

# Sortino Investment Advisors, LLC

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## Form ADV, Part 2A Brochure

April 1, 2014

This brochure provides information about the qualifications and business practices of Sortino Investment Advisors, LLC. If you have any questions about the contents of this brochure, please contact us at (949) 481-5051. The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority.

Any reference to or use of the terms “registered investment adviser” or “registered,” does not imply that Sortino Investment Advisors, LLC or any person associated with Sortino Investment Advisors, LLC has achieved a certain level of skill or training.

Additional information about Sortino Investment Advisors, LLC is available on the SEC’s website at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).

## ITEM 2 - MATERIAL CHANGES

**Revised April 1, 2014**

The purpose of this page is to inform you of any material changes since the prior annual filing of this brochure. If you are receiving this brochure for the first time this section may not be relevant to you.

Sortino Investment Advisors, LLC ("SIA") reviews and updates our brochure at least annually to make sure that it is still current. We have not made material changes since the annual update to the brochure dated March 28, 2013.

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## ITEM 4 - ADVISORY BUSINESS

### Description of Advisory Firm

Sortino Investment Advisors, LLC ("SIA," "we," "our," or "us") is a privately owned Limited Liability Company headquartered in Menlo Park, CA. SIA is registered as an investment adviser with the U.S. Securities and Exchange Commission effective April 2009.

Frank Sortino and Jim Kaffen have been working together since early 2003. In January 2008, both Frank and Jim founded Sortino Investment Management, LLC. The Pension Research Institute, LLC and Abbott-Kaffen Family trust are the principal owners, as they each own more than 25% of SIA.

We provide managed account solutions to consultants, other advisors and broker/dealers (collectively "Financial Advisors"). Our tailored solutions help these Financial Advisors provide their clients with solutions to assist in meeting each client's financial needs.

### Advisory Services Offered

SIA offers the following services to advisory clients:

#### Portfolio Solutions Services

SIA develops an investment strategy for a Financial Advisor's individual high net worth or institutional clients (the "FA Client") based on the FA Client's investment profile. The FA Client completes a series of questions that determines the Desired Target Return<sup>®</sup> (DTR<sup>®</sup>) necessary to accomplish the investor's goals. Financial Advisors provide SIA with the asset allocation and SIA then seeks to identify the optimal asset allocation and the optimal mix of actively- and passively-managed investments given the FA Client's DTR<sup>®</sup>. The optimal portfolio is that which has the highest DTR<sup>®</sup> Alpha, as discussed below under **Item 8 - Methods of Analysis, Investment Strategies, and Risk of Loss**.

We describe fees charged for these services below under **Item 5 - Fees and Compensation**.

#### Limitations on Investments

In some circumstances, SIA's advice may be limited to certain types of securities. We are limited by the asset allocation and list of managers provided to us by each Financial Advisor.

### Tailored Services and Client Imposed Restrictions

#### Financial Advisor or FA Client Determined Asset Mix

SIA's services include providing portfolio solutions to Financial Advisors. SIA tailors their solutions to help Financial Advisors' clients meet their financial goals, as discussed below under **Item 8 - Methods of Analysis, Investment Strategies, and Risk of Loss**. SIA develops an investment strategy for a Financial Advisor's individual clients (the "FA Client") based on the FA Client's investment profile provided by the Financial Advisor. Our recommendations may be limited if the Financial Advisor does not provide SIA

with accurate and complete information. It is the Financial Advisor responsibility to keep SIA informed of any changes to the investment objectives or restrictions. It is the FA Client's responsibility to keep their Financial Advisor informed of any changes to the investment objectives or restrictions.

If the Financial Advisor or FA Client determines the optimal allocation between fixed income, U.S. equity, and foreign equity, then SIA will solve for the optimal combination of active and passive managers only. If an FA Client needs to place a restriction on their account, they should consult with their Financial Advisor.

## **Wrap Fee Programs**

SIA does not manage accounts as part of a wrap or bundled fee program.

