

# Corporate Executive Charged in First-of-Its Kind 10b5-1 Insider Trading Case

March 23, 2023

According to news releases issued by the U.S. Department of Justice and the Securities and Exchange Commission on March 1, 2023, the founder and CEO of publicly traded health care company Ontrak Health faces charges for an alleged insider trading scheme. The indictment alleges that Terren Peizer fraudulently used Rule 10b5-1 trading plans to trade Ontrak stock. The case is the first by the DOJ to allege criminal charges based exclusively on the misuse of Rule 10b5-1 trading plans. Peizer also has been charged with civil insider trading in a parallel action by the SEC. Under the classical theory of insider trading, insiders such as the officers, directors, and employees of a company are prohibited from trading based on material nonpublic information (MNPI) that they have obtained in connection with their positions in the company. This theory gives rise to a duty to disclose because a relationship of trust and confidence exists between the shareholders of a corporation and those insiders who have obtained confidential information because of their position with that corporation. The insider's duty mandates him or her to either disclose or abstain from trading until disclosure takes place. To protect insiders who routinely are exposed to MNPI, the SEC in 2000 adopted Rule 10b5-1. The rule allows corporate insiders to use "trading plans" to sell shares in advance at a *predetermined* time and share price. A Rule 10b5-1 plan thus permits a public company insider who may come into possession of MNPI to buy or sell shares on a scheduled basis without violating the insider trading prohibitions — so long as the plan satisfies certain conditions and is adopted at a time when the insider has no MNPI. For more than 20 years, Rule 10b5-1 has provided an affirmative defense for corporate insiders and companies to buy and sell company stock as long as they formed their trading plans in good faith — before becoming aware of MNPI. However, 2022 saw an increase in SEC enforcement actions for insider trading, pursuant to suspicious trades even though the trades occurred under Rule 10b5-1 trading plans. For example, in September 2022, the SEC brought an action against Cheetah Mobile Inc.'s CEO and former president for insider trading. The charges stemmed from trades made under Rule 10b5-1 trading plans, allegedly established only after the discovery of MNPI, which would later cause a drop in Cheetah Mobile's share price. The executives in that case settled with the SEC without admitting or denying its

findings and agreed to civil penalties and future trading restrictions. In response to regulators' perceived increase in the misuse of its liability protections, Rule 10b5-1 was recently amended. The amended rule became effective only three days before the SEC and DOJ brought action against Peizer. The amendments added a mandatory "cooling-off period" and codified various other restrictions including the requirement that the prearranged plan be entered into in good faith, without material nonpublic information, and not as part of an effort or scheme to evade the prohibitions of Rule 10b5-1. The March 1 DOJ indictment and SEC complaint describe a classical insider trading scheme alleging that Peizer sold approximately \$24 million of Ontrak stock between May and August 2021, while in possession of MNPI — i.e., the manifest possibility that its largest client would soon terminate its contract with Ontrak. In fact, at the time that Peizer established his prearranged Rule 10b5-1 trading plans, Ontrak's contract with its then-largest customer, Cigna, represented more than half of its revenues. According to the DOJ, Peizer certified to Ontrak's CFO, in seeking approval for the plan, that "this proposed dealing was not a result of access to, or receipt of Material Nonpublic Information as described in the Company's Insider Trading Policy." Yet, just six days after Peizer established these trading plans, Cigna terminated the contract, causing a stock price decrease of more than 44%. In establishing his Rule 10b5-1 plans, Peizer allegedly chose not to engage in the cooling-off period in contravention of the rule and against the advice of at least two stockbrokers. The DOJ alleges that Peizer's misuse of the Rule 10b5-1 trading plans allowed him to avoid more than \$12.7 million in losses. According to the SEC, the Peizer investigation arose from a data-driven initiative into executive trading pursuant to Rule 10b5-1 plans. While the SEC has been using analytics to combat insider trading for some years now, 2022 saw a flurry of insider trading actions generated using data analytics. This case is a signal of the SEC's ongoing usage of data analytics to uncover suspicious trading patterns. If convicted, Peizer could face a maximum penalty of 25 years imprisonment on the securities fraud scheme charge and 20 years imprisonment on each of the two insider trading charges. The SEC complaint also seeks severe penalties including permanent injunctive relief, disgorgement of ill-gotten gains with prejudgment interest, civil penalties, and an officer and director bar for Peizer.

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