Grant Thornton
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2014

Hedge Funds 101 for emerging managers

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Hedge funds were hit hard by the financial crisis, and many closed up shop[1]. The industry has since bounced back: Assets under management (AUM) at the end of 2013 rose to more than $2 trillion, and performance for the year was the best since 2010[2].

The turnaround is of course welcome news for hedge fund startups. But launching and growing a new fund is as challenging as ever. Competition for capital is fierce, and many funds – particularly those just starting out – are more than willing to cut fees to attract money. In addition, the majority of assets now come from institutions, which prefer well-established funds over newcomers lacking committed capital and a long history of high returns. And all investors across the board are much more skittish about safeguarding their money, giving rise to a due diligence process that is increasingly quantitative and complex.

On the cost side of the ledger, a raft of new legislation, most notably the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) has greatly increased compliance expenses. Managers that raise enough money for a full-fledged fund must now contend with the onerous requirements of SEC registration. At the same time, funds that remain outside the registration requirement are unlikely to attract the interest of institutional investors.

Despite the obstacles, a more settled economic climate and better industry conditions improve the odds for managers seeking to start their own funds. This paper provides answers to four essential questions managers have:

1. How do I raise capital?

2. How do I get the best people, both internal staff and external providers?

3. How can I sustain profitability under severe margin pressure?

4. How do I organize the fund for maximum tax efficiency?

After reading the article, if you have any questions, feel free to contact a member of our Asset Management practice. We look forward to working with you as you create a thriving fund.

[1] "Hedge funds fight back," Grant Thornton, See www.grantthornton.com/issues/library/articles/financial-services/2013/AM/AM-07-Hedge-funds-fight-back.aspx
[2] Source: EurekaHedge Indicies.

1. Raising capital from cautious investors

The biggest challenge for most new funds is finding investors. A startup often begins with $10 million to $30 million – not enough to make any money, but sufficient to establish an investment track record that will be key to the fund's marketing efforts. Much of the initial capital will come from the fund manager, ensuring that the manager's own interests align with those of other investors and the fund overall. Family and friends typically form the next ring of early investors. Building on that nucleus, funds seek out capital from a broader mass of potential investors, including high net worth individuals, family offices, nonprofits (e.g., pension funds and foundations), hedge fund seeders, and funds of funds.

Since the financial crisis, two major changes in the hedge fund landscape have altered the pursuit of capital: (1) the rise of institutional money, and (2) the freedom given to hedge funds to advertise.

More institutional money, more due diligence

For the industry as a whole, about 60% of its capital now comes from institutional investors[3]. Unfortunately for new funds, tapping this source is something of a Catch 22: You have to have substantial capital to get institutional money, but institutions won't invest with you unless you have substantial capital. "In theory, there's no AUM threshold for institutional money," says Yossi Jayinski, audit partner, Asset Management. "In practice, it's difficult to get if you have less than $100 million."

In addition, it is taking a lot longer for investors of all stripes to commit funds. "Since the financial crisis, people want to make absolutely sure their assets are secure," says Kunjan Mehta, senior manager, Asset Management. "Due diligence is now extremely cumbersome and time-consuming, with no guarantees of additional money to fund managers after the process is complete. There are extensive background checks and tons and tons of paperwork. A process that used to be two or three months now often takes six months to a year."

Whatever funding source you target, potential investors are going to scrutinize your business, including strategies, exposures (both investment and operational), policies and procedures. And they're going to take a long, hard look at the team you have in place, both internal and external, to do the job. Fund managers need to be prepared: Obtain one or more due diligence questionnaires and be ready to answer all the questions.

Having an outstanding investment track record, of course, gives you a big boost. But historical performance, no matter how stellar, is not enough to convince investors that your strategy works long term. It will be dissected to determine whether its past successes can be duplicated in different economic and regulatory environments, and whether it will continue to perform for your fund as it grows and changes.

