

Spotlight on Index RIC Diversification Capping Rules

Exchanged Traded Funds (ETFs) and mutual funds must meet certain diversification requirements to be registered as an Regulated Investment Company (RIC) with the Securities Exchange Commission (SEC).

Index methodologies are therefore constructed to include weighting caps on individual issuers to help ensure RICs uphold those diversification rules. These caps are most applicable for sector, style, and factor indices that seek to offer more concentrated stock exposure than do broader equity indices.

RIC Diversification Test Rules

Because RICs are considered pass-through entities by the Internal Revenue Service (IRS), taxes are not owed at the fund level. Instead, dividend income and capital gains (if any) are passed through to end investors.

This tax benefit comes with constraints on how the underlying exposure is constructed. To maintain its RIC status, the RIC must pass this diversification test:

- No issuer can be more than 25% of the fund's total assets.
- Positions exceeding 5% cannot in aggregate exceed 50% of the fund's total assets.

Cash, government security funds, and RICs that classify as fund-of-funds are exempt from these diversification thresholds.

Index Rules for RIC Diversification Test

As narrow market exposures, all 11 of the S&P Select Sector Indices include caps to satisfy the RIC diversification test.

Applied during the quarterly rebalancing (third Friday of the last month of the quarter) based on the prices from a week earlier, the capping mechanism requires a:

- **23% security cap to meet the 25% rule**: If any company has a weight greater than 24%, the company's weight is capped at 23%, allowing for a buffer to the 25% rule. All excess weight is proportionally redistributed to uncapped companies.
- **4.5% security cap to meet the 50% rule**: If the sum of the companies with weight greater than 4.8% exceeds 50%, the smallest company that causes the breach with a weight greater than 4.8% will be capped at 4.5%, allowing for a buffer.

If either rule is breached on the second-to-last business day of the rebalancing month, a secondary rebalancing is triggered after the close of the last business day of the month. Then, the two capping rules described above will be applied.

Index RIC Diversification Capping Rules Example

The latest rebalance process for the Technology Select Sector Index and Communication Services Select Sector Index illustrates the application of capping rules versus the GICS-based non-RIC compliant sector exposure.

The different constituent weights for both the Technology Select Sector Index and its GICS-based exposure depict how Apple, Nvidia, and Broadcom are impacted by the capping rules (Figure 1).

Those firms are impacted as a result of:

- Apple's 20.6% weight when added to Microsoft's 22% and NVIDIA 21.8% leads to a total greater than 50%, triggering the 50% rule and leading to Apple being capped at 4.5%.
- Broadcom, with a weight greater than 4.8%, when added to Microsoft's 22%, NVIDIA's 21.8%, and Apple's newly-capped 4.5%, leads to a total greater than 50%, triggering the 50% rule and leading Broadcom to be capped at 4.5%.

Figure 1

Tech Sector Holdings:
RIC versus Non-RIC
Index

Ticker	Firm Name	Technology Select Sector Proforma Index (RIC Compliant)	S&P 500 Information Technology Sector GICS Level 1 (non-RIC)
MSFT	MICROSOFT CORP	21.9	22.0
NVDA	NVIDIA CORP	21.6	21.8
AAPL	APPLE INC	4.5	20.6
AVGO	BROADCOM INC	4.5	5.1
AMD	Advanced Micro Devices Inc	2.6	1.7
QCOM	QUALCOMM INC	2.4	1.6
ADBE	ADOBE INC	2.4	1.6
CRM	SALESFORCE INC	2.3	1.5
ORCL	ORACLE CORP	2.2	1.5
AMAT	APPLIED MATERIALS INC	2.0	1.3

Source: State Street Global Advisors, as June 14, 2024. **Characteristics are as of the date indicated and subject to change thereafter.**

The different constituent weights for both the Communication Services Select Sector Index and its GICS-based exposure depict how Meta and Alphabet's dual share classes, among other securities, are impacted by the capping rules. (Figure 2).

Those firms are impacted as a result of:

- Meta's natural weight being greater than 25%, so it's capped at 23% in the Select Sector Index, compared to 26.3% in the non-RIC compliant sector index.
- Alphabet's combined share classes, as the rule looks at the issuer and not the single stock level, being greater than 25%, so they are capped for the combined weight to equal 23% instead of 45.6%.
- The excess weight removed from Meta and Alphabet being prorated in a waterfall fashion to the remaining securities meaning Netflix, Walt Disney, Verizon, Comcast, AT&T, T-Mobile, and Electronic Arts are capped at 4.5%.

