effective platform for the trading of Shares;
- All necessary changes to legislation (including to the Dairy Industry Restructuring Act 2001);
- All necessary approvals and consents have been obtained on acceptable terms;
- Approval from not less than 50% of members of the Shareholders' Council.

While not a pre-condition to launch, the Board has indicated that before resolving to implement TAF, it would need to form a view on the price that Shares are likely to trade at when trading commences on the Fonterra

[1] These are more fully set out in clause 49.2 of Form A of Fonterra's Constitution.

Shareholders' Market. The Board would seek expert advice on this matter and would take into account the most recent valuation by the Valuer. This is not a guarantee, or any form of assurance, as to any particular price at which Shares will trade at upon the launch of TAF, or at any time thereafter.

1.4. TAF Mandate

The booklet provided to farmer shareholders prior to the June 2010 vote (and the marked-up and annotated Form A and Form B Constitutions that accompanied it) provided information to farmer shareholders. That material collectively contained the TAF mandate. It is set out in the table below, together with a reference to the sections in this Blueprint where each feature is addressed.

Information provided in 2010 to farmer shareholders proposed that farmer shareholders who sold economic rights of Shares to the Fonterra Shareholders' Fund would retain legal title to those Shares. Subsequently Fonterra has determined that it would be preferable for the legal title to such Shares to be held by a Custodian. The features of this Custodian are set out in Section 3.5.

In February 2012, the Board confirmed that the Custodian will be owned by a farmer owned trust, to strengthen the commitment to 100% farmer control and ownership of the Co-operative.

Trading Among Farmers mandate	Blueprint Reference
Objectives	
Sustainable co-op with voting linked to production	Section 1.2
Removing obligation to redeem Shares	Section 1.2
Permanent capital base to drive highest sustainable returns to farmers	Section 1.2
Farmers able to buy and sell Shares in a well-informed and liquid market	Section 1.2
Stable outcomes for the foreseeable future	Section 1.2
Must be delivered in a way that maintains 100% farmer control and ownership	Section 1.2
Board and Council must ensure the five pre-conditions in the Form A Constitution are satisfied before TAF can be launched	Section 1.3
Share standard	
Minimum remains 1 Share per kg/MS production	Section 2.4
Compliance measured by rolling three-season historical average on the first day in each Season. (Board can allow compliance against estimated production).	Section 2.4 Fonterra Constitution (Form B)
Grace period of at least six months to become compliant set by Board before each Season	Fonterra Constitution (Form B)
Board can set a Base Limit of Shares that must be held at all times between annual compliance measurement (could be less than minimum Share Standard)	Fonterra Constitution (Form B)
Three years in/out for entry/exit. (Board can shorten or lengthen entry/exit period).	Section 3.2.2 Fonterra Constitution (Form B)
Dry Shares	
Maximum individual shareholding initially set at two times production. Board can set maximum anywhere between one and two times.	Section 3.3.2 Fonterra Constitution (Form B)
Board will manage maximum percentage of Dry Shares within 20% of total Shares. Board can specify a percentage at any level below 25%[2] constitutional threshold. (As outlined in this Blueprint, the Board will manage Dry Shares to a level that is well below these constitutional thresholds).	Section 3.3.1 Fonterra Constitution (Form B)
No individual shareholder (plus associates) can hold Dry Shares in excess of 5% of total Shares	Section 3.3.2
Fonterra Shareholders' Market (FSM)	
Board initially establishes operating rules with NZX and appoints a Market Operator for FSM	Section 3.4.1
Trading available on any trading day, online through Fencepost or via 0800 number	Section 3.1 Section 3.6

[2] It is proposed that this threshold be reduced from 25% to 15%. For this reduction to occur, shareholders would need to approve this change to Fonterra's constitution by a special resolution. A special resolution having this effect will be voted on by shareholders at the Special Meeting on 25 June 2012, but it is not intended to be a pre-requisite for TAF.

Costs of transacting Shares on FSM largely borne by Fonterra	Section 3.7.2
Shareholders can request an independent agent appointed by Fonterra to buy or sell Shares on their behalf	Section 3.11
Off-market transactions (e.g. Shares transferred to a purchaser of a farm) allowed	Section 3.13
Registered Volume Providers	
One or more RVPs selected by competitive tender and contracted to Fonterra	Section 3.8
Must post buy and sell prices at all times, at agreed narrow price ranges and specified minimum volumes	Section 3.8
Key elements of RVP contracts and RVP activities publicly disclosed	Section 3.8
RVP fees paid by Fonterra and set by commercial negotiation	Section 3.8
RVPs can off-set some of their risk by being able to convert Shares to Units	Section 4.1
Limit on all RVPs holding more than 5% of total Shares	Section 3.8
Fonterra Shareholders' Fund (Fund)	
Shareholders can transfer some of their underlying economic rights in Shares and get paid the then market value of a Unit issued by the FSF	Section 4.1
Cannot transfer any voting or milk payment rights	Fonterra Constitution (Form B)
Shareholders can buy Units and exchange them for Shares	Section 2.2.3 Section 3.1 Section 3.7.2 Section 4.1
No obligation for retiring farmers to 'buy-back' rights which they may have transferred to the FSF	Section 3.2.2
Underlying rights held by a Custodian on behalf of the FSF	Note that this feature has been superseded by the Custodian See: Section 3.5
FSF is a unit trust with an independent trustee	Section 4.6
FSF issues Units to the public	Section 4.6.2
Board intends to manage the size of the FSF within a threshold of 20% of total Shares (lower than 25% constitutional threshold)[3] As described in this Blueprint, the Board will manage the size of the Fund to a target level well below this constitutional threshold	Section 4.2 Section 5
Board sets threshold for individual shareholders contracting with the FSF. Initially unlikely to be more than 33% of individual shareholding[4]	Section 4.2 Section 5
No individual investor (together with associates) can hold more than 20% of FSF Units[5]	Section 4.4
Fonterra holds a 'Fonterra unit' to provide certain protections (e.g. in relation to minimum contract terms between shareholders and the Fund)[6]	Section 4.6.3
Fonterra's role	
To manage its share capital, Fonterra can either issue more Shares directly to shareholders (e.g. 'bonus' Share issue) or use company law mechanisms to issue or buy back Shares as appropriate via the FSM (maybe through an RVP)	Section 5.5
Fonterra may also issue more Shares at the outset of TAF to create a sufficient pool of Dry Shares, and may do so after that to meet production increases	Section 4.7.2 Section 5.2
Retentions are expected to be the main source of new capital for Fonterra over time	Section 5.4

[3] It is proposed that this limit be reduced from 25% to 20%. For this reduction to occur, shareholders would need to approve this change to Fonterra's constitution by a special resolution. A special resolution having this effect will be voted on by shareholders at the Special Meeting on 25 June 2012, but it is not intended to be a pre-requisite for TAF.

[4] It is proposed that this 33% limit be included in the Constitution. For this to occur, shareholders would need to approve this change by a special resolution. A special resolution having this affect will be voted on by shareholders at the Special Meeting on 25 June 2012, but it is not intended to be a pre-requisite for TAF.

[5] This feature has changed to 15%, as explained in section 4.4

[6] This feature has changed, as explained in section 4.7

Board intends to start off well below stated target thresholds and limits	Section 5.1
If thresholds are exceeded then the Board has to act to return below them	Section 5.5 Fonterra Constitution (Form B)
Valuer	
Council able to continue appointment of the Valuer if they think this appropriate, but nature of the role would be different (no inside information provided)	Section 2.6
Implementation	
Board can put TAF in place before the end of December 2013 or at a later date specified by Board. Board is not obliged to do so if pre-conditions cannot be met	Section 1.1

1.5. Launch window

The targeted launch window is mid-November 2012 to mid-December 2012 for the implementation of TAF. This launch window fits around the public availability of Fonterra's full year results, and the existing period for farmer shareholders to enter/exit or increase/decrease supply for the 2013/14 Season.

It is the responsibility of the Board to determine final timing, following appropriate consultation with the Shareholders' Council and other stakeholders.

1.6. Policies

The Fonterra Board will determine policies in relation to aspects of TAF. This document describes policies that are currently in force (such as the dividend policy) and other policies that are intended to be in force on or before the launch of TAF.

The Fonterra Board retains the discretion to determine and change its policies from time to time as circumstances warrant. Policies described in this Blueprint that are intended to be in force on or before the launch of TAF are indicative of the expected approach of the Fonterra Board, as at the date of this Blueprint.

It is intended that any change to a policy that is outlined in this Blueprint which is altered prior to TAF commencing will be clearly communicated to farmer shareholders.

2. OVERVIEW OF TRADING AMONG FARMERS

Outline

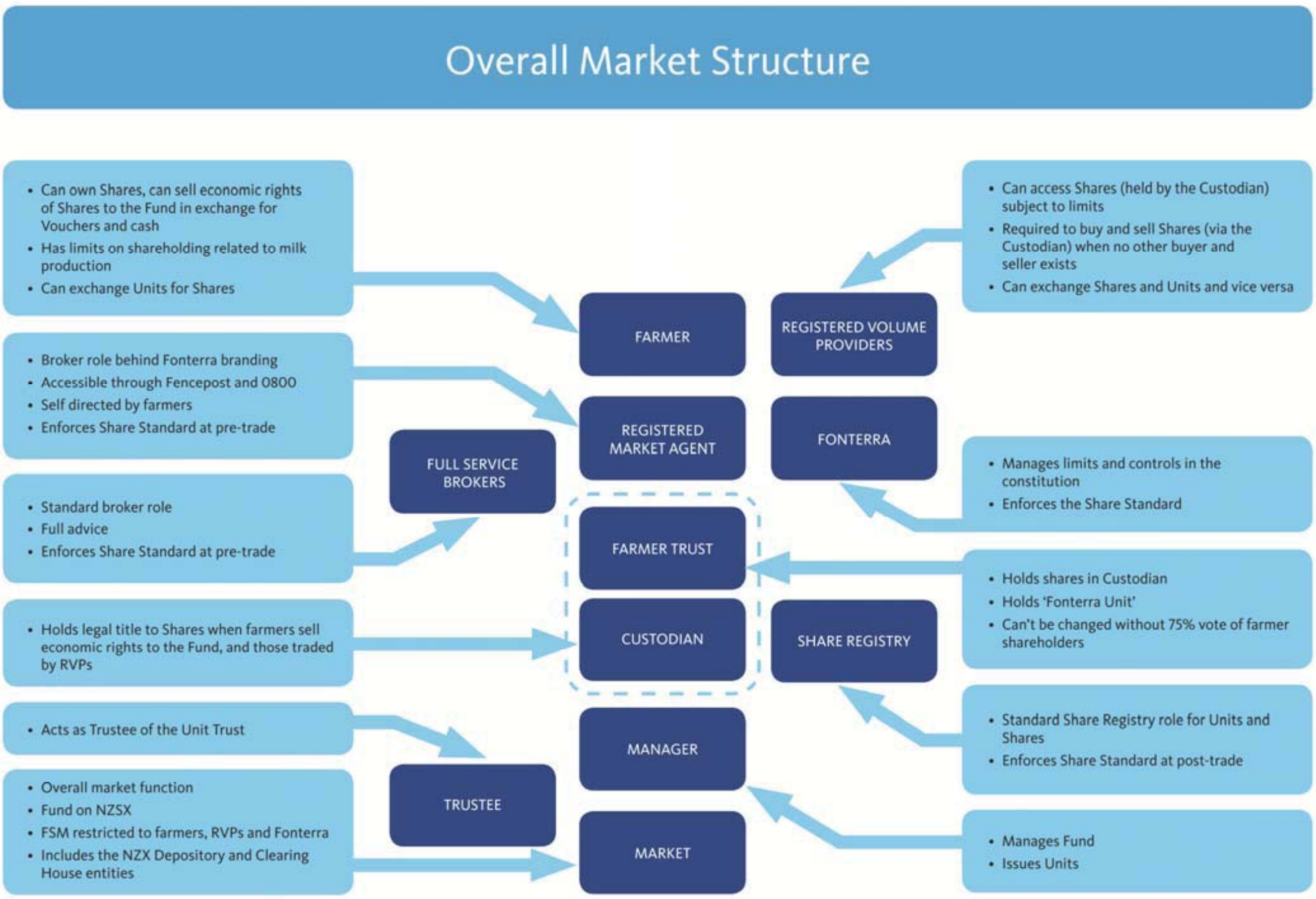
This section provides an overview of TAF. In particular:

- The role of the Fonterra Shareholders' Market, that will be restricted to farmer shareholders, the RVP, exiting farmers and Fonterra itself;
- The role of the Fonterra Shareholders' Fund which issues units to the public which trade on the NZSX;
- How the Fonterra Shareholders' Market and the Fonterra Shareholders' Fund inter-relate;
- How the Share Standard will be set; how compliance will be measured; and the role of Vouchers in meeting the Share Standard;
- The on-going role of the Valuer.

Sections 3 and 4, which follow, explain the FSM and the FSF in more detail.

2.1 Participants and Roles

TAF will be facilitated by a number of inter-dependent service providers and systems. It will not be a single "TAF System" that is built in isolation. The intent is for TAF to re-use existing market systems, processes and service providers where possible. This approach has enabled the build time for TAF to be minimised whilst increasing the likelihood of delivering a trusted, robust and stable market. A high level overview of the participants and their major roles is shown below:



2.2 High Level Activities of the Markets

TAF is designed to facilitate the following:

- Trading of Shares on the Fonterra Shareholders' Market;
- Trading of Units issued by the Fonterra Shareholders' Fund on the NZSX; and
- The exchange of Shares and Units.

2.2.1 Trading on the Fonterra Shareholders' Market

The Fonterra Shareholders' Market is designed to facilitate:

- Farmer shareholders buying Shares for cash;
- RVP buying Shares for cash. The Shares which the RVP buys are held by the Custodian;
- Farmer shareholders selling Shares for cash; and
- The RVP selling Shares for cash.

2.2.2 Trading on the Fonterra Shareholders' Fund

The Fonterra Shareholders' Fund issues Units, which are listed on the NZSX. As a result:

- Anyone may buy Units for cash; and
- Anyone may sell Units for cash.

2.2.3 Exchange of Shares and Units

The Fonterra Shareholders' Market and the Fonterra Shareholders' Fund allow Shares and Units to be exchanged, in summary, as follows:[7]

- A farmer shareholder sells economic rights of Shares to the FSF (which Shares are then held by the Custodian). Units are created which are then sold on the NZSX and the cash paid to the farmer shareholder. The farmer shareholder may also receive Vouchers, subject to individual limits on the number of Vouchers that can be accrued - refer to Section 2.5. These transactions would all happen automatically. From the perspective of the farmer shareholder, he or she would elect to sell economic rights of Shares, the share register would be updated, and the farmer-shareholder would receive cash (and, subject to limits, Vouchers) at settlement three days later.
- The RVP sells economic rights of Shares to the FSF (which Shares are then held by the Custodian). The RVP would receive Units which the RVP can then sell on the NZSX for cash if it wishes.
- A farmer shareholder purchases Units on the NZSX. The farmer shareholder may elect to hold these Units or elect that Units be exchanged for Shares on a one for one basis;
- The RVP purchases Units on the NZSX. The RVP may elect to hold these Units, subject to a specified limit, or elect that these Units be exchanged for Shares on a one for one basis.

A Share and a Unit are discrete and separate instruments. One cannot "convert" into the other. However, for ease of use in this Blueprint the terms 'convert' and 'exchange' are used in relation to transactions where a Unit is 'swapped' for a Share (and vice versa).

When reference is made to "selling economic rights of Shares to the FSF", what this means is that the farmer shareholder transfers Shares to the Custodian. The Custodian holds those Shares as the legal owner, but holds the economic rights of those Shares in trust for the trustee of the FSF.

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[7] Fonterra may also create Units, as explained in sections 4.1 and 5.2.

2.3 TAF instrument and market names

Fonterra will use the standard NZX naming convention for identifying the Fonterra Shareholders' Market and Fonterra instruments. The NZX follows global convention and uses acronyms as unique identifiers for securities. The TAF related instruments will be named as follows:

- FCG – a Fonterra Co-operative Group Share (traded on the Fonterra Shareholders' Market only)
- FSF – a Fonterra Shareholders' Fund Unit (traded on the NZSX only).

In addition, the Fonterra Shareholders' Market will be known as the FSM.

2.4 Setting the Share Standard and measuring compliance

The shareholding requirements for farmer shareholders will be determined on the Measurement Date (being the first day of a Season, currently 1 June) and will then be advised to farmers. It will be tested on the Compliance Date (which will be set by the Board and will be not less than six months following the Measurement Date). It is currently intended to be on or after 1 December.

The Share Standard requires that, as a minimum, one Share is held for every kilogram of milk solids supplied by a farmer shareholder. For these purposes, supply will be based on a three season rolling average of a farm's production. The level of supply for a new entrant will be based on an estimate. A farmer shareholder will be able to apply to Fonterra to adjust their expected level of production during a Season if they could show special circumstances (such as a change to their farm system).

The three-season rolling average will commence on the first Measurement Date following the launch of TAF. The consequence of this is that all farmer shareholders will be compliant with the Share Standard (under the current framework) on the launch of TAF. This removes any immediate obligation for a farmer shareholder to trade at, or soon after, the launch of TAF.

After TAF has commenced, a farmer shareholder who has not taken the necessary steps to become compliant with the Share Standard by the Compliance Date will have Shares purchased/sold on their behalf by the Independent Agent.

2.5 Vouchers

Under the Form B Constitution the Board has the discretion to allow the Share Standard to be satisfied by the holding of both Shares and Vouchers. If the economic rights of Shares are sold by a farmer shareholder to the FSF (with legal title in those Shares then transferred to the Custodian), the FSF will record this sale and issue to the farmer shareholder one Voucher for each Share transferred to the FSF, subject to limits.

The Board will have the discretion to set from time to time the FSF Transfer Limit. This will specify the maximum number of economic rights of Wet Shares which farmer shareholders may sell to the FSF. The number of Vouchers that qualify for the Share Standard will match the individual FSF Transfer Limit. For example, if the individual FSF Transfer Limit was set at 15% of the minimum shareholding that a shareholder is required to hold, then only 15% of the minimum holding required by the Share Standard can be satisfied by Vouchers. This means that economic rights to no more than 15% of the Wet Shares held by the shareholder at that time may be sold to the FSF.