A well-conceived marketing plan is another must. What types of investors are you going to approach? How are you going to reach them? What story will you tell them? Mehta's advice is to "network, network, network" to reach as many potential investors as possible and to build your brand in the hedge fund community. Choosing service providers that are known and respected can also be a big plus. In developing your marketing strategy, the right PR firm can be a good investment.

[3] "Hedge funds: Trends and insight from the industry and investors," Managed Funds Association, May 2012. See https://www.managedfunds.org/wp-content/uploads/2012/05/MFA_HedgeFunds_Trends_and_Insight_05-2012.pdf.

Hedge fund advertising

Effective September 2013, as a result of the JOBS Act, the ban on general solicitation and advertising for hedge funds was lifted. The SEC now allows funds to advertise through a wide range of media, including print publications and TV. A company's website, which had been a mostly password-protected tool for current investors, has been positioned to become a much more robust promotional medium.

Given its ability to reach a greatly expanded universe of potential investors, advertising is certainly something startups will at least want to consider. At the same time, its use raises a host of issues for hedge funds to deal with:

- Advertising requires a set of marketing skills and capabilities that is unlikely to reside at most smaller funds. If a firm does decide advertising is worth pursuing, it will have to acquire that expertise by upgrading its internal organization, contracting with external marketers, signing with advertising agencies, and so forth.

- Most of the audience reached through advertising will have far fewer assets than traditional hedge fund investors. That means a lot more of them will be needed to achieve a critical mass of capital.

- Eager to ensure that the new investors are indeed high net worth individuals, the SEC has issued stricter guidance for determining investor suitability: Self-certification by the investor through simply checking a box is no longer sufficient. The fund now bears the burden (and associated costs) of ensuring that all the money it gets comes from accredited investors or qualified purchasers. (There is grandfathering for existing investors.)

- The investors attracted by advertising are also more likely to be new to hedge funds. They will ask more questions and need more personalized attention, which raises administrative costs or at least increases the burden on current staff.

- Firms must file a Form D before a general solicitation begins and an amended Form D when it is completed. Overall, the raised profile that advertising brings to the fund may come at the price of increased regulatory scrutiny. The firm must be careful to avoid making statements of material fact that could be perceived as misleading, because performance results are especially likely to receive close examination.

Despite these challenges and costs, hedge fund advertising opens an intriguing avenue for capital acquisition. But it's obviously not as simple as making a couple of buys in *The Wall Street Journal*; in fact, as the five points above suggest, it has the potential to fundamentally alter the way the fund does business.

2. Choosing the right people for your operation: internal staff and external providers

In any organization, getting the right people for the job is a key requisite for success. But it's especially crucial for the hedge fund startup.

First, as noted, investors have become vigilant in delving into all aspects of a fund's operations to safeguard their assets and minimize any exposure to operational risk. Having a good team in place is critical to raising capital.

Second, the new fund's working capital is limited; each employee will have a lot on his or her plate and has to be good at many things — especially administrative staff who will be responsible for a wide variety of functions, whether they have to perform them internally or oversee outsourced tasks. Consequently, the exposure for each hire is much higher than for a large fund with dozens of employees. In a small firm, staff has to show flexibility and be willing to take on all necessary tasks.

Hiring internal staff

The most important team members are the traders. The exodus of traders from large financial institutions in recent years has substantially expanded the talent pool of candidates with a wealth of experience who have managed accounts on their own or traded for another fund. Funds must critically examine the trader's past performance as audited by a reputable accounting firm.

For administrative matters like accounting, legal, compliance and IT, new hedge fund managers are surprised — and experienced ones dismayed — at how much time they must devote to support functions: They require as much as 30% or more of their hours. Like other entrepreneurs emigrating from the corporate world, they suddenly find themselves responsible for an array of administrative tasks that are essential to the fund's success, but have little to do with the investing skills that gave them the confidence to open their own shop in the first place.

