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Stay Vigilant: The Government Shutdown Didn't Shut Down Insider Trading Enforcement

Shutting down the United States federal government in late 2018 and early 2019 created the unfortunate perception that government watchdogs might not be able to catch up with illegal behavior, like insider trading. The government reopened in February, though, and the Securities and Exchange Commission's Division of Enforcement continues to actively investigate potential wrongdoing. Political frustration, safety risks, economic impact, and especially the personal toll on families of federal workers and other businesses aside, the longest government shutdown in history did not stop government enforcement. And for corporate officers, directors, employees, or service providers who do not intend to violate the law, nothing has changed regarding their need to protect confidential company information from disclosure to those who don't need to hear it.

For several years, we have written reminders to avoid inadvertent tipping of material, non-public information.² Responsible business executives and service providers nevertheless continue to become trapped in ominous and expensive government investigations when they confide in, or unknowingly provide access to confidential information to, loved ones or friends who then trade in securities. These investigations – even when they conclude without charges against the corporate executive – can result in the executive being terminated or sanctioned by their employer for their lack of discretion or failure to comply with company policy, not to mention the personal toll on personal relationships. The legal standard for when a tipper is liable for a tippee's trades remains somewhat in flux,³ but no one should want to inspire government scrutiny in the first place.

With a five-year statute of limitations, demonstrated benefits to cooperating witnesses,⁴ and a 24% increase from 2017 to 2018 in the number of insider trading actions filed, the SEC is certainly not shutting down its insider trading enforcement program.⁵ And as the following examples make clear, good people who share corporate information in confidence continue to become embroiled in intrusive and hurtful investigations. Better to not share information in the first place.



SPOUSAL BETRAYAL⁶

Harold Altvater, once an anesthesiologist, operated a medical marijuana consultation practice. His wife worked in various drug safety roles at Ariad Pharmaceuticals, Inc. (Ariad). In late 2013, Altvater's wife met several times with the U.S. Food & Drug Administration (FDA) concerning the safety profile for Ariad's leukemia drug, Iclusig. In October 2013, Altvater learned from his wife, in confidence, that Iclusig was facing regulatory safety problems with the FDA. On October 3 and 4, 2013, shortly before a negative public announcement by Ariad on October 9, Altvater sold stock in Ariad. Then on October 24, 2013, less than a week before another negative public announcement by Ariad on October 31, Altvater again sold stock in Ariad. Each of Altvater's sales occurred almost immediately after he spoke with his wife.

In December 2013, Altvater's wife shared with him the now positive confidential news that a reapproval process for Iclusig was being fast-tracked. This time in response Altvater not only purchased shares in advance of Ariad's public announcement on December 20, 2013, but he also tipped multiple friends to purchase. All told, Altvater's timely trading and tips resulted in illegal profits and losses avoided of more than \$100,000. In addition to confiding in her husband regarding the status of Iclusig, Altvater's wife is also alleged to have made her husband aware of Ariad's insider trading policy and to have reminded him not to trade in Ariad's stock.

Altvater's decisions to ignore his wife's admonitions led to his first being charged civilly by the SEC on June 26, 2017, and then charged criminally for the same trading by the Massachusetts U.S. Attorney's Office the following month. On October 9, 2018, a jury convicted Altvater of three counts of insider trading. In January of this year, Altvater was sentenced to 18 months in prison and ordered to forfeit \$115,657. His SEC case remains pending.

In short, even where Altvater's wife's company had insider trading policies, and she reminded her husband not to trade, he still pursued the illegal activity after learning of the confidential information concerning the FDA safety reviews. Leaving aside any impact on their marriage, the cost to Altvater's wife's employer and accompanying negative publicity might well have been avoided had the information never been disclosed outside the company at all.⁷

THE DANGERS OF WORKING FROM HOME

James Hengen's wife worked as a vice president of human capital at UnitedHealth Group, Inc. (UnitedHealth). In her role at UnitedHealth, she assisted in the human resources aspects of mergers and acquisitions. Hengen's wife typically worked from home at least one day per week.