The purpose of the Voucher is two-fold:

- First, when determining whether a farmer shareholder is in compliance with the Share Standard and accordingly will receive the full purchase price for milk supplied, Vouchers will be included in the calculation of the number of Wet Shares held; and
- Secondly, when determining the number of votes a farmer shareholder may cast on the Shares held by that farmer shareholder, the number of Vouchers held will be included in the calculation of the number of Wet Shares held.

The Voucher is not a security. It simply records that a farmer shareholder has sold the economic rights of a Share to the FSF and, in return, has preserved the voting rights and full milk supply payment (if the Share was a 'Wet' Share and backed production) to the extent that the Board determines that Vouchers can be used for the purpose of satisfying the Share Standard.

Vouchers are currently not proposed to be transferable; however the Board may develop a policy which would allow for the transfer of Vouchers in certain circumstances. This could include deceased estates, changes of entity, or amalgamations and divisions (where all farms involved are owned by the same party). The policy will require any transfer of Vouchers to obtain the explicit approval of Fonterra.

2.6 The Valuer

It has not yet been determined whether the Valuer currently appointed under the Constitution would continue to have a role. If the Valuer does, the nature of that role will be different from its current role as the Valuer would effectively be no different from any other external person who provides their view on the value of Shares. Appropriate protocols would need to be established to ensure that the Valuer can obtain access to the information necessary to enable it to undertake its role, while complying with relevant securities laws.

3 FONTERRA SHAREHOLDERS' MARKET (FSM)

Outline of Section 3

This section describes the Fonterra Shareholders' Market (FSM). This section also:

- provides an overview of the FSM with diagrams that illustrate the steps that occur when a farmer shareholder buys or sell Shares, or when an RVP buys or sells Shares (with those Shares held by the Custodian);
- sets out specific requirements relating to farmer shareholders on the FSM, and payments for milk;
- describes overall and individual thresholds and limits relating to Shares, both under the Share Standard and for trading on the FSM;
- describes rules that govern the FSM;
- describes the role of the Fonterra Farmer Custodian that will hold Shares where economic rights of those Shares have been sold by farmer shareholders to the FSF, or any Shares acquired by the RVP;
- describes the operation of the FSM (in terms of market hours etc.) and the role of the Market Operator that runs the FSM under a contract with Fonterra;
- describes the role of the Registered Market Agent (RMA) to provide access by farmer shareholders to the FSM via Fencepost;
- describe the roles of the RVP, the Share Registry, full service brokers (if farmer shareholders wish to use them as their agents) and the Independent Agent;
- describes how farmer shareholders can have an Independent Agent buy or sell shares on their behalf in order to comply with the Share Standard;
- describes processes relating to the payment of dividends; and
- describes procedures farmer shareholders would follow to register Share transactions that do not occur through the FSM.

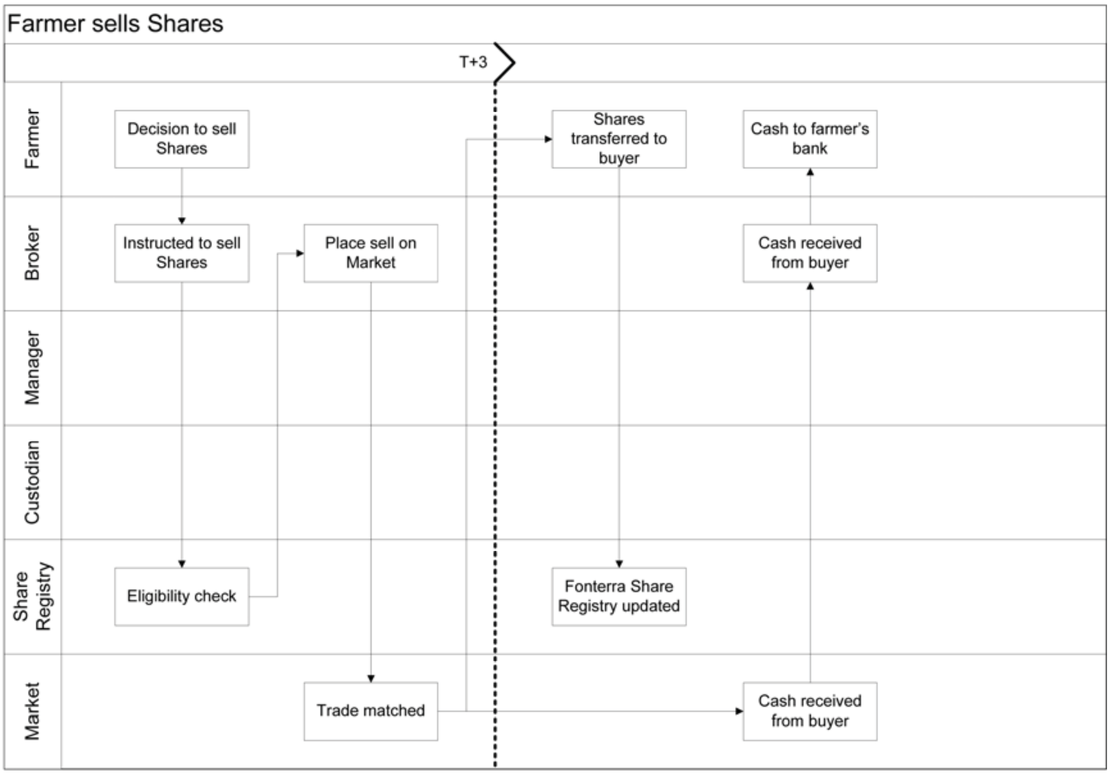
3.1 Overview

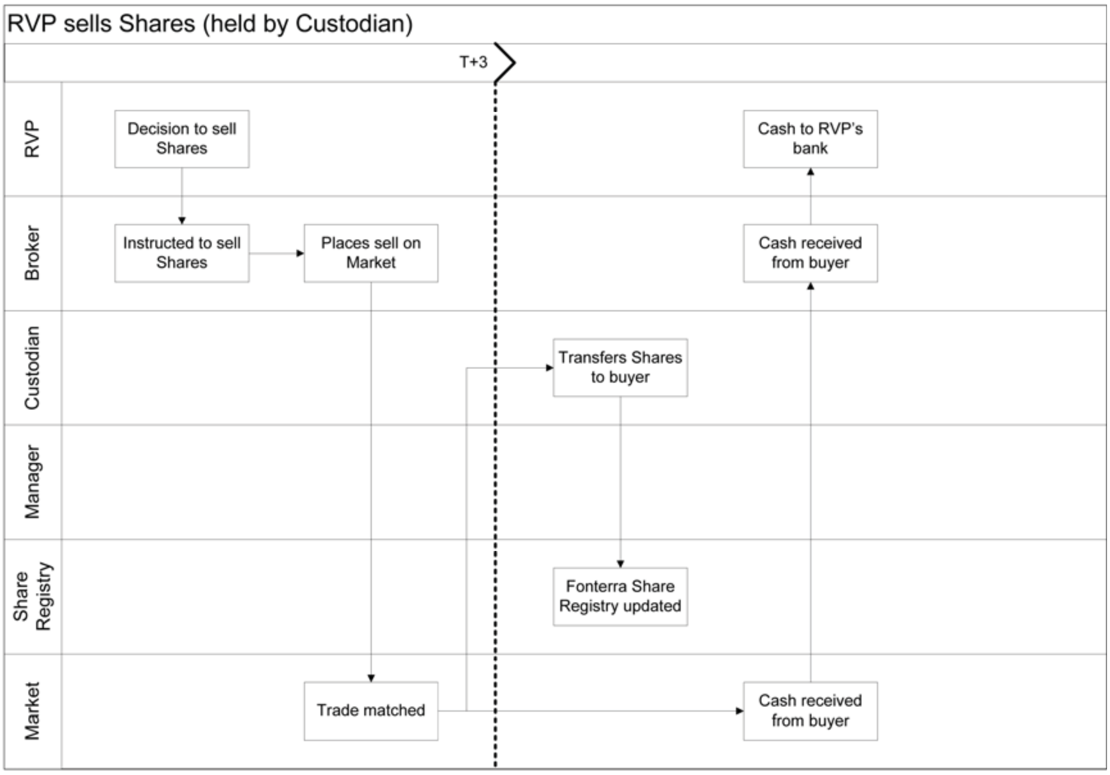
The Fonterra Shareholders' Market will be a restricted market with only farmer shareholders[8], the Custodian (on behalf of the Registered Volume Provider[9]) and Fonterra able to hold Fonterra Shares directly.

[8] Under the Form B Constitution, shares will also be able to be held by farmers who have ceased supplying milk to Fonterra but continue to hold shares, on a 'three-year-out' exit.

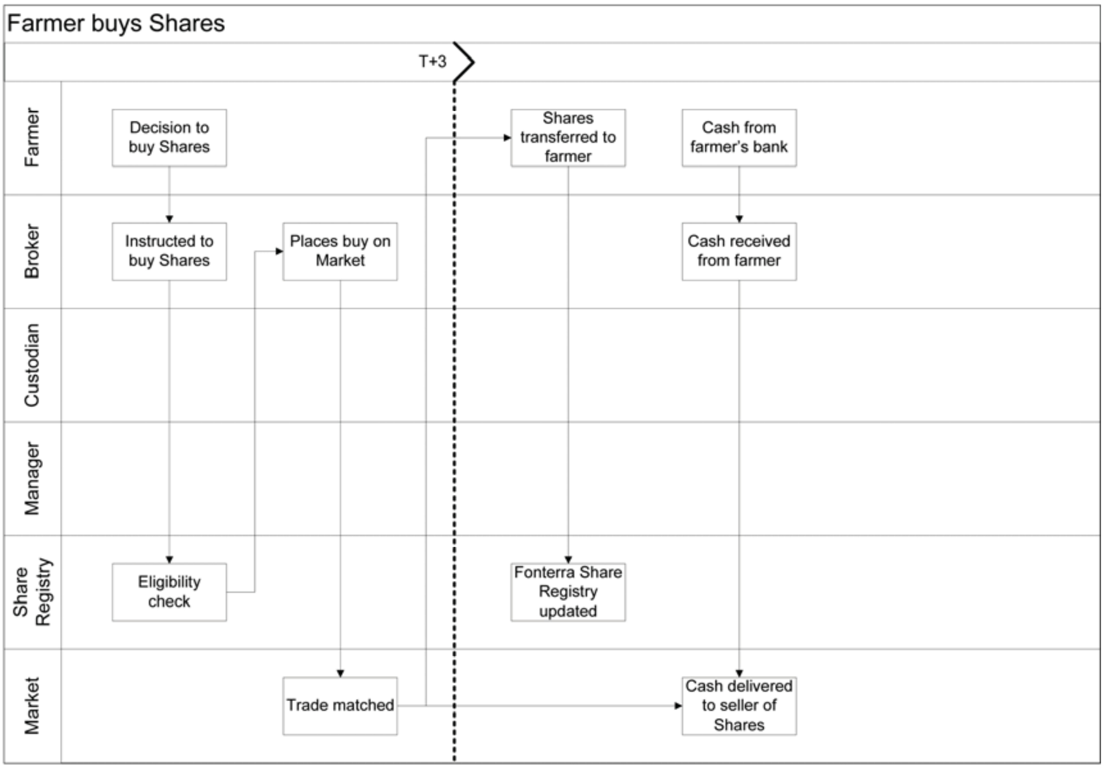
[9] Fonterra intends to appoint one Registered Volume Provider, however it is able to appoint additional RVPs if the need arises.

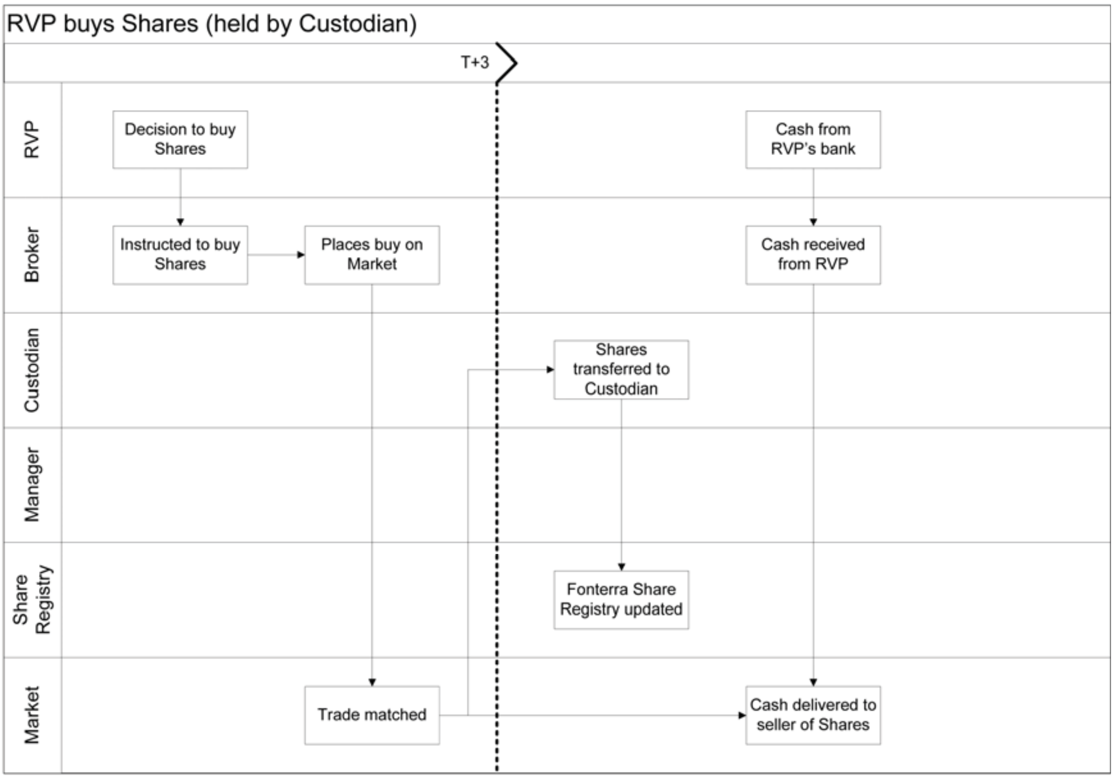
The operating scenarios within the FSM are set out in the following diagrams. These diagrams are simplistic and do not show all the required steps.





T+3 describes the standard settlement period of 3 business days after trade date (T+0).





In addition:

- Farmer shareholders can exchange Units for Shares. In this scenario the farmer shareholder purchases Units on the NZSX. The farmer shareholder would then require that those Units be redeemed by the FSF in exchange for the transfer to the farmer shareholder of one Share for each Unit redeemed;[10]

[10] Fonterra can similarly exchange Units for Shares.

- The RVP can exchange Shares for Units. In this scenario the RVP purchases a Share from a farmer shareholder on the FSM (with legal title to that Share passing to the Custodian). The RVP then sells the economic rights in those Shares to the FSF (these Shares are still held by the Custodian but the economic rights in those Shares are now held in trust for the FSF). The RVP receives Units from the FSF in consideration for this sale;
- RVP can exchange Units for Shares. In this scenario the RVP purchases Units on the NZSX. The RVP would then require that those Units be redeemed by the FSF in exchange for the Custodian recording that it now holds on behalf of the RVP one Share for each Unit redeemed.

The FSM will be a registered market under section 36F of the Securities Markets Act 1988 and will be operated by NZX as a registered exchange under the Securities Markets Act 1988. Given the close association required between the FSM and the NZSX on which Units of the FSF are listed, the rules for the FSM will be very similar to the rules for the NZSX. One of the key differences between the rules for the FSM and the NZSX listing rules, will be the requirement that only farmer shareholders, the RVP and Fonterra are able to trade on the FSM (but all Shares acquired by the RVP must be held by the Custodian).

The settlement rules applicable to trades on the FSM will be the standard NZX clearing and settlement procedures which requires that certain market participants temporarily take title to Shares to facilitate settlement. These will allow failed trades to be resolved (although these should be infrequent).

Farmer shareholders will access the FSM either through a full service broker, or via Fencepost; or via the standard Fonterra 0800 number. Direct Broking Limited (a subsidiary of ANZ National Bank) has been appointed as the Registered Market Agent (or RMA, typically referred to as an "on-line broker" in equity markets). The RMA will provide the share brokerage service that will be undertaken if a farmer shareholder uses either Fencepost or the Fonterra 0800 number to undertake trading.

3.2 Farmer Shareholder Participation

Outline of Section 3.2

This section provides an overview of how a farmer shareholder participates in the FSM:

- General terms in respect of the shareholding requirements under which a farmer shareholder can exit or enter Fonterra are described in sections 3.2.1 and 3.2.2, including the flexible shareholding requirements referred to as ‘three years in/three years out’;
- Section 3.2.3 explains why each farm dairy will be treated separately, even if owned by the same farmer shareholder; and
- Milk payments under TAF are described in section 3.2.4; in particular the Share-backed milk price (including for supply backed by Vouchers), the non Share-backed milk price and the contract milk price.

3.2.1 Farmer Shareholder Requirements

Under TAF, farmer shareholders who cease milk supply to Fonterra may continue to hold Shares over a period following cessation of supply. The Board proposes to adopt a policy that exiting farmer shareholders are permitted to sell down their shareholding within three years (with a minimum of 1/3rd sold in each year). This policy is commonly known as the ‘three-year out’ rule. However, exiting farmer shareholders are not entitled to vote once they cease supplying milk. (See clause 3.10 of the Form B Constitution for the ‘three year out’ rule, and Clause 8 of the Form B Constitution in relation to voting rights.)

The existence of the Fonterra Shareholders’ Fund creates the ability for the farmer shareholder to sell the economic rights in some of their Shares to the FSF (with the Shares to be held by the Custodian). As a consequence, subject to certain limits described in section 4.2, the farmer shareholder will receive a Voucher in respect of each Wet Share transferred to the Custodian. A Voucher will record that the farmer shareholder remains entitled to:

- receive the full purchase price for milk supplied, because Vouchers will be taken into account when determining whether a farmer is in compliance with the Share Standard and accordingly will be included in the calculation of the number of Wet Shares held; and
- have those Vouchers taken into account in determining the number of votes a farmer shareholder may cast on the Shares held by that farmer shareholder (again because Vouchers held will be included in the calculation of the number of Wet Shares held).

Vouchers are not expected to have any value, will be personal to a specific farmer shareholder, and cannot be transferred (other than as described in section 2.5).

3.2.2 Entry & Exit

New farmers joining Fonterra, or farmer shareholders increasing supply, will have up to three seasons to buy the necessary shares (which would result in a requirement to buy a minimum of one-third of shares in each season). Milk supplied that is not backed by Shares (and/or Vouchers) will be paid at the non-Share-backed milk price (Refer to the discussion below on Non-Share backed Milk Price).