Using external providers

External service providers are the solution for many of the fund's operational needs. For startups, third-party administrative services often make sense for reasons beyond those of efficiency. In the case of accounting, for example, an external administrator provides investors with an independent set of eyes that ensures objectivity and transparency, such as in calculations of net asset value (NAV). Hedge funds, of course, are ultimately responsible for the accuracy of their own records, so many small funds will run a parallel set of books using off-the-shelf accounting software. Overall, the skill set that internal administrative personnel must have depends heavily on how much the fund relies on external providers.

As always, there are numerous trade-offs — quality, cost, control — of hiring internally versus going outside. As the fund grows and matures, it must regularly evaluate its organization to determine whether it is optimally using internal and external resources, depending on its current investing, marketing and compliance needs.

Among the service providers that funds hire are prime brokers, administrators, legal counsel and auditors. Unfortunately, because the fund manager's focus tends to be on investing, the selection of external providers sometimes receives inadequate attention — in some cases, they may be casually chosen on the basis of a single cocktail party conversation.

But first-rate selections in this area are critical. The fund needs these services to operate successfully. Equally important, however, the strength and reputation of external providers become part and parcel of the image the fund presents to investors in the marketplace. Hiring the best providers instills confidence in investors, while poor choices diminish it. The quality of third-party services is especially important for gaining the trust of institutional investors, given their strict due diligence requirements.

Finding the right external providers

Hedge fund startups — and many large funds as well — look to external service providers to perform many of the administrative and support functions of the firm. The key actors include:

Prime brokers

The most important responsibility of a prime broker, which is usually a large financial institution, is executing orders. But the prime broker offers many other important services, including real-time portfolio reporting; global custody; securities lending; portfolio financing and margining; technology support; and capital introduction. Prime brokers, among other providers, can also furnish office space — commonly known as hedge fund hotels — that frees managers from the headaches of setting up their own offices.

"Some hedge funds were burned during the financial crisis by the collapse of their prime broker," says Jayinski. "Since then, many hedge fund managers have decided to use more than one prime broker to spread their risk."

Legal counsel

Counsel is especially important in the startup stage, when the fund is putting together its formation documents. There is no requirement — legal or otherwise — that a lawyer write these papers. But experienced counsel can ensure that the company's legal foundation serves its business purposes. The attorney's review for compliance will also make certain they satisfy relevant securities laws, both during the fund's formation and further down the road. The slew of new hedge fund legislation and guidance introduced in the wake of the financial crisis has created demand for legal advice on a regular, ongoing basis.

The key questions in selecting a lawyer are: (1) How comfortable do you feel working with the person, and (2) Do they have significant hedge fund experience?

Administrators

External administrators handle the fund's accounting function, either exclusively or in parallel with an internal accountant. Their tasks encompass partnership accounting and reporting, which include the calculation of the fund's NAV and the statement of change in partners' net capital and partnership interests in each fund class. Administrators can also provide transfer and custodial services. Although using an external administrator may increase costs, it gives investors added assurance and confidence that may help in the marketing process. Obtaining SSAE 16/SOC reports on the administrator's systems and controls may be necessary and useful to the governance process. When hiring, funds should ask candidates to see a list of similar clients as well as contact references.

Even where the fund has outsourced back office functions, it still maintains a fiduciary duty to the investor. In-house support must be in a position to analyze the work of the external administrator.

Auditors

An external auditor is required for providing assurance on the firm's financial statements. Some fund managers opt for a low-cost provider because they think of an audit simply as a compliance function rather than a beneficial service. But an audit firm with a strong reputation is essential when marketing the fund, especially to institutional investors. Moreover, auditors ensure that the fund's internal controls are in place and working, reducing the fund's operational risk. As with other functions, funds should seek out auditors with experience in the hedge fund industry, especially those who can give you a lot of attention early on and grow with you. Those funds that expect to have significant overseas exposure in their marketing, investments, etc., should make sure their auditors and other service providers can identify issues in jurisdictions outside the U.S. and have the capability to work with funds on such issues.

External marketers

External marketers and placement agents help the firm find investors. Opinion varies on their utility – as with many other hired hands, good ones are worth their weight in gold, while bad ones can do significant damage. What is certain is that while acquiring capital is essential, it's also lots of work. Some fund managers are understandably reluctant to contend with what can seem like constant rejection. If the fund manager does not perform the capital procurement function, for whatever reason, this critical responsibility has to be done by someone else. External marketers could be the solution.

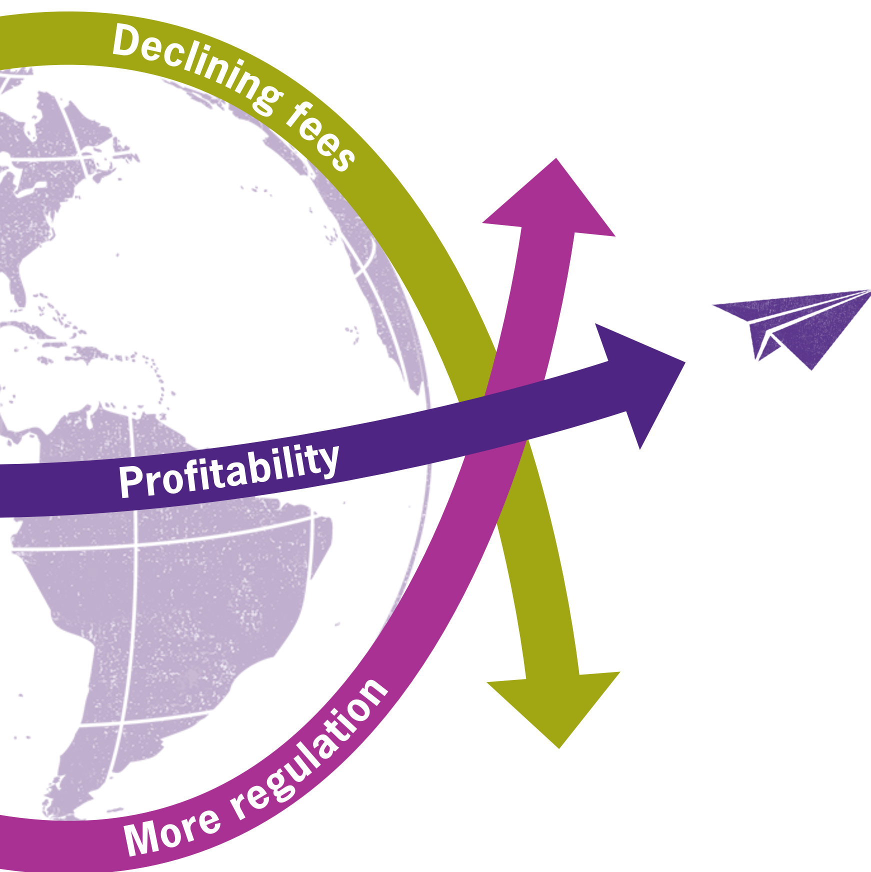
IT data managers

IT data managers who specialize in financial services help manage the firm's data and applications on a private cloud. The cloud environment is available 24/7 and maintained by a service-level agreement. These providers can save the firm hundreds of thousands of dollars in IT investment and provide unlimited support and maintenance.

Investors are keenly aware of cyber security menaces, and they will want to know your policies and procedures for ensuring data safety — including vulnerability assessments and penetration tests to identify possible risks. "Even a small manager has thousands and thousands of transactions every day, executed through numerous third parties," says Mehta, "all of which are subject to security threats." As part of an overall strategy, the firm should have clear, well-articulated policies to show investors that it implements best practices to help prevent costly attacks.

3. Sustaining profitability in the face of declining fees and heightened regulation

Hedge funds are under margin pressure, squeezed between reduced fees and higher costs, especially for compliance.



Declining fees

The traditional "two and twenty" fee structure — management fees of 2% of AUM and performance fees of 20% of investment returns — has been eroding. Smaller firms are getting heated competition from big funds and are slicing fees to compete. "We're definitely seeing fees come down," says Jayinski. "Management fees are now between 1% and 2%, and for a small fund trying to attract new clients it might be even less than that." As for performance fees, the average for the entire hedge fund industry has fallen to about 18%. Moreover, the use of hurdle rates (i.e., benchmark levels of return that a fund must clear before performance fees kick in) has become more common[4]. Investors willing to lock up their money for several years, make a big investment or put money in a new fund can get even better deals on already-reduced fee schedules.

More regulation

At the same time, an onslaught of new regulations — SEC registration for advisers stemming from Dodd-Frank, the Foreign Account Tax Compliance Act (FATCA), anti-money laundering requirements and other regulatory regimes — are raising compliance costs.

According to the *Financial Times*, "Few financial institutions have been hit as hard by the onslaught of new global regulation since 2008 as hedge funds[5]." Although in some aspects welcomed by larger funds seeking greater credibility with institutional investors, the additional rules place a substantial burden on smaller funds.

[4] Gregory Zuckerman, Juliet Chung and Michael Corkery, "Hedge funds cut back on fees," *The Wall Street Journal*, Sept. 9, 2013. See http://online.wsj.com/news/articles/SB10001424127887323893004579054952807556352

[5] Sam Jones. "Regulation changes the way hedge funds grow," *Financial Times*, Oct. 22, 2013. See http://www.ft.com/cms/s/0/0f337998-2ab5-11e3-8fb8-00144feab7de.html#axzz2kOAruHKY

The Dodd-Frank Act

The piece of legislation that has most affected the hedge fund industry is the Dodd-Frank Act. Key changes brought about by the Act include:

Adviser registration

The Investment Advisers Act of 1940 included an exemption from registration for an investment adviser — including those to hedge funds — with fewer than 15 clients and which did not hold itself out to the public as such. Under Dodd-Frank, that sweeping exclusion has been eliminated. Hedge funds with more than $150 million in regulatory assets under management (RAUM) now have to register.

Among the requirements of a registered investment adviser filing with the SEC are:

- Filing disclosures on Form ADV
- Designating an individual as chief compliance officer
- Maintaining financial books and records to facilitate SEC examinations
- Keeping client assets with a qualified custodian
- Adopting a written code of ethics, which includes standards for personal securities trading

Advisers with less than $25 million are prohibited from registering with the SEC; unless an exemption applies, they will register with state regulators, if applicable. The rules for midsized advisers with $25 million to $100 million are more complex, but in general, they will register with state regulators, except for those in New York and Wyoming, which will register with the SEC.

Form PF

Form PF is a joint initiative of the SEC and the Commodity Futures Trading Commission. Its purpose is to allow the Financial Stability Oversight Council (FSOC) to monitor risks to the U.S. financial system. In general, all private fund advisers have to file an annual Form PF if they advise private funds greater than $150 million in RAUM.

A hedge fund is defined for purposes of Form PF to be generally "any private fund that has the ability to pay a performance fee to its adviser, borrow in excess of a certain amount, or sell assets short." Large hedge fund advisers above the $1.5 billion RAUM threshold have additional reporting obligations, including quarterly filings for some data.

Hedge funds may be required to provide information on:

- Gross and net assets of each private fund
- The aggregate notional value of the fund's derivative positions
- Performance
- Counterparty credit risk exposure
- Trading practices
- Percentages of fund ownership
- Financing (including secured and unsecured positions)
- Valuation and methodology
- Liquidity of holdings
- Portfolios of insiders

Such an abbreviated listing understates the complexity of Form PF, which requires extensive data identification, collection, verification and aggregation. Much of the information has never been required on any form, and simply locating and gathering the data has been a major challenge for some funds.

Anti-money laundering

The Securities Industry and Financial Markets Association (SIFMA), an association of several hundred securities firms, banks and asset managers, has released a suggested AML due diligence practices guide for hedge funds. The SIFMA document prescribes two regimes, simplified and increased, of procedures, based on the level of risk, adherence to an equivalent AML regime, and other factors.

