

CLIENT MEMORANDUM

Regulatory Focus on Waterfall Calculations for Private Equity Funds

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Recent pronouncements by senior staff of OCIE (Office of Compliance Inspections and Examinations, Securities and Exchange Commission) suggest an emerging regulatory focus on the accuracy of waterfall calculations and the application of fund provisions governing the determination of preferred returns and the allocation and distribution of profits, including the general partner's carried interest.

Waterfall provisions in private equity fund agreements come with considerable variation and complexity and private equity sponsors often provide examples to potential investors of the distribution waterfall under various scenarios. Calculations during the life of a fund are generally confirmed by outside auditors in the context of their review. Misinterpretations of fund provisions – or miscalculations – could have implications not only for interim distributions to limited partners and the general partner (which might be able to be remedied), but also for presentation of net performance data in fundraisings and allocations of incentives internally at a firm or in connection with arrangements regarding partners who separate from a firm.

Over the last several years, OCIE and enforcement efforts have focused on the allocation of fees and expenses at private equity funds and whether disclosure of allocation practices and inherent conflicts was adequate. Increased regulatory focus on the accuracy of waterfall calculations themselves could present another area where private equity firms should assess their internal processes and procedures and levels of review.

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