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IN FOCUS

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Introduction to Financial Services: Capital Markets

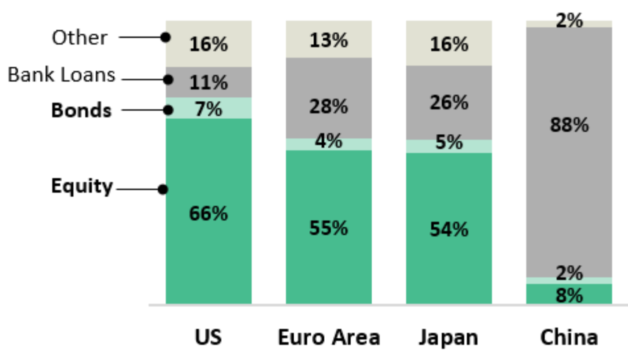
This In Focus provides an overview of U.S. capital markets, Securities and Exchange Commission (SEC) regulation, and related policy issues.

Market Composition

Capital markets are where securities such as stocks and bonds are issued and traded. U.S. capital markets instruments include (1) stocks, also called equity or shares, referring to ownership of a firm; (2) bonds, also called fixed income or debt securities, referring to the indebtedness or creditorship of a firm or a government entity; (3) digital asset securities, referring to digital representations of value in securities form; and (4) shares of investment funds, which are pooled investment vehicles that consolidate money from investors.

As a main segment of the financial system, capital markets provide the largest sources of financing for U.S. nonfinancial companies. U.S. capital markets provided 73% of the financing for nonfinancial firms in 2020 (**Figure 1**). By contrast, capital markets play a less prominent role in other major economies.

Figure 1. Capital Markets Financing Compared with Bank Loans for Nonfinancial Firms



Source: CRS, using data from SIFMA.

Notes: Data as of 2020, except for China, which is as of 2017.

Key Players

Participants in U.S. capital markets include companies and municipalities that issue securities, broker-dealers, investment companies (i.e., mutual funds and private equity), investment advisers, securities exchanges, institutional investors, and retail investors. The SEC and various self-regulatory organizations are the principal regulators of the markets.

Fundamental Concepts

Regulatory Philosophy. The SEC's regulatory philosophy for capital markets is different than that of banking regulators. The SEC is principally concerned with disclosure, on the theory that investors should have sufficient access to information from companies issuing stocks and bonds to enable investors to make informed decisions on whether to invest and at what price level to compensate for their risks. Banking regulators, by contrast, focus more on safety and soundness to avoid bank failure. This is largely because bank deposits are often ultimately guaranteed by the taxpayers, whereas in capital markets, investors generally assume all the risk of loss.

Public and Private Securities Offerings. The SEC requires that offers and sales of securities, such as stocks and bonds, be either registered with the SEC or undertaken pursuant to a specific exemption. The goal of registration is to ensure that investors receive key information on the securities being offered. Registered offerings, often called public offerings, are available to all types of investors. By contrast, securities offerings that are exempt from certain registration requirements are referred to as "private offerings" or "private placements." Private offerings are available to institutions or individual investors who meet certain net worth, income, or technical expertise thresholds.

Retail and Institutional Investors. Investors are often divided into retail investors (individuals and households) and institutional investors. Retail and institutional investors are generally perceived as having different capabilities to process information, comprehend investment risks, and sustain financial losses. In general, retail investors are thought to warrant more protection from inadequate disclosure and education than institutional investors.

Primary and Secondary Markets. The primary markets are where securities are created through public and private securities offerings. The secondary markets are where securities are traded, through buying and selling activities, to provide "liquidity" for existing securities. *Liquidity* is a common term that measures how quickly and easily transactions can occur without affecting the price. Certain market structures—for example, national securities exchanges, broker-dealers, and service firms—are essential enablers of secondary market trading and liquidity, which are important to the markets' overall health and efficiency.

Policy Issues

COVID-19 has had profound effects on U.S. capital markets, which have in turn attracted attention from Congress and federal regulators. Although some policy focus may have changed since the pandemic, Congress continues to consider a broad range of issues.

COVID-19, Federal Government Capital Market Interventions, and Capital Market Conditions. The spread of COVID-19 induced heavy capital market selloffs and rebounds in 2020. The crisis-induced stress was broadly felt in all corners of capital markets—stocks, bonds, investment funds, and other segments all experienced heightened volatility. In response, the Federal Reserve, sometimes with support from the Department of the Treasury, established several emergency facilities to provide support for key capital market segments. Changes in the course of the pandemic, other economic factors, and other government responses, such as the CARES Act (P.L. 116-136), also likely had significant effects. Following the rapid selloff and rebound during the early stages of the pandemic, U.S. capital markets experienced record price appreciation across many asset classes, including stocks, bonds, and digital assets. Some observers are concerned about the sustainability of such market performance and whether the conditions could quickly deteriorate if triggering events (e.g., unexpected changes in public health, government programs, and economic growth) were to occur.

Capital Formation versus Investor Protection. Policy debates involving the capital markets often revolve around a perceived tradeoff between capital formation and investor protection (through disclosure and other compliance requirements), two of the SEC's core missions. Expanded capital formation allows businesses to more easily obtain funding for new projects, which in turn spurs economic growth. But lax regulations could also leave investors unprotected against risks such as fraud and market manipulation. In general, the SEC and lawmakers try to focus protections on less-sophisticated retail investors. However, expanding capital formation and investor protection need not always be in conflict. Investor protection could contribute to the health and efficiency of capital markets, because investors may be more willing to provide capital, and even at a lower cost, if they have faith in the integrity and transparency of the markets.

Public versus Private Securities Offerings. The number of U.S.-listed domestic public companies has declined by close to half since the mid-1990s. At the same time, private capital markets have surpassed public markets as the preferred way to raise money. This phenomenon has shaped policy discussions around the capital markets and led to proposals to encourage public offerings, facilitate both public and private market efficiency, and enable proper investor access to private securities market investment opportunities. In November 2020, the SEC adopted changes to the regulatory framework for private securities offerings. The new framework expands the size limit on multiple types of private offerings and makes it easier for certain companies to communicate with investors and transition from different offering types.

Asset Management. The asset management industry collectively manages money for nearly half of all U.S. households. The industry has experienced periods of high growth largely attributable to retail investors' increased reliance on asset managers to invest their money for them rather than investing the money themselves. This growth in the industry has generated financial stability and other concerns. For example, commentators have raised concerns about certain exchange-traded funds' risk structures (including leveraged and inverse structures) and passive investment strategies, business practices at some private equity funds, and money market mutual funds (MMFs). The pandemic prompted special attention to MMFs, as the Fed responded to the prospect of a run on the industry by lending to institutions that purchased certain assets from MMFs facing redemption requests. The Fed took this step despite post-financial crisis reforms aimed at strengthening the MMF industry's resilience. In the wake of these disruptions, some commentators flagged the MMF industry as a problem area in need of further reform.

Market Structure. Market structure issues often relate to the SEC's mission to maintain fair and orderly markets. Multiple discussions of structural vulnerabilities surfaced during recent episodes of stock price volatility at companies such as GameStop. These events have prompted growing support for a holistic examination of the capital markets structure to identify potential changes to enhance overall market operations. The GameStop event drew policymaker attention to a broker-dealer revenue model, referred to as *payment for order flow*. Other market-driven discussions that triggered policy inquiries include settlement cycles, short selling, and game-like digital engagement practices. In addition, broader market structure issues include the increased frequency of Treasury securities market disruptions and corporate bond market efficiency.

Digital Assets and Financial Innovation. In recent years, financial innovation in capital markets has generated new forms of fundraising—such as initial coin offerings and crowdfunding—as well as a new and emerging asset class, digital assets. Digital assets have a growing presence in the financial services industry, and in cases where they qualify as securities, securities regulation generally applies. Their increasing use in capital markets raises policy questions regarding whether changes to existing laws and regulations are warranted and, if so, when such changes should happen, what form they should take, and which agencies should take the lead. Examples of issue areas include stablecoins, digital asset securities exchanges and trading, and questions of the SEC's jurisdiction (in relation to proposals to change the definition of *security*). In addressing innovation, policymakers and regulators often walk a fine line between fostering innovation and protecting investors.

CRS Resources

CRS Report R46424, *Capital Markets Volatility and COVID-19: Background and Policy Responses*, by Eva Su

CRS Report R45957, *Capital Markets: Asset Management and Related Policy Issues*, by Eva Su

CRS Report R45221, *Capital Markets, Securities Offerings, and Related Policy Issues*, by Eva Su

CRS Report R46208, *Digital Assets and SEC Regulation*, by Eva Su

CRS In Focus IF11714, *Introduction to Financial Services: The Securities and Exchange Commission (SEC)*, by Gary Shorter

CRS In Focus IF11256, *SEC Securities Disclosure: Background and Policy Issues*, by Eva Su

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