When exiting Fonterra (or decreasing production), farmer shareholders will have up to three Seasons to sell their Shares (minimum of 1/3rd, 1/3rd, 1/3rd each Season). Exiting farmer shareholders have the option to sell all of their Shares at any time during the three-year period, including at the time they exit. Exiting farmer shareholders are not entitled to buy Shares during the three-year exit period, and are only able to sell their Shares via the FSM (or an off-market transaction. Refer Section 3.13). Exiting farmer shareholders are not able to exit via the Fund (i.e., by selling economic rights of Shares to the Fund in exchange for Units and selling those Units for cash on the NZSX).

Compliance for each season of entry or exit is enforced at the Compliance Date, which is intended to be on or after 1st December in each Season.

Any Vouchers held by an exiting farmer will be cancelled with effect from the first day of the season following their last Season of supply.

3.2.3 Farm dairy aggregation

The Constitution provides flexibility in recognising what constitutes a farmer shareholder. Currently, a farm dairy constitutes a farmer shareholder but it is possible that the Board may in the future allow suppliers to aggregate, so that a group of farm dairies could constitute a single farmer shareholder.

Consideration has been given as to whether it is appropriate to aggregate to allow a farmer shareholder who owns multiple farms to manage their Share compliance as a single entity, rather than managing the Share Standard on each individual farm. This is not a requirement for TAF as it is feasible and practical to require a farmer shareholder to trade on the basis of each farm dairy.

Farm dairy aggregation is not contemplated at the launch of TAF, or immediately after. The TAF system will be designed so that a farm dairy constitutes a Fonterra shareholder. If a need for farm dairy aggregation is required in the future, then the system can be changed for this at the relevant time.

3.2.4 Milk payments

Under TAF, milk payments will continue to be set by the Board, based on the aggregate farm gate milk price calculated under the Farmgate Milk Price Manual. The Board will continue to have the discretion to determine an average milk price for Share-backed milk (which will be determined by including Vouchers, refer Section 4.2) and non Share-backed milk (including contract milk).

Share-backed milk price

The Board will continue to set an average milk price based on Share-backed supply. To be entitled to this milk price for a given month, a farmer shareholder must own Shares by the qualification date described below equivalent to (or greater than) the production to that date for the Season[11]. A Share purchase which has not settled by the record date would not be taken into account. The key dates for assessing Share-backed supply are:

- Qualification date for Share-backed milk price: Last day of the month of production
- Advice date of milk payment: 7th of the month following the month of production
- Payment date of milk payment: 20th of the month following the month of production

Non Share-backed milk price

The Board has determined that milk supplied which is not backed by Shares at the end of each month will be paid a non Share-backed milk price This price will be set by the Board and can be a discount from the full Share-backed milk price. It will be important for farmer shareholders to note that a farmer shareholder could be compliant with the Share Standard based on their three-season rolling average but produce kgMS of milk over and above the number of Shares they hold, as a result of a better than average Season. If the supplier did not buy more Shares to cover this extra production by the time his/her kgMS production exceeds their Shares then he/she will be paid the non Share-backed milk price on that extra production. A shareholder approaching this position will receive a number of warnings that they may end up in a position where they have fewer Shares than they are required to hold to match the level of his/her production (in kgMS).

The manner in which this could impact a farmer shareholder is illustrated below. In this example, the farmer shareholder would be required to purchase additional Shares prior to the end of March, in line with their increased production, to qualify for the full (Share-backed) milk price on their production in March and April.

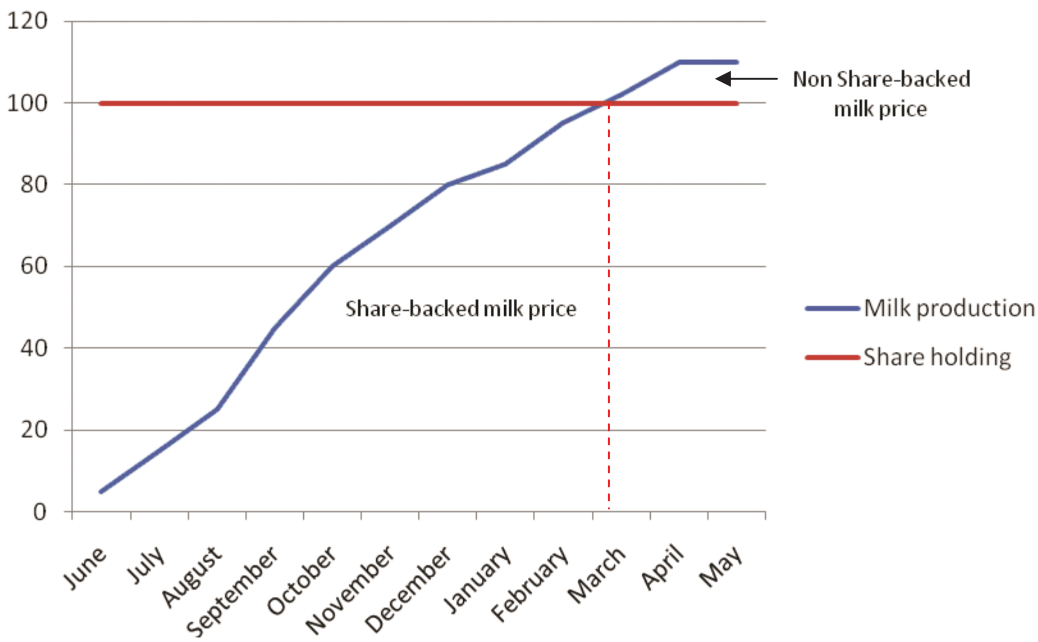


Figure: Non Share-backed milk price

Contract milk price

The contract milk price is set by the Board, commonly by reference to the full milk price. For Season 2012/13, this is expected to be 5c/kg less than the full (Share-backed) milk price.

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[11] To achieve this, the Board would set a “Base Limit” in accordance with Clause 3.23 of the Form B Constitution, and this limit will take effect from the launch of TAF.

3.3 Overall and Individual Thresholds and Limits

Outline of Section 3.3

This section describes the role of overall and individual Share thresholds and how they will be managed, in particular:

- The overall (aggregate) and individual 'Dry Share' thresholds;
- How the permission function in the FSM will operate to ensure constitutional thresholds are complied with;
- How 'Relevant Interests' in Shares are monitored; and
- 'Substantial Security Holder' disclosure requirements.

3.3.1 Overall Dry Share Threshold

Although Fonterra has only one class of Share, the terms "Dry Share" and "Wet Share" are used in relation to shareholding. The term "Wet Share" is used to describe the component of a farmer shareholder's shareholding that is backed by production. For example, if a farmer owns 150,000 Shares, and has a three season average of 120,000 kg/MS per season, 120,000 of his or her Shares are described as "Wet". This is what would be set as the minimum required holding (under the Share Standard). The remaining 30,000 Shares that exceed the minimum required holding are described as "Dry".

As noted in section 5.5, the Board intends to adopt a policy to manage the number of Dry Shares on issue to within an acceptable tolerance of 5% of total Shares on issue. This target level is substantially below the constitutional threshold in Form B of the Constitution.

The number of Dry Shares on issue will be disclosed to farmer shareholders regularly.

3.3.2 Individual Dry Share limits

Farmer shareholders are required to hold the number of Shares needed to meet the Share Standard. A farmer shareholder can meet the Share Standard by holding Shares and Vouchers[12]. In addition, the Board may permit an individual farmer shareholder to hold between 100% and 200% of the Shares they must hold under the Share Standard. The Board has indicated that it will set this limit at 200% (which it will formally approve prior to the launch of TAF). By way of example, a farmer shareholder who has averaged 120,000kg/MS over the previous three seasons must hold 120,000 Shares, but may hold up to 240,000 Shares.

No individual farmer shareholder can hold "Relevant Interests" in Dry Shares in excess of 5% of the total number of Shares on issue, excluding treasury stock. Should this be exceeded, those Shares in excess of the 5% limit must be disposed of (or will be disposed of by the Independent Agent on direction from Fonterra). Section 3.3.4 indicates how this restriction will be monitored. Section 3.3.5 provides detail on the requirements for substantial security holders under the Securities Markets Act 1988.

3.3.3 Permission function

The permission function of the FSM is a set of system controls designed to ensure that the Constitutional requirements and restrictions for FSM trading activity are complied with.

To properly enforce these requirements and restrictions, a pre-trade and post-trade permission confirmation will be undertaken for all FSM trades.

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[12] Refer to section on Vouchers in Section 2.5.

Pre-trade

The pre-trade permission function is undertaken by FSM registered brokers (including the RMA). A broker is obliged to check a farmer shareholder's constitutional trading limits prior to placing any buy or sell order for Shares, to ensure any order sent to the FSM is compliant with the Share Standard and related requirements and restrictions applicable to that farmer shareholder. The broker checks this via an online query to the Share Registry.

Post-trade

Once an order has been matched and a trade agreed, a post-trade permission function is initiated at trade settlement. This again checks each trade against a farmer shareholder's constitutional trading limits, providing Fonterra a second level of review and enforcement of the Share Standard and related requirements and restrictions. The Share Registry is responsible for post-trade permission verification.

The FSM will require a unique identifier for each farmer shareholder, so that all trading activity can be electronically checked against the Share Standard and related requirements and restrictions applicable to that farmer shareholder. The FSM will adopt standard industry practice by ensuring that all farmer shareholders have a Common Shareholder Number (CSN) as the unique identifier. A CSN will be assigned to each unique Farm/Party relationship (where the *Farm* is the Fonterra farm number and *Party* is the legal shareholding entity). Farmer shareholders with multiple farms will therefore require multiple CSNs. The Fencepost trading site will allow a farmer shareholder with multiple farms to "link" different farm CSNs, making it straight-forward for a farmer shareholder to "switch" between CSNs when viewing shareholdings or trading, without the requirement to log on to the system separately for each CSN.

The CSN will not be transferrable or reusable for other Farm/Party relationships, as it must continue to be linked to the Farm/Party to which it was originally assigned. Upon the sale of a farm, for example, that CSN will no longer be used by Fonterra. It cannot be transferred to the purchaser of that farm. A purchaser would be assigned a new CSN.

3.3.4 Relevant interest

Under the Form B Constitution, a shareholder cannot hold, nor have, a "Relevant Interest" in Dry Shares in excess of 5% of the total number of Shares on issue, excluding treasury stock (regardless of the number of Wet Shares held). Under the Form B Constitution, the term "Relevant Interest" has the same meaning as under the Securities Markets Act 1988, subject to the exceptions provided in that Act and the Board's discretion to determine that a person does not have a Relevant Interest. By way of example, a person will have a Relevant Interest in a Share if that person:

(a) Is the registered holder of that Share; or
(b) Is a beneficial owner of that Share; or
(c) Has the power to exercise, or control the exercise of, a right to vote attached to that Share; or
(d) Has the power to acquire or dispose of, or to control the acquisition or disposition of, that Share.

The Form B Constitution envisages that Fonterra will monitor "Relevant Interests" in Shares in two ways:

- Every farmer shareholder is required to provide to Fonterra the information that the Board specifies from time to time, to enable Fonterra to monitor the level of shareholding (and Relevant Interests) of the farmer shareholder and whether he or she is complying with the limits applicable to him or her.

  To implement this, it is intended that a policy will be developed prior to launch of TAF. That policy will be adopted by the Board and will be issued to farmer shareholders. It will advise farmer shareholders of the level of shareholding (in absolute terms, because individual farmer shareholders may not have the information to determine their percentage interest) that they are required to disclose to Fonterra. Fonterra will review those disclosures and monitor any further increases in shareholding that could mean that the limits in the Constitution are likely to be exceeded.

- The Board is given the power to require a shareholder, at any time, to provide information to Fonterra as to their shareholding and their Relevant Interests. In practice, this power will only be used where Fonterra considers that a shareholder may be breaching the limits applicable to him/her.

  As an overall comment, given the size of shareholding (or Relevant Interests) that will cause a breach of the thresholds in the Constitution compared to the proportion of Shares held by our largest farmer shareholder, it is expected that action will need to be taken under these provisions infrequently (if at all). Nonetheless, the disclosure and monitoring of Relevant Interests are important mechanisms to give effect to the controls in the Constitution.

3.3.5 Substantial Security Holder disclosure requirements

Under the Securities Market Act 1988, substantial security holders in Shares or Units are required to disclose their relevant interests to both the NZX and, to Fonterra (in the case of Shares) or the FSF (in the case of Units).

A person is a substantial security holder if that person has a relevant interest in 5% or more of the relevant security. At the point of becoming a substantial security holder (5%), the individual is immediately required to give notice to Fonterra (where the relevant interest is in respect of Shares) or the FSF (where the relevant interest is in respect of Units) and NZX.

Subsequently, the person must also give notice to Fonterra or the FSF (as the case may be) and NZX when:

(a) There has been any movement in the relevant interest held of 1% or more of the total number of the relevant securities. (For example, there is a movement of 1% or more if the person disposes of relevant securities comprising 1% or more of the total number of those securities on issue);
(b) There is a change in the "nature" of the relevant interest of the substantial security holder; or
(c) That person ceases to be a substantial security holder (i.e. the person then has relevant interests in less than 5%).

Every person who fails to disclose information in accordance with a substantial holding disclosure obligation commits an offence under the Securities Markets Act 1988.

Under the Form B Constitution, a farmer shareholder cannot hold, nor have, a “Relevant Interest” in Dry Shares in excess of 5% of the total number of Shares on issue, excluding treasury stock (regardless of the number of Wet Shares that farmer shareholder holds). Fonterra will know the number of Wet Shares that each farmer shareholder is required to hold in accordance with the Share Standard. Therefore, the regime will be useful in monitoring the limits on holding Relevant Interests in Dry Shares (excluding treasury stock) as each person will have to make disclosure upon achieving a substantial security holding in 5% of Shares, and thereafter a movement in 1% or more of the substantial security holding.

3.4 Market Rules and Participant Rules

Outline of Section 3.4

This section describes the key rules and procedures that apply to the FSM, as well as fees that will apply to market participants, like full-service brokers who may act on behalf of farmer shareholders. In general terms, this section describes:

- The role of Market Rules to ensure the integrity of the FSM is described in section 3.4.1. These would be agreed between Fonterra and the Market Operator (NZX), and approved by the Financial Markets Authority, with compliance overseen by the Market Operator (NZX). The rules would also define an 'Independent Director' of Fonterra;
- How 'related party' transactions, particularly in relation to setting of the Fonterra Farmgate Milk Price, would be governed, and the role of the Milk Price Panel; and
- The separate set of rules that will apply to market participants, like the RVP or the Registered Market Agent (through whom farmer shareholders would transact Shares on the FSM via Fencepost), as well as the approach that will be taken to fees for market participants.

3.4.1 Market Rules

The Fonterra Board will establish the initial FSM rules in conjunction with NZX as the Market Operator and the Financial Markets Authority. Fonterra will appoint the Market Operator for the FSM to oversee compliance with these rules. As noted earlier, the rules for the FSM will be based on the NZSX listing rules, except where there are specific reasons to deviate. This is required so as to promote fungibility across the FSM and the trading of Units of the FSF on the NZSX, as well as for ease of operation.

The rules for the FSM require approval from the Financial Markets Authority. In order to gain approval, input to the rules is being obtained from NZX (in its capacity as New Zealand's only registered exchange and given its in-depth knowledge of the NZSX listing rules). As at the date of this Blueprint, draft rules have been produced, have been the subject of public consultation, and are being prepared for submission to the Financial Markets Authority for approval.

The rules of the FSM are recognised in the Form B Constitution[13]. If any provision in the Constitution is inconsistent with a rule, then the rule takes precedence. In the proposed rules for the FSM, no provisions have been identified that are inconsistent with the Constitution[14]. There are a number of matters that are included in the rules for the FSM that supplement provisions in the Constitution. They include the following:

a. The requirement for independent directors;
b. The requirement for certain resolutions of the Fonterra Board to be passed by a 75% majority of directors that includes a majority of the independent directors;
c. The requirement for the Milk Price Panel[15].

Following the launch of TAF, changes may be made to the FSM rules. In general, any change to the rules will require the consent of both Fonterra and the Market Operator (with such consent not to be unreasonably withheld). Fonterra can withhold consent to any proposed change to a rule which could prejudice Fonterra's status as a co-operative company under the Co-operative Companies Act 1996 or will, or will be likely to, in Fonterra's reasonable opinion, affect Fonterra's co-operative structure and ethos or the nature of the FSM as a "private market" in which only farmer shareholders, the RVP and Fonterra can trade. Any change to the

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[13] Clause 48.4, Form B Constitution.

[14] There is a technical inconsistency to facilitate the standard clearing and settlement function.

[15] Whether these remain in the FSM Rules may depend on whether they are dealt with in the DIRA amendments. If the resolution amending the Constitution proposed to the meeting on 25 June 2012 is passed, these requirements will be included in the Constitution, and may not be in the FSM rules.

rules caused by a change in law, or a change in the NZSX listing rules, will be incorporated through a change control process.

Once agreed by Fonterra and the Market Operator, the Securities Markets Act 1988 requires that any proposed rule change be approved by the Financial Markets Authority.

Independence of Fonterra directors[16]

The FSM rules will require that a minimum of one-third (rounded down) of Fonterra directors must be 'independent".[17] Fonterra's (up to) four Appointed Directors[18] will be required to formally satisfy the definition of "independence".

The definition of independence is set out in the draft FSM rules and is based on the definition of independence in the NZSX listing rules, but has been adapted to recognise that Fonterra's Appointed Directors should not have farming interests, subject to the exceptions noted below. To further emphasise their independence, Appointed Directors will not be able to have an interest in Units.

The definition in the FSM rules of an 'independent director' in Fonterra's context will require that a person has no interest in a New Zealand dairy farm and no interest in Units issued by the FSF and otherwise having no interests or relationships such that they cannot be properly considered to be independent.

Under the draft FSM rules, an Appointed Director will still meet the definition of "independent" even if they also have the following roles:

a. A director of a company that holds an interest in a New Zealand dairy farm or a Unit, provided that the director does not derive a substantial portion of his or her income from that company (excluding director fees);
b. An independent trustee of a trust that has an interest in a New Zealand dairy farm or a Unit.

