

Recent Insider Trading Conviction Demonstrates The Government's Focus On Rule 10b5-1 Trading Plans

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On June 21, 2024, a federal jury convicted the founder and former CEO of Ontrak Inc., a publicly traded telehealth company, of securities fraud and insider trading – marking the first insider trading prosecution (and subsequent conviction) brought by the Department of Justice (“DOJ”) based exclusively on trades placed in accordance with a Rule 10b5-1 trading plan.¹

The charges were unsealed in March 2023, just days after the effective date of several amendments to Rule 10b5-1 aimed at “strengthen[ing] investor protections concerning insider trading and to help shareholders understand when and how insiders are trading in securities for which they may at times have material nonpublic information”.²

Originally adopted in 2000, Rule 10b5-1 under the Securities Exchange Act of 1934 provides an affirmative defense to insider trading liability under Section 10(b) of the Exchange Act and Rule 10b-5 in circumstances where, subject to certain conditions, the trade is pursuant to (1) a binding contract, (2) an instruction to another person to execute the trade for the instructing person’s account, or (3) a written plan adopted when the trader was not aware of material nonpublic information.³ Essentially, plans adopted under the Rule allow executives and other corporate insiders to set a predetermined date for selling or buying shares contingent upon their certifying that they are not aware of any material nonpublic information that is informing their decision. However, in response to what it perceived as abusive practices associated with Rule 10b5-1 trading plans, in January 2022, the SEC proposed amendments to the rule.

Among the revisions were an added requirement in Rule 10b5-1(c)(1)(ii) that any person entering into a Rule 10b5-1 contract, instruction, or plan has “acted in good faith with respect to” the contract, instruction, or plan.⁴ The new Rule 10b5-1(c)(1)(ii) also narrowed the availability of the affirmative defense for any Rule 10b5-1 plan adopted by a director or Section 16 officer—that is, a director or “officer” as defined by Rule 16a-1(f)—by requiring the director or officer to include a representation in the trading plan certifying that, at the time of adoption or modification, they (1) are not aware of material nonpublic information about the issuer or its securities and (2) are adopting the contract, instruction, or plan in good faith and not as part of a plan or scheme to evade the confines of Rule 10b5-1.⁵ Additionally, the amendments instituted new “cooling-off periods,” which prevent a Section 16 officer who adopts a new Rule 10b5-1 plan (or makes certain changes to an existing plan) from relying on the Rule 10b5-1 affirmative defense unless the plan provides that trading under the plan will not begin until the later of (a) 90 days after the adoption or modification of the plan **or** (b) two business days following disclosure of the issuer’s financial results in a

Form 10-Q or 10-K for the fiscal quarter in which the plan was adopted (but not to exceed 120 days following adoption or modification of the plan).^[9]

The DOJ's indictment charged Terren S. Peizer, Ontrak's former CEO, with one count of engaging in a securities fraud scheme (18 U.S.C. §§ 1348(1)) and two counts of securities fraud (15 U.S.C. §§ 78j(b)) for allegedly engaging in insider trading via fraudulent use of a Rule 10b5-1 trading plan. The indictment alleged that, despite having knowledge that Ontrak's \$90 million contractual relationship with its then-largest customer, Cigna, was in serious jeopardy of being terminated and Ontrak faced significantly reduced potential billings, in May 2021, Peizer established a Rule 10b5-1 trading plan via his personal investment vehicle in which he attested to being unaware of any material nonpublic information concerning the company and subsequently sold nearly 600,000 shares of company stock worth more than \$19.2 million. When Cigna later informed Ontrak in August 2021 of its intent to terminate its relationship with the company, Peizer—allegedly just one hour later—set up a second Rule 10b5-1 trading plan pursuant to which he sold another 45,000 shares of stock worth more than \$1 million.^[10] In total, the DOJ alleged that by exercising his Ontrak warrants and selling the resulting shares pursuant to his Rule 10b5-1 plans, Peizer avoided more than \$12.5 million in losses when, six days after Peizer adopted his second plan, Ontrak's stock price dropped by more than 44% when the company disclosed the Cigna contract termination in a Form 8-K.^[11]

