

Introduction to Financial Services: Capital Markets

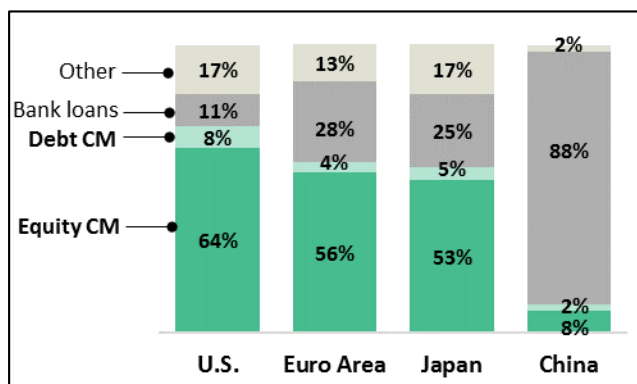
This In Focus provides an overview of U.S. capital markets, Securities and Exchange Commission (SEC) regulation, and related policy issues.

Market Composition

Capital markets are where securities like stocks and bonds are issued and traded. U.S. capital markets instruments include (1) stocks, also called equities 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; and (3) shares of investment funds, which are forms of 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 72% of the financing for nonfinancial firms in 2019 (**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: CM = capital markets. Data as of 2019, 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 (SROs) 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, either be 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

Coronavirus Disease 2019 (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 and Federal Government Capital Markets

Intervention. The spread of COVID-19 induced heavy capital markets selloffs and rebounds in 2020. The crisis-induced stress conditions have been broadly felt in all corners of capital markets—stocks, bonds, investment funds, and other segments have all experienced heightened

volatility. In response, the Federal Reserve (Fed), sometimes with support from the Treasury Department, established several emergency facilities to provide support for key capital markets segments. The SEC also took actions to monitor price movements and ensure orderly market functions. Some of the SEC's existing tools to manage market volatility—market-wide and single-stock halts—were triggered at an unprecedented rate at the peak of market volatility to allow investors to pause and digest information during fast-paced market movements. 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.

Capital Formation Versus Investor Protection. Policy debates involving the capital markets often revolve around perceived tradeoff between capital formation and investor protection, 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 phenomena 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 certain financial stability concerns. Among other things, commentators have raised concerns about certain exchange-traded funds' structure and passive investment style, the risk of funds that invest in leveraged loans, 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 regulatory reform.

Investment Advice. Some policymakers have shown continued interest in the standard of care governing securities brokers who offer financial advice to retail investors. In 2019, the SEC adopted "Best Interest" standards to improve the quality and transparency of financial advice. This package of rules and interpretations has been the focus of significant congressional attention, with some commentators criticizing the SEC for not going further and subjecting brokers to a fiduciary standard.

Securities Trading. Sophisticated electronic trading and computer programs now dominate capital markets trading and research, making data availability and accessibility for affected institutions a key policy issue. Some policymakers have expressed concern about the fees national exchanges charge for market participants to access data. SROs are working to develop and implement a consolidated audit trail (CAT), which could provide a single database for regulators to track all U.S.-listed equities and options. According to the SEC, CAT is "intended to enable regulators to oversee the securities markets on a consolidated basis—and in so doing, better protect these markets and investors." Other trading-related issues include transparency and oversight of alternative trading systems, high frequency trading, and the standards for listing and delisting companies from national securities exchanges.

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. Some policymakers hope to clarify uncertainties involving the regulation of digital assets, such as the circumstances in which these assets qualify as "securities" and the regulation of digital-asset trading and custody. Congress has passed legislation to facilitate certain types of innovation. For example, Title III of the Jumpstart Our Business Startups Act (JOBS Act; P.L. 112-106) created an exemption from the Securities Act's registration requirements for certain crowdfunding activities. In addressing innovative technologies, policymakers and regulators often walk a fine line between encouraging 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

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