Appointed Directors[19]

To reinforce the independence of the Appointed Directors, the Authorised Fund Contract will provide for the following requirements in relation to the appointment of independent directors:

- The Board will follow a robust selection process to identify a suitable candidate or candidates;
- As a vacancy arises (or prior to any three-yearly re-ratification of an incumbent Appointed Director), the Board will consult with FSF representatives[20] on a list of possible candidates determined by the Board;
- At the time of launch of the FSM, the appointments of each of the four existing Appointed Directors will be deemed to be confirmed;
- A Director who is appointed through this process will require ratification by Fonterra shareholders at the next Fonterra Annual Meeting.

In addition, the FSM rules will provide that the Board can appoint an Appointed Director who is not supported by FSF representatives, but this resolution of the Board would need to be supported by a majority of the Appointed Directors. Disclosure would be made that the appointment has not been supported by the FSF representatives.

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[16] This section may be altered depending on the form of the DIRA amendments.

[17] Based on 13 directors, Fonterra would be required to maintain at least four "independent directors".

[18] In this Blueprint, the term Appointed Director is used to describe a director appointed by the Board (and ratified by farmer shareholders). The Appointed Directors will also need to be independent directors for the purpose of the rules of the FSM.

[19] This section may be altered depending on the form of the DIRA amendments.

[20] The FSF representatives will be the three directors of the Manager of the FSF determined by unit holders.

Related party transactions[21]

Under the standard NZSX rules, there are restrictions on "related party transactions". Where there is a material transaction between a company subject to the NZSX rules and a related party (which includes directors), then the transaction must be approved by an ordinary resolution of shareholders. In the Fonterra context, we need to recognise that farmer directors are also supplying shareholders and that certain provisions that would normally impact on transactions involving directors will need to recognise this co-operative relationship.

We also think it is desirable to include some additional governance protections in relation to key decisions that would impact on the holders of Shares that are not backed by production (which would include Shares held by the Custodian).

These key decisions will be required to be passed (as a minimum) by a 75% majority decision of the Board but this majority must include a majority of the Appointed Directors. These key decisions are:

- A decision by the Board to pay an aggregate amount for milk in excess of the aggregate amount for milk calculated under the Milk Price Manual;
- A decision to amend or replace the Milk Price Manual;
- A decision to promote or support any change to, or replacement of, the Constitution that would have a material adverse impact on the rights attached to the Shares which are from time to time held by the Custodian for the FSF;
- (As noted above), the appointment of an Appointed Director whose appointment is not supported by the representatives of the FSF.

Milk Price Panel[22]

The FSM rules will recognise the existence and composition of the Milk Price Panel.

The FSM rules will require that the Milk Price Panel is appointed and that it comprises five members. The Shareholders' Council is entitled to appoint two members with the remaining members appointed by the Board of Fonterra (with the Board's practice that one of these is a farmer director).

Not less than half of the members must be independent. The Chairman must be an independent member and will not have a casting vote. A member will be independent where the member is not an employee of Fonterra and has no direct or indirect interest or relationship with Fonterra that could reasonably influence, in a material way, that member's decisions in relation to their duties as a member, nor any other "Disqualifying Relationship" (being the test applied to determine whether a director of Fonterra is independent). Notwithstanding this, an Appointed Director may be an independent member.

3.4.2 Participant Rules

The Participant Rules relating to the Fonterra Shareholders' Market will be the NZX Participant Rules. The NZX Participant Rules will be amended to include a chapter on specific provisions which will apply to Registered Volume Providers and brokers trading on behalf of clients (farmer shareholders) on the FSM. This includes a requirement for all market participants to operate within the Constitutional limits. The NZX Participant Rules cover rules for trading securities, requirements for designation as a market participant and financial requirements.

NZX oversees compliance with the NZX Participant Rules. In particular, NZX is responsible for assessing risk, capital adequacy, technological compliance, and the record keeping and client order procedures, to ensure compliance with the NZX Participant Rules.

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[21] This section may be altered depending on the form of the DIRA amendments.

[22] This section may be removed depending on the form of the DIRA amendments. If removed it is expected that DIRA would have similar principles as those outlined above. If the resolution amending the Constitution proposed to the meeting on 25 June 2012 is passed, these requirements will be included in the Constitution, and may not be in the FSM rules.

3.4.3 Fonterra Shareholders' Market participant fees

Market participants operating on the NZSX (i.e. brokers) are subject to a range of fees charged by NZX, including:

- Application and accreditation fees;
- Initial admission fees;
- Annual membership fees;
- Transaction fees (per trade fee);
- Trade penalties (for infringements or trade cancellations);
- Market surveillance fees; and
- Participant and vendor technology fees.

FSM Market Participants will already be subject to these fees (in respect of their trading on NZSX/NZDX and NZAX markets) as they will need to be NZX Market Participants to be eligible to be FSM Market Participants. In order to ensure consistency between the FSM and the NZSX (on which Units in the FSF will be traded), but without discouraging broker participation, it is currently proposed that the transaction fees and penalty fees that are imposed on market participants in respect of their trading on the NZSX will also be applied to FSM Market Participants in respect of their trading on the FSM. These fees are subject to regular review and change, but the intent will be for these fees to remain consistent with the NZSX fees on an ongoing basis.

As well as maintaining parity with the NZSX, the benefit of this approach in respect of FSM participant fees for TAF will be threefold:

- It will reduce the likelihood of any discrepancy between the Share and Unit prices as a consequence of differing transaction fee levels;
- It would provide Fonterra with the ability to rebate transaction fees to participants (such as the RVP) for meeting certain volume targets; and
- Disciplinary procedures for both markets will be consistent as a consequence of the same approach to trade penalty fees.

Trade penalty fees will be levied on the relevant market participant by the Market Operator, and credited to the NZX Disciplinary Fund (which is also responsible for market discipline in the FSM). This amount is not expected to be material on an annual basis.

Outline of Sections 3.5 to 3.11

These sections describe the role of various entities and agents in the FSM, in particular:

- the role and function of the Custodian. The Custodian must hold any Shares where economic rights to those Shares have been sold by farmer shareholders to the FSF. The Custodian will also hold any Shares purchased by the RVP and for market participants (brokers) as noted in section 3.1. The Custodian will be a company that is wholly-owned by the Fonterra Farmer Custodian Trust. This Trust will be controlled by farmer shareholders directly, not through Fonterra;
- the role and function of the Market Operator appointed by Fonterra to manage and operate the FSM;
- the role and function of the Registered Market Agent (RMA). The RMA is the channel through which farmer shareholders will trade Shares on the FSM via Fencepost, or through an 0800 telephone service;
- how the Registered Volume Provider (RVP) will promote day-to-day liquidity on the FSM;
- the role and function of the Share Registry, which will record Shares and Vouchers held by farmer shareholders, and will ensure that all trades comply with the FSM rules and the Share Standard;
- the role of full-service brokers. Some farmer shareholders may wish to trade Shares on the FSM through a full-service broker acting as their agent;
- the basis upon which 'delegated compliance trading' can occur. Some farmer shareholders may elect to have an Independent Agent manage their shareholding by buying or selling Shares on their behalf to comply with the Share Standard and
- While the various entities and agents outlined in these sections are important to enable TAF to operate smoothly, they will not intrude or be visible to farmer shareholders or unit holders in day-to-day trading.

3.5 Custodian

The Custodian must hold the Shares where economic rights of those Shares have been sold by farmer shareholders to the FSF, and any Shares that have been acquired by the RVP or are held by a market participant at the end of any trading day (as set out in section 3.1). In the instance where the RVP purchases Shares by trading on the FSM, legal title to those Shares will be transferred to the Custodian.

Consistent with the objective that Fonterra remains 100% farmer controlled and owned, the Custodian will be wholly owned and controlled by the Fonterra Farmer Custodian Trust (see below) which is controlled by farmer shareholders. The required characteristics of the Custodian will be as follows:

- A limited liability company with all its shares held by the trustees of the Fonterra Farmer Custodian Trust;
- Three directors who are the trustees of the Fonterra Farmer Custodian Trust;
- The constitution of the Custodian will recognise that only the trustees of the Fonterra Farmer Custodian Trust can hold shares in the Custodian;
- There will be restrictions on any change in the shareholding of the Custodian, including the granting of any security or encumbrance over any share in the Custodian;
- Changes to the Custodian structure will require a 75% resolution of farmer shareholders.

The majority of the functions of the Custodian will be carried out under contract by Fonterra's Share Registry.

The Custodian will maintain separate accounts for each of the following purposes, where the Custodian retains legal title to the Shares:

- RVP – The Custodian will maintain a specific account for the RVP. This allows Fonterra to monitor the individual holdings for the RVP;
- FSF – The Custodian will maintain a specific account for the FSF, where economic rights of Shares have been sold to the FSF. This is critical in ensuring Fonterra can monitor the size and performance of the FSF, by comparing the number of Units on issue to the number of Shares held in this Custodian account; and
- To the extent necessary, provide a facility to hold Shares for the purposes of resolving any issues with clearing and settlement.

Despite the number of accounts described above, there will only be one Custodian. As noted above, the Custodian will be a company that is wholly owned by the three trustees of the Fonterra Farmer Custodian Trust. The Fonterra Farmer Custodian Trust will be structured as follows:

- The Trustees will be three farmer representatives:
  - A farmer directly elected by Fonterra shareholders;
  - A Fonterra farmer director;
  - A member of the Shareholders' Council.
- The discretionary beneficiaries of the trust will be Fonterra farmer shareholders from time to time;
- The final beneficiary will be Fonterra;
- The sole purpose of the trust will be to hold the legal title to shares in the Custodian, and to hold the Fonterra Unit ("**Fonterra Unit**") in the FSF;
- Any material change to the trust deed will require a 75% resolution of farmer shareholders;
- The trust deed of this trust will also provide for the following:
  - Fonterra will authorise only one Authorised Fund;
  - Fonterra will require the Trustee of the Fund to agree that there will only be one "custodian", being the Fonterra Farmer Custodian;
  - Apart from the operation of clearing and settlement arrangements, the only persons who may be registered as the holders of Co-operative Shares will be:
    - shareholders (in effect, supplying shareholders, but including those who have ceased supply but are selling down their shareholdings over three seasons);
    - persons whose applications to supply have been accepted by Fonterra;
    - the Fonterra Farmer Custodian, when it holds shares for the RVP or economic rights of shares for the Fund; and
    - Fonterra itself (when it holds treasury stock); and
  - Fonterra will maintain registration as a co-operative dairy company under Part 3 of the Co-operative Companies Act 1996.

3.6 Market Operator

As noted in section 3.1, the FSM will be a registered market under section 36F of the Securities Markets Act 1988 and will need to be operated by a registered exchange under the Securities Markets Act 1988. Given the close association required between the FSM and the NZSX on which Units of the FSF are listed, the rules for the FSM will be very similar to the rules for the NZSX. There will need to be a close connection between the FSM and the NZSX to enable farmer shareholders and the RVP to switch easily between both markets. Given these factors, and that NZX Limited is the only registered exchange in New Zealand, NZX Limited was the natural candidate for the role of Market Operator under a contract with Fonterra.

Given the important linkages between the FSM and the NZSX, market hours in the FSM will mirror that of the NZSX, including non-trading days, abbreviated trading days, and non-settlement days. This is to ensure that the exchange of Shares to Units (and vice versa) by farmer shareholders and/or the RVP can occur continuously. Under the FSM rules, only the Market Operator would be able to suspend trading, although it may suspend trading on the request of Fonterra. Reasons to suspend trading could include excessive within-day price movements that cannot be explained by a specific event or market news. If the FSM market is suspended for any reason, trading in Units is also likely to be suspended (and vice versa).

In addition to the market rules and the participant rules noted above, Fonterra and the operator of the FSM will enter into a Market Operator Agreement that will determine the basis on which the FSM is to be operated.

3.7 Registered Market Agent (RMA)

3.7.1 Overview

The Registered Market Agent will provide trading functionality via Fencepost and the current Fonterra 0800 telephone number. The provision of this service will be entirely outsourced at launch to Direct Broking Limited (who has been appointed following a competitive process). Fonterra will not develop any new systems or capability in relation to trading.

The RMA solution has been designed to meet the expected current and future requirements for farmer shareholders trading both in the FSM and in Units of the FSF, including:

- Standard market agent functions at pre-trade, order entry, order execution, clearing, performance reporting, cash management, compliance and reconciliation;
- Interfaces to and from Aspire, Fencepost, banks, the NZX and the Share Registry (refer Section 3.9);
- Performing pre-trade compliance with the FSM rules.

3.7.2 Fencepost Trading

Fencepost will provide access to the trading platform with some key functionality:

- The Fencepost trading interface will have a separate logon function that creates a second level of authentication, in addition to that on Fencepost;
- There will be a single logon ID for each farm, which means only one person can be authenticated to trade via the Fencepost trading website per farm[23]. Other recognised individuals can be approved to trade on the same farm, but only via the 0800 number;
- Multiple farm owners will be able to link a number of farms to a single Fencepost logon. This will allow a farmer shareholder to logon to Fencepost once, and manage Shares across each of their farms separately. Settlement of cash transactions will be to a single cash account, not one for each farm;
- The trading functionality will be integral/seamless with the existing Fencepost website and the user interface is designed to be straight-forward, consistent, flexible and efficient, mirroring that of the existing Fencepost pages i.e. comply with Fonterra's design guidelines;
- Fencepost will provide equal access to both the FSM and the NZSX market for Units of the FSF:
    - To aid price convergence, Fencepost will provide the same information for both the FSM and FSF markets;
    - The process and workflow for trading will be identical across the two markets;
    - To aid cross market comparison, farmer shareholders will be provided with tools that have been designed to clearly and easily show shareholding balances, compliance figures and trading information for both the FSM and in respect of Units;

[23] In this scenario, we consider the farm a party/farm relationship as described in Section 3.2.3.

- Farmer shareholders will have the ability to sell Units by trading on the NZSX (i.e. exchange Shares into Units, to allow the farmer shareholders to use those Units to settle a sale contract on Units);
- Farmer shareholders will have the ability to convert Units to Shares.

- To use the Fencepost Trading Interface, farmer shareholders will need to open a trading account(s) with the RMA. This process should be a once-only step;
- Farmer shareholders will be able to check balances, obligations, shareholding requirements and monitor the market, add orders and monitor trades and orders;
- On launch, the Board will adopt a policy under which brokerage fees incurred when trading Shares via Fencepost will be paid by Fonterra directly to the RMA. This will include circumstances where farmer shareholders sell economic rights in respect of Shares to the FSF. The ongoing intent of this policy will be to provide brokerage-free compliance trading for farmer shareholders. (This policy will also provide the Board with the ability to monitor excessive trading, and retain the right to make any changes to the extent to which brokerage fees are shared between Fonterra and those who trade significant volumes of Shares, consistent with the ongoing intent of the policy);
- Brokerage fees will be incurred by farmer shareholders when:
  - trading Units via Fencepost i.e. these will not be reimbursed by Fonterra. Brokerage will be charged directly to farmer shareholders at trade settlement, with farmer shareholders charged the wholesale brokerage rate agreed between Fonterra and the RMA. Brokerage will be charged on a volume basis, rather than a per trade basis;
  - exchanging Units for Shares via Fencepost will be reimbursed by Fonterra. The Unit to Share transfer fee will be a flat fee, regardless of the number of Units being exchanged for shares.

Fencepost Trading – Example Overview[24]

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[24] The limits as detailed in this example assume an FSF Transfer Limit of 15%.

3.7.3 0800 Service

The RMA will also provide the trading service behind the current 0800 telephone number (farmer shareholders will have an option to choose the FSM service when calling). This will provide basic trading support and the same suite of services that are available on the Fencepost trading site, plus helpdesk support for the Fencepost trading interface. The 0800 trading service will not provide any financial advice.

3.8 Role of the RVP

There will initially be only one RVP who has been appointed via a competitive tender process. The RVP will be obliged to trade Shares in the FSM. The RVP will be able to participate in the trading of Units, and will be able to exchange Shares for Units and vice versa. The RVP will have the ability to sell economic rights of Shares to the FSF, with legal title to the Shares being held by the Custodian in exchange for being issued Units.

The Constitution requires that the RVP can hold no more than 5% of the total Shares on issue at any point in time (legal title to all such Shares will be held by the Custodian). However, under the contract with the RVP, the actual percentage of Shares held by the RVP (via the Custodian) will be capped at 1.5%.

Within the FSM, the RVP will provide services intended to enhance the operation and liquidity of the FSM. The RVP is prohibited from exercising, or directing the exercise of, voting rights attached to any Shares held by the Custodian on its behalf. For any Shares held by the Custodian on behalf of the RVP, on a dividend record date, the dividend would be paid to the Custodian on behalf of the RVP or direct to the RVP at the Custodian’s instruction.

The principal duties of the RVP are to ensure the smooth execution of transactions and improve liquidity through continuous quoting of both uy and sell orders within a contracted maximum spread between buy and sell prices quoted. A key role for the RVP will be to ensure that the spread between buy and sell prices is restricted to a narrow range.

The contract with the RVP will be publicly disclosed (other than commercially-sensitive pricing terms). The trading activities of the RVP on the FSM will be displayed via the highlighting of RVP orders in the market depth charts on the Fencepost trading site.

3.9 Role of the Share Registry

At present, Fonterra maintains an internal share registry. Given the close interaction required between the FSM and the FSF, continuing with the internal Fonterra share registry for the FSM would be operationally complex. Therefore, the current Fonterra share registry functions will, prior to launch, be discontinued and the existing share register will be migrated to an external share registry. Computershare Investor Services Limited ("Computershare") has been appointed via a competitive process to undertake the share registry functions. Fonterra will continue to manage all farmer shareholder applications (for example, farm sales, material changes, contracts), as well as setting the measurement and compliance requirements for TAF. Accordingly, farmer shareholders should notice few, if any, differences, other than improved functionality.

The Share Registry will be responsible for providing pre-trade access to FSM market participants of the compliance requirements, in addition to enforcing the Share Standard and related requirements and restrictions post-trade to ensure all trades of Shares are compliant with the Constitution.

Computershare will provide the share registry services for both Fonterra, in respect of Shares, and the FSF in respect of Units. This will be a requirement under the Authorised Fund Contract between Fonterra and the FSF.

As far as possible, the functions of Computershare will be based on an industry standard structure and functionality. This solution provides maximum flexibility, as well as the simplest solution in terms of connectivity, in operating TAF.

3.10 Full-service Brokers

Any broker authorised to participate in the NZSX will be able to provide full-service broking services to farmer shareholders wishing to trade on the FSM, on terms (including the payment of fees) agreed between the parties (i.e. the farmer shareholder and the broker).

