



Introduction to Financial Services: Capital Markets

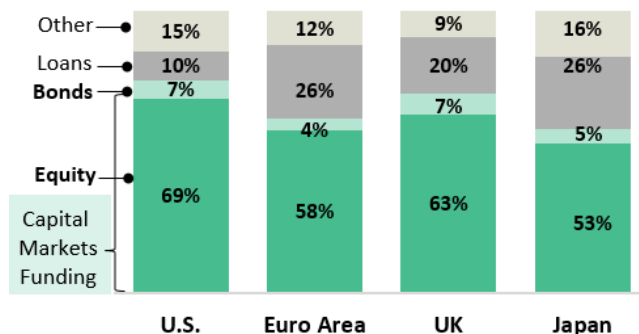
This In Focus provides an overview of U.S. capital markets, Securities and Exchange Commission (SEC) regulation, and related policy issues.

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 75.4% of the financing for nonfinancial firms in 2021 (Figure 1). By contrast, capital markets play a less prominent role in other major economies.

Figure 1. Financing for Nonfinancial Firms



Source: CRS, using data from SIFMA.

Notes: Data as of 2021. Euro Area = 19 EU member states using the Euro. Other = insurance reserves, trade credits, and trade advances.

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, various self-regulatory organizations, and state securities regulators are the principal regulators of the markets.

Fundamental Concepts

Regulatory Philosophy. 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. The SEC’s regulatory philosophy for capital markets is different than that of banking regulators. 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

Capital Formation versus Investor Protection. Policy debates involving 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 Markets. 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. Some observers are concerned that the growth in private offerings could hinder equal access to investment opportunities and investment portfolio diversification. Their policy proposals aim to expand the size and eligibility of investor access to certain private securities offerings or make certain public securities offerings processes easier. Other observers are concerned about investor protection and the lack of transparency in private securities markets. They believe that the opacity of large private securities markets could pose risks related to market disruptions and misallocation of capital. Their policy proposals aim to increase private securities market regulatory oversight and reporting.

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. Some observers view money market mutual funds as needing further reform as the industry has repeatedly received government assistance during periods of market volatility. Policy proposals include rolling back some earlier reform provisions that were not functioning as expected, removing incentives for certain investor behavior that could trigger systemic risk concerns, increasing transparency, and reducing portfolio risks.

Private equity (PE) funds—which pool investor money to purchase company shares with the aim of selling them after changing the portfolio companies' structure or operations—also face continuous policy debates. The PE industry has gained more importance because of the significant growth of the private securities and private funds markets. Some academic research suggests that PE enhances competition, enables capital formation, assists distressed company resolution, and transforms financially underperforming companies. However, some observers have raised financial stability concerns in light of the industry's growth in size, importance, and complexity. The PE industry draws additional policy debates regarding its performance records, operational practices, and industry-specific issues, including the compatibility of PE's profit maximization practices with certain public-service-oriented industries.

Market Structure. Market structure issues involve how securities are bought and sold and often relate to the SEC's

mission to maintain fair and orderly markets. Multiple discussions of structural vulnerabilities surfaced during episodes of stock price volatility. For example, the GameStop event drew policymaker attention to a broker-dealer revenue model in which they receive payment from market makers for routing trades, referred to as *payment for order flow*. Other market-driven discussions that triggered policy inquiries include settlement cycles 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. According to a number of observers, the root cause of the increased Treasury market disruptions relates to the rapid growth of the market size that outstripped dealers' intermediation and market-making capacity. Proposed policy options include ways to enhance market-making capacity, mandate central clearing of more Treasury market trading, increase market oversight and transparency, and establish new trading venues.

Digital Asset Investments. The SEC is the primary regulator overseeing securities offers, sales, and investment activities, including those involving digital assets. In cases where the digital assets are securities, the SEC has both (1) *enforcement* authority that allows the SEC to bring civil enforcement actions, such as anti-fraud and anti-manipulation actions, for securities laws violations *after the fact*; and (2) *regulatory* authority, including over digital asset securities, which could include registration requirements, oversight, and principles-based regulation. Activities in non-security digital asset markets are not subject to the same safeguards as those established in securities markets. Examples of such safeguards include certain rules and regulations that encourage market transparency, conflict-of-interest mitigation, investor protection, and orderly market operations. Policymakers have proposed amendments to the SEC's jurisdiction to bridge this perceived regulatory gap.

CRS Resources

CRS Report R47309, *Money Market Mutual Funds: Policy Concerns and Reform Options*

CRS Report R47053, *Private Equity and Capital Markets Policy*

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

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

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

CRS Report R46208, *Digital Assets and SEC Regulation*

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

Eva Su, Analyst in Financial Economics

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.