## **Assets Under Management**

SIA manages client assets in non-discretionary accounts on a continuous and regular basis. As of 01/23/2014, the total amount of assets under our management was:

|                          |                |
|--------------------------|----------------|
| Discretionary Assets     | \$ 1,000,000   |
| Non-Discretionary Assets | \$ 283,000,000 |
| Total Assets             | \$ 284,000,000 |

## **ITEM 5 - FEES AND COMPENSATION**

### **Fee Schedule & Billing Method**

#### *Portfolio Solutions Services*

SIA receives an annual management fee based on the percentage of assets under management per the following fee schedule:

#### *Annual Fee Schedule*

|                      |       |
|----------------------|-------|
| \$100 k to \$1 mm    | 0.50% |
| >\$1 mm to \$10 mm   | 0.35% |
| >\$10 mm to \$100 mm | 0.30% |
| >\$100 mm to \$1bn   | 0.25% |
| >\$1bn to \$5bn      | 0.15% |
| >\$5bn to \$10bn     | 0.10% |
| Above \$10bn         | 0.05% |

The Financial Advisor will calculate and pay us directly for our management fees. We will determine frequency of payment in advance with each Financial Advisor. Typically, the billing method is similar to the billing method that the Financial Advisor uses with clients. Our fees are negotiable based upon portfolio size and other business considerations.

## **Other Fees and Expenses**

SIA's fees do not include custodian fees. Clients pay all brokerage commissions, stock transfer fees, and/or other similar charges incurred in connection with transactions in accounts from the assets in the account, which are in addition to the fees client pays to SIA. In addition, SIA's fees do not include the advisory and/or management fees charged by each Financial Advisor for their services.

Also, any mutual fund shares held in an account may be subject to deferred sales charges, 12b-1 fees, early redemption fees, and other fund-related expenses. The fund's prospectus fully describes the fees and expenses. All fees paid to SIA for their services are separate and distinct from the fees and expenses charged by mutual funds. Mutual funds pay advisory fees to their managers, which are indirectly charged to all holders of the mutual fund shares. Consequently, clients with mutual funds in their portfolios are effectively paying both SIA and the mutual fund manager for the management of their assets.

## **Termination**

Portfolio Solution Services will continue until either the FA Client or SIA gives written notice of termination to the other party. The FA Client or SIA may terminate the agreement at any time. Upon notice of termination, the Financial Advisor will calculate the final fees due for services provided through the date of termination. FA Clients who wish to terminate their agreement must do so by contacting their Financial Advisor.

## **Other Compensation**

SIA does not accept compensation for the sale of securities or other investment products, including asset-based sales charges or service fees from the sale of mutual funds.

## **ITEM 6 - PERFORMANCE-BASED FEES AND SIDE-BY-SIDE MANAGEMENT**

SIA does not charge performance-based fees or other fees based on a share of capital gains on or capital appreciation of the assets of a client.

## **ITEM 7 - TYPES OF CLIENTS**

We provide managed account solutions to consultants, other advisors and broker/dealers. Our tailored solutions help these Financial Advisors provide their clients with solutions to assist in meeting each client's financial needs.

## **Account Requirements**

Generally, SIA requires clients to maintain a minimum account size of \$100,000. Significant funds withdrawal may result in a request for additional fund deposits to continue with management of accounts. SIA may reduce or waive the account minimum requirements at our discretion.

## ITEM 8 - METHODS OF ANALYSIS, INVESTMENT STRATEGIES AND RISK OF LOSS

### Methods of Analysis and Investment Strategies

SIA provides a custom-tailored approach to investing by identifying the optimal portfolio given the FA Client's Desired Target Return (DTR®). SIA seeks to provide its clients with model portfolios, using both passive and active investments, that are optimized to provide the highest risk-adjusted return given the asset allocation and return objectives provided by the FA Client. SIA proprietary process uses a combination of statistical methods using the active and passive investment return data along with a degree of expertise. The model portfolios that SIA creates may include exchange-traded funds, index funds, mutual funds, and independent money managers. The optimal portfolio is that which has the highest alpha excess return, a risk-adjusted return described in the article "Short-Term Risk-Adjusted Performance: A Style-Based Analysis" by Frank A. Sortino, Gary A. Miller, and Joseph M. Messina, in the Journal of Investing in Summer 1997 and used by Dr. Sortino since 2000 to evaluate mutual funds in Pensions & Investments magazine.

