JENNER&BLOCK

"3 Ways to Lower Insider Trading Risk After First 10b5-1 Case," *Law360*

Publications

August 5, 2024
By: Charles D. Riely, Brandon D. Fox

In an expert analysis article for *Law360*, Partners Charles Riely, Brandon Fox, and Jennifer Lee, and Associate Sara Cervantes discuss the first criminal charges in a case involving Rule 10b5-1 plans and recent significant changes to Rule 10b5-1, including mandatory cooling-off periods, restrictions on overlapping plans, and a good faith requirement.

The authors lay out three steps that can be taken to lower insider trading risk involving Rule 10b5-1 plans below.

In June, a jury in Los Angeles convicted Terren Peizer, the chairman of a publicly traded health company, Ontrak Inc., of insider trading after a nine-day trial. The U.S. Department of Justice's case against Peizer was the first case brought against an executive for abuse of so-called Rule 10b5-1 plans.

After the verdict, Principal Deputy Assistant Attorney General Nicole M. Argentieri, head of the Justice Department's Criminal Division, highlighted that there would be continued focus on such plans, stating, "This is the Justice Department's first insider trading prosecution based exclusively on the use of a trading plan, but it will not be our last. We will not let corporate executives who trade on inside information hide behind trading plans they established in bad faith."[1]

Originally enacted in 2000, Rule 10b5-1 provided insiders a limited safe harbor that was designed to allow executives to sell their companies' securities without risking insider trading liability.[2] It gave executives, for whom shares can make up a major part of their compensation, a pathway to ensure that they would have a way to liquidate a portion of their shares, even if they later came into possession of inside information.

To implement a Rule 10b5-1 plan, insiders are required to enact a written plan when they do not have access to material nonpublic information. At most companies, in-house counsel worked to vet whether insiders who entered into a plan did not have inside information.

Over time, though, the U.S. Securities and Exchange Commission and others became concerned that executives were abusing Rule 10b5-1 plans. As a result, the DOJ and SEC started to proactively search for possible misconduct involving Rule 10b5-1 plans.

The DOJ and SEC's plan to target abusive conduct led to the prosecution and conviction of Peizer. When they announced actions against Peizer in March 2022, both the DOJ and SEC highlighted that they used data analytics to seek out misconduct involving 10b5-1 plans.[3]

The authorities alleged that this data showed that Peizer sold Ontrack shares about one week before the company released news that its contract with a key customer was being terminated. Despite mounting a defense that highlighted that his trades had been vetted internally, Peizer was ultimately convicted.

The irony is that it appears that Peizer had been targeted for using what was originally intended to be a safe harbor. This article details the Peizer case, discusses recent amendments to Rule 10b5-1 designed to reduce alleged abuse and discusses how to reduce risk for corporate insiders conducting stock trades going forward.

The Peizer Case

In the charging documents, the government alleged a relatively straightforward insider trading scheme in which Peizer, as chairman of Ontrak, knew that the company's agreement with The Cigna Group, its key customer, was in peril.[4]

Peizer allegedly participated in dialogue with Ontrak's CEO and consultants to try and salvage the customer relationship, which represented over half of Ontrak's annual revenue. Through these conversations, Peizer received information as to how the attempts to repair the relationship were not going well.

At the same time Peizer was privy to this nonpublic information, he allegedly entered into 10b5-1 plans providing for the immediate sale of securities, and through those plans he sold $20 million worth of stocks. The government alleged that Peizer entered into one of these plans the same day that Peizer spoke to the Ontrak executive and learned that it was likely Ontrak would lose its key customer.

For each plan he entered into, Peizer began selling his shares immediately, ignoring warnings from multiple brokers that industry best practice was to implement a 30-day cooling-off period between entering into the 10b5-1 plan and selling his stocks.[5]

According to the DOJ's indictment, Peizer ignored the brokers' warnings that skipping such a cooling-off period, together with "rapid transaction executions subsequent to plan adoption," might "create an appearance of impropriety and call into question whether a plan adopter had material

nonpublic information at the time of plan adoption."[6]

After Peizer had sold his shares, Ontrak announced that Cigna had terminated its contract, resulting in the stock price falling more than 44%. Through his timely sales, the government alleges that Peizer avoided over $12.7 million in losses as a result of selling his stock early based on insider information.

