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November 7, 2011

Via e-mail to: rule-comments@sec.gov

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Use of Derivatives by Investment Companies under the Investment Company Act of 1940; Release No. IC-29776; (File No. S7-33-11)

Dear Ms. Murphy:

AQR Capital Management, LLC ("AQR") appreciates this opportunity to comment on Investment Company Act Release No. 29776 (Aug. 31, 2011) (the "Concept Release"), in which the Securities and Exchange Commission solicited comment on the use of derivatives by management investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act").[1] Although the Concept Release solicits comments in a number of areas, we are confining our comments to a few limited areas of particular interest to AQR.

AQR was founded in 1998 and currently employs approximately 230 people. AQR is an investment management firm that utilizes a disciplined multi-asset, global research process. (AQR stands for Applied Quantitative Research.) AQR advises separate accounts and pooled investment vehicles, including registered investment companies, UCITS and hedge funds that utilize certain alternative investment strategies. AQR also serves as a sub-adviser to several registered investment companies. The nine separate series of AQR Funds, a registered investment company advised by AQR, employ a variety of alternative investment strategies, including momentum investing, risk parity, managed futures, arbitrage, international and global equity investing and a combination of the above strategies. AQR and its affiliates had approximately $38.5 billion in assets under management as of September 30, 2011.

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1 *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Release No. IC-29776 (Aug. 31, 2011), 76 Fed. Reg. 55237 (Sept. 7, 2011), available at http://www.sec.gov/rules/concept /2011/ic-29776.pdf.

Usage of Derivatives

Question: *The Commission generally requests data and comment on the types of derivatives used by funds, the purposes for which funds use derivatives, and whether funds' use of derivatives has undergone or may be undergoing changes and, if so, the nature of such changes.*

From its founding in 1998, AQR has offered separate accounts and unregistered pooled vehicles to its customers applying what are described as "alternative" strategies. Those strategies employ a number of sophisticated trading practices, such as risk parity, momentum, convertible-arbitrage, fixed-income relative value, event-driven, dedicated short bias, equity market neutral, long-short equity, emerging-markets, global macro and managed futures. In implementing those strategies and practices we use derivatives extensively.

Since the financial crisis of 2008, a growing number of retail investors have sought access to more sophisticated investment strategies to protect against downside risk and, so, they have turned to mutual funds that employ alternative investment strategies to achieve greater diversification. This increasing demand for alternative mutual funds is also fueled by institutional investors seeking greater transparency and liquidity, as well as more conservative investment strategies than are typically utilized by mutual funds. To accommodate these new investors and the converging demands of both retail and institutional investors, investment managers have developed mutual funds designed to mimic alternative investment strategies to the extent permitted under federal securities laws. AQR launched its first registered mutual fund in 2009. We now offer nine registered mutual funds to retail customers that use many of the same strategies as those implemented in our unregistered offerings. As a result, retail customers are able to benefit from allocations to "alternative" strategies in order to rebalance portfolios that historically may have been over-weighted in terms of risk to other asset classes.

Without the use of derivatives, it would be impossible for AQR mutual funds to achieve their objectives. Suffice it to say, we use derivatives in a variety of ways, including for hedging. But our primary use is to gain exposure to entire classes of instruments, rather than to individual securities. We are more apt to buy exposure to the U.S. equity market as a whole through a swap on the market than we are to gain exposure to a single stock through a credit default swap or stock future. For example, the AQR Risk Parity Fund seeks to balance the allocation of risk across four major risk sources: equity risk, fixed income risk, credit risk and currency risk. In order to cost-effectively shift assets between and among the risk sources, we use futures and swaps that provide exposure to different asset classes. In appropriate circumstances, when our models call for a shift among risk sources, the transaction costs would be prohibitive if trades were done in individual securities, rather than through closing out a swap or futures position that provides broad asset-class exposure. In addition to the enhanced costs – which would be borne by fund investors – there would be market impact due to the trade execution. Further, given the volatility of prices of instruments, the return to investors could be adversely impacted as large numbers of trades get executed.

The success of much of our quantitative asset management techniques depends on the ability to execute trades quickly and efficiently. Derivatives allow that and, since we think that exposure to "alternative" strategies is an important tool to manage risk on an overall portfolio basis, imposing regulations in a way that makes funds like ours impossible to offer shrinks investment options to the detriment of mutual fund shareholders. Nothing in the way that mutual funds have used derivatives (of which we are aware) would support a roll-back of the flexibility mutual funds have enjoyed under the current regulatory regime. Any review of that regime should preserve the ability of funds like the AQR Funds to function and be an investment option for mutual fund investors.

The derivatives market has certainly evolved over the last thirty years, and made it possible for mutual fund investors and their advisers to have additional investment tools/products available to them. We cannot predict where the usage of derivatives is headed; however, it is safe to say it will not diminish and will likely continue to evolve to meet market needs.

Asset Segregation

Question: *In the Merrill Lynch no-action letter, the staff took the position that "cash or liquid securities (regardless of type)" may be segregated for section 18 purposes. Should the Commission permit funds to segregate any liquid asset? Or should the Commission further limit the types of assets that may be placed in a segregated account?*

The purpose underlying the segregation of assets is to assure that a fund has sufficient assets to meet its obligations under section 18 exposures.[2] Segregation of assets also functions as a practical limit on the amount of leverage which a fund may undertake.[3] When we at AQR segregate liquid assets we take their expected volatility into account based on current market conditions. To avoid having to add additional collateral, we tend to use less volatile assets. In fact, we tend to use cash items and high quality debt as collateral for our funds because our strategies result in large holdings of these securities. We also monitor the extent of assets used as collateral to avoid having a forced unwinding of a derivative due to a market decline in the value of collateral. Nevertheless, our swap and futures exposures are structured to allow for an "unwind" should market volatility create a collateral "shortfall," assuming additional assets are not available to increase collateral. This has never happened, even amid the market turmoil of 2007-to-present.

We agree with the position taken in the 2010 ABA Derivatives Report[4] that the ability to segregate any liquid assets gives the AQR Funds (and other mutual funds) greater flexibility to

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2 *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979) ("Release 10666").

3 *Id.*

4 *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010) ("2010 ABA Derivatives Report").

use derivatives without running a cash or debt position higher than the strategy otherwise warrants. In addition, the flexibility to modify a swap or close out a future significantly mitigates the risk of a default under those instruments due to a decline in the value of the collateral. Further, we note that high quality debt securities can be volatile; in certain markets they can be as volatile as certain equity or lower quality debt securities.

If the Merrill Lynch Letter[5] were withdrawn, we believe investors in certain funds would be harmed. Equity funds or high yield funds, for example, would find it difficult to utilize derivatives because these funds do not usually hold large quantities of cash and high grade debt obligations that could be used as collateral.[6] These funds may be required to increase these holdings and potentially adversely affect their returns or forgo or limit derivative use. We see no reason to limit the use of derivatives indirectly by rolling-back what collateral is eligible to what it was in 1996. Since then, mutual funds have managed their collateral requirements in a way that has passed regulatory muster and protected investors, while providing access to newer investment tools. We do not support undoing a laudable example of regulatory foresight that recognized evolving market developments.

Question: *In what respects would fund-determined asset segregation policies be expected to deviate from the current segregated account approach? Would such policies be likely to incorporate VaR or other risk methodologies?*

The current asset segregation approach, while it has been effective in mitigating the risks section 18 was designed to address (*i.e.*, excessive borrowing and operating without adequate assets and reserves), has some weaknesses. In particular, as applied to swaps, the daily end-of-day segregation of changes in market value do not reflect the likelihood of loss or volatility of the reference instrument. Intra-day value fluctuations are ignored. For futures, the issues are similar.

The idea presented in the 2010 ABA Derivatives Report to allow each fund to determine the amount of assets to be segregated based on the risk profiles of the derivative instrument and its assessment of risk, subject to Commission guidance, has a lot of appeal. It would let advisers and fund Boards craft guidelines suitable to the particular fund and the particular derivatives it employs for the particular usage it makes of them. On its face, it is logical that the place where oversight of derivative usage occurs primarily be the place where the trades occur. But we remain concerned that different funds could reach different determinations, perhaps some taking more aggressive positions to allow for greater use of derivatives to drive performance. Absent clear Commission guidance, fund Boards will have little insight into either industry practice or reasonable parameters to guide them in overseeing derivative risk. A problem in one fund could have a negative impact on other funds using the same derivative or the same strategy. Given that derivatives are evolving and risk oversight procedures are evolving along with them, we are

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5 Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996) ("Merrill Lynch Letter").

6 *See* Release 10666.

uncomfortable at this point with an approach that allows each fund to create its own cover or collateral guidelines, unless, as stated above, there is clear Commission guidance issued at the same time. Much as we as a firm favor generally lesser or "smart" regulation of financial activities, we believe the integrity of the industry requires funds to be acting in like manner, though perhaps not identically, in the area of asset segregation. In this area, clear rules to which all mutual funds adhere are appropriate. For funds like the AQR Funds that make extensive use of derivatives and whose investment thesis rests on their use, investors deserve a regulatory structure that provides a measure of assurance that there is a level playing field. Boards, too, would benefit from a baseline standard against which they could monitor derivative use.

At this point, we are unable to identify one risk measurement method to be used by all funds in lieu of the current asset segregation methodology. We are familiar with the "value at risk" or VaR methodologies, both through our management of UCITS funds and as an effective tool for day-to-day overall firm risk management, and think there could be real benefits with such an approach for advisers managing funds subject to the Investment Company Act. Yet at this point, we have not sufficiently analyzed the limitations of VaR to be able to endorse this approach. Nonetheless, we think an approach to asset segregation that incorporates a quantifiable measure of volatility and risk is appropriate, and bears further study.

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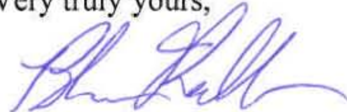
We appreciate the efforts of the Commission and its staff in connection with the Concept Release. The issues raised are complex and we expect the Commission may need an extended period to address them. We understand that the Commission intends to address related disclosure matters and Board oversight responsibilities separately. It would seem to make sense to deal with all derivative-related matters holistically, rather than in parts. Having said this, a number of items raised in the Concept Release have created uncertainties for investment companies for years. While the industry has been living with them, clarifications of some matters would be very helpful even apart from the larger project.

We hope the Commission and its staff find our comments above helpful, and we would be pleased to discuss any aspect of the letter with the Commission or its staff. Questions regarding this letter may be directed to Brendan Kalb at (203) 742-3618 or Nicole DonVito at (203) 742-3815.

Very truly yours,



AQR CAPITAL MANAGEMENT, LLC

By: Brendan R. Kalb
Title: General Counsel