#### Model Construction Process

1. The Financial Advisor and the FA Client must provide SIA with their benchmark asset allocations for each of their investment objectives. Typically, Financial Advisors provide SIA with a range of asset allocation for different portfolio objectives ranging from conservative to aggressive. Additionally, if the FA Client has a specific list of active managers that they wish SIA to consider in the model construction process, they must provide that list as well. Individual FA Clients will also provide their desired return objectives.
2. SIA will enter into its proprietary program the most recent 5 years of monthly return data for 17 passive indexes representing the 17 style categories of: 9 domestic styles for Value, Growth, Centric(for each Large, Mid, Small), Japan, Europe, Pacific ex-Japan, Emerging Markets, Cash & Equivalents, Domestic Bonds, Foreign Bonds and REITS. SIA uses Barclays iShares to represent the index returns.
3. SIA will then enter the most recent 5 years of monthly return data of all active managers as represented by actively managed exchange-traded funds, mutual funds, and independent money managers. SIA sources for this return data are PSN and/or Morningstar. SIA excludes managers:
  - a. With less than \$300 million in assets managed
  - b. Who are closed to new business
  - c. With less than 5 years of performance data
  - d. Upon request of the Financial Advisor and FA Client
4. SIA evaluates each of the managers using a process called style analysis. The purpose of the style analysis is to attempt to explain, or understand, the returns of each fund in terms of the 17 asset classes. Specifically, the style analysis tries to find the weights (or percentages) of each asset class whose sum closely approximates the returns of the given fund.



5. SIA uses a statistical process to calculate the DTR® Alpha and other downside risk statistics for the active managers. DTR® Alpha is the added value projected that the active managers will contribute to the portfolio.
6. SIA, using its expertise to evaluate the data produced in the above process, selects which active managers to include in the optimal portfolios. SIA's criteria in selecting the managers includes eliminating the bottom 50% of managers, i.e. the managers that do not have the highest upside return potential and looking at which managers are adding alpha. The goal is to select the best managers in each of the 17 style categories.
7. SIA evaluates the asset allocation ("benchmark") provided by the client. SIA will determine the likelihood that each portfolio could achieve the desired target return for that portfolio. SIA may edit those benchmarks based on the information provided by the client.
8. Using the data from the above process, SIA runs its optimizer that will result in 5 recommended model portfolios (level 1,2,3,4, and 5, representing the optimal portfolio with a desired target return of either 4%, 6%, 8%, 10%, or 12%). These portfolios are optimized to have the highest probability and lowest downside risk of achieving the desired target return of the portfolio. The optimal portfolio will consist of a combination of active and passive investments. However, if none of the active managers are adding alpha, the optimum portfolio will consist of completely passive investments. If the Financial Advisor or FA Client provided SIA with more than 5 benchmark asset allocations, SIA will return the 5 DTR® model portfolios with each portfolio likely being some combination of one or more of the benchmark asset allocations.
9. The Financial Advisor and the FA Client are responsible for the implementation of SIA's recommendations should they decide to invest in the recommended optimal portfolio.
10. SIA's process for reviewing and updating the model portfolios includes:
  - a. We will consider manager changes annually
  - b. We try to minimize the turnover of active managers.
  - c. We review managers quarterly as new data becomes available. We will replace any manager who has a negative DTR® with ETF's constituting that manager's style blend as soon as feasible. A reduction in the manager's positive value of the DTR® will not require replacement.