Peizer's defense focused primarily on advice he received from Ontrak's chief financial officer and management team. According to Peizer's counsel, those advisors "told Mr. Peizer that there was no material nonpublic information at the time he entered in his trading plans," and that 10b5-1 plans were designed to protect him.[7]

His attorneys argued that Peizer was entitled to rely on these representations. Peizer's counsel also argued that Peizer wanted to sell the securities before their expiration, at which point the shares would become worthless, and that he had expressed his intention to do so well before there were any concerns about Oktrak's relationship with Cigna.

After deliberating for about six hours, the jury convicted Peizer, finding him guilty of all three counts of insider trading. This made Peizer — the founder, chairman and former CEO of Ontrak — the first person to ever be criminally charged based exclusively on his use of Rule 10b5-1 plans.

Peizer's defense counsel maintains his innocence and plans to challenge the verdict, stating, "We will not rest until it is overturned." The DOJ, meanwhile, has indicated that it will pursue more cases on this theory.

Changes to Rule 10b5-1

Since the time the DOJ and SEC brought the original action against Peizer, the SEC has enacted amended Rule 10b5-1.[8] In a December 2022 statement announcing the change, the SEC's chair said that the SEC had "heard from courts, commenters, and members of Congress that insiders have sought to benefit from the rule's liability protections while trading securities opportunistically on the basis of material nonpublic information" and noted that the "amendments will help fill those potential gaps."

The new rule includes three important changes.[9] First, Rule 10b5-1 plans now require a mandatory cooling-off period before any sales can be made by directors, officers or employees. This cooling period requires directors and officers to wait either (1) 90 days after the adoption of the plan, or (2) two days after the company files its Form 10-K or 10Q — whichever is longer.

This minimum cooling-off period is subject to a maximum of 120 days. Other public company employees are required to wait 30 days after implementing a plan before making a trade.

Second, the amendment places limitations on executives' ability to use multiple overlapping 10b5-1 plans, and the plans now require executives to provide a personal certification verifying that the executives are not aware of material nonpublic information and that they are not acting in scheme to evade the requirements of Rule 10b5-1 plan.

Third, the amended rule also provides that, in order to rely on the Rule 10b5-1(c)(1) as an affirmative defense, all persons entering into 10b5-1 plans must act in good faith with respect to those plans.

Measures to Prevent Abuse of Rule 10b5-1 Plans

Companies and individuals share an interest in working to avoid attention for potential insider trading issues. Even when the focus is solely on the conduct of an authority, insider trading investigations are costly and obtrusive for companies.

This is especially true where the DOJ or SEC takes steps to determine the detailed chronology related to the nonpublic events that led to the market moving announcement at the center of the investigation, as they did in the Peizer investigation.

The implementation of the new rules will go a long way toward preventing what the authorities had believed were abuses of Rule 10b5-1 plans. To further reduce risk, in-house teams can take the following steps:

1. Be aware of the perils of liquidations before bad news.

Insider trading lore often revolves around stories of people who tried to capitalize on material nonpublic information before any market moving announcement. Frequently, executives find themselves under scrutiny for selling securities right before bad news.

The temptation to make such trades is understandable given aversion to losses. But, from the perspective of authorities, these sales are no less problematic. In cases like the one against Peizer, the authorities conduct a profit calculation that is based on so-called avoided losses, meaning the difference between actual sale price and the sale price immediately after the news.

As such, in-house teams should be especially vigilant when the company has hit potential setbacks that have not been disclosed, appropriately scrutinize requests to implement or change Rule 10b5-1 plans, and highlight these risks to insiders.

2. Prepare to have determinations concerning material nonpublic information second-guessed.

As highlighted above, the government brought the case even though there was evidence that people other than Peizer had been involved in the determination that there was no material nonpublic information.

This is a reminder that the government will not hesitate to second-guess determinations of in-house teams on what constitutes material nonpublic information. This is especially true where the market moves in a defined way when the information at issue in the material nonpublic information analysis is released.

Thus, in house teams should document their analysis on why a certain piece of information constitutes or does not constitute inside information. Taking the time to memorialize counsels' view on why there was no material nonpublic information preventing implementing a plan should help a company demonstrate its good faith in the event of an investigation, and avoid a perception that a company is enabling insider trading or otherwise has a weak compliance function.

3. Use training and the required certifications to highlight the importance of good faith.

It