March 28, 2011

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Proposed Federal Speculative Position Limits for Referenced Contracts

Dear Mr. Stawick:

This letter is submitted on behalf of the Centaurus Energy Master Fund, LP ("Centaurus"), in response to the proposed rule issued by the Commodity Futures Trading Commission (the "CFTC" or the "Commission") regarding the imposition of speculative position limits on futures and option contracts in 28 exempt and agricultural commodities (the "Proposed Rules")[1] and their economically equivalent swaps, pursuant to Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").[2] We are pleased to take this opportunity to share our comments with the Commission, building on the comments we submitted in August 2009 during the CFTC Hearings on Position Limits, Hedge Exemptions and Transparency for Energy Markets (the "2009 CFTC Hearings") and our comment letter submitted to the CFTC in connection with the proposed rules to impose speculative position limits on referenced energy commodities (the "April 2010 Comment Letter").[3]

Founded in 2002, Centaurus manages over $4 billion in assets. Our largest business is natural gas and electricity trading, and we rely on a market that is governed by supply and demand and produces a fair settlement price. In addition, our primary role in the market is to provide liquidity to the commercial hedger. Our comments reflect our belief that liquidity and trading volume bring stability to these markets and ensure that the price formation function works efficiently and fairly for all market participants.

CFTC Has Not Demonstrated Any Need for Position Limits

As an initial matter, neither the Proposed Rules nor the release accompanying the Proposed Rules justified the need for the imposition of position limits, nor do the Proposed Rules comply with the statutory requirements under Dodd-Frank. New Section 4a(a)(1) of the Commodity Exchange Act ("CEA") provides the Commission authority to impose position limits that "are necessary to diminish, eliminate, or prevent" the burden of excessive speculation. New Section 4a(a)(3) of the CEA qualifies the CFTC's authority by directing it to set position limits, "as appropriate . . . [and] to the maximum

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1 Position Limits for Derivatives, 76 Fed. Reg. 4752 (Jan. 26, 2011) (to be codified at 7 C.F.R. pts. 1, 150, and 151).

2 H.R. 4173 (111th Cong. 2d Sess. 2010).

3 *See* Testimony of John D. Arnold, Managing Partner, Centaurus Advisors, LLC, August 5, 2009.

extent practicable, in its discretion: (i) to diminish, eliminate, or prevent excessive speculation . . . ; (ii) to deter and prevent market manipulation, squeezes, and corners; (iii) to ensure sufficient market liquidity for bona fide hedgers; and (iv) to ensure that the price discovery function of the underlying market is not disrupted." Dodd-Frank mandates that the CFTC impose position limits "as appropriate," and "as appropriate," we submit, requires factual support for position limits based on "diminish[ing], eliminating, or prevent[ing] excessive speculation" or "deter[ring] and prevent[ing] market manipulation balanced against the impact on "market liquidity" and "price discovery." There is no such factual support, and the Commission cites to none. Therefore, we do not believe that the Commission should move forward with Phase One of the proposed position limit regime, that would set an initial spot-month position limit on futures and swaps on the 28 referenced contracts, based on limits currently imposed by designated contract markets and exempt commercial markets, or with Phase Two of the Proposed Rules, which would impose single-month and all-months-combined position limits on futures and swaps, as well as an aggregate limit across both futures and swaps, of the 28 referenced contracts.

As a practical matter, we note that the CFTC does not have any meaningful data on the size of the commodity swap market and that it would be premature to impose a position limit regime without fully understanding these markets, and, in particular, the size of these markets. At a minimum, the Commission should postpone the implementation of the Proposed Rule until a later date when and if it has the factual support and can demonstrate to all market participants that position limits will address problems related to excessive speculation and market manipulation in commodity markets, and that such limits will not harm the liquidity or price discovery function of the commodity markets.

Commission Should Not Impose Limits on Financially-Settled Contracts

The Proposed Rule would impose hard position limits aggregated across futures contracts (physically-settled and financially-settled) and their "economically equivalent" swaps. The CFTC would impose separate spot month, single month, and all-months-combined intra-day limits for futures and swaps.

As stated in our testimony during the 2009 CFTC Hearings and our April 2010 Comment Letter, we strongly urge the Commission not to impose position limits on financially-settled contracts. We continue to believe that physically-settled and financially-settled contracts are not true economic equivalents: they serve different functions in the market and, therefore, should be regulated differently. We do believe that the CFTC should have transparency and oversight into all financially-settled contract positions, but the imposition of hard limits on financially-settled contracts will decrease liquidity in the markets, and will increase transaction costs and volatility associated with expiration of the physically-settled contracts.

Financially-Settled Contracts Serve Different Markets

Physically-settled contracts serve as a liquidity tool for the physical commodity. Any commercial producer or end-user can make or take delivery if their needs are met by the specifications of the contract. However, market participants have frequently used the physically-settled contract as a proxy to broadly hedge commodity exposure. In many

cases, these market participants have no intention of making or taking delivery of the physically-settled contract. Such hedges can be problematic as the market participant must eventually exit the physically-settled contract while trying to keep the price protection in place for as long as possible to most closely replicate the settlement price. This leads to large open interest in physically-settled contracts that is unstable for the market. The financially-settled contract, however, addresses these concerns, as it settles against the physically-settled contract. Therefore, a market participant that seeks to hedge its financial risk does not have to use a physically-settled contract, as it has access to a financial product that mirrors the risk that the counterparty desires to hedge.

Some have argued that the high correlation between physically-settled contracts and their financially-settled counterparts is evidence that the contracts are fungible. We disagree. The physically-settled contract requires one to either make or take delivery or exit the contract, while the financial contract can be worn to settlement. This is a key difference. So long as the contract has a robust design, the physically-settled contract must settle at the price of market indifference, and the financial contract must follow that settlement price.

Financially-settled Contracts Are Beneficial to the Physical Markets
Despite the increase in trading volumes and open interest by all market participants (including commodity index funds and ETFs) in financially-settled contracts, the volatility in commodity markets has steadily decreased over the past ten years. The more participants and capital in the markets, the more liquidity there should be around any price point, and the less likely the market is to deviate from fair value. In short, increased financial trading over the years has led to less volatility and greater liquidity for the commercial hedger. The imposition of position limits on financially-settled contracts will greatly impair this liquidity and the price discovery function of these markets.

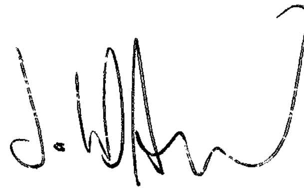
Conditional Spot Month Limit Will Be Disruptive to the Markets
Under the Proposed Rule, a trader holding financially-settled contracts would be subject to a spot-month speculative position limit of five times (5X) the level fixed for the financially-settled contract's physically-settled counterpart, if the trader holds no physically-settled contracts in the spot month. Otherwise, traders would be subject to the same limits for financially-settled contracts in the spot month as for physically-settled contracts. We believe that this provision will increase volatility for physically-settled contracts during the spot month, as it will essentially prevent a trader from holding any physically-settled contracts during the spot month, if they held any financially-settled positions. This will result in a significant amount of unnecessary trading and increased market volatility, as traders have to unwind previously existing positions. Moreover, it would make the market more dependent upon small speculators merely by virtue of their size and without regard to their ability or willingness to provide the best price to commercial hedgers. Furthermore, the Proposed Rule will force market participants to move to financially-settled contracts at the expense of physically-settled contracts, which will reduce liquidity and the price discovery function of the physically-settled markets, harming commercial producers and the integrity of the markets.

Limits on Trading Venues

The Proposed Rule will impose aggregate limits across trading venues, as opposed to providing a separate limit for each trading venue. As a result, a market participant that is currently permitted to hold 1,000 contracts on ICE and 1,000 contracts on ClearPort will now be restricted to holding 1,000 contracts across ICE, ClearPort, and the bilateral OTC market. These new limits will immediately impose restrictions on market participants that will reduce liquidity and hamper the price discovery function of these markets. This is particularly true as these limits, even in Phase One in the spot month, will apply to the bilateral market when the CFTC admits it does not have any meaningful information about the size or other features of that market. As discussed above, we believe that financially-settled contracts are beneficial to commodity markets and we urge the CFTC to reconsider whether it should place restrictions on these products, absent clear evidence of excessive speculation or market manipulation in these markets. We believe that the Proposed Rule should not apply to bilateral markets and should impose limits by trading venue (e.g., NYMEX and ICE), with a correspondingly higher aggregate limit, to ensure sufficient liquidity for contracts across the venues.

Conclusion

We appreciate the opportunity to share our concerns regarding the Proposed Rule. We strongly urge the CFTC to reconsider its Proposed Rule. In particular, the Commission should reexamine the imposition of position limits on financially-settled contracts, to ensure that the Proposed Rule will not reduce the volume and liquidity of commodity markets.



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