Full-service brokers will be required to be approved to participate in the FSM market, which will include adherence to the Constitutional limits as they apply to trading and which are captured under the Participant Rules. Full-service brokers will be obliged to complete pre-trade permission checks prior to order placement.

3.11 Independent Agent

An Independent Agent will be appointed to provide the following functions:

- Managing trading for those farmer shareholders that elect Fonterra to manage their shareholdings in accordance with the Share Standard. This is described as "delegated compliance trading";
- Managing trading for those farmer shareholders that are not compliant with the Share Standard by the Compliance Date. This is described as "enforced compliance trading";
- Providing order execution and expertise in any on-market capital management programme Fonterra may initiate from time to time, e.g. share buy-backs.
- As required by Fonterra, resolving other possible ad-hoc breaches of the Share Standard during the Season.

The Independent Agent will be an authorised participant of the NZSX and FSM.

Compliance trading (whether "delegated" or "enforced") will be managed by the independent agent in line with the following principles:

- Compliance trading is defined as buying up to a farmer shareholder's minimum holding, or selling down to a farmer shareholder's maximum (200%) holding only. To illustrate this, a farmer shareholder sitting at 98% of the minimum holding, will be bought up to 100%; but a farmer shareholder sitting at 102% of the minimum, will not be sold down to 100%. Selling only occurs by the Independent Agent when a farmer shareholder exceeds the 200% maximum, and in this scenario, will only be sold down to 200% of the minimum holding (not 100%);
- All shareholders who elect delegated compliance trading will be pooled together and the Shares required by all those shareholders will be purchased over a defined period of time and then allocated to individual shareholders as appropriate;
- All participants in delegated compliance trading, to the extent possible, should achieve the same average Share price;
- The market impact of the Independent Agent compliance trading should be minimised;
- Dividends will be taken into account when calculating the average Share price;
- Each participating shareholder will authorise funds to be debited from their milk payment to pay for Shares purchased for them;
- Farmer shareholders' Seasonal cash flow should be considered when debiting the milk payment for Share purchases related to delegated compliance trading;
- All necessary advice (including legal and capital markets advice) should be sought when identifying appropriate Share purchase/selling windows; and
- If volumes are small, consideration should be given to issuing Shares, as well as purchasing on market.

Delegated compliance trading fees

As the Independent Agent has yet to be appointed, a delegated compliance trading brokerage rate has not yet been agreed. Due to the additional effort required in managing delegated compliance trading, it is likely that this brokerage fee will exceed the Fencepost brokerage rate.

Brokerage incurred by farmer shareholders participating in delegated compliance trading will be partially reimbursed by Fonterra by the same wholesale brokerage amount agreed with the RMA (refer Section 3.7.1). This will be subject to periodic review and may change.

Enforced compliance trading fees

Enforced compliance trading will only be required for farmer shareholders who are in breach of their Share Standard after a number of warnings. As enforced compliance trading will involve additional effort, including likely funding costs, fees associated with enforced compliance trading will exceed the delegated compliance trading brokerage rate. The associated brokerage fees and interest will be charged directly to farmer shareholders. Farmer shareholders who reach compliance via enforced compliance trading will not be entitled to a brokerage subsidy.

These fees will be subject to periodic review and may change.

Outline of Sections 3.12 to 3.13

These sections explain:

- how dividends would be paid under TAF (section 3.12); and
- the way in which farmer shareholders can transact transfers of Shares or Units among themselves outside the FSM or NZSX (in respect of Units) (section 3.13).

3.12 Dividends

Under TAF, the Board will retain the discretion to make distributions to shareholders via dividends. There are three important dividend-related dates which the Board will set for determining each dividend entitlement:

- Record date: this is the time fixed for determination of the Shares and shareholders to whom a dividend will be paid;
- Ex date: The second business day before the record date for that dividend. Shareholders purchasing Shares on or post the Ex date will not be entitled to receive the dividend paid on the Share acquired. It will remain payable to the previous holder;
- Payment date: The date on which the dividend payment is paid.

At present, Fonterra pays dividends twice a year, an interim dividend in April and a full-year dividend in October. The record date for dividends is currently 31st March (interim) and 31st May (final). Under TAF, the record date will change from current practice to be consistent with normal company requirements. This requires a record date to be set within 20 working days of the payment date.

3.13 Off-market transfers

An off-market transfer is a method for transferring Shares (or Units) without using the services of Fencepost or a broker. Common forms of off-market transfers are where Shares are sold as part of a farm sale. They are executed via an Off-Market Transfer Form (OTF) which is actioned by the Share Registry. The Share Registry requires an original copy of the OTF, including shareholder and witness signatures. Electronic or faxed copies of OTFs will not be actioned.

Off-market transfers of Shares will be subject to a check of the Share Standard prior to being completed (see Section 3.3.3).

4 FONTERRA SHAREHOLDERS' FUND (FSF OR FUND)

Outline of Section 4

This section provides an overview of the role of the Fonterra Shareholders' Fund (FSF or Fund):

- The role of the Fund is described in section 4.1, in particular to support liquidity in the Fonterra Shareholders' Market and lead to better discovered prices in that market, and to provide additional flexibility for farmer shareholders.
- To meet these objectives it must be easy for farmer-shareholders to sell economic rights to the Fund. Similarly, it must be easy for the RVP and farmer shareholders, to be able to exchange a Unit for a Share. The sale and exchange processes are illustrated in section 4.1.
- Section 4.2 describes how the size of the Fund will be managed, including by setting limits on how many economic rights a farmer-shareholder can sell to the Fund (the FSF Transfer Limit).
- The FSF will be set up as a Unit Trust and will be separate from Fonterra. Its structure and governance is described in section 4.6.
- Section 4.8 describes the role of the share registry that will record the ownership of Units.
- The way in which it is envisaged that the Fund will be launched is outlined in section 4.9.
- Section 4.10 describes circumstances where the FSF can come to an end, and the processes that would be followed if that occurred.

4.1 Overview

The purpose of the Fund is to facilitate liquidity of trading Shares in the FSM to lead to better-discovered prices in the FSM and to provide additional flexibility for farmer shareholders. The Fund will provide support to the FSM by allowing farmers and other investors limited access to the economic benefits of a Share, thereby creating a more liquid market for farmer shareholders (and the RVP) to trade Shares. This will allow farmer shareholders to dispose of economic rights of shares to the Fund as well as sell Shares on the FSM, and will allow the RVP to move between the two markets (i.e., between the FSM and NZSX) in order to match supply and demand. This will facilitate price convergence between the two markets.

It is intended that farmers, sharemilkers and retired farmers will also have the opportunity to participate in the Fund, but the public and institutions will also be investors.

To allow farmer shareholders to transact Shares through the Fund (i.e., by selling economic rights of shares to the Fund) as well as selling the Shares themselves through the FSM, Units and Shares must be fungible. Fungibility requires that Units and Shares are exchangeable according to a pre-determined ratio - one for one in the case of TAF. As a consequence of fungibility, price differences between Units and Shares should converge, with differences being quickly closed.

The alternative of no fungibility with Units and Shares tradable on separate unlinked markets means that price differences between the two markets are likely to be significant, persistent and volatile over time. This would expose farmer shareholders and Unit holders to unnecessary risk and uncertainty.

A stable 1:1 exchange ratio between Units and Shares requires the investment features of both Units and Shares to be as close as possible, including equivalence of dividend flows and other economic benefits that flow from Shares.

A key component in delivering this is to ensure that investors receive the same income streams they would if they invested directly in Shares. To provide this, the unit trust being used for the Fund will be a "look through" for tax purposes, so that income derived from the economic rights of Shares held by the Fund is taxed as if those rights were held by Unit holders. The treatment of those dividends for tax purposes in the hands of unit investors and farmer shareholders may differ according to their individual circumstances.

Dividends on Shares transferred to the Custodian by farmer shareholders will be paid by Fonterra either directly to Unit holders based on information provided by the Fund, or directly from the Fund after transfer of the gross amount from Fonterra to the Fund. In either case, payment of dividends and payment of returns to Unit holders is expected to occur at the same time.

There will be two primary methods of creating Units in the Fund as follows:[25]

- A farmer sells economic rights of Shares to the Fund (with Shares held by the Custodian), a Unit is created, which is then immediately sold and the farmer receives cash and Vouchers, subject to individual limits on the number of Vouchers that can be accrued; and
- An RVP sells economic rights of Shares to the Fund (with Shares held by the Custodian) and receives a Unit, which the RVP may retain or sell for cash.

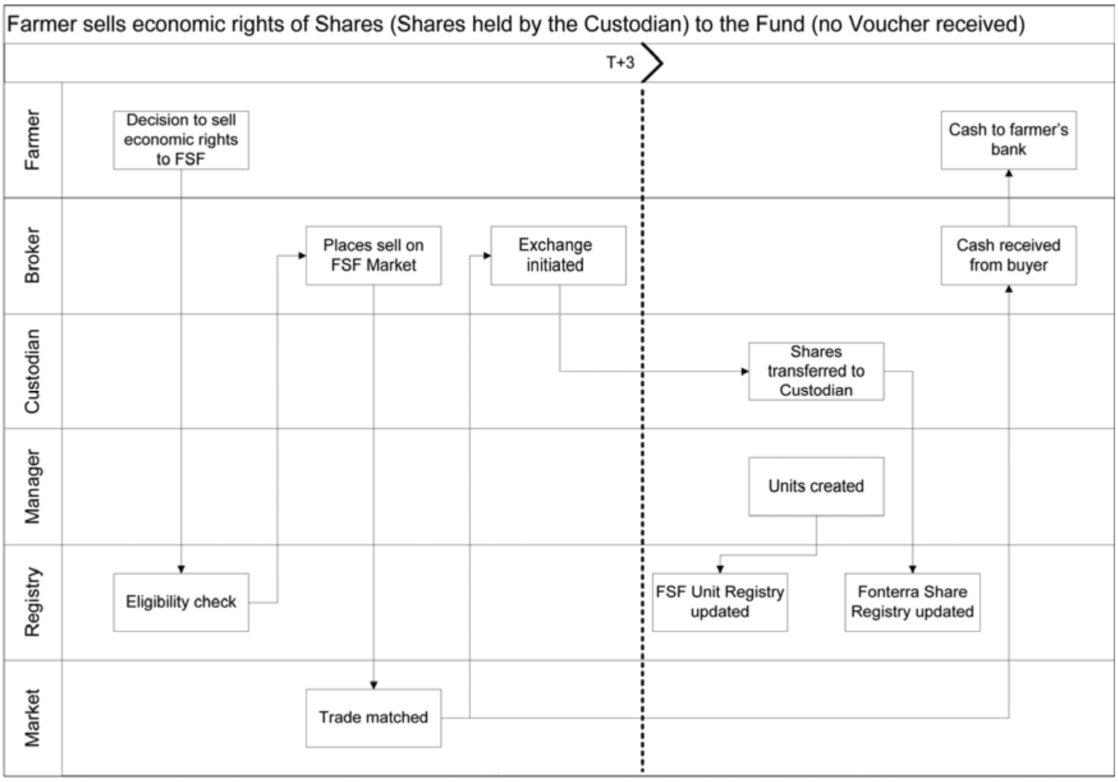
In addition, Fonterra may, for example to enhance liquidity, sell economic rights of Shares to the Fund. The Shares in respect of which it has sold economic rights would go to the Fonterra Farmer Custodian.

The essence of the transactions noted above is relatively simple. The mechanics that will sit behind the 'single click of a button' transaction are more complex, as illustrated below.

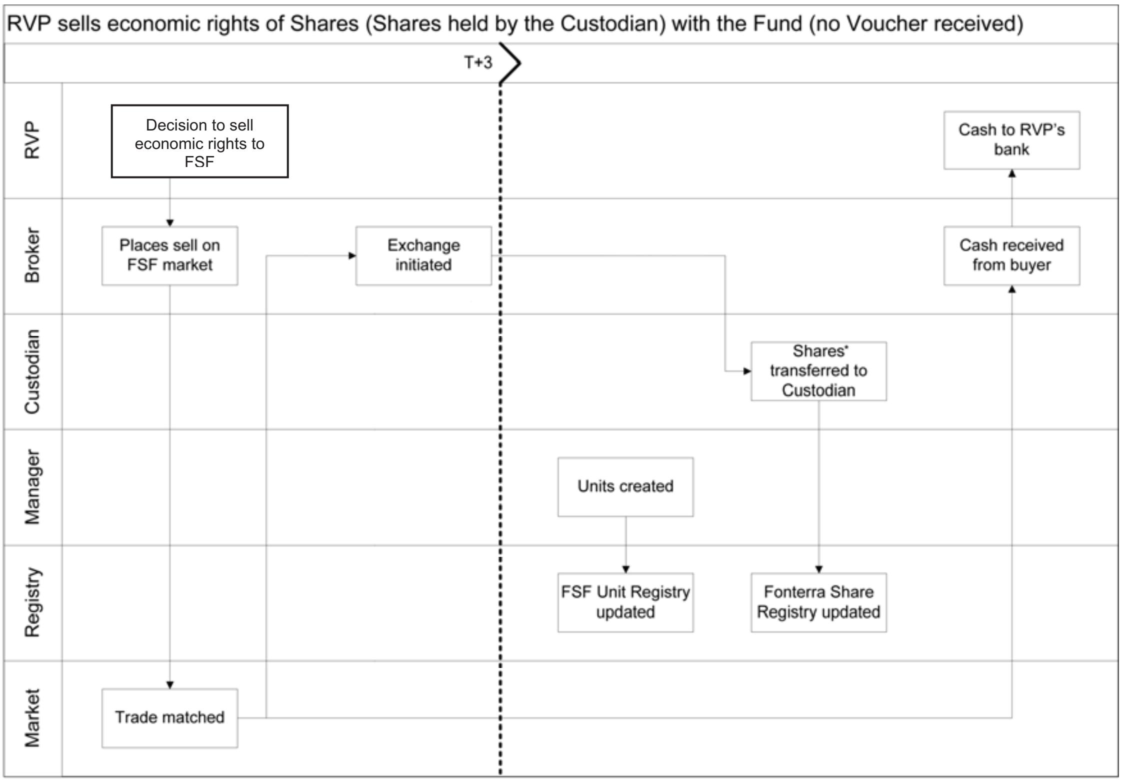
When a farmer shareholder elects to sell economic rights of Shares to the Fund, he/she is effectively entering into an agreement to sell Units in the Fund market (i.e. on the NZSX). Shares are lodged with the Custodian, and a corresponding number of Units are created. These Units are then delivered to the buyer of the Units, and the farmer shareholder receives cash in recognition of the sale of the economic rights. Subject to individual limits on Vouchers, the farmer shareholder also receives Vouchers that can be used to satisfy the Share Standard (and thereby support production-based voting rights and the right to the Share backed milk price). These mechanisms are necessary to ensure that the number of economic rights of Shares sold to the Fund will always equal the number of Units on issue.

[25] Fonterra may also create Units, as explained in section 5.2.

The process by which Units are issued or redeemed (cancelled) by the Manager is described in the diagrams below. These diagrams are simplistic and do not show all the required steps.



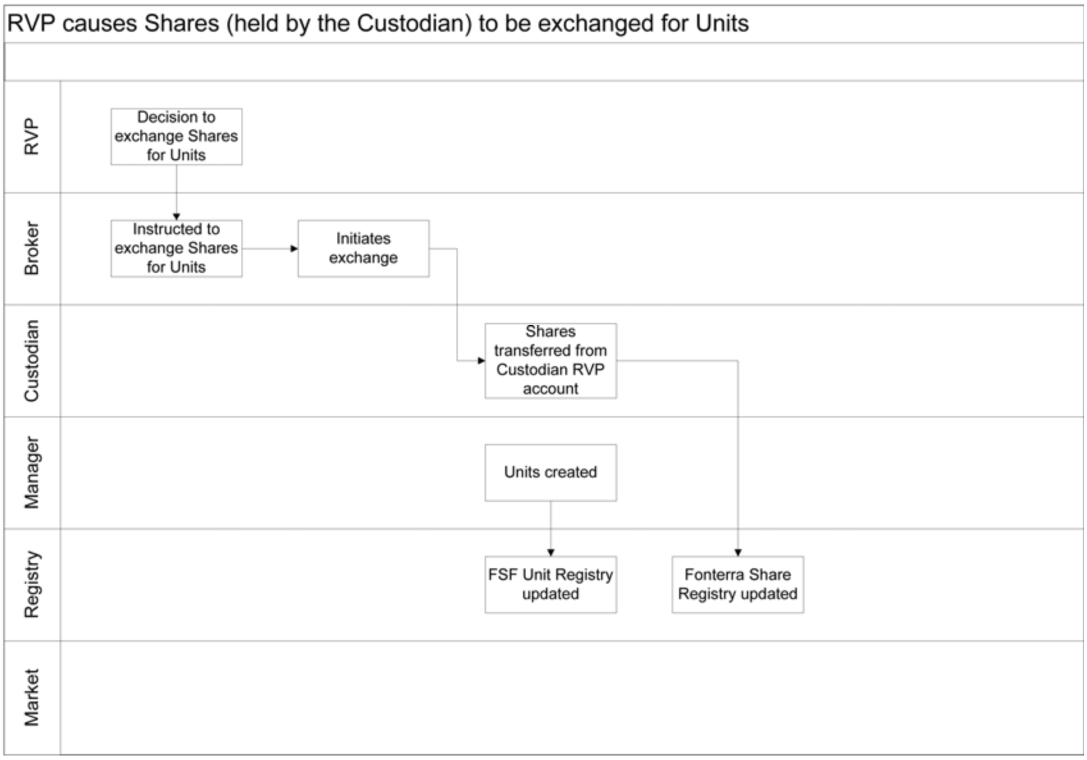
When the RVP sells economic rights of shares to the FSF, only cash is received in exchange (no Vouchers).



*In this instance, Shares are actually transferred from the Custodian RVP Account, to the Custodian FSF Account.

T+3 describes the standard settlement period of 3 business days after trade date (T+0).