According to reports, among the witnesses heard at trial were Peizer's Jefferies Wealth Management broker who executed his trades under the Rule 10b5-1 plans, a former Ontrak consultant who gave Peizer strategic counseling in business growth and challenges, and an RBC Capital Markets stock analyst who covers publicly traded companies like Ontrak. The jury heard how Peizer informed his broker that he wanted to immediately begin selling his shares under the plan, that Peizer had expressed anxiety over the Cigna relationship to Ontrak's consultant, and that Peizer and other Ontrak executives failed to inform the RBC stock analyst or include in the company's August 2021 Form 8-K and 10-Q filings any of the issues it was experiencing with Cigna. Despite Peizer maintaining that he simply sought to sell his warrants for 1 million shares that were set to expire and that he expressed his trading intentions in January 2021, long before Cigna began communicating its grievances to the company, the jury was ultimately not persuaded. Also unpersuasive were the defense's attempts to emphasize that Peizer was only selling warrants and not common stock, that these warrants represented only a fraction of his ownership in the company, and that he continued to sell shares even after the company announced Cigna's termination of the contract—the jury found Peizer guilty on all three charges.

SO WHERE DID PEIZER GO WRONG?

Though not legally required at the time Peizer entered into the plans,^[12] the DOJ largely focused on Peizer's disregarding advice to observe a cooling-off period before trading under the plan. Peizer sought to exercise warrants that were set to expire in August 2021 and wanted to sell the shares under Rule 10b5-1. When the first broker he approached informed him of the recommended 30-day cooling-off period which was potentially negotiable down to 14 days at best, Peizer sought out another broker. Despite the second broker advising Peizer that a 30-day cooling-off period was "industry best practice," which failure to follow along with "rapid transaction executions subsequent to plan adoption" could "create an appearance of impropriety," Peizer allegedly refused to abide by any cooling-off period before he began selling his shares.^[13]

The government also emphasized Peizer's allegedly false certifications that he was not in possession of material nonpublic information. Text messages included in the DOJ's indictment and subsequently heard by the jury reflected various conversations occurring from March 2021 to May 2021 among Peizer, Ontrak consultants and Ontrak's CEO in which Peizer said, among other things, that they needed to "save Cigna" and described the Cigna relationship as a "nightmare."^[14] One consultant testified at trial that Peizer frequently consulted with her by phone, email, and text about anything related to the success of Ontrak and that Peizer and Ontrak executives "knew the company was starting to have problems with Cigna in the spring of 2021."

WHAT IS THE TAKEAWAY?

The SEC and the DOJ have stated outright that they are undertaking a "data-driven initiative" in search of 10b5-1 trading plan violations – and they are holding true to their word.^[15] The conviction makes Peizer the first individual to ever be criminally convicted based exclusively on an executive's use of Rule 10b5-1 trading plans, but—per

comments made by both the SEC and the DOJ—it will likely not be the last.^[1] Martin Estrada, the U.S. Attorney for the Central District of California, responsible for the DOJ’s Corporate Crime and Securities Fraud Strike Force, stated that the verdict should serve as a “clear message” that even corporate executives must abide by the law.^[2]

With the DOJ and the SEC likely to increase their scrutiny of trading under Rule 10b5-1 plans, companies should be mindful of the parameters of Rule 10b5-1 and update their insider-trading compliance programs and policies accordingly. While the SEC did not charge the company with any wrongdoing in this case, Ontrak’s compliance officer and chief financial officer certified and approved both trading plans and testified at trial that they were not entered into based on material nonpublic information. With corporate officers certifying and approving plans, potential risk may run to the company where the individual entering into the plan makes false certifications concerning material nonpublic information.