## **General Risk of Loss Statement**

The Desired Target Return® (DTR®) managed account program should not be considered a financial planning tool nor should it be used to assess an investor's risk/return characteristics. The DTR® does not factor market volatility as a primary risk nor does it sufficiently account for the investor's level of acceptable risk or risk tolerance. The determination of the DTR® for the investor does not consider the investor's periodic payments, bonuses or commissions other than salary, nor does it take into consideration assets held outside of the plan or any other forms of external income sources such as social security or spousal support. The DTR® program does not take into consideration the investor's tax situation, debt or future changes in assets or income needs. The investor should evaluate their level of risk tolerance based on their own investment knowledge, experience, demographics and net worth and consider either adjusting their portfolio risk, investigating alternative investment options, or consulting with an investment advisor to consider their specific situation and needs. The program assumes that the

DTR® is the underlying goal of the investor, and the possibility of the investor failing to reach the DTR® accordingly is a primary investor risk. Investing in financial securities involves risk. The higher the DTR® the greater the potential for significant loss of principle in your retirement account balance. Ignoring or underestimating the DTR® increases the risk of an investor not achieving their financial goals. SIA makes no assurances, implied or implicit, that the DTR® assigned to each participant will be achieved nor if achieved will result in replacing a significant amount of pre-retirement salary. Investors should use the DTR® program as a starting point to assist in determining the requirements needed to replace a significant portion of pre-retirement salary at retirement. Past performance is no guarantee of future results.

### *Risk Management*

SIA believes the primary way to reduce risk is through diversification. SIA diversifies portfolios across asset categories (fixed income and equities). Equity allocations will vary across nine U.S. management styles and four foreign sectors. The greater the allocation to equities and the greater the range between fixed income and equity, the greater will be the risk. The greater the DTR® the greater the risk one must assume in order to achieve their goal.

SIA will not attempt to time markets to pick tops and bottoms. SIA will attempt to reduce exposure to equities gradually as the upside potential decreases and the downside risk increases. Conversely, SIA will attempt to increase exposure to equities gradually as the upside potential increases and the downside risk decreases.

SIA in no way guarantees performance of a portfolio and Financial Advisors and FA Clients should understand that the actual return and value of a FA Client's account may fluctuate and at any point in time be worth more or less than the amount originally invested.

### *Independent Money Manager Strategies and Risks*

The independent money managers that SIA recommends utilize their own investment process and methods of analysis. The strategies and securities these managers invest in may have different or additional risks than those described in this brochure. Clients can find more information about the strategies and related risks of the independent money managers in ***Item 8 – Methods of Analysis, Investment Strategies and Risk of Loss*** in each manager's Form ADV disclosure brochure.

## **Specific Security Risks**

### *General Risks of Owning Securities*

Investing in securities involves risk of loss, and clients should be prepared to bear that risk. The prices of securities held in client accounts and the income they generate may decline in response to certain events taking place around the world. These include events directly involving the issuers of securities held as underlying assets of mutual funds in a client's account, conditions affecting the general economy, and overall market changes. Other contributing factors include local, regional, or global political, social, or economic instability and governmental or governmental agency responses to

economic conditions. Finally, currency, interest rate, and commodity price fluctuations may also affect security prices and income.

### Exchange-Traded Funds (ETFs)

An ETF is a type of Investment Company (usually, an open-end fund or unit investment trust) whose primary objective is to achieve the same return as a particular market index. An ETF is similar to an index fund in that it will primarily invest in securities of companies that are included in a selected market index. Unlike traditional mutual funds, which can only be redeemed at the end of a trading day, ETFs trade throughout the day on an exchange. Like stock mutual funds, ETF prices may be affected by the prices of the underlying securities, the overall market. ETF prices that track a particular sector may be affected by factors affecting that particular industry segment.

### Mutual Funds (Open-end Investment Company)

A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. The portfolio of the fund consists of the combined holdings it owns. Each share represents an investor's proportionate ownership of the fund's holdings and the income those holdings generate. The price that investors pay for mutual fund shares is the fund's per share net asset value (NAV) plus any shareholder fees that the fund imposes at the time of purchase (such as sales loads).

The benefits of investing through mutual funds include:

#### Professionally Managed

Mutual funds are professionally managed by investment advisers who research, select, and monitor the performance of the securities the fund purchases.

#### Diversification

Mutual funds typically have the benefit of diversification, which is an investing strategy that generally sums up as "Don't put all your eggs in one basket." Spreading investments across a wide range of companies and industry sectors can help lower the risk if a company or sector fails. Some investors find it easier to achieve diversification through ownership of mutual funds rather than through ownership of individual stocks or bonds.

#### Affordability

Some mutual funds accommodate investors who do not have a lot of money to invest by setting relatively low dollar amounts for initial purchases, subsequent monthly purchases, or both.

#### Liquidity

At any time, mutual fund investors can readily redeem their shares at the current NAV, less any fees and charges assessed on redemption.

Mutual funds also have features that some investors might view as disadvantages:

### Costs Despite Negative Returns

Investors must pay sales charges, annual fees, and other expenses regardless of how the fund performs. Depending on the timing of their investment, investors may also have to pay taxes on any capital gains distribution they receive. This includes instances where the fund went on to perform poorly after purchasing shares.

### Lack of Control

Investors typically cannot ascertain the exact make-up of a fund's portfolio at any given time, nor can they directly influence which securities the fund manager buys and sells or the timing of those trades.

### Price Uncertainty

With an individual stock, investors can obtain real-time (or close to real-time) pricing information with relative ease by checking financial websites or by calling a broker or your investment adviser. Investors can also monitor how a stock's price changes from hour to hour—or even second to second. By contrast, with a mutual fund, the price at which an investor purchases or redeems shares will typically depend on the fund's NAV, which the fund might not calculate until many hours after the investor placed the order. In general, mutual funds must calculate their NAV at least once every business day, typically after the major U.S. exchanges close.

## **ITEM 9 - DISCIPLINARY INFORMATION**

SIA does not have any disciplinary information to disclose.

## **ITEM 10 - OTHER FINANCIAL INDUSTRY ACTIVITIES AND AFFILIATIONS**

SIA does not offer any other services or have any affiliates in the financial industry.

## **ITEM 11 - CODE OF ETHICS, PARTICIPATION OR INTEREST IN CLIENT TRANSACTIONS AND PERSONAL TRADING**

### **Code of Ethics**

SIA believes that we owe clients the highest level of trust and fair dealing. Further, as part of our fiduciary duty, we place the interests of our clients ahead of the interests of the firm and our personnel. SIA's personnel are required to conduct themselves with integrity at all times and follow the principles and policies detailed in our Code of Ethics.

SIA's Code of Ethics attempts to address specific conflicts of interest that either we have identified or that could likely arise. SIA's personnel are required to follow clear guidelines from the Code of Ethics in areas such as gifts and entertainment, other business activities, and adherence to applicable state and federal securities laws. All personnel receive a copy of each amendment of the Code of Ethics, which they acknowledge in writing. Additionally, individuals who make securities recommendations to clients, or who have access to nonpublic information regarding any clients' purchase or sale of securities are subject to personal trading policies governed by the Code of Ethics.

SIA will provide a complete copy of the Code of Ethics to any client or prospective client upon request.

### *Personal Trading Practices*

SIA and our personnel may purchase or sell securities for themselves, regardless of whether the transaction would be appropriate for the client account. SIA and our personnel may purchase or sell securities for themselves that we also recommend to clients. This includes related securities (e.g., warrants, options, or futures). SIA mitigates this potential of a conflict of interest, as we do not trade securities for clients or have discretion over any client's or FA Client's invested assets. SIA is not aware of the timing when or if recommendations are acted upon. It is up to the client or FA Client to act upon the recommendations of SIA.

Our personal trading policies address the following:

1. SIA and our personnel may purchase or sell securities for themselves, regardless of whether the transaction would be appropriate for the client account.
2. Conflicts of interest also may arise when SIA's personnel becomes aware of Limited Offerings or IPOs. Such trading includes private placements or offerings in interests in limited partnerships or any thinly traded securities, whether public or private. Given the inherent potential for conflict, Limited Offerings or IPOs demand extreme care. SIA's personnel are required to obtain this pre-approval from the Chief Compliance Officer before transacting.