In March of 2016, Hengen's wife became involved in the confidential negotiations between UnitedHealth and USMD Holdings, Inc. (USMD). USMD was a Texas-based company that managed clinics, hospitals, and other medical facilities. In June 2016, while at his home, Hengen overheard his wife on a conference call discussing USMD and its CEO. Combined with his knowledge of his wife's recent frequent trips to Texas, Hengen correctly concluded that USMD was an acquisition target of UnitedHealth. On June 27, 2016, Hengen began buying shares of USMD. Not content just to trade, Hengen tipped his brother and two of his co-workers. Together, the three purchased additional shares of USMD throughout June and July 2016. In July and August 2016, Hengen made specific efforts to listen to his wife while she was on work calls, and based on what he overheard, purchased additional shares of USMD. He then updated his co-workers, who also purchased additional shares of USMD. Following UnitedHealth's announcement on August 30, 2016, that it was acquiring USMD, Hengen, Hengen's brother and his co-workers sold their holdings for combined profits of \$40,655.

Separately, in December 2016, Hengen's wife began working on a confidential project involving UnitedHealth's planned acquisition of Illinois-based Surgical Care Affiliates, Inc. (Surgical Care). While she was working from home, Hengen rifled through his wife's papers when she was out of the room and saw references to Surgical Care. Hengen then made multiple purchases of Surgical Care stock between December 27 and 30, 2016. Following the announcement on January



9, 2017, that UnitedHealth was making a tender offer to Surgical Care, Hengen sold his Surgical Care holdings for profits of \$31,489.

On November 8, 2018, the SEC charged Hengen with multiple counts of insider trading and tipping. He settled with the SEC at the time of filing without admitting or denying the allegations in the complaint, agreeing to disgorge the profits of his and his tippees' trades in the amount of \$63,804 and to pay a civil penalty of \$72,144.⁸

A FAMILY FEAST GONE WRONG

The Hengen matter was not the only insider trading action the SEC brought related to UnitedHealth's 2017 acquisition of Surgical Care. Slobodan Dragojlovic's brother was an executive at Surgical Care.

On December 17, 2016, Dragojlovic's brother learned that his employer would shortly be acquired by UnitedHealth. A week later, Dragojlovic's brother confided in him, during the family's annual Christmas Eve holiday gathering, that UnitedHealth was in negotiations to acquire Surgical Care. Dragojlovic's brother allegedly wanted to explain both why he had been travelling so much for work lately and why – as alleged by the SEC – that year's Christmas Eve dinner would not be quite the "lavish meal" as usual. The SEC alleged that Dragojlovic knew his brother had shared the information with him in confidence and knew that the information was material and non-public. Despite this knowledge, on January 5, 2017, Dragojlovic purchased 2,000 shares of Surgical Care. On January 9, 2017, UnitedHealth announced its tender offer for Surgical Care, and Dragojlovic sold his Surgical Care shares that same day for a profit of \$20,101.

On November 7, 2018, the SEC charged Dragojlovic with insider trading, for misappropriating the confidential information provided to him by his brother in confidence. Dragojlovic settled with the SEC at the time of filing without admitting or denying the allegations in the complaint, agreeing to pay back the \$20,101 in illegal profits and to pay a penalty of \$20,101 as well.⁹

COHABITING BEFORE MARRIAGE

Peter Cho and his then fiancé shared an apartment in New York. In the Spring of 2016, she worked as an investment banker, advising Alaska Air Group (Alaska Air) on its planned acquisition of Virgin America, Inc. (Virgin America). Cho's fiancé worked late nights and on weekends from their apartment, which allowed Cho to become aware of the Alaska Air – Virgin America transaction.

Between March 10 and 21, 2016, based on the information Cho learned from his fiancé, Cho purchased short-term, out-of-the-money call options in Virgin America. When news of the potential transaction was reported by the media on March 23 and 28, 2016 – resulting in a significant increase in Virgin America's trading price – Cho closed out his position for a significant gain. Cho immediately rolled a portion of his profits into even further out-of-the-money call options, which he closed out after the transaction was publicly announced by Alaska Air and Virgin America on April 4, 2016. All told, Cho's options purchases of a little more than \$4,000 yielded profits of \$251,386.

The SEC sued Cho on December 17, 2018. He settled with the SEC at the time of filing without admitting or denying the allegations in the complaint, agreeing to disgorge his profits of \$251,386 and to pay an additional \$251,386 civil penalty on top of his disgorgement.¹⁰

A DISAPPOINTING CHILD

According to the SEC, Aaron Smith and his father were very close, communicating frequently by phone, seeing each other on weekends, and regularly confiding in each other concerning sensitive family and financial matters. Smith's father was also a director of Valley Commerce Bancorp. (Valley Commerce).