Blue sky laws

Hedge funds will also have to make blue sky filings in each state where they have investors. Blue sky laws are state regulations designed to protect investors against fraudulent sales practices by requiring sellers of new issues to register their offerings. These generally run no more a few hundred dollars, but in the case of New York, where a filing is required before the initial investment, it will be over $1,000.

Additional regulations

Other regulatory regimes that affect hedge funds include:

- As noted, regulation of the CFTC is, in part, aligned with that of the SEC. For example, CFTC registration requirements may require funds to complete Form CPO-PQR, which is the counterpart of the SEC's Form PF. Hedge funds would also be subject to rules in markets regulated by the CFTC, such as swap transactions[6].
- FATCA requires all non-U.S. hedge funds to report information on their clients[7].
- The Alternative Investment Fund Managers Directive (AIFMD) has rules that apply to any fund, no matter where it's based, if it takes any money from an EU-based investor. Most existing AIFMs have until July 21, 2014, before the application of the provisions[8].
- When the SEC lifted the ban on hedge fund advertising, it also issued regulations that disqualify felons and other so-called bad actors from participating in hedge fund offerings. Bad actors are primarily officers, 20% owners and fund managers who engage in "disqualifying events," including criminal convictions, court orders, final orders and other orders in connection with violations of securities laws.

With expenses rising and fees dropping, hedge funds have their work cut out to maintain profitability. "The current cost structure of the industry is tough on smaller funds. Firms need to grow so that they generate sufficient income," says Jayinski. But cost-cutting has to be done with a scalpel, not a saw: Choosing bargain-basement services and staff may initially help the bottom line, but in the long run it can hurt the firm's reputation and back-office operations.

[6] "New CFTC rules on swaps challenge offshore funds," Grant Thornton, September 2013. See http://www.grantthornton.com/issues/library/articles/financial-services/2013/BD/CFTC-US-person-offshore-funds.aspx

[7] "Understanding FATCA: Know the implications for your business," Grant Thornton, July 2013. See http://www.grantthornton.com/issues/library/whitepapers/tax/2013/Tax-2013-07-understanding-fatca-2013.aspx

[8] "What hedge funds need to know about the Alternative Investment Fund Managers Directive," Grant Thornton. June 2013. See http://www.grantthornton.com/issues/library/articles/financial-services/2013/AM/AM-06-AIFMD.aspx

4. Organizing effectively for tax efficiency

When setting up a hedge fund, there are many factors to consider from organizational, regulatory and tax standpoints. Organizing a hedge fund for maximum efficiency is a task of considerable, sometimes enormous complexity. The following discussion serves only as a brief overview.

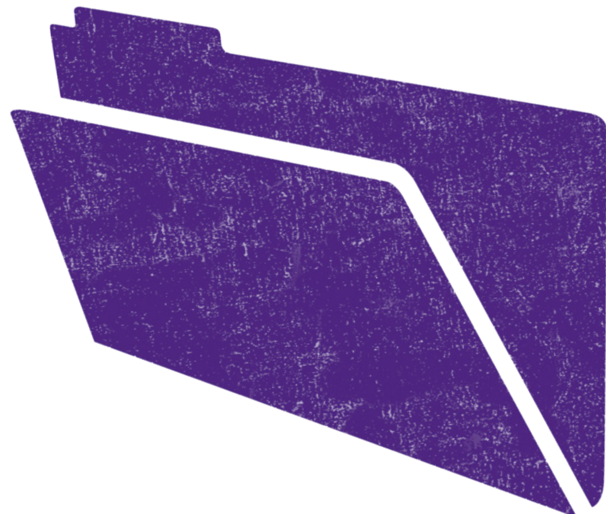
Tax status of investors

A key factor in organizing and structuring a hedge fund is the tax status of the investor the fund seeks to attract.

