UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 4672/ March 29, 2017

ADMINISTRATIVE PROCEEDING
File No. 3-17891

In the Matter of **COVENANT FINANCIAL SERVICES, LLC AND STEPHEN SHAFER,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 203(e), 203(f), AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Covenant Financial Services, LLC ("Covenant") and Stephen Shafer ("Shafer") (collectively referred to as "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act Of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds that:

Summary

1. This matter involves Covenant, an investment adviser registered with the Commission from June of 2007 to August of 2016, and Shafer, the Vice-President, majority owner, portfolio manager, and Chief Investment Officer of Covenant, materially misstating the value of assets in five private funds, resulting in the funds paying Covenant excessive management fees and incorrectly calculating redemptions from the funds. Beginning in 2009, Covenant used a third party vendor pricing service (the "Pricing Service") to value municipal bonds held in the funds. However, beginning in approximately mid-August 2011, a period of significant market volatility, the values provided by the Pricing Service (the "Pricing Service Values") were not consistent with a Generally Accepted Accounting Principles ("GAAP") measurement of fair value. Among other indications that the funds overstated the value of their recorded assets beginning in mid-August 2011, the funds sold some of the municipal bonds at prices that were materially less than amounts recorded. Nevertheless, Respondents continued to use the Pricing Service Values for the funds' municipal bonds through the first quarter of 2013. This approach was inconsistent with the funds' statements in their 2011 financial statements, Covenant's written valuation policy, and the representations in the funds' PPMs and LPAs. As a result of this conduct, Covenant received excess fees of over $400,000. Based on the foregoing, Covenant and Shafer negligently violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. Moreover, Covenant negligently violated Section 206(4) of the Advisers Act and Rule 206(4)-7, and Shafer negligently caused such violation.

Respondents

2. Covenant Financial Services, LLC, an Oklahoma limited liability company with its principal place of business in Oklahoma City, Oklahoma, was a Commission-registered investment adviser from June of 2007 to August of 2016. Currently, Covenant provides advisory services to eight private funds, and has approximately $81 million in assets under management.

3. Stephen Shafer resides in Oklahoma City, Oklahoma, and has been the Vice-President and a minority owner of Covenant since 2004, the portfolio manager and Chief Investment Officer of Covenant since 2008, and the majority owner of Covenant since 2009. Shafer made the investment decisions for the funds at issue during the August 2011 through February 2013 time frame (the "Relevant Period").

FACTS

A. The Funds, the Private Placement Memoranda, and the Limited Partnership Agreements

4. From August 2009 through 2012, Covenant sold limited partnership interests in five private funds: the Covenant Income Appreciation Fund, LP, the Covenant Total Return Fund, Ltd., and the Covenant Total Return Fund, LP (the "Domestic Funds") and the Covenant Global Alpha Fund, Ltd. and Covenant Global Alpha Fund, LP, respectively (the

"Offshore Funds" and collectively with the Domestic Funds, the "Funds"). The limited partners included Covenant's investment advisory clients. Pursuant to the Funds' documents, Covenant was entitled to an annual management fee calculated as a percentage of the net asset value of the Funds.

5. The Offshore Funds' Private Placement Memoranda ("PPMs") provided that the Directors of the Offshore Funds were responsible for determining the net asset value of the Offshore Funds in accordance with GAAP, but delegated the determination of the value of the funds' securities and the calculation of the net asset value to the Offshore Funds' administrator and to Covenant. The PPMs and Limited Partnership Agreements ("LPAs") for the Domestic Funds did not represent that the net asset value of those funds would be determined in accordance with GAAP, but they did provide that Covenant determines the value of the assets held in the Domestic Funds in good faith.

B. Fair Value

6. Covenant's valuation policy provided that the assets held in the Funds would be valued in accordance with GAAP, specifically Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("FAS 157"). Effective for periods ending after September 15, 2009, FAS 157 was subsequently codified as Accounting Standards Codification 820 ("ASC 820").

7. ASC 820 defines fair value for purposes of GAAP as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

8. ASC 820-10-35-36 states that the methods used to measure fair value "shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs." ASC 820 prioritizes inputs used to measure fair value into three levels based on the observability of the inputs. The highest, and generally most reliable, level of inputs – Level 1 – are "quoted prices (unadjusted) in active markets for identical assets or liabilities." ASC 820-10-35-40. Level 2 inputs are "inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly." ASC 820-10-35-47. Level 3 inputs are "unobservable inputs for the asset or liability." ASC 820-10-35-52. ASC 820-10-35-53 further notes as follows: "Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any market activity for the asset or liability at the measurement date."

