Statement of
Michael A. Mendelson, AQR Capital Management LLC

Before the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues
August 11, 2010

Chairman Schapiro, Chairman Gensler, and members of the Joint Committee, my name is Michael Mendelson. I am a Principal at AQR Capital Management, an investment management firm that for the past twelve years has managed assets for pension funds, endowments, and foundations and now also manages public mutual funds.

Thank you for inviting me today to discuss our experiences of the events of May 6. The Flash Crash highlights a risk in an otherwise well-functioning US equity market. While AQR and the great majority of other investors managed to avoid damage from this event, not everyone did. We can reduce the likelihood of a repeat Flash Crash and the work of this Committee and the extensive efforts of the staffs of your respective agencies may be the most important steps in that effort.

AQR employs quantitative methods in most of its investment strategies. We invest in a wide variety of instruments, including US equities. Our holding periods are typically months to years. Some of our investment strategies turn over every few days, though none would be considered “high frequency”. We are liquidity seekers – though we don’t use market orders - and rely on liquidity providers to perform their essential function. In many of the markets in which we trade, liquidity is provided by dealer firms whose presence tends to rise and fall with the health of the financial system. But, in the US equities market, liquidity is provided by a broad base of participants. This was a great benefit to all investors during the most difficult weeks of the financial crisis. Our exchange-traded markets performed admirably and those responsible for that, from the small electronic market makers to the regulators who led us to a competitive, broadly democratized market structure, should be proud of this achievement.

At AQR, we build safeguards into our trading process and have human oversight of them, important steps for protecting client assets. On May 6, our trading staff noticed early on that the market was potentially disrupted and shut down our equity trading. We suffered no “busted” trades, we avoided trading at dislocated prices, and we were able to complete the overwhelming share of portfolio transactions planned for that day. Nevertheless, May 6 highlighted risks in the trading ecosystem that need to be managed.

I would like to highlight three issues.

First, questions remain about the cause of the Flash Crash, but we know there was significant negative macroeconomic news, trading volume was very high and liquidity demand from market sellers was substantial, many trade reports appeared to be erroneous and some market data feeds slowed, trading centers de-linked, and liquidity providers experienced large P&L moves. It is easy to understand why these liquidity providers would have felt compelled to withdraw their limit orders while liquidity demanders continued unaware. I want to emphasize the importance of “unaware.”

Second, had some of the weak links been stronger, what alternative course could events have taken that day? Perhaps the events culminating with the evaporation of the limit order book was our good fortune, as the subsequent shocking trade reports screamed out to market sellers “stop!” Without that loud blast, selling may have continued unabated, causing a real crash from which it would have taken far longer than 15 minutes to recover. The effective clearing of the limit order book might have acted much like a circuit breaker, albeit a sloppy one. Better market data, better exchange coordination, and additional rules might have prevented the flash crash, but may have enabled a real one. I don't know. I would like to know.

Third, the complexities of our trading environment should give us pause and at least drive us toward seeking lightweight and simple solutions. Toward that end, the current circuit breaker pilot program may be a good start, but modifications may be needed. We have seen as recently as last Thursday that erroneous trade reports can halt a stock. With broad access to the Trade Reporting Facility, there is too much potential for abuse, even catastrophic abuse. So perhaps consideration should be given to a limit offer rule. Perhaps we should just make it easy for liquidity demanders to see how plentiful liquidity supply is at that moment.

Another proposed solution is to impose market-making obligations. This will increase costs for retail and institutional investors every second of every normal trading day. But on those rare occasions when markets are severely disrupted, market-maker obligations will accomplish nothing. The function of a market maker is not to buy stock at the wrong price as a market is crashing. Market making, whether complete with a strong set of obligations or not, has never worked that way, and it never will.

Market maker obligations come with special privileges and some markets may need this to encourage liquidity providers on a day-to-day basis. But, these obligations aren't created to prevent crashes – it wouldn't be effective. Let's not do that here, it will just add a burden for all investors. Thank you