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IN FOCUS

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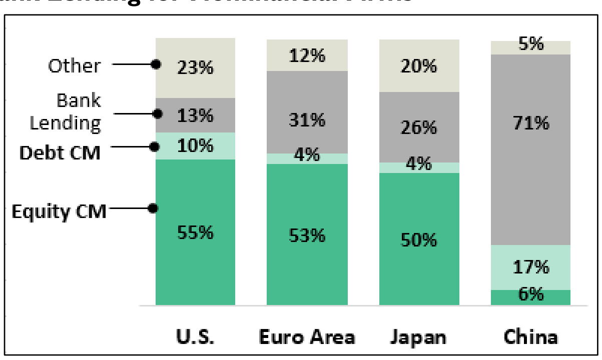
Introduction to Financial Services: Capital Markets

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

Market Composition

Capital markets are where securities, such as stocks and bonds, are issued and traded. U.S. capital markets are generally composed of (1) around $32 trillion in stocks, also called equities or shares, referring to ownership of a firm; and (2) around $37 trillion in bonds, also called fixed income or debt securities, referring to the indebtedness or creditorship of a firm or a government entity. Capital markets are also composed of additional asset classes, such as derivatives, which derive value from other underlying assets. As a main segment of the financial system, capital markets provide the largest sources of financing for U.S. nonfinancial companies. As **Figure 1** shows, capital markets provide 65% of financing for nonfinancial firms compared with 13% for bank lending, which is higher than the Euro Area, Japan, and China.

Figure 1. Capital Markets Financing Compare with Bank Lending for Nonfinancial Firms



Source: CRS, using data from SIFMA.

Notes: CM = capital markets. Data presented as of 2016, except for China, which is presented as of 2014.

Key Players

Participants in U.S. capital markets include about 8,000 reporting companies, of which approximately 4,300 are exchange-listed public companies; more than 26,000 investment advisers, mutual funds, exchange-traded funds, broker-dealers, and other registered entities; and millions of retail and institutional investors domestically and abroad.

U.S. capital markets are mainly regulated by the SEC, state securities regulators, self-regulatory organizations (SROs), and the Commodity Futures Trading Commission, which generally regulates derivatives markets.

Fundamental Concepts

Regulatory philosophy. The SEC's regulatory philosophy for capital markets is different than that of banking regulators. The SEC's primary concern is information 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 financial institutions' risk control and mitigation. This is largely because most bank deposits are ultimately guaranteed by the taxpayers, whereas in capital markets, investors generally assume all the risk of loss and receive risk-adjusted investment returns.

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 be undertaken with an exemption from certain registration requirements. 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 are referred to as private offerings or private placements. Various private offerings are available to institutions or individual investors with certain financial or income wherewithal.

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 these 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, trading venues, broker-dealers, and service firms—are essential enablers of secondary market trading and liquidity, which are important to the overall health and efficiency of capital markets.

Policy Issues

Congress may consider a number of broad policy issues related to U.S. capital markets.

Capital formation versus investor protection. Capital markets policy debates often revolve around perceived tradeoffs between expanding capital formation and protecting investors, two of the SEC's core missions. Expanding capital formation allows for greater access to investment opportunities for more investors and increased funding for businesses. Nevertheless, expanded capital formation could also lead to concerns over whether investors are adequately protected from unreasonable risks of making certain investments. In general, the SEC and lawmakers seek to ensure that less sophisticated retail investors have access to, and full comprehension of, the risk disclosures of their investments. Expanding capital formation and investor protection, however, 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 underlying markets.

Public versus private securities offerings. The number of U.S.-listed domestic public companies has declined by half since the mid-1990s. At the same time, private capital markets have now 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 liquidities, and enable proper investor access to investment opportunities.

Short-term versus long-term corporate thinking. *Short-termism* refers to corporate stakeholders making decisions based on an earlier economic payoff rather than the long-term prospects of a company or society. Some policymakers have advocated various proposals to encourage long-term corporate thinking, including (1) allowing public companies to stop giving quarterly reporting and earnings guidance, to avoid perceived success or failure to be measured quarterly; (2) mandating individual companies' capital allocation decisions give priority to research and development expenditures that are perceived to generate long-term prospects, instead of certain share buybacks that reportedly have the potential to boost executive compensation linked to short-term stock prices; (3) scrutinizing so-called shareholder activism-related voting practices that some consider prioritize short-term gain over long-term shareholder value creation; and (4) considering the extent to which lawmakers or the SEC should mandate that companies report their environmental, social, and governance practices.

Asset management. According to *Financial Times* and *The Wall Street Journal*, since the Great Recession, assets and influence have shifted from banks to asset management firms. Some argue that with tightened banking regulation, risks have transferred to certain capital markets segments rather than the banking system. For example, some raise systemic risk concerns regarding exchange-traded funds that act as mechanisms to provide liquidity in market segments that are structurally illiquid. Others argue that asset managers are increasingly holding high-risk positions, such as leveraged loans, that could pose systemic risk concerns.

Investment advisers. Some policymakers have shown continued interest in the standard of care applied to the investment advice financial advisors provide to retail investors. In 2018, the SEC proposed a package of "Best Interest" standards to improve the quality and transparency of financial advice. This proposal is not yet finalized but has been the focus of significant congressional attention.

Capital markets data and data access. 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 increase in 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. 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."

Financial innovation. In recent years, financial innovation in capital markets has brought new forms of fundraising as well as a new and emerging asset class—initial coin offerings, crowdfunding, and digital assets. It has also created integrated services that are building on the existing markets and platforms, such as robo-advisory services for providing financial advice. Some innovation has also led to new regulation. For example, Title III of Jumpstart Our Business Startups Act (JOBS Act; P.L. 112-106) created a regulation regarding securities-based crowdfunding. Nevertheless, many other financial innovations operate under the existing regulatory framework without tailored regulatory approaches. Policymakers and regulators walk a fine line between providing regulatory clarity and investor protection and preventing the unintended hindrance to financial innovation, financial inclusion, and technological advancements. Although no clear consensus has formed on what new regulations, if any, are appropriate, financial innovation practices affect the lives of millions of Americans and will likely continue to be a source of congressional interest.

CRS Resources

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

CRS In Focus IF10032, *Introduction to Financial Services: The Securities and Exchange Commission (SEC)*, by Gary Shorter

CRS Report R45308, *JOBS and Investor Confidence Act (House-Amended S. 488): Capital Markets Provisions*, coordinated by Eva Su

CRS Report R45318, *Exchange-Traded Funds (ETFs): Issues for Congress*, by Eva Su

CRS In Focus IF10747, *Private Securities Offerings: Background and Legislation*, by Eva Su

CRS In Focus IF11004, *Financial Innovation: Digital Assets and Initial Coin Offerings*, by Eva Su

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