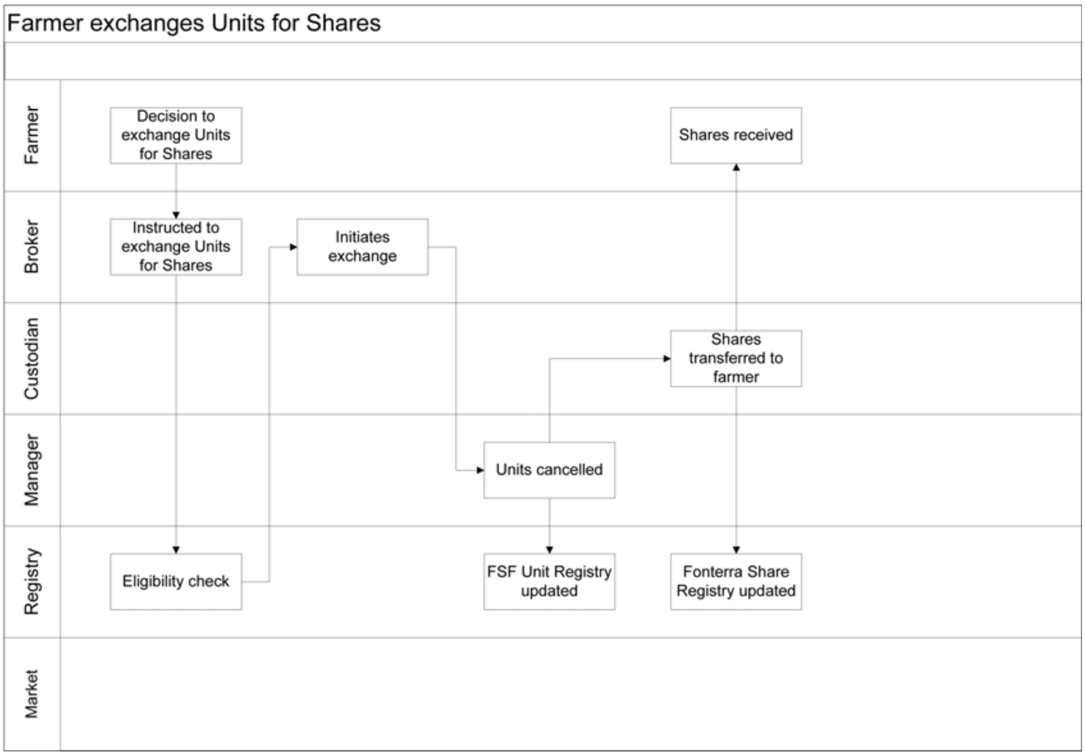
The RVP can also exchange Shares (held by the Custodian) for Units.

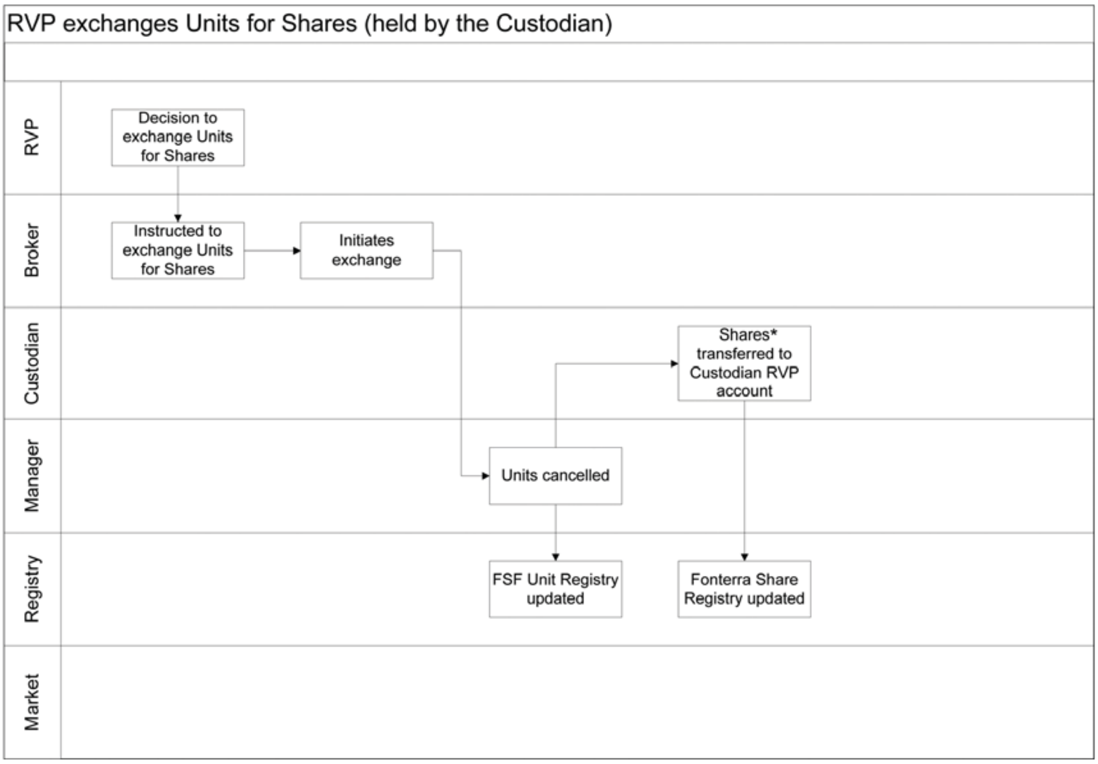


Units can also be traded directly between investors through the NZSX as standard listed units.

Units can be cancelled via two mechanisms:

- Farmer exchanges Units for Shares;
- RVP exchanges units for Shares (held by the Custodian).





*In this instance, Shares are actually transferred from the Custodian FSF Account to the Custodian RVP Account.

Outline of Sections 4.2 to 4.5

Section 4.2 to 4.5 explains in more detail the following features of the FSF:

- How the Board will manage: (a) the actual Fund size to within its policy range of 7-12% of total Shares on issue (excluding treasury stock); and (b) the potential Fund size (taking into account "dry "shares) to within 7-15% of total Shares on issue (excluding treasury stock).
- In particular the role of the FSF Transfer Limit is outlined. This limit is the proportion of "Wet"Shares that a farmer shareholder is able to sell the economic rights to.
- When a farmer shareholder sells economic rights of Shares to the Fund, title to those Shares is transferred to the Fonterra Farmer Custodian and a Voucher is recorded in the farmer-shareholder's name in the share registry (but only for Wet Shares up to the maximum FSF Transfer Limit).
- The maximum proportion of total units that any one person (and their "associates") can hold will be 15%
- The Board will manage the size of the Fund under the terms of the Fonterra Fund Size Risk Management Policy, which not only sets out the policy on an acceptable Fund size range, but also describes actions the Board will take if the Fund falls outside that range.

4.2 Fund Size and Limits

Fund size

As noted in section 5.5, the Board will adopt a policy to manage the aggregate actual size of the Fund to between 7 and 12% of total Shares on issue, (with the corresponding range for the potential size of the Fund, which includes Dry Shares, being 7-15% of total Shares on issue).

FSF Transfer Limit

The FSF Transfer Limit puts a cap on economic rights to Shares that a farmer shareholder can sell to the FSF. The FSF Transfer Limit will restrict the number of economic rights of ‘Wet’ Shares. Except in circumstances where the Fund Risk Management Policy is invoked to suspend or halt the flow of economic rights of Shares to the Fund, there will be no limit on the sale of economic rights to Shares held above the minimum (“Dry Shares”). A limit on selling economic rights of Dry Shares to the Fund would not have any real effect as farmer shareholders can always sell all of their Dry Shares on the FSM at any time. These Dry Shares could be purchased by the RVP and then placed with the Fund.

As noted in Section 5.2, farmer shareholders will have the opportunity to sell economic rights of Shares at or about the time of the launch of TAF. This process, and the management of the FSF Transfer Limit (which is designed to assist in limiting the size of the Fund to within the policy range noted above are explained in more detail in section 5.

In this context, the initial FSF Transfer limit will be set as part of the initial launch of the Fund and will be set having regard to the target initial Fund size of $500 million, or about 7-8% of Shares on issue (depending on the Share price at launch). If there is a relatively wide interest by farmer shareholders in selling economic rights of Shares to the Fund, the FSF Transfer Limit will be lower, to target a size for the Fund that doesn’t exceed its target level. It is likely that the FSF Transfer Limit may be set significantly below the Board’s indicated maximum of 33%. In notes provided to shareholders at meetings in February 2011 Fonterra indicated a potential range of 10-20%, depending on uptake.

Vouchers

Under the Form B Constitution the Board has the discretion to allow the Share Standard to be satisfied by the holding of both Shares and Vouchers. If the economic rights of Shares are sold by a farmer shareholder to the FSF (with legal title in those Shares then transferred to the Custodian), the FSF will record this sale and issue to the farmer shareholder one Voucher for each Share transferred to the FSF, subject to limits.

The Board will have the discretion to set from time to time the FSF Transfer Limit. This will specify the maximum number of Wet Shares which farmer shareholders may sell to the FSF. The number of Vouchers that qualify for the Share Standard will match the individual FSF Transfer Limit. For example, if the individual FSF Transfer Limit was set at 15% of the minimum shareholding that a shareholder is required to hold, then only 15% of the minimum holding required by the Share Standard can be satisfied by Vouchers.

This means that economic rights in no more than 15% of the Wet Shares held by the shareholder at that time may be sold to the FSF. The same limit applies to the number of Vouchers that can be accrued by farmer shareholders. In the event that farmer shareholders have reached the limit on the number of Vouchers that can be accrued, farmer shareholders will not be able to sell further economic rights of Wet Shares to the Fund.

The purpose of the Voucher is two-fold:

- First, when determining whether a farmer shareholder is in compliance with the Share Standard and accordingly will receive the full purchase price for milk supplied, Vouchers will be included in the calculation of the number of Wet Shares held; and
- Secondly, when determining the number of votes a farmer shareholder may cast on the Shares held by that farmer shareholder, the number of Vouchers held will be included in the calculation of the number of Wet Shares held.

The Voucher is not a security. It simply records that a farmer shareholder has sold the economic rights in a Share to the FSF and, in return, has preserved the voting rights and full milk supply payment (if the Share was a Wet Share and backed production) to the extent that the Board determines that Vouchers can be used for the purpose of satisfying the Share Standard.

Vouchers are currently not proposed to be transferrable. However, the Board may develop a policy which would allow for the transfer of Vouchers in certain circumstances. This could include deceased estates, changes of entity, or amalgamations and divisions (where all farms involved are owned by the same party). The policy will require any transfer of Vouchers to obtain the explicit approval of Fonterra.

4.3 RVP limits

The RVP has no restriction on the number of economic rights of Shares it can sell to the Fund. But, as noted in section 3, the RVP Contract will provide that the RVP cannot hold (through the Fonterra Farmer Custodian) interests in more than 1.5% of shares at any time. The RVP is likely at any point in time to hold significantly less than this amount.

4.4 Limit on individual holdings of Units

Individuals and their associates will be permitted to hold no more than 15% of the Units on issue in the Fund. This requirement will be set out in the Trust Deed for the Fund at its launch. This restriction will not apply to Fonterra.

4.5 Constitutional thresholds

As noted in Section 5.5, the Fund will be managed to a target aggregate actual Fund size of between 7 and 12% of total Shares on issue, excluding treasury stock, (and a corresponding range for the potential Fund size, having regard to Dry Shares, of 7-15% of total Shares on issue, excluding treasury stock). These thresholds are well below that in the Form B Constitution. A higher threshold in the Constitution is designed to provide additional financial flexibility for farmer shareholders while enabling tolerance to deal with exceptional circumstances where several major adverse events occur simultaneously.

Constitutionally, in the event of this threshold being exceeded for any reason, the Fonterra Board is required to come up with a plan to return under the threshold within an appropriate time. In practice, the Fonterra Board will implement a Fund Risk Management Policy designed to manage the Fund size within the ranges noted above (Refer Section 5.5).

Outline of Sections 4.6

Section 4.6 outlines the structure of the FSF Unit Trust:

- The FSF will be separate from Fonterra and will be constituted as a Unit Trust under the Unit Trusts Act 1960.
- A Trustee of the Trust has been appointed (The New Zealand Guardian Trust Company Limited). The Trustee has a number of statutory roles and powers to ensure the unit trust is managed in accordance with the trust deed.
- A Manager will manage the investments of the FSF (which will consist solely of economic rights of Shares that have been sold to the Fund and related assets) and will be responsible for offering Units to the public.
- It is important that the Manager is independent. It will be set up as a company with its own Board.
- The requirements around the governance of the Trust and its Board will be set out in the Trust Deed and the Authorised Fund Contract.
- The Authorised Fund Contract between Fonterra and the Fund will set out requirements for the Trustee and the Manager. If these requirements are breached, Fonterra has the right to require them to be remedied and, in certain circumstances of severe non-compliance, ultimately can terminate the Authorised Fund Contract.
- The administrative functions of the Fund will be conducted by Fonterra given the pass-through nature of the economic rights. The costs of the Fund will not be extensive.

4.6 FSF Unit Trust Structure

After establishment, the Fund will be appointed by Fonterra as an Authorised Fund as provided for in the Constitution. It will be set up as a conventional unit trust under the Unit Trusts Act 1960.

Outline of Standard Trustee and Manager Roles and Duties

As a stand-alone from Fonterra, the Fund is subject to a range of general legal requirements. These are described below, and most do not relate specifically to Trading Among Farmers but instead refer to the general statutory and contractual duties of a Trustee and Manager of a Unit Trust.

- Section 4.6.1 outlines the general statutory and contractual obligations of a Trustee;
- Section 4.6.2 outlines the general role and duties of a Unit Trust Manager, regardless of what the activities of the Unit Trust are;
- Section 4.6.3 explains the foundation document of any unit trust, which is the Trust Deed entered into by the Trustee and the Manager. The trust deed is the foundation governance document, like the constitution of a company.

However, the standard terms that are described in this section will be supplemented by terms of the Trust Deed that are important to safeguard 100% farmer control and ownership, including the role of the 'Fonterra Unit' that will be held by the Fonterra Farmer Custodian. Other important protections will be contained in the Authorised Fund Contract. These are described in section 4.7.

4.6.1 Trustee

The Trustee will be a trustee who holds a licence under the Securities Trustees and Statutory Supervisors Act 2011. The initial appointment has been made by Fonterra following an RFP process.

The role of the Trustee will be to ensure that the unit trust is managed in accordance with the trust deed. The Trustee also has a custodial role for the property of the trust which will be the economic rights of Shares sold to the Fund. Those Shares are held by the Custodian.

The Trustee has key statutory duties:

- To act on the directions of Unit holders (reflected in extraordinary resolutions of unit holders), where those directions are consistent with the provisions of the trust deed, the Unit Trusts Act or the directions of the FMA;
- To use the same standard of care and diligence in the performance of its duties as any other trustee.

The Trustee also has a number of statutory powers:

- To inspect the Manager's books and records, and all books relating to the trust, and to be provided with such information as the Trustee requests relating to the trust, or the Manager;
- To request the Manager to summon a meeting of Unit holders;
- To apply to the High Court for an order to remove the Manager.

The Trustee cannot be discharged or removed by the Manager except with the approval order of the Court. The Trustee cannot retire unless:

- All functions and duties of the position have been fulfilled; or
- The Manager has appointed another person who holds a license under the Securities Trustees and Statutory Supervisors Act 2011 to the position, and the new trustee has accepted the appointment; or
- The Court consents.

4.6.2 Manager

The role of the Manager is to manage the investments and other property of the unit trust, and it is responsible for issuing or offering units to the public.

Fonterra considers that it is important that the Manager is independent. To achieve this in the context of TAF, the Manager will be a company wholly owned and controlled by Trustees Executors Limited, which is a trustee corporation which holds a licence under the Securities Trustees and Statutory Supervisors Act 2011. The Manager company will be created prior to the launch of TAF.

The Manager will play a relatively contained role given the nature of the assets of the Fund. Fonterra will provide most of the services needed by the Fund (including investor relations function, share registry, preparation of offer documents).

The Manager will have a board of five directors with three appointed by Fund investors, and two being Fonterra representatives (who will be Fonterra directors or Fonterra Senior Executives). At launch, the Board intends to appoint two Fonterra Directors to the board of the Manager, one of whom will be Independent. At the same time, Fund investors would take comfort from the fact that they are able to appoint a majority of directors of the Manager.

It is possible for the Manager to be removed by the Court or by a 75% resolution of Fund investors. However, the requirements around the governance of the Manager and its Board (as noted above) would be set out in the trust deed and in the contract between Fonterra and the Fund, and would continue to apply despite the appointment of a replacement Manager. This means that the removal and replacement of the Manager would not affect its governance, and Fund investors and Fonterra would continue to appoint directors to the Board of the Manager.

The Manager can be removed including by:

- Court order, on application of the Trustee, any Unit holder, or the FMA;
- The Unit holders, at a meeting of Unit holders (subject to voting majorities specified in the Trust Deed); or
- The Trustee, if the Trustee certifies that to do so is in the interest of Unit holders.

The Authorised Fund Contract between Fonterra and the Fund will set out the requirements for the Trustee and the Manager, and their key obligations and constraints (including those under the Fonterra Constitution).

4.6.3 Trust Deed

A unit trust is constituted by a Trust Deed entered into by the Trustee and Manager.

The Trust Deed must:

- Include standard provisions relating to the conduct of the trust's business, inspection of books, the provision of information to the Trustee, the summoning of meetings etc;
- State whether the Manager has an obligation to buy back (or "redeem") interests in the unit trust if requested to do so, and the manner and conditions on which such interests are to be bought back;
- State the manner in which transfers of units are to be made and recorded;
- Include relevant provisions from the NZSX listing rules.

There are some key features of the Fund that will not be able to be changed by unit holders without the approval of the trustees of the Fonterra Farmer Custodian Trust as the holder of the Fonterra Unit. To give effect to this, the trustees of the Fonterra Farmer Custodian Trust will hold a 'Fonterra Unit' in the Fund that requires the trustees' approval for the amendment, alteration or removal of certain provisions of the Trust Deed (see section 4.7).

4.6.4 Reporting

The accounts of a unit trust will be audited annually and a report sent to Unit holders.

In addition, the Securities Act and Regulations also contain detailed requirements for the provision of information to investors, which apply to all unit trusts.

4.6.5 Costs

The primary objective is that Units and Shares will trade at the same price. This would be achieved by:

- Allowing farmer shareholders and the RVP to freely participate in both the FSM and Fund markets, and to easily exchange a Unit for a Share (and in the case of the RVP vice versa); and
- Equivalence of economic rights (to dividends etc) between Units and Shares.