Further, given that the SEC and the DOJ have taken an aggressive position when it comes to identifying trades that are based on material nonpublic information, companies should provide or update comprehensive guidance to their officers and directors as to what may be deemed material nonpublic information so individuals can be sure to avoid entering into or amending any plans when potentially in possession of such information. Officers and directors should exercise caution when setting up plans during periods in which it could even possibly be construed that they are in possession of material nonpublic information and fully comply with the now-required cooling-off period. Failure to do so, as *Peizer* makes clear, can have serious consequences.

[1] The same day that the DOJ’s indictment was unsealed, the SEC brought a parallel civil suit against Peizer for violations of (i) Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b); (ii) Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a); and (iii) Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a). The civil action was stayed in April 2023 pending conclusion of the criminal proceedings.

[2] The amendments to Rule 10b5-1 were adopted by the SEC on December 14, 2022 and became effective on February 27, 2023. See Insider Trading Arrangements and Related Disclosures, Exchange Act Release Nos. 33-11138; 34-96492, 17 C.F.R. § 240.10b5-1 (Dec. 14, 2022).

[3] 17 C.F.R. § 240.10b5-1.

[4] Insider Trading Arrangements and Related Disclosures, Exchange Act Release Nos. 33-11138; 34-96492, 17 C.F.R. § 240.10b5-1 (Dec. 14, 2022).

[5] *Id.*

[6] *Id.*

[7] The plan provided for the sale of approximately 450,000 shares; however, Peizer was only able to sell 45,000 shares under the plan before the customer formally notified Ontrak of its contract termination.

[8] In March 2021, shareholders brought a federal securities class action suit against Ontrak, Peizer, and three other Ontrak officers alleging that they had made materially false and misleading statements about the company’s relationships with two major customers – Aetna Inc. and Cigna Corp. Defendants filed a motion to dismiss, which the court took under review in April 2024. The case is *Farhar v. Ontrak, Inc. et al.*, C.A. No. 2:21-cv-01987.

[9] As noted, Peizer was charged the same week that the SEC’s new Rule 10b5-1 rules went into effect. The amended Rule 10b5-1 implements a mandatory “cooling-off period,” but because the rules were not in effect that the time Peizer created the plans, they did not apply.

[10] Indictment at 8-9, *United States of America v. Terren Scott Peizer*, 2023 WL 2369980 (C.D. Cal. Feb. 2023).

[11] *Id.* at 6-7.

[12] In public remarks following the indictment, Assistant Attorney General Kenneth Polite credited the work of DOJ analysts who searched 10b5-1 filings to identify “company insiders who greatly outperformed the market when

trading pursuant to 10b5-1 plans.” See Press Release, *Assistant Attorney General Kenneth A. Polite, Jr. Delivers Keynote at the ABA’s 38th Annual National Institute on White Collar Crime*, U.S. Dep’t of Justice (Mar. 3, 2023), <https://www.justice.gov/opa/speech/assistant-attorney-general-kenneth-polite-jr-delivers-keynote-aba-s-38th-annual-national>.

[13] Press Release, *Chairman of Publicly Traded Health Care Company Convicted of Insider Trading*, U.S. Dep’t of Justice (June 21, 2024), <https://www.justice.gov/opa/pr/chairman-publicly-traded-health-care-company-convicted-insider-trading>.

[14] *Id.*

8 Min Read

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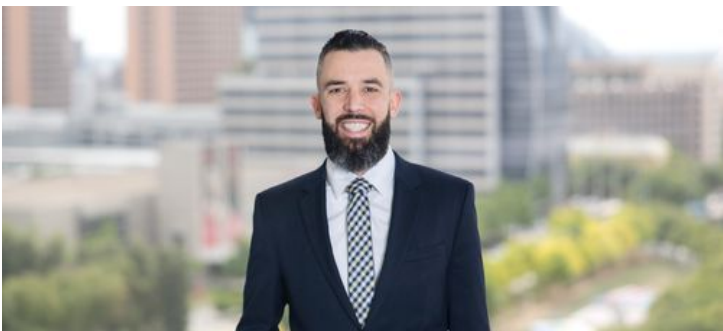
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