## **ITEM 12 - BROKERAGE PRACTICES**

SIA does not have discretion to trade client accounts and does not determine or recommend broker-dealers to clients.

## **ITEM 13 - REVIEW OF ACCOUNTS**

### **Managed Account Reviews**

SIA's advisory board manages the models on a continuous basis. We review the asset allocation and/or changes in manager rankings at least quarterly. We conduct additional reviews based on market events, changes in the asset allocation strategy, or material changes at the independent money manager(s). The meetings can lead to changes in asset allocation and/or changes in manager rankings. In the short term a client's portfolio is not expected to be affected by the advisory board's actions.

### **Account Reporting**

Each client receives a written statement from the custodian that includes an accounting of all holdings and transactions in the account for the reporting period. Generally, SIA does not provide additional reporting to clients. However, 401(k) participants will receive quarterly reports that SIA prepares. SIA provides these reports to the record-keeper or plan sponsor who will then provide the reports to the 401(k) participants. The reports will generally include:

- Rate of return required to achieve 70% of salary
- Before and after tax salary deferral ramifications
- Change in DTR if investor wants to increase or decrease contributions
- Monthly income at retirement age

## **ITEM 14 - CLIENT REFERRALS AND OTHER COMPENSATION**

SIA does not have any arrangement for which we compensate anyone specifically for referring clients to us. We do not have any cash solicitation arrangements.

## **ITEM 15 - CUSTODY**

SIA does not take custody of client funds or securities in any way.

## **ITEM 16 - INVESTMENT DISCRETION**

SIA does not trade securities or have discretion over any client's or FA Client's invested assets. All clients are solely responsible for making their own investment decisions. SIA does not require any client or FA Client to act upon the recommendations of SIA.

## **ITEM 17 - VOTING CLIENT SECURITIES**

### *Proxy Voting*

SIA does not accept authority to vote FA client securities. SIA does not have authority to vote FA client securities. The investment adviser that manages the assets of the mutual fund generally votes proxies issued on securities held by a registered investment company (i.e. mutual fund). FA Clients will receive their proxies or other solicitations directly from their custodian or a transfer agent.

### *Class Actions*

SIA does not instruct or give advice to FA clients on whether or not to participate as a member of class action lawsuits and will not automatically file claims on the client's behalf.

## **ITEM 18 - FINANCIAL INFORMATION**

Registered investment advisers are required in this item to provide clients with certain financial information or disclosures about the firm's financial condition. SIA does not require the prepayment of more than \$1,200 in fees per client, six months or more in advance, and does not foresee any financial condition that is reasonably likely to impair our ability to meet contractual commitments to clients.

## Privacy Notice

Your relationship with us is based on trust and confidence and we value our relationships with our clients. In order to fulfill our responsibilities to you, we require that you provide us with current and accurate financial and personal information. We will protect the information you have provided in a manner that is safe, secure and professional. We are very committed to protecting your privacy and to safeguarding that information.

### Type of Information We Require

We may require and obtain the following kinds of confidential personal information about you:

- Information on applications or other forms, such as your name, address, assets, phone number, social security number, occupation, assets, income and other financial and family information;
- Information about your transactions with us, our affiliates or with brokerages, banks and custodians with whom you hold investment or cash accounts. This information includes account numbers, holdings, balances, transaction history and other financial and investment activities.

### Sharing Nonpublic Personal and Financial Information

We are committed to the protection and privacy of our customer's and consumer's personal and financial information. We will not share such information with any non-affiliated third party except:

- When necessary to complete a transaction in the account, such as with the clearing firm or account custodians
- When required to maintain or service the account
- To resolve customer disputes
- When requested by a fiduciary or beneficiary on the account
- When required by our attorneys or accountants
- When required by a regulatory agency, or for other reasons required or permitted by law
- In connection with a sale or merger of SIA's business
- In any circumstance that has the customer's instruction or consent

### Protection of Personal Information

We restrict access to your personal and account information to those employees who need to know that information to provide products or services to you. We maintain physical, electronic, and procedural safeguards to guard your personal information.