Equivalence of dividends between Units and Shares implies the need for Fonterra to meet the operating costs of the Fund so that these costs are not deducted from dividends received. The costs should not be extensive. Once established, the main costs of operating the Fund will largely be confined to the costs of the Trustee and the Manager, listing costs and Share Registry costs. All main functions required by the Fund will be provided by Fonterra given the pass-through nature of the economic rights. By way of example, Fonterra's investor relations function should extend to investor relations required for the Fund. The expectation is that the Manager would not require extensive infrastructure. Most of the operations will be undertaken by the Share Registry.

To give effect to this, Fonterra would agree an annual budget with the Manager for it to undertake its activities. Fonterra will meet these costs, including the costs of preparing the Fund's Annual Report to Unit holders. This would be a short document that references Fonterra's Annual Report. Fonterra would meet the cost of conducting the Fund's Annual Meeting, and the annual fees of the Trustee and the shareholder of the Manager, audit fees, legal and other fees associated with annual compliance by the Manager would also be met by Fonterra.

The relationship between Fonterra and the Fonterra Farmer Custodian on the one hand, and the Fund Manager/Trustee on the other is governed by the Authorised Fund Contract. The likelihood of any breach of this contract by Fonterra or the Fonterra Farmer Custodian is low, since neither party's obligations are extensive under this contract and Fonterra is fully in control of circumstances that might cause its breach.

Despite this low risk, Unit holders would be concerned if the Manager or Trustee did not have access to resources to fund any action if a breach by Fonterra is alleged.

Accordingly, Fonterra would meet the reasonable cost of legal advice the Manager may wish to obtain as to whether Fonterra has met its obligations under the Authorised Fund Contract. Fonterra would also meet the reasonable cost of any action by the Manager if there is an alleged breach by Fonterra or the Fonterra Farmer Custodian of their obligations to the Manager or Trustee.

The Trust Deed of the Fund sets out the obligations of the Manager and the Trustee to unit holders, in the same way that a company's constitution sets out the obligations of its directors to shareholders. Accordingly, any costs of Unit holders initiating action against the Trustee or Manager would be met by Unit holders, in much the same way that action initiated by shareholders against a company is funded by shareholders (who may recover some of those costs if that action is successful).

4.7 Role of the Trustee, Manager and Trust Deed in the Context of Trading Among Farmers

The trust deed for the Fund will contain important protections to safeguard 100% farmer control and ownership in addition to the standard terms discussed above. Matters covered in the Trust Deed include:

- The Fund must match, on a one-for-one basis, economic rights purchased from farmers with units that it issues to the public.
- The Fund cannot carry out any other activity. Its only investment and asset will be economic rights that it has purchased from shareholders and its related assets.

- An acknowledgement that:
  - The Manager and Trustee have no production based voting rights relating to Fonterra shares and cannot require the Fonterra Farmer Custodian (who will hold legal title when economic rights to shares are sold to the Fund) to exercise production based voting rights on its behalf.
  - Any instructions from unit holders to the Trustee must be consistent with the Trust Deed.

The Trust Deed would also specify the role of a 'Fonterra Unit' that would be held by the Fonterra Farmer Custodian Trust. This would be a special unit that would mean that the following key features of the Trust Deed couldn't be changed without the approval of the trustees of the Fonterra Farmer Custodian Trust:

- The governance structure of the board of the Manager;
- The scope and role of the FSF;
- The obligation of the FSF to facilitate the issue of a unit when a farmer (or RVP) sells economic rights to a share, or to surrender a unit when a farmer (or RVP) exchanges a unit to a share;
- The limit of 15% on the number of units that can be held by any person (or their associates);
- The terms of the Fonterra Unit.

As an added protection, the trustees of the Fonterra Farmer Custodian Trust could only agree to these changes after first obtaining at least 75% voting support from farmer shareholders.

The Authorised Fund Contract covers standard matters covered in any contract (compliance with applicable laws, keeping of records, registration of units issued etc.). Particular items cover the following:

- The Manager and Trustee must act in accordance with the Trust Deed;
- Farmers and the RVP are the only persons who may convert a unit for a share;
- Acknowledgement that the Trustee and Manager will not:
  - directly or indirectly exercise, control or exert influence of any production based voting rights in shares held by the Fonterra Farmer Custodian (where economic rights to those shares have been sold to the FSF);
  - call for a meeting of shareholders of Fonterra;
  - attend or speak at any meeting of shareholders unless invited to do so;
- Obligations on Fonterra, such as compliance with the FSM rules.

Outline of Sections 4.8 and 4.9

Section 4.8 and 4.9 describe:

- The role of the share registry and recording the holdings of units (section 4.8).
- The launch of the Fund, including steps involved prior to launch and the 'book build' process (which is described in general terms in section 4.9)

4.8 Role of the Share Registry

The Fund will require a registry for Unit holdings which is separate from and independent of Fonterra.

4.9 Launch of the Fund

The Fund will be launched by way of an offer to the public of Units to investors ("Offer") at the same time as the Fund is listed. Joint Lead Managers ("JLMs") have been appointed for the Offer, who will be providing advice to Fonterra on the Offer process and managing the Offer on behalf of Fonterra.

Section 5 outlines how Fonterra can achieve a minimum Fund size at launch and on an ongoing basis. This primarily involves encouraging farmers to sell the economic rights of a portion of their current Shares to the Fund, and Fonterra committing to sell additional Shares directly to the Fund to the extent this is required to achieve a minimum Fund size.

There will be two inter-related steps in launching the Fund, as set out below.

4.9.1 Preparation

Before the Offer is launched by the registration of a prospectus for the Fund, the following steps will be undertaken:

- Fonterra will establish a range of acceptable parameters for the Fund at launch, including size as a proportion of Shares on issue, and price range;
- All information gathered will be used by Fonterra to establish the launch parameters for the Fund – including the initial FSF Transfer Limit and the minimum and maximum size of the Offer.

4.9.2 Book-build Process

A book-build is a process generally used to capture investor demand for Shares. In a typical book-build, investors are invited to submit bids at various prices, within a set range. The “book-build runner” then determines the price at which the supply of Shares should be sold.

For the Fund Offer, farmer shareholders will have an opportunity to offer to sell economic rights to the Fund. Likewise, potential Fund investors will have the opportunity to express their interest in buying Units. The initial size of the Fund will be determined and scaling, if any, will be applied so that the maximum size of the Fund is not exceeded. The initial price of Units will also be an outcome of this process.

The precise working of this process will be determined closer to the time of launch in the light of (among other things) market conditions, expected supply from farmer shareholders and levels of interest from potential buyers of Units.

Outline of Sections 4.10 and 4.11

Section 4.10 describes the circumstances where the Fund can be unwound.

Section 4.11 notes that Units will be listed on the New Zealand Stock Exchange, although consideration will be given to also listing units on the Australian Stock Exchange now or in the future. This may provide a range of benefits, including making it much easier for Fonterra’s Australian suppliers to hold units in the FSF.

4.10 Termination of Fund arrangements

TAF has been designed to provide the Co-operative with permanent capital, and farmer shareholders with more flexibility, for the indefinite future. Fonterra has a range of tools and policies to manage the size of the Fund which are described in Section 5, including the ability to suspend the sale of further economic rights of Shares to the Fund. Among the reasons why terminating the Fund is a last step is because it is likely to result in Fonterra reverting to issuing and redeeming Shares as it does currently under DIRA.

While TAF has been designed to deliver on its objectives, any change involves some risk. The implementation of TAF is the biggest change to Fonterra since its formation, which also involved risks. For that reason, Fonterra would retain the unilateral right to give notice to terminate the Fund without cause within two years after the launch of TAF. Termination would occur within 12 months of notice being given. If this occurred, the Shares held by the Fonterra Farmer Custodian would be acquired by Fonterra on the basis of a pre-specified valuation methodology and process.

It was noted to farmer shareholders in February meetings this year that any compulsory sale by unit holders would need to be at a price that reflects the hassle, uncertainty and other costs of an early termination. We likened a termination to being ‘like entering into a long-term contract to lease some of your land, but with an option for you to terminate the lease early – this will come at a price’.

The fair buy-out price would therefore be at a premium to the price at which units traded before notice of termination was disclosed. The precise level of that premium has yet to be established, since the Trustee of the Fund and the board of the Manager would need to be consulted.

And the basis of valuation and extent of the premium over the previously traded value may be a factor that will influence the price of units in the Fund. Accordingly, this detail is most appropriately to be finalised in the offer documents that will precede the launch.

The other circumstances that may result in an unwind of the Fund are where:

- Unit holders vote by an extraordinary resolution to liquidate the Fund. Unit holders have this right, like shareholders in a company. This would not result in Fonterra being required to purchase units or economic rights, although it can choose to do so if it wishes; and

- In certain cases of breaches of the Authorised Fund Contract that are material and have not been remedied within reasonable timeframes.

As noted above, oversight of the Fund will be conducted by a professional and independent Trustee with significant experience in conducting this role. The Manager could be expected to attract a Board of high commercial calibre. The likelihood that the Trustee, the Manager or Fonterra would breach the terms of the Trust Deed or the Authorised Fund Contract is therefore expected to be very low. But it is necessary, nonetheless, to set out what the consequences of breach would be. In severe cases of breach, the unwind and termination of the Fund could be a potential outcome, with an obligation to purchase units at a price to reflect the nature of the breach and the hassle and cost to unit holders.

In circumstances where the Fund is wound up or the Authorised Fund Contract is terminated, Fonterra will have the ability to set up a new Authorised Fund to take the place of the previous Fund.

The table below describes some of the key circumstances where the Fund could be "wound up" or suspended. The circumstances are as follows:

Circumstance	Consequences

1 Unilateral termination by Fonterra without cause	• At any time within 24 months after the establishment of the Fund Fonterra may (by a Board resolution supported by the majority of the Independent Directors) give notice to terminate the Authorised Fund Contract.
	• This right would not require the agreement of unit holders (by resolution or otherwise).
	• The Fund would be liquidated within 12 months of the notice of termination.
	• During this notice period, the Fund would continue to operate.
	• At the end of this time period Fonterra can require:
	  • the Manager to dispose of the economic rights to Fonterra's nominated transferee (which may be a substitute Authorised Fund); or
	  • the Manager to procure the Custodian to dispose of the Shares held by the Custodian under the economic rights Trust to Fonterra or its nominated transferee,
	at a specified basis of valuation.

2 Evergreen right to suspend transfer of Economic Rights to the Fund	• Fonterra will retain an evergreen right to suspend the ability of farmers or the RVP to sell further economic rights to the Fund, thereby suspending further Fund growth. • This right would not require the agreement of unit holders (by resolution or otherwise). • The circumstances in which suspension would occur are envisaged to be interim as outlined in the Fonterra Shareholders' Fund Risk Management Board Policy (refer to Section 5).
3. Unit Holders elect to wind up the FSF by Extraordinary Resolution	• Any such resolution is binding on all Unit Holders. • Upon this resolution being passed, Fonterra must act efficiently and use reasonable efforts to facilitate another party nominated by it (which could include a replacement Authorised Fund) to acquire the economic rights held by the Fund. Note that any new purchaser of the rights would need to be acceptable to Fonterra and would need to fully comply with the terms of the Trust Deed and Authorised Fund Contract. • In addition, Fonterra can if it wishes to purchase the economic rights itself, but is under no obligation to do so.
4. Restructuring	• If Fonterra proposes a change in its capital structure which involves the winding up of the Trust, Unit Holders would be asked to approve the change by Extraordinary Resolution. • Unit Holders could not, however, be compelled to agree. • If the Unit Holders approve the change by Extraordinary Resolution, that approval would be binding on all Unit Holders.

DIRA provides that Fonterra can revert to the issue and redemption of Shares, not only during the first two years when Fonterra can give notice to terminate and unwind the Fund, but thereafter as well. The two year period following the launch of TAF will be the critical bedding down period during which Fonterra will be able to decide whether TAF is working and, if it isn't, can exercise an option to unwind the Fund. If TAF works well in the first few years after launch, as expected, it will likely work well thereafter. This means that it will be very unlikely that Fonterra would revert to issue and redemption in the more distant future with all the risks to the Co-operative that would likely impose. But if Fonterra did so, it would need to establish the basis for redeeming Dry Shares, which may include interests held by the Custodian.

4.11 Listing of the Fund

The NZX is the choice for the Fund listing, given the large domestic base of underlying potential investors and the likely high level of retail interest. With an initial size of around $500 million the Fund would rank somewhere in the middle of the NZX50 Index and, on this basis, it is expected that the Fund will meet all the criteria to qualify for NZX50 inclusion.

Consideration will also be given to listing the units on the Australian Stock Exchange either at the time of the launch of TAF or at some stage in the future. Benefits that this may bring include making it easier for our Australian suppliers to hold the Units, thereby encouraging them to feel more linked to the Fonterra family.

5 MANAGING DRY SHARES AND FUND SIZE

Outline of Section 5

This section provides an overview of how the Fonterra Shareholders' Fund (FSF) will be managed:

- The role of the Fund is described in section 5.1, and Board's policy of managing the size of the Fund to within a range of 7-12% of total Shares on issue (with the corresponding range for the potential size of the Fund being 7-15% of total Shares on issue).
- Section 5.2 describes how the Board would ensure that a minimum Fund size is achieved when the Fund is launched.
- Following the launch of TAF, there will be a moratorium on the ability of shareholders to sell economic rights to wet shares to the Fund. That moratorium will last for at least six months. This is to enable a 'settling down' period for TAF and to ensure that Fund limits are prudently managed. Sections 5.3 and 5.4 provide more detail.
- Section 5.5 describes how the size of the Fund will be managed on an ongoing basis, including by setting limits on how many economic rights of Shares a farmer-shareholder can sell to the Fund (the FSF Transfer Limit), and the tools that Fonterra has to manage within these thresholds.
- Section 5.5 also describes the tools that Fonterra has to increase the number of Shares on issue or reduce the number of Shares or Units in the Fund.

5.1 Fund to support FSM

As noted above, a key goal of establishing the Fund is to support the efficient operation of the FSM by deepening liquidity and promoting a well-discovered price. In considering this goal, the following considerations are relevant:

- As noted elsewhere, the targeted initial size of the Fund is around $500 million which, using the current share price of circa $4.50 per share, implies an initial Fund size of about 7-8% of shares forecast to be on issue at the time TAF is launched;
- This target fund size is well below the Board's threshold of 20% of shares and will be managed under the Board's Fund Risk Management Policy;
- The Board's threshold is to deal with exceptional circumstances where several major adverse events occur simultaneously (such as another GFC, low commodity prices, a national adverse biological event and the entry at national scale of a competitor).

A further goal of the Fund is to provide additional flexibility to farmer shareholders. The ongoing management of the Fund size should also reflect this goal.

Farmer shareholders will (except where Fund size limits are breached or at risk of being breached - see further comments below) be able to sell the economic rights of shares they hold in excess of their minimum required shareholding (i.e. "Dry Shares") to the Fund without constraint.

5.2 Achieving a Minimum Size of Fund at Launch

In launching the Fund, the following are priorities:

- To achieve a minimum Fund size at launch of at least $500 million;
- To avoid a 'flood' of Shares into the Fund after launch.

To achieve a minimum launch size of $500 million, farmer shareholders will be invited to participate in a supply side book build under which they can sell economic rights to a specified percentage of 'Wet' Shares to the Fund. The percentage of Wet Shares that farmer shareholders may tender into the offer could vary among farmer shareholders – with some tendering more than others according to their individual circumstances If the level of economic rights offered by farmer shareholders under this process exceeds the minimum Fund launch size of $500 million, acceptances could be scaled.

If there is any shortfall, Fonterra could choose to issue Shares to the Fonterra Farmer Custodian with the economic rights in respect of those Shares then being held for the Fund. The funds provided to Fonterra from such an issue would create balance sheet capacity This would assist in managing the actual and potential size of the Fund in accordance with Board policy as farmers sell economic rights of Shares to the Fund after launch.

5.3 Moratorium following Launch

After launch, the FSF Transfer Limit could be set at zero until the Board elects otherwise. Setting the FSF Transfer Limit to zero in effect places a moratorium on further economic rights of Wet Shares being sold to the Fund until the limit is changed. During any such moratorium, a shareholder would be able to sell their Dry Shares on the Fonterra Shareholders' Market, or sell the economic rights in them to the Fund (although they will not receive Vouchers in that case).

There could be an exception to any such moratorium for new entrants, who could have a once-only opportunity to sell economic rights to Wet Shares to the Fund up to the maximum proportion of Wet Shares any farmer shareholder in similar circumstances was allowed to sell. In the case of new entrants, the proportion would be set by reference to their estimated production. This would give all farmer shareholders an equal right to sell economic rights to Shares to the Fund, either at launch or when they first become farmer shareholders.

The term of any moratorium would be reviewed by the Board no later than 6 months after the launch of TAF, and at no longer than 6 month intervals thereafter.

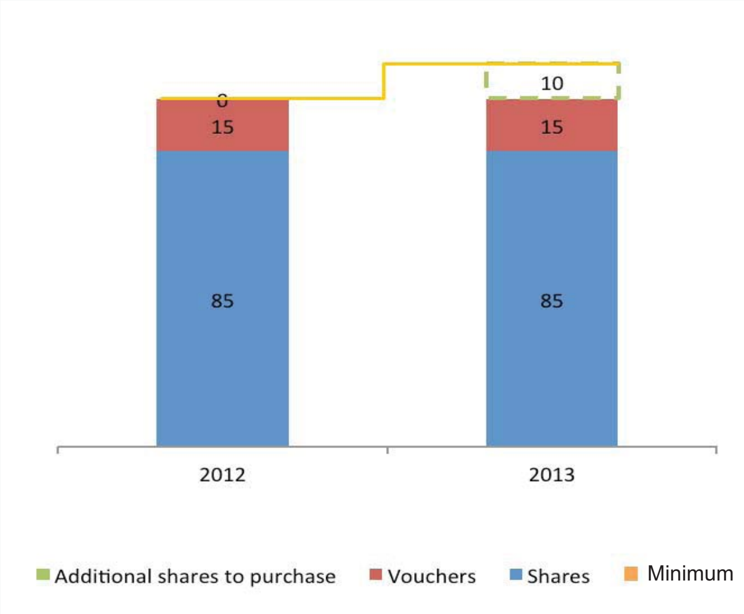
Setting the FSF Transfer Limit to zero means that if a farmer shareholder's minimum required shareholding increased during the moratorium, for example because of increased production, they would need to purchase Shares. As a consequence, as production increases, the effect for farmer shareholders should be to reduce the proportion of economic rights of Shares sold to the Fund from its initial level at the time of the launch. If this happens across the shareholder base, capacity is created for the controlled release of more Units via an increase in the FSF Transfer Limit.

See illustrative example overleaf.

An Illustrative Example

Shareholder Y participates in the book-build by selling the economic rights of 15,000 Shares to the Fund when TAF is launched, for which Shareholder Y obtains cash and 15,000 Vouchers. Shareholder Y's minimum required shareholding at the time is 100,000 Shares.

Shareholder Y's production is increasing, and for the season beginning 1 June 2013, their required minimum shareholding increases to 110,000 Shares. Shareholder Y would be required, assuming the FSF Transfer Limit remains at zero to purchase 10,000 additional Shares between 1 June 2013 and the Compliance Date (1 December 2013). The 15,000 Vouchers that Shareholder Y holds falls from 15% of their minimum required shareholding to 13.6%.



5.4 Adjustments at end of Moratorium

No later than 6 months after TAF is launched, the Board will review the FSF Transfer Limit in light of TAF's operation to that time. Factors the Board could consider include the proportion of Dry Shares forecast to be on issue, how many Dry Shares have found their way to the Fund, and the anticipated impact on shareholder behaviour of the introduction of a 3 season average minimum share standard from 1 June 2013. The Board could at that time (or later):

- Set the FSF Transfer Limit at a low standard level for all farmer shareholders. A low threshold will help the Board to live within its target actual and potential Fund size thresholds while giving some level of financial flexibility to farmer shareholders in managing their cash flows;
- Offer another Fund transfer opportunity to allow farmer shareholders access to the Fund (particularly those who did not take up the earlier opportunity); or
- A combination of both.

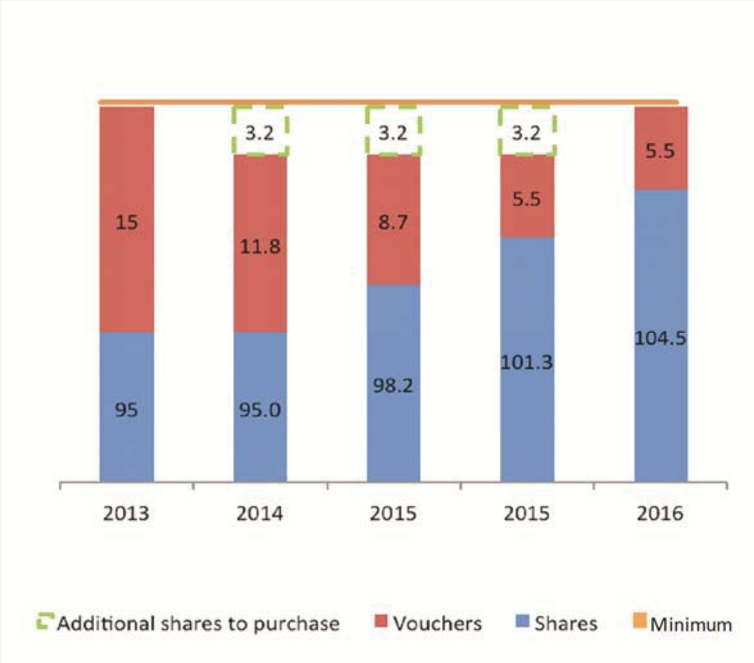
Under the Constitution, the Board has the discretion to reduce or adjust the FSF Transfer Limit on any basis that it considers appropriate. The Board would be unlikely to do so for a minimum period after launch (unless the need to reduce the Fund size dictated otherwise). A reduction might apply to some farmer shareholders and not others - for example, to those who have sold a higher proportion of economic rights of Wet Shares to the Fund than others. It could also be used to reduce or eliminate participation by farmer shareholders in the Fund once they have had the benefits of using the Fund for a particular period of time. This in effect would require the purchase of additional Shares. For example, if there was a general FSF Transfer Limit of 5%, with some farmer shareholders well above this threshold, the Board could reduce the latter group of farmer shareholders to the prevailing 5% FSF Transfer Limit, which would subsequently require an increase in their shareholding. The approach and the tools that the Board would use to set and adjust the FSF Transfer Limit are still under consideration, and would be subject to further detailed consideration by the Board before implementation.

In addition, if any of these scenarios were to occur, the Board could allow a reasonable period of transition (three years would be consistent with the three-season average minimum share standard), without introducing constraints in the circumstances where the Board might consider such an option, or the exact approach it would adopt. As noted above, this is all subject to further consideration in the period leading up to the launch of TAF.

See illustrative example overleaf.

An Illustrative Example

To continue with the above example, Shareholder Y's required minimum shareholding is 110,000 Shares, currently supported by 15,000 vouchers and 95,000 Shares. The Board decides to invoke an across the Board FSF Transfer limit of 5%, to be implemented over 3 seasons. Assuming production remains static, the maximum number of Vouchers Shareholder Y could use to back production would be 5% of 110,000 (5,500). This would require Shareholder Y to purchase 9,500 additional Shares (over 3 seasons) to become compliant with the new 5% FSF Transfer Limit, so that they eventually hold 104,500 Shares and 5,500 Vouchers.



5.5 Management of Fund limits over the medium to long-term

Background

The Board will adopt a policy which will set out the parameters under which the Fonterra Board will manage the size of the Fonterra Shareholders' Fund. The policy has been designed to meet the following objectives:

- Ensure liquidity in the Fonterra Shareholders' Market, thereby promoting a well-discovered price, and providing flexibility for farmer shareholders.
- Ensure the size of the Fund remains within manageable limits.
- Ensure Fund size is managed on the basis of graduated responses that cannot be gamed by the market.
- Ensure Fonterra retains sufficient financial flexibility to manage Fund size.

The Fund Risk Management Policy the Board expects to adopt is set out in the table below. Ultimately this will form part of the prospectus for the issue of Units in the Fund. This will serve to put all investors in the Fund, and other market participants, on notice as to the process that Fonterra proposes to adopt to manage the Fund size.

The Board will have a commitment to consult with the Shareholders' Council prior to any changes to its Fund Risk Management Policy, fully informing the Council as to the nature and rationale of the change. If resolution 2 to be put to the meeting on 25 June 2012 is passed, this commitment will be included in the Constitution.

The Board will manage the Fund size within this Policy. Fonterra will have tools available to do this, including through prudently managing its balance sheet so that it is in a position to fund the purchase of Units or Shares at an appropriate level should that be required.

The actions to be taken by Fonterra if breaches of the Policy are anticipated, or occur, are set out in the Policy. The extent and nature of actions required will vary according to the extent to which the target range is exceeded. The goal will be to avoid more intensive actions through early intervention.

In addition to the measures and actions required under the Policy, the Board will develop and report on measures and actions that are designed to provide the Board with quantitative and qualitative assessments in relation to the Fund.

Regular reporting to the Board's Audit, Finance and Risk Committee (AFRC) (at an interval and in a form to be agreed by that Committee) will include:

- Fund trading metrics (size, trading activity)
- FSM trading monthly trading metrics;
- Monthly movements in actual and potential Fund size;
- Market activities undertaken by Fonterra, if any (buy-backs, share issues);
- Market activities in the reporting period undertaken by external parties on the FSM and FSF (the RVP, authorised brokers including Direct Broking as the default on-line broker, compliance trading by the Authorised Agent etc.).
- Trends in trading on the FSM (e.g., farmers selling down, those who are net purchasers, transactions related to entry/exit and trends in share-backed production) and net sales or purchase of units by shareholders.
- Measures of the longer term balance sheet capacity.

The AFRC will also consider and approve the nature and form of regular public disclosure of information provided to the AFRC to promote an informed market.

The Policy will be reviewed and updated no less than annually by the AFRC with advice from management and external independent experts, where appropriate, and may be amended following consultation with the Shareholders' Council and approval by the Board.

Compliance with the Policy will be reviewed by Fonterra's Auditor and reported annually to shareholders.

In the table below, the following measurement criteria are referred to:

- Dry Shares are Shares on issue over and above the aggregate minimum required holdings measured at the beginning of a season based on forecast production.
- Potential Fund size is the maximum size the Fund could reach based on the prevailing FSF Transfer Limit and the number of Dry Shares on issue.

Proposed Risk Management Policy[26]

Policy: Fund Size	Response
Parameters: The Actual Size of the Fund will be managed within a Target Range of 7% to 12% of total Shares on issue (excluding treasury stock). The Potential Size of the Fund will be managed within a Target Range of 7% to 15% of total Shares on issue (excluding treasury stock).	The Board will use a range of measures to ensure the Actual Fund Size and Potential Fund Size remain within the relevant Target Ranges, including: a) Introducing or cancelling a Dividend Reinvestment Plan; b) Operating a Unit and/or Share repurchase programme; c) Increasing or reducing the FSF Transfer Limit; and d) Issuing new Shares.

Policy: Dry Share Proportion	Response
The number of Dry Shares on issue should fall within an acceptable tolerance of 5% (or such lesser percentage as the Board determines) of total Shares on issue (excluding treasury stock).	The Board will take steps to issue or buy back Shares to maintain the number of Dry Shares within the required range.

Consequences of exceeding Policy Thresholds

If the Fund Size falls outside the ranges noted above, certain actions will be taken, as noted below. The extent and nature of actions required will vary according to the extent to which the target range is exceeded.

Consequences of exceeding a threshold	
If the Actual Fund Size breaches 12% or the Potential Fund Size breaches 15% for a majority of days within any 30 day period.	The Board will: a) as soon as it becomes aware of the breach, inform the market; b) within 90 days develop a strategy to address the underlying causes of the expansion in the Actual or Potential Fund Size (depending on which has been breached) and consult with the Shareholders' Council on that strategy; c) for so long as the Actual or Potential Fund Size remains above the breach level, consult with the Shareholders' Council at intervals of not more than 3 months, and disclose progress towards returning to within the policy range.

[26] The Board expects to adopt the Policy wording set out in this section. Some minor wording changes may be required as the final documentation for the launch of TAF is completed. Any such changes to the wording will be subject to prior consultation with the Shareholders' Council.

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<td>If the <u>Actual Fund Size breaches 15%</u> or the <u>Potential Fund Size breaches 18%</u> for a majority of days in any 30 day period.</td>
<td>The Board will:

a) immediately advise the Shareholders’ Council;
b) within 90 days obtain advice from an independent expert on a strategy to return to the Target Range and its likelihood of being successful;
c) during that 90 day period consult with the Shareholders’ Council on plans to return to the Target Range;
d) disclose non-commercially sensitive aspects of those plans.

If the Actual or Potential Fund Size remains in breach of these thresholds for 6 consecutive months, then unless the Shareholders’ Council agrees otherwise, the Board must take the steps required if the Actual Fund Size breaches 18%, except suspending the sale of further economic rights under paragraph (a).</td>
</tr>
<tr>
<td>If the <u>Actual Fund Size breaches 18%</u> or the <u>Potential Fund Size breaches 20%</u> for a majority of days in any 30 day period.</td>
<td>Within 90 days the Board will:

a) suspend the ability for further economic rights to be sold to the Fund, unless there is a compelling reason otherwise (with that reason to be disclosed to shareholders). This suspension will cease when the Board is satisfied that the Actual or Potential Fund size are sustainably below the thresholds that trigger suspension of the further sale of economic rights, or in any event when the Actual Fund Size falls below 12% (and the Potential Fund size is below 15%);
b) give notice of a Special Meeting of shareholders to consider options, subject to the minimum required notice periods under the Constitution;
c) consult with the Shareholders’ Council on the options to be presented to the Special Meeting;
d) obtain expert independent advice on the likely outcome of each of those options, and review that advice with the Shareholders’ Council;
e) recommend its preferred option at the Special Meeting, together with an Independent Advisor’s report on the likely outcome of that option; and
f) enable the Shareholders’ Council to present the Council’s preferred option to the Meeting if it is different from the Board’s preferred option.</td>
</tr>
</table>

The Board may maintain other thresholds and reserve the ability to take action at those thresholds without disclosing commercially sensitive terms, however these would need to be consistent with the disclosed policy settings described above.

Fonterra has a variety of the following tools to manage the size of the Fund on an ongoing basis.
A preliminary indication of the sort of tools that the Board might use to achieve this is outlined below.
This analysis would be further considered in the period prior to launch of TAF and could change.

Parameters <u>below</u> desired target levels	Mechanism
Dry Shares fall below target level	Increase number of shares on issue. For example: • Dividend Reinvestment Plan (DRP) 1 • Pro rata bonus issue
Fund size falls below target level	Ease out FSF Transfer Limit. Set additional 'one-off' higher limits like that proposed at launch
Parameters <u>exceed</u> desired target levels	**Mechanism**
Dry Shares exceed target level	Repurchase programme over an extended period Terminate any DRP Reduce FSF Transfer Limit (with possible phase down for those above the new limit)
Fund size exceeds target level	Terminate any DRP Reduce FSF Transfer Limit (with possible phase down for those above the new limit) Fonterra purchases units

A DRP offers shareholders the opportunity to elect to receive shares in lieu of cash dividends.

6 GLOSSARY

AFRC means the Audit, Finance and Risk Committee of the Board.

Appointed Director means a Director appointed by the Board under clause 12.4 of the Constitution.

Aspire means the computer system operated by Fonterra for milk payment and other milk management and shareholder services.

Authorised Fund means any person or persons authorised by the Board under clause 7.1 of the Form B Constitution to perform the role and functions of an "Authorised Fund" outlined in that clause.

Authorised Fund Contract means the agreement to be entered into between Fonterra and the Manager in respect of the establishment and operation of the FSF.

Board means the board of Directors of Fonterra.

Common Shareholder Number or **CSN** means a unique alphanumeric identifier issued to Shareholders to uniquely identify farm and shareholder relationships for the purposes of trading on the FSM.

Compliance Date means the date on which the Board reviews Shareholder compliance with the Share Standard and other requirements set out in clause 3 of the Form B Constitution.

Computershare means Computershare Investor Services Limited, who has been appointed under a registry services agreement to undertake share registry functions in relation to the FSM.

Constitution means the constitution of Fonterra, as amended from time to time.

Contract milk price means the amount determined by the Board to be paid to Shareholders for Milk supplied to Fonterra on Contract Supply, in accordance with the Constitution.

Contract Supply means the supply of milk to Fonterra by a Shareholder which is not backed by Shares.

DIRA means the Dairy Industry Restructuring Act 2001.

Director means a means a person elected or appointed as a director of Fonterra in accordance with the Constitution.

Dry Shares means any Shares held by a Shareholder in excess of number of Shares determined in accordance with the Share Standard for any Season.

Economic rights means rights to receive dividends and other economic benefits derived from a Share, including any change in the value of the Share, as well as the other rights and benefits comprised in the Share (not including any right to hold the legal title to a Share or to exercise production-based voting rights).

Farmgate Milk Price Manual or **Milk Price Manual** means the manual overseen by the Board, which sets out the policies and methodology for the determination of the farmgate milk price in accordance with the Constitution.

FCG means the identifier for a Co-operative Share on the FSM.

Fencepost means the website where Fonterra farmers manage their dairy business online.

Fonterra Farmer Custodian or **Custodian** means the legal entity that will hold the legal title to Shares, including Shares that are purchased by the RVP or where farmer shareholders sell the economic rights of Shares to the FSF.

Fonterra Farmer Custodian Trust means the trust to be established to hold the shares of the Custodian and the Fonterra Unit.

Fonterra Unit means the unit to be issued as such by the Manager in accordance with the Trust Deed for the FSF.

Form A Constitution means the current Constitution of Fonterra, which will be replaced by the Form B Constitution on the launch of TAF.

Form B Constitution means the constitution set out as annexure 2 of the Form A Constitution, which is to be adopted by Fonterra on the launch of TAF upon the Board resolving that certain preconditions provided in clause 49.2 of the Form A Constitution have been met.

FSF or **Fund** means the Fonterra Shareholders' Fund, which will be an Authorised Fund.

FSF Transfer Limit means the limit set by the Board from time to time in relation to the maximum number of Wet Shares which farmer shareholders may sell to the FSF.

FSM means the Fonterra Shareholders' Market, being the facility selected by the Board to provide for the trading of Shares among Shareholders.

Fund Size Risk Management Policy or **Policy** means the policy used by the Board to manage the size of the Fund and provide for the actions that the Board will take if the Fund falls outside that range.

FY12 means Fonterra's 2011-2012 financial year ended 31 July 2012.

Independent Agent means the person appointed to purchase/sell Shares on behalf of a Shareholder who has not taken the necessary steps to become compliant with the Share Standard by the Compliance Date.

Joint Lead Managers or **JLMs** means the joint lead managers appointed in relation to the Offer.

Manager means the appointed manager of the FSF.

Market Operator means NZX, who will be appointed as the operator of the FSM pursuant to the Market Operator Agreement.

Market Operator Agreement means the agreement to be entered into by Fonterra and NZX for the provision of operational and administrative functions in relation to the FSM.

Market Rules means the market rules of the FSM.

Measurement Date means the first day of a Fonterra season, currently being 1 June.

NZX means NZX Limited.

Offer means the initial offering of Units in the FSF.

Off-Market Transfer Form means the form actioned by the Share Registry which used to execute off-market transfer of Shares (or Units) without using the services of Fencepost or a broker.

Participant Rules means the participant rules which apply in relation to the FSM.

Relevant Interest has the meaning given to that term in the Securities Markets Act 1988, as varied by the Form B Constitution.

RMA means the registered market agent.

RVP means a person appointed, authorised or engaged under clause 6.1 of the Form B Constitution to provide services to enhance the operation and liquidity of the FSM.

Share or **share** means a co-operative share issued by Fonterra.

Share-backed milk price means the average milk price set by the Board based on Share-backed supply.

Share Registry means the registry recording ownership of Shares.

Share Standard means the number of Shares a Shareholder is required from time to time to hold as determined in accordance with clause 3.2 of the Constitution.

Shareholders' Council means the persons elected in accordance with clause 16 of the Constitution, who have the functions set out in that clause.

TAF means the share trading system known as "Trading Among Farmers".

Trust Deed means the trust deed which established the FSF.

Trustee means the trustee of the FSF.

Unit or **unit** means a unit issued by the FSF.

Valuer means the person for the time being holding office as the Valuer under the Constitution.

Voucher means a voucher to be issued to a Shareholder upon transfer of a Wet Share to the FSF.

Wet Shares means any Shares held by a Shareholder which are backed by milk supply, and determined in accordance with the Share Standard for that Season.

Notes

Fonterra™

Dairy for life