In April 2016, Smith's father became aware through his position as a director that Valley Commerce was in talks to be acquired by CVB Financial Corp. (CVBF). Not long after his father learned of the potential transaction, he shared the



news in confidence with his son. On May 3, 2016, Smith wired \$100,000 to his brokerage firm to invest in Valley Commerce. In September 2016 when Valley Commerce announced its acquisition by CVBF, Smith's holdings increased significantly in value, resulting in illegal gains of more than \$40,000.

The SEC instituted an administrative proceeding against Smith on August 7, 2018, finding that he had engaged in insider trading. Simultaneous with its institution, Smith settled the proceeding without admitting or denying the Commission's findings, agreeing to disgorge his profits of \$40,578.28, and further to pay an additional \$40,578.28 civil penalty equal to his disgorgement.¹¹

NOT YOUR BROTHER'S KEEPER

Stephen Leonard's sibling worked in a senior position at Puma Biotechnology, Inc. (Puma Bio), a company that in 2014 was involved in a late stage FDA clinical trial for its cancer treatment drug, neratinib. From April through July 2014, Leonard's sibling learned key, non-public details regarding the FDA approval status for neratinib.

The SEC alleged that on four separate occasions from May through July 2014, Leonard and his sibling had telephone conversations in which Leonard's sibling shared news regarding neratinib with him in confidence, and that almost immediately following each conversation, Leonard purchased shares of Puma Bio. Leonard's last purchase of Puma Bio on July 18, 2014, came just hours after his sibling was informed by Puma Bio's CEO that a "major milestone" in the FDA process had been reached. After Puma Bio announced the positive FDA results for neratinib on July 22, 2014, its share price nearly quadrupled, leading to illegal trading profits of \$107,000 for Leonard.

On December 7, 2017, the SEC charged Leonard with insider trading, for misappropriating the confidential information from his sibling. Leonard settled with the SEC at the time of filing without admitting or denying the allegations in the complaint, agreeing to pay back the \$107,000 in illegal profits and to pay an additional penalty of \$107,000.¹²

CREDIBILITY IS CRUCIAL

In each of these instances, the corporate employee allegedly shared confidential information trusting that it would not be abused, and the loved one or friend receiving the information breached that trust and traded for personal gain. The SEC did not charge these corporate employees, finding instead that the traders had essentially stolen the information. But to get to the decision not to charge the employees, the SEC's staff undoubtedly conducted a very intrusive investigation that put at risk the employee's job and personal relationships. In each of these situations, it seems likely that the corporate employee's credibility was challenged and confirmed.

Credibility of witnesses is always important, but it's crucial in situations like this, as the government decides whether it believes conduct was intentional, reckless, or inadvertent. So in addition to reminding executives to be careful with confidential company information, these cases are a good reminder to be extremely cautious if the government calls asking questions.

Individuals and companies are entitled to experienced counsel. Although government lawyers may be disappointed that a witness declines to give off-the-cuff answers during an unscheduled call, they respect people who act responsibly. An individual who politely expresses a desire to answer the questions while acknowledging a lack of familiarity with the government's processes can state an intention to consult with counsel without sending up red flags. Having a fully refreshed recollection and an appreciation for the nuances of the government's tactics can help a witness be accurate and credible from the very first conversation with the government. Preparation with counsel can also help to avoid the type of innocent inconsistencies that government lawyers often seize upon in questioning. If information has been shared and trading has occurred, a witness's demeanor and credibility in that initial appearance before the government can often be the difference between a quick declination and a lengthy investigation.



In short, the lessons in this edition of our inadvertent tipping series remain constant: even if you believe your loved ones and friends are trustworthy, don't share confidential information that they don't need to know. And if the government calls, don't provide off-the-cuff answers. Get help and get organized.

ABOUT KING & SPALDING

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This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."

Table with 5 columns: ABU DHABI, ATLANTA, AUSTIN, CHARLOTTE, CHICAGO, DUBAI, FRANKFURT, GENEVA, HOUSTON, LONDON, LOS ANGELES, MOSCOW, NEW YORK, PARIS, RIYADH, SAN FRANCISCO, SILICON VALLEY, SINGAPORE, TOKYO, WASHINGTON, D.C.

¹ Dixie L. Johnson and Aaron W. Lipson are partners, and Matthew B. Hanson is a senior associate, on King & Spalding's Special Matters and Government Investigations team, focusing on SEC enforcement and regulation matters.