– Individuals and for-profit institutions based in the United States. They pay U.S. taxes based on their worldwide income.

– Tax-exempt U.S. investors, including pension plans and charitable entities. They do not pay U.S. income taxes. Importantly, a U.S.-based nonprofit cannot invest in an onshore hedge fund without addressing the unrelated business taxable income (UBTI).

– Non-taxable offshore investors (i.e., individuals and institutions not based in the United States); they do not pay U.S. income taxes.



Common hedge fund structures

Master-feeder funds

Master-feeder is the structure most often used by hedge funds. Investors put their money in feeder funds, which in turn supply it to a master fund. All the investing and trading is done by the master fund, which is typically an offshore corporation taxed as a partnership — a flow-through entity — for US tax purposes.

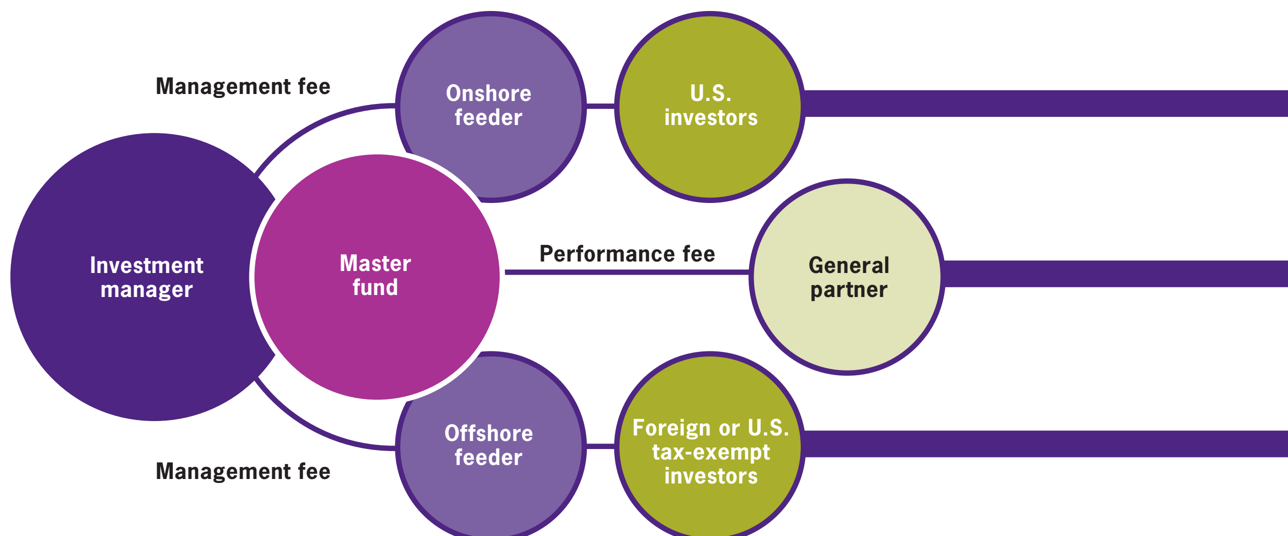
Usually, the master fund receives capital from:

- A U.S. domestic feeder (typically a partnership called the "onshore"), with funds from U.S. taxable investors
- An offshore feeder (usually a corporation), with funds from U.S. tax-exempt and non-taxable offshore investors

The master fund is often incorporated in places friendly to alternative investment entities, especially the Cayman Islands, Bermuda and the British Virgin Islands (BVI), although there are numerous locations outside the Western Hemisphere. These jurisdictions, where offshore funds represent a significant part of the local economy, offer well-established investment law, a strong infrastructure of service providers, and no- or low-tax favorable tax treatments — investors are taxed where they live. Regulatory bodies, such as the Cayman Islands Monetary Authority (CIMA) and the Bermuda Monetary Authority (BMA), maintain strong policies and guidelines. Investors see these regimes as underpinning risk management, and managers accordingly select these jurisdictions.

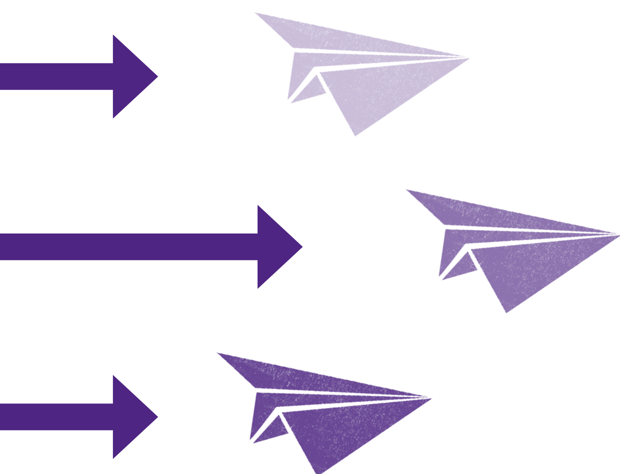
The master-feeder fund structure

Master-feeder funds consolidate trading activities into a single portfolio, while allowing managers to accumulate funds from U.S. taxable, U.S. tax-exempt and foreign investors. This commonly used structure creates a critical mass of tradable assets, improves the economies of scale and helps to reduce costs.



Single domestic hedge funds
Most U.S. startups begin with investors solely from the U.S., so the hedge fund may be structured as a U.S.-based limited partnership (LP) or limited liability corporation (LLC). Generally, each fund will have its own management company and general partner (GP); the manager establishes an LLC to serve as the fund's GP. Onshore funds are usually domiciled in Delaware, because of the state's long tradition of well-developed and generally business-friendly corporate laws.

Single foreign hedge funds
An offshore hedge fund, such as a foreign corporation that trades securities for its own account, is not considered to be engaged in a trade or business in the U.S. Thus its investors are exempt from U.S. taxes. For a few selected funds in their initial stages, this may provide a less costly solution than the more complex master-feeder and side-by-side structures.



Incubator hedge funds
As the name implies, an incubator fund provides a controlled environment for investment managers to test out strategies and show what they can do before hiring an administrator and launching the actual fund. The incubator fund has a simple organization structure, usually comprising: (1) an LP or LLC for the fund, and (2) an LLC as the investment manager/general partner of the fund (or managing member if the fund is an LLC). An incubator doesn't provide all the offering documents of a traditional hedge fund, and it is usually only open to the actual managers of the fund.

The manager invests for six to 12 months, sufficient time to create a performance history and to cultivate investors. If there's sufficient interest, the fund can take the next steps to establish itself as a full-fledged fund.

Side-by-side structures
In a side-by-side structure, a single management company manages an LP, organized in the United States for U.S. investors, and an offshore corporation, organized overseas, for non-U.S. investors. Both funds typically have the same trading strategies, and trade tickets are allocated to each entity. But because the onshore and offshore funds are two separate entities, operating independently, the fund manager can better accomplish tax-efficiencies for U.S. investors while seeking the best returns for investors not subject to U.S. taxation. The negatives are increased administrative costs as well as decreased leveraging power because assets are in two pools.

How Grant Thornton can help

If you are considering starting a fund, Grant Thornton can help give your firm the critical edge. Our firm can advise on fund formation and structuring and assist throughout the initial fund launch.

Our specialists have real-world industry knowledge, and as your fund grows from a startup with less than $150 million in AUM to an SEC-registered business, we can address the day-to-day business situations you may encounter. We can provide assistance with matters such as audit, tax and regulatory compliance; investment adviser registration readiness; internal control and risk management reviews; operational and performance evaluations; IT strategy and effectiveness analysis; and litigation support services.

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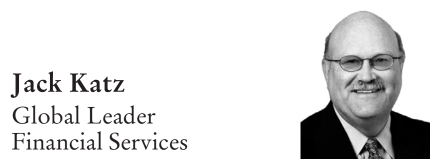

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