Statement of
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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 experience 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, unfortunately 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 the SEC and CFTC 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, but 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, such as fixed income, liquidity is provided by dealer firms whose ability to provide liquidity rises and falls 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 processes 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 highlights 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, very heavy trading volume, substantial liquidity demand from market sellers, trade reports that appeared to be erroneous or delayed, and a de-linking of our trading centers. With liquidity providers experiencing large P&L moves while fearing they were flying blind without reliable market data, it is easy to understand why they would have felt compelled to withdraw their limit orders. Meanwhile, liquidity demanders continued to send market orders, unaware that the typically deep limit order book, wasn't. I want to emphasize the importance of liquidity demanding investors being "unaware" of the disappearing liquidity.

Second, had some of the weak links been stronger, what alternative course could events have taken that day? Perhaps the evaporation of the limit order book was actually 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 very sloppy one. Better market data, better exchange coordination, and additional rules might have prevented the flash crash, but might have enabled a real one. I don't know. Careful analysis of market data may yield an answer, and I encourage the Committee to work with industry participants to explore this. We need to understand what role demanders of liquidity had on May 6 and perhaps consider steps to better inform those participants of the live, aggregate supply of liquidity.

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.

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 by reducing the availability of liquidity providing capital and increasing its risk. Adding insult to injury, on those rare occasions when markets are severely disrupted, market-maker obligations will accomplish nothing. After all, 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 in the ordinary course of business. But instead, here the suggestion is that these privileges will encourage liquidity provision in extraordinary times. They won't.

Thank you