² We welcome this year's Guest Author, Aaron W. Lipson, to King & Spalding and to this annual tradition, and we thank again last year's Guest Author, Richard H. Walker. Any delay in this year's edition is in no way attributable to the government shutdown. See, e.g., Dixie L. Johnson, Richard H. Walker, & Matthew B. Hanson, Loose Lips Still Sink Ships: Inadvertent Tipping in 2017, LAW360, Dec. 21, 2017; Dixie L. Johnson, Alana L. Griffin, & Matthew B. Hanson, Avoid Inadvertent Tipping This Holiday Season, LAW360, Dec. 21, 2016; Dixie L. Johnson & Matthew B. Hanson, Post-Newman Reality: Investigations Involving Unwitting "Tips" to Close Friends and Relatives Will Continue, King & Spalding LLP Client Alert, Oct. 8, 2015; Dixie L. Johnson & Matthew B. Hanson, Friends and Family: Keeping Loved Ones Safe from Insider Trading Temptations, King & Spalding LLP Client Alert, Dec. 8, 2014; Dixie L. Johnson, Maintaining Client Confidences During the Holidays: Avoiding Accidental Tipping, Fried, Frank, Harris, Shriver & Jacobson LLP, Dec. 23, 2013; Dixie L. Johnson & Matthew B. Hanson, Accidental Tipping: The Wrong Kind of Holiday Present for Family and Friends, Fried, Frank, Harris, Shriver & Jacobson LLP, Dec. 14, 2012; Dixie L. Johnson & Robert Greffenius, Topics to Avoid in Holiday Conversation: Religion? Politics? Work!, Fried, Frank, Harris, Shriver & Jacobson LLP, Nov. 30, 2011; and Dixie L. Johnson and Robert Greffenius, Insider Trading by Friends and Family: When the SEC Alleges Tipping, BUSINESS LAW TODAY, Aug. 18, 2011.

³ See, e.g., U.S. v. Pinto-Thomaz, ___ F.Supp.3d. ___ (S.D.N.Y. Dec. 6, 2018) (J. Rakoff) 2018 WL 6378118, *3-4 (tracking changes in the standard for tipper liability from Dirks v. SEC, 463 U.S. 646 (1983) to U.S. v. Newman, 773 F.3d 438 (2d Cir. 2014) to Salman v. U.S., 137 S.Ct. 420 (2016) to U.S. v. Martoma, 894 F.3d 64 (2d Cir. 2017)).

⁴ See, e.g., SEC Charges Six Individuals With Insider Trading in Stock of E-Commerce Company Prior to Acquisition by eBay, SEC Press Release (Apr. 25, 2014) (identifying multiple insider trading actions arising from eBay Inc.'s acquisition of GSI Commerce, Inc., including a non-prosecution agreement against one trader that provided for only disgorgement and pre-judgment interest, "because this individual provided early, extraordinary, and unconditional cooperation"); SEC v. Wrangell, 7:12-CV-00274 (E.D.N.C. 2012) (Complaint filed Sep. 20, 2012) (settlement announcement same day identified a civil penalty equal to only 25% of the trading profits for cooperating witness "[d]ue to his significant cooperation").

⁵ See SEC Annual Report of the Division of Enforcement, Fiscal Year 2018, at p. 19.

⁶ All descriptions of insider trading actions in this article are based on the allegations contained within the criminal indictments, civil complaints, or administrative proceedings at the time of filing. The factual recitations within these documents are only allegations at the time of filing, and the burden remains on the government to sufficiently establish these allegations for purposes of civil or criminal liability.



⁷ SEC v. Altvater, 1:17-CV-1178 (D. Mass 2017) (Complaint filed June 27, 2017; case pending); U.S. v. Altvater, 1:17-CR-10216 (D. Mass 2017) (Indictment announced Jul. 20, 2017; jury verdict announced Oct. 9, 2018; judgment entered Jan. 22, 2019).

⁸ SEC v. Hengen, 0:18-CV-03135 (D. Minn. 2018) (Complaint filed Nov. 8, 2018; settlement announced same day).

⁹ SEC v. Dragojlovic, 2:18-CV-09456 (C.D. Cal. 2018) (Complaint filed Nov. 7, 2018; settlement announced same day).

¹⁰ SEC v. Cho, 1:18-CV-11811 (S.D.N.Y. 2018) (Complaint filed Dec. 17, 2018; settlement announced same day).

¹¹ In the matter of Aaron R. Smith, SEC Admin. Pro. File No. 3-18625 (SEC Rel. No. 83795, Aug. 7, 2018) (Order instituting proceedings and accepting offer of settlement).

¹² SEC v. Leonard, 8:17-CV-02926 (M.D. Fla. 2017) (Complaint filed Dec. 6, 2017; settlement announced the next day).