C. Covenant's Valuation Policy

9. On June 1, 2008, Covenant initially adopted the provisions of FAS 157, Fair Value Measurements. Covenant's written valuation policy, effective on or about July 21, 2011 states, among other things, that:

- in measuring fair value, Covenant maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available;

- for the assets that rely on Level 2 inputs of the fair value hierarchy, valuations are based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly;

- when determining which pricing method should be used, Covenant's order of preference is:

    - when there is an active market for a security, a broker quote; and

    - when there is not an active market available, Covenant evaluates the compilation of pricing data it acquires and considers factors specific to each position. Covenant is actively monitoring the activity associated with its positions throughout the month, weekly, if not daily.

    - for municipal bonds, Covenant obtained and documented the indicated price for the bond on month-end assigned to the bond via the Pricing Service.

D. <u>Covenant Relied Almost Exclusively on the Pricing Service and Failed to Use Substantial Observable Inputs to Value the Municipal Bonds</u>

10. Beginning in 2009, Covenant used the Pricing Service to value the Funds' municipal bond holdings. The Pricing Service's literature disclosed to Covenant that the Pricing Service provided estimated values based on a model that required unobservable inputs (i.e., an approach that uses Level 3 inputs), as opposed to quoted market prices based on the sale of similar bonds (i.e., an approach that uses Level 2 inputs). In early 2013, the company providing the Pricing Service discontinued this service.

11. Covenant continued to rely on the Pricing Service Values when valuing municipal bonds held by the Funds even though after approximately mid-August 2011, there existed relevant observable and unobservable inputs indicative of fair value that should have been considered. Those indicators included trades Covenant made in similar or the same bonds, broker marks routinely obtained by Covenant, as well as broker quotes obtained by Covenant. The trades, broker marks, and broker quotes data from mid-August 2011 through February 2013 provided indications of fair value significantly lower than the Pricing Service Values during those periods. In particular, beginning in mid-August 2011 through the first quarter of 2013, on over twenty occasions over approximately nineteen months Covenant sold a portion of the Funds' municipal bonds at prices between 10% to 42% less than the Pricing Service Values for those same bonds immediately before the sale. For example, on August 16, 2011, Covenant sold Miami Dade County bonds at a price that was approximately 41% less than their then current Pricing Service Values. Similarly, on September 29, 2011, Covenant sold some public highway bonds at a price that was approximately 30% less than their then current Pricing Service Values.

12. As a result, from approximately August 15, 2011 until February 28, 2013, Respondents did not record the Funds' holdings in accordance with GAAP or its stated valuation

policy. Moreover, Respondents failed to value the Offshore Funds' assets as required by the PPMs and LPAs.[1] Similarly, Respondents also failed to value the Funds' holdings in good faith as required by the Domestic Funds' PPMs and LPAs in that Respondents had information establishing that the values provided by the Pricing Service for certain municipal bonds were overstated and that they did not comply with Covenant's valuation policies and procedures.

13. Respondents' inaccurate valuations during the Relevant Period resulted in the overstatement of the Funds' performance of between 3.43% to 6.99% in monthly and quarterly reports provided to the Funds' investors. In particular, the revaluation for the Relevant Period caused the cumulative performance of four of the five Funds to be negative rather than positive and caused the fifth fund's performance to change from 7.26% to 1.93%.

14. The Funds' 2011 financial statements provided to fund investors included numerous misstatements. First, the financial statements provided that they were prepared in conformity with GAAP. Second, the financial statements stated that Covenant maximized the use of observable inputs and minimized the use of unobservable inputs in measuring fair value. Third, the financial statements provided that Covenant valued debt securities based on the quotes obtained from various securities brokers and market markers, when it was relying almost solely on the Pricing Service Values for municipal bonds.

15. Covenant received over $400,000 in excess management fees based on these valuations.

E. <u>Covenant Failed To Implement Its Valuation Policy</u>

16. Despite Covenant's written valuation policy, Covenant failed to maximize the use of observable inputs and minimize the use of unobservable inputs when valuing the municipal bonds. Moreover, Covenant failed to comply with the order of preference as set out in its valuation policy when valuing the municipal bonds because it failed to evaluate the pricing data it acquired and failed to consider factors specific to each position. By almost exclusively using values provided by the Pricing Service to value the municipal bonds and by not using substantial available observable inputs, Covenant failed to follow its own valuation policy.