Figure 2

Comm. Svcs. Sector Holdings: RIC versus Non-RIC Index

Ticker	Firm Name	Comm. Svcs. Select Sector Proforma Index (RIC Compliant)	Comm. Svcs. Sector GICS Level 1 Index (non-RIC Compliant)
META	META PLATFORMS INC-CLASS A	23.0	26.3
GOOGL	ALPHABET INC-CL A	12.5	24.7
GOOG	ALPHABET INC-CL C	10.5	20.9
NFLX	NETFLIX INC	4.5	6.9
DIS	WALT DISNEY CO/THE	4.5	4.3
VZ	VERIZON COMMUNICATIONS INC	4.5	4.0
CMCSA	COMCAST CORP-CLASS A	4.5	3.5
T	AT&T INC	4.5	3.0
TMUS	T-MOBILE US INC	4.5	2.2
EA	ELECTRONIC ARTS INC	4.5	0.8

Source: State Street Global Advisors as June 14, 2024. **Characteristics are as of the date indicated and subject to change thereafter.**

At the most recent rebalance, three other S&P Select Sector Indices had the capping rules applied (Figure 3). For Consumer Staples, only the 5% rule was triggered. Meanwhile, both rules were triggered for Energy and Consumer Discretionary.

Figure 3

Additional Sectors Capping Details

Index Name	Comment
Consumer Staples Select Sector Index	Philip Morris and Pepsico capped at 4.5%
Consumer Discretionary Select Sector Index	Amazon capped at 23%. McDonald's Corp. capped at 4.5%
Energy Select Sector Index	Exxon Mobile capped at 23%. ConocoPhillips, Schlumberger Ltd and Marathon Petroleum Corp capped at 4.5%

Source: State Street Global Advisors as June 14, 2024. Based on proforma index data. **Characteristics are as of the date indicated and subject to change thereafter.**

**Sensitivity
Analysis of
Capped versus
Uncapped Sectors**

Despite the select sector indices not holding stocks at the exact weights as in the non-RIC compliant market-based sector index, the historical return relationship between the two are similar — as are their systematic sensitivities.

While short-term performance deviations can occur, over a long-time horizon (10 years) the correlations between all 11 select sector indices and their non-RIC compliant barometers are each one.¹ And the level of systematic risk (beta) to the market (S&P 500 Index) for both the RIC and non-RIC compliant sectors is also one (Figure 4).

Figure 4

**Sector Beta Sensitivities
to S&P 500 Index**

	Select Sector 10-Year Beta to S&P 500	Non-RIC Sector 10-Year Beta to S&P 500
Cons. Disc.	1.18	1.18
Cons. Staples	0.60	0.60
Energy	1.23	1.21
Financials	1.09	1.09
Health Care	0.74	0.74
Industrials	1.11	1.11
Materials	1.11	1.11
Real Estate	0.84	0.84
Tech	1.12	1.14
Utilities	0.48	0.48

Source: State Street Global Advisors as March 18, 2024. Based on 10-years of monthly return data for each sector and the S&P 500 index (2014-2024). Communication Services is excluded as it does not have a 10-year history. Yet, its 5-year history shows similar betas. **Past performance is not a reliable indicator of future performance.**

Given the difference in weightings, and their ability to change at each quarterly rebalance, understanding the regulations and potential capping rules in narrow markets is a critical step in your due diligence process.

Footnotes

¹ State Street Global Advisors, as March 18, 2024, based on 10-years of monthly return data for each sector.

ssga.com**Marketing Communication****State Street Global Advisors Worldwide Entities**

<https://www.ssga.com/global/en/our-insights/state-street-global-advisors-worldwide-entities.html>

Important Risk Information

This material or any portion thereof may not be reprinted or redistributed without the written consent of State Street Global Advisors.

ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETFs' net asset value. Brokerage commissions and ETF expenses will reduce returns.

The views expressed in this material are the views of the SPDR Research and Strategy team and are subject to change based on market and other conditions. It should not be considered a solicitation to buy or an offer to sell any security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. There is no representation or warranty as to the current accuracy of such information, nor liability for decisions based on such information.

Past performance is no guarantee of future results.

Unless otherwise noted, all data and statistical information were obtained from Bloomberg LP and SSGA as of March 31, 2024. Data in tables have been rounded to whole numbers, except for percentages, which have been rounded to the nearest tenth of a percent.

The research and analysis included in this document have been produced by SSGA for its own investment management activities and are made available here incidentally. Information obtained from external sources is believed to be reliable and is as of the date of publication but is subject to change. This information must not be used in any jurisdiction where prohibited by law and must not be used in a way that would be contrary to local law or legislation. No investment advice, tax advice, or legal advice is provided herein.

The S&P 500® Index is a product of S&P Dow Jones Indices LLC or its affiliates ("S&P DJI") and have been licensed for use by State Street Global Advisors. S&P®, SPDR®, S&P 500®, US 500 and the 500 are trademarks of Standard & Poor's Financial Services LLC ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones") and has been licensed for use by S&P Dow Jones Indices; and these trademarks have been licensed for use by S&P DJI and sublicensed for certain purposes by State Street Global Advisors. The fund is not sponsored, endorsed, sold or promoted by S&P DJI, Dow Jones, S&P, their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of these indices.

State Street Global Advisors Funds Distributors, LLC, member FINRA, SIPC, One Iron Street, Boston, MA 02210.

Expiration Date: 4/30/2025 6555581.2.1.GBL.INST