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General Criteria for S&P U.S. Index Membership

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INTRODUCTION

One of the most frequent questions we get at Standard & Poor's is, "What are the criteria for being added to an S&P Index?" First and foremost, S&P Indices are not rules-based; all changes are fully discretionary and are determined by the Index Committee based upon public information. Companies may not apply for inclusion.

The Standard & Poor's Index Committee examines five main criteria when looking for Index candidates: trading analysis, liquidity, ownership, fundamental analysis, market capitalization, and sector representation. Explaining these five items may give investors a better understanding of the Index management process.

UNIVERSE

Before we begin discussing the criteria, we should first outline the overall universe from which Standard & Poor's picks Index candidates. Selection begins with Standard & Poor's Stock Guide Database of over 10,000 companies. Screened out of the universe are stocks headquartered in foreign countries, American Depository Receipts (ADRs), American Depository Shares (ADSs), real estate investment trusts (REITs)[1], closed-end funds, equity derivatives, and tracking stocks[2]. Initial public offerings (IPOs) within the last six months are screened out of the S&P MidCap 400- and S&P SmallCap 600-eligible universe, and those within the last 12 months are screened out of the S&P 500-eligible universe.

A word on foreign stocks is in order. Currently, there are seven foreign companies in the S&P 500: Royal Dutch Petroleum, Unilever N.V., Nortel Networks, Alcan Aluminum, Inco, Placer Dome and Barrick Gold. In the early 1990s, the Index Committee announced that no non-US companies would be added to the S&P 500, specifying that those non-US companies in the Index would not be removed simply because they are not US companies. From time to time, this policy has been clarified to explain that criteria for US companies include incorporation, tax treatment, organization, and location.

Offshore registered companies are sometimes considered domestic, however, with eligibility examined on a case by case basis. With the announcement of the addition of Global Crossing to the S&P 500 in September 1999, Standard & Poor's clarified its position on offshore registered companies by stating that "… for financial reporting Global Crossing follows GAAP and is reported in US dollars, the majority of its trading volume is in the US, the majority of its operations are in the US, and it registered offshore for tax purposes." Along with Global Crossing, Carnival, Tyco International, McDermott, Schlumberger, and Transocean Sedco Forex are all registered offshore.

TRADING ANALYSIS

One major criterion for a good benchmark is that it be investable. Standard & Poor's attempts to insure this by choosing only stocks with sufficient liquidity to be included in its Indices. The liquidity measure Standard & Poor's analyzes is a version of share turnover calculated as average monthly volume divided by shares outstanding. At a minimum, this number should be 0.3 for New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) shares, and 0.6 for NASDAQ National Market System (NASDAQ) shares (NASDAQ effectively double counts its volume by treating the two parts of a transaction separately).

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1. REITs are included in the S&P REIT Composite Index developed in 1997.
2. Standard & Poor's issued a pronounced bias against the addition of any new tracking stocks into the S&P domestic index family in 1999.

Standard & Poor's sometimes reviews three or so months of daily volume to see if the absolute volume appears sufficient. S&P also analyzes a company's stock price history in an effort to minimize the number of single-digit priced stocks in the Indices. Finally, if options trade on a stock, that is also viewed as a good sign of liquidity.

OWNERSHIP

Another factor in making S&P Indices investable is the size of the float available to the public. Standard & Poor's would like to ensure that a sufficient amount of stock is available to investors to replicate the Index. To do this, Standard & Poor's looks for Index candidates that meet the following two conditions: 1) no single entity may hold more than 50% of the outstanding shares, and 2) multiple entities may not hold more than 60% of the outstanding shares. Such entities do not include open- or closed-end mutual funds.

FUNDAMENTAL ANALYSIS

The profitability criteria are four quarters of positive net income on an operating basis. Sometimes, Standard & Poor's will include a company that would be profitable except for a loss due to a merger or acquisition. A recent example of this is JDS Uniphase (JDSU), which was added in July 2000.

MARKET CAPITALIZATION

As a size consideration, Standard & Poor's uses the market capitalization of a company to decide the appropriate Index for it to be in. Here are some general guidelines Standard & Poor's uses for each of its Indices:

For the S&P SmallCap 600, Standard & Poor's generally looks for companies with market caps in the range of $300 million to $400 million, going up to about $1 billion. These are not absolute rules; sometimes, companies with market caps below $300 million are deemed worthy of addition. Also, for certain high market cap sectors, such as technology, Standard & Poor's may add companies with market caps of up to $1.5 billion to the S&P SmallCap 600.

For the S&P MidCap 400, the market cap range is from $1 billion to around $5 billion. From a market cap range perspective, this is the most difficult of the three Indices to manage because most companies do not stagnate. Rather, they rise or fall, inevitably ending up outside the ranges set out above.

Finally, for the S&P 500 there are no capitalization restrictions. The guiding principle for inclusion in the S&P 500 is leading companies in leading US industries. Generally, companies are over $4 billion, although Standard & Poor's sometimes adds companies below this range. For example, Visteon (VC) — a spin-off from Ford Motor Company — was added to the S&P 500 in June 2000 despite its market cap of only $1.6 billion because its sales were similar to those of S&P 500 companies and the company is considered to be a leader in its industry. In reality, most companies added to the S&P 500 are much bigger than $4 billion. For example, technology company JDS Uniphase entered the S&P 500 with a market cap of over $90 billion. Indeed, as of August 31, 2000, the average market cap for the S&P 500 was $26.7 billion, compared to $2.4 billion for the S&P MidCap 400 and $668 million for the S&P SmallCap 600.

Standard & Poor's tries to use market cap as a guide when deciding into which Index a particular stock should be placed, but as market caps change continually, there is always a large number of stocks in each Index that are trading outside the ranges given above. As of July 31, 2000, 171 of the 600 companies in the S&P SmallCap 600 were below the $300 million lower range and 119 companies were above the $1 billion upper range. For the S&P MidCap 400, 106 of the 400 were below the lower range and 47 were above the upper range. For the S&P 500, 136 of the 500 were below the lower range.

SECTOR REPRESENTATION

A final criterion is the economic sector in which the stock is classified. The Index Committee tries to keep the weight of each sector in each Index in line with the sector weightings of the universe. In this case, the respective universe is all the stocks in the Standard & Poor's Stock Guide Database, with the exception of real-estate investment trusts (REITs), closed-end funds, and American Despotory Receipts (ADRs), which fall within the market capitalization ranges described above. As a result of corporate actions, market cap changes in the Index, and market cap changes in the universe, various Indices will, from time to time, become overweighted and underweighted versus their universe. While it would be very rare for Standard & Poor's to remove a company from an Index to correct an overweight condition, Standard & Poor's does have a preference for adding new companies to an Index from a sector that will correct an underweight condition.

For example, from December 1980 to July 2000, Standard & Poor's increased the number of technology companies in the S&P 500 from 18 to 78. As a percentage of the market cap of the S&P 500, this was an increase from 8% to 35%. While this may seem like a large increase, the technology percentage of the universe increased from 13% to 40% during that same period, so the technology portion of the S&P 500 Index really only tried to keep pace.

LACK OF REPRESENTATION

Standard & Poor's definition of lack of representation is, "If the Index were created today, this company would not be included because it fails to meet one or more of the above criteria." It often involves corporations whose market capitalizations are small and that no longer contribute to the performance of their sub-industry groups. Companies may also have been restructured so that they have become illiquid. Being delisted from an exchange and filing for bankruptcy also are factors.

If a company buys a large stake in an S&P Index member and as a result less than 50% of the shares outstanding are held by outsiders, that Index member no longer meets the ownership criteria. Companies in the S&P 500 whose stock prices are $5.00 or below, or in the S&P MidCap 400 or S&P SmallCap 600 whose stock prices are $2.00 or below, also fall into this category.

Often, lack of representation cases are not clear-cut. A spin-off of a company from its Index-member parent or an industry group that is growing in importance may prompt some reshuffling in the Index, resulting in the removal of a company that is less suited at this time. Finally, if a company changes its line of business and moves into an economic sector that overweighted in the Index versus the universe, it may no longer meet the sector representation criteria.

Again, it is important to reiterate that just because a given stock might not represent its Index well does not mean that it will definitely be removed from that Index, just that the potential exists. We go back to the definition above and ask ourselves, "If we were starting this

Index afresh today, would this company be a member?" If the answer is no, the stock would seriously be considered as a removal candidate.

CONCLUSION

These are the main five criteria used by the S&P Index Committee to identify Index candidates. Please keep in mind that a company meeting all of these criteria is not assured of being added to an S&P Index. Likewise, the fact that a company might not meet all of the above requirements does not mean that it cannot be added to an Index. Candidates are reviewed regularly, and eligible candidates are placed in a replacement pool. Upon an Index opening, an appropriate candidate is selected for Index inclusion. Remember, these are only guidelines and not rules, and on occasion Standard & Poor's may go outside these guidelines in choosing Index candidates.

Finally, the fact that a company does not meet any of the above criteria does not guarantee that it will be removed from the Index, although this is possible. While removal from an S&P Index is often caused by very low relative market capitalization, very low share price, or financial distress, many more stocks are removed from S&P Indices as a result of corporate actions than all of the preceding reasons combined.[3] From its inception in 1926 to September 15, 2000, 1001 companies exited the S&P 500, the overwhelming majority as a result of mergers and acquisitions.

3. Standard & Poor's tries to keep turnover to a minimum by not making excessive changes to the Indices.