F. <u>The Revised Valuation of the Funds' Municipal Bond Holdings</u>

17. The Funds' outside auditor identified the municipal bond valuation issue during its audit of the Funds' fiscal year 2012 financial statements. Ultimately, Covenant and the Funds' administrator obtained fair value estimates of the Funds' municipal bonds using another pricing service that relied on market pricing of the bonds at issue and similar bonds to determine the fair value of the bonds. As a result, the Funds' performances during the period from May 2011

[1] The value of all the assets in the Offshore Funds (minus liabilities) comprised the net asset value of the Offshore Funds. Since the Offshore Funds' assets were not valued in accordance with GAAP, the net asset values of the Offshore Funds were not determined in accordance with GAAP.

through February 28, 2013 (the "Revaluation Period") decreased by 8.25% to 13.5%, depending on the fund at issue. [2]

18. In May of 2013, shortly after the auditor identified the valuation issue, Covenant refunded approximately $444,000 in excess management fees to the Funds.

19. Covenant also determined that in connection with redemptions the Funds had made during the Revaluation Period and through May 1, 2013, the Funds had overpaid approximately 40 redeeming limited partners a total of over $3 million. Covenant has paid approximately $270,000 to the Funds as partial compensation for these over-redemptions.

G. Violations

20. Section 206(2) of the Advisers Act prohibits investment advisers from directly or indirectly engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." A violation of Section 206(2) of the Advisers Act may rest on a finding of simple negligence; scienter is not required. SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963)). As a result of the negligent conduct described above, Respondents willfully violated Section 206(2) of the Advisers Act.[3]

21. Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder prohibits investment advisers from (1) making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle. Proof of scienter is not required to establish a violation of Section 206(4) of the Advisers Act and rules thereunder. SEC v. Steadman, 967 F.2d 636, 647 (D.C. Cir. 1992). As a result of the negligent conduct described above, Respondents willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

22. Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder require an investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and rules thereunder. Proof of scienter is not required to establish such a violation of Section 206(4) of the Advisers Act and the rules thereunder, and a violation of Section 206(4) and the rules thereunder may rest on a finding of simple negligence. SEC v. Steadman, 967 F.2d 636, 647 (D.C. Cir. 1992) . As a result of the negligent conduct described above, Covenant willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7

[2] The Revaluation Period is three months longer than the Relevant Period.

[3] A willful violation of the securities laws means merely "'the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

thereunder by failing to implement written policies and procedures designed to prevent violation of the Advisers Act and rules thereunder. Shafer negligently caused Covenant's failure to implement its valuation policy in violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

H. Respondents' Remedial Efforts

23. In determining to accept the Offers, the Commission considered remedial acts promptly undertaken by Covenant and Shafer. Specifically, Covenant notified investors of the restatement and refunded approximately $444,000 in management fees directly to the Funds, resulting in a pro-rata increase of the capital account of each limited partner who held a limited partnership interest as of February 28, 2013.

24. Moreover, in an effort to make the Funds whole following the overpayment of redemptions, Covenant also repaid approximately $270,000 to the Funds.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offers.

Accordingly, pursuant to Sections 203(e), 203(f) and 203(k) of the Advisers Act, it is hereby ORDERED THAT:

A. Respondents Covenant and Shafer shall cease and desist from committing or causing any violations and any future violations of Sections 206(2) and, 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder.

B. Respondents Covenant and Shafer are censured.

C. Respondents shall pay, on a joint and several basis, a civil penalty and prejudgment interest as follows:

1. Respondents shall pay a civil penalty of $130,000.

2. Respondents shall pay prejudgment interest of $14,845.78.

3. Payment shall be made in the following installments: $28,969.16 within 30 days of the entry of the Order, an additional $14,484.58 within 120 days of the entry of the Order, an additional $14,484.58 within 210 days of the entry of the Order, and an additional $86,907.46 within 300 days of the entry of the Order. Respondents shall deposit these amounts, as described in this paragraph (collectively, the "Distribution Fund") into an escrow account acceptable to the Commission staff and shall provide the Commission staff with evidence of such deposit in the form acceptable to the Commission staff. Payments shall be deemed made on the date they are placed into the escrow account referenced above, and shall be applied first to the prejudgment interest. If any payment is not made by the date the payment is required by this Order, the entire outstanding

balance plus any additional interest accrued pursuant to SEC Rule of Practice 600 or pursuant to 31 U.S. C. § 3717, shall be due and payable immediately, without further application.

4. Respondents shall be responsible for administering the Distribution Fund and may hire a professional to assist them in the administration of the distribution. Respondents shall pay from the Distribution Fund the affected limited partners of the Funds who held limited partnership interests as of February 28, 2013, the date of the revaluation of the funds. The following limited partners will not be eligible to participate in the distributions: a) limited partners who redeemed their limited partnership interests prior to February 28, 2013; b) limited partners who purchased limited partnership interests subsequent to February 28, 2013; and c) limited partners who redeemed their partnership interest after February 28, 2013 and who were overpaid based on the overvaluation of the Funds. The Distribution Fund will be allocated across the five Funds in proportion to the excess redemptions made from each Fund. Each distribution payment will be calculated by multiplying each investor's percentage of ownership interest in the Funds by the amount of the Distribution Fund. Respondents shall distribute the Distribution Fund to the Funds' investors based on each investor's interest in the Funds during the Relevant Period pursuant to a disbursement calculation (the "Calculation") that has been submitted to, reviewed, and approved by the Commission staff in accordance with this Subsection C. Within thirty (30) days of the entry of this Order, Respondents shall submit a proposed Calculation to the staff for review and approval. The proposed Calculation will include the names of the affected investors in the Funds and payment amounts. The Respondents also shall provide to the Commission staff such additional information and supporting documentation as the Commission staff may request for its review. In the event of one or more objections by the Commission staff to the proposed Calculation or any of its information or supporting documentation, the Respondents shall submit a revised Calculation for the review and approval of the Commission staff or additional information or supporting documentation within ten (10) days of the date the Respondents are notified of the objection, which revised calculation shall be subject to all of the provisions of Subsection C.

5. The distribution of the Distribution Fund shall be made within 330 days of the date of the entry of this Order, unless such time period is extended as provided in Paragraph 10 of this Subsection C. Such distribution is to be based on the methodology set forth in the Calculation and as reviewed and not objected to by the staff. No portion of the Distribution Fund shall be paid to any affected person or entity directly or indirectly in the name of or for the benefit of either Respondent in this proceeding.

6. If the Respondents do not distribute any portion of the Distribution Fund for any reason, including factors beyond their control, the Respondents shall transfer any such undistributed funds to the Commission for transmittal to the United States Treasury in accordance with Section 21F(g)(3) of the Securities Exchange Act of 1934 after the final accounting provided for in Paragraph 8 of this Section C is submitted to the Commission staff. Any such payment must be made in one of the following ways:

a. Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

b. Respondents may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or

c. Respondents may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Covenant Financial Services, LLC and Stephen Shafer as Respondents in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to C. Dabney O'Riordan, Co-Chief, Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, 444 South Flower Street, Suite 900, Los Angeles, CA 90071.

7. Respondents agree to be responsible for all tax compliance responsibilities associated with distribution of the Distribution Fund and may retain any professional services necessary. The costs and expenses of any such professional services shall not be paid out of the Disgorgement Fund;

8. Within 365 days after the date of the entry of the Order, Respondents shall submit to the Commission staff a final accounting and certification of the disposition of the Distribution Fund not unacceptable to the staff, which shall be in a format to be provided by the Commission staff. The final accounting and certification shall include: (i) the amount paid or credited to each person or entity (designated by Fund); (ii) the date of each payment or credit; (iii) the check number or other identifier of money transferred or credited to the person or entity; and (iv) any amounts not distributed to be forwarded to the Commission for transfer to the United States Treasury. Respondents shall submit the final accounting and certification, together with proof and supporting documentation of such payments and credits in a form acceptable to Commission staff, under a cover letter that identifies Respondents in these proceedings and the file number of these proceedings, to Dabney O'Riordan, co-Chief, Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, 444 South Flower Street, Suite 900, Los Angeles, CA 90071, or such other address the Commission staff may provide. Any and all supporting documentation for the accounting and certification shall be provided to the Commission staff upon request;

9. After Respondents have submitted the final accounting to the Commission staff, the staff shall submit the final accounting to the Commission for approval and shall request Commission approval to send any remaining amount to the United States Treasury; and

10. The Commission staff may extend any of the procedural dates set forth in this Subsection C for good cause shown. Deadlines for dates related to the Distribution Fund shall

be counted in calendar days, except that if the last day falls on a weekend or federal holiday, the next business day shall be considered to be the last day.

D. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, a Fair Fund is created for the prejudgment interest and penalties referenced in paragraph C above. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondents, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary