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IN FOCUS

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# Introduction to Financial Services: Capital Markets

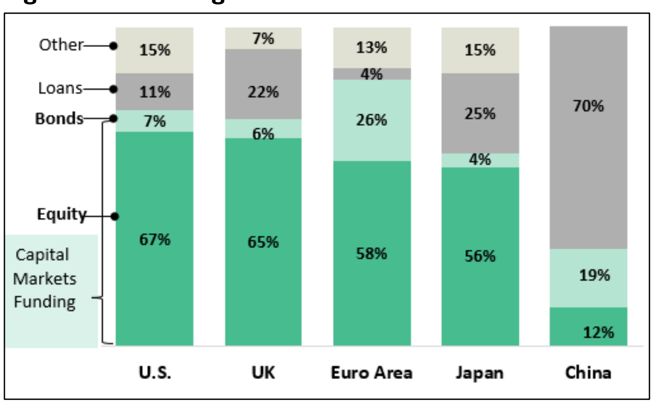
This In Focus provides an overview of U.S. capital markets, Securities and Exchange Commission (SEC) regulation, and related policy issues.

## 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 creditorship of a firm or a government entity; (3) shares of investment funds, which are pooled investment vehicles that consolidate money from investors; and (4) digital asset securities, referring to digital representations of value in securities form.

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 74% of the financing for nonfinancial firms in 2023 (**Figure 1**). By contrast, capital markets play a less prominent role in other major economies, which rely more on bank financing.

**Figure 1. Financing for Nonfinancial Firms**




**Source:** CRS, using data from the Securities Industry and Financial Markets Association.

**Notes:** "Bonds" and "equity" include both public and private offerings. "Loans" include all bank financing. "Other financing" generally includes insurance reserves, trade credits, and trade advances. Data as of 2023, except for China as of 2021.

## Key Players

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

## Fundamental Concepts

**Regulatory philosophy.** The SEC is principally concerned with disclosure, the theory being 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 banks benefit from an explicit and implicit government safety net, whereas in capital markets, investors generally assume all the risk of valuation losses.

**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 are.

**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 trade-off 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. 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. Certain compliance rules may also mitigate risks of market failure, safeguarding both investors and the financial system.

**Public versus private securities markets.** The number of U.S.-listed domestic public companies has declined by more than 40% since the mid-1990s. At the same time, private securities markets have surpassed public markets as the preferred way to raise money. This phenomenon has shaped policy discussions around 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 offering 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.

**Market-based nonbank financial intermediation (NBFI).** Vulnerabilities affecting financial stability are present in capital markets, such as certain "runnable" behavior at money-like instruments, leverage levels, interconnectedness between nonbanks and banks, data and transparency issues, liquidity mismatch at open-end funds, and concentration risk at market intermediaries. Some observers believe NBFI is a source of financial stability concern and thus warrants increased policy action to address its vulnerability. Others argue that as the banking system increasingly faces tightened regulatory requirements, more fundraising activities and their related risks may have migrated to NBFI. This interconnectedness has also led researchers to argue that instead of viewing businesses and risks as having migrated from banks to nonbanks, the interactions between the two resemble an interwoven relationship that has evolved over time.

**Asset management.** The asset management industry collectively manages money for around 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. In addition to related debates mentioned in the NBFI section, some observers are concerned about private equity (PE) firms, which pool investor money to purchase company shares with the aim of selling them after changing the portfolio companies' structure or operations. The PE industry has gained more importance because of the growth of the private securities markets. Some academic research suggests that PE enhances competition, enables capital formation, assists distressed company resolution, and transforms financially underperforming companies. Other observers raised 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 2021 GameStop event drew policymaker attention to a revenue model in which broker-dealers 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. Some argue that the cause of the increased Treasury market disruptions relates to the market's rapid growth that outstripped dealers' intermediation and market-making capacity. 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 certain 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, 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 In Focus IF11714, *Introduction to Financial Services: The Securities and Exchange Commission (SEC)*

CRS Report R47431, *Capital Markets: Overview and Selected Policy Issues in the 118th Congress*

CRS Report R45221, *Capital Markets: Public and Private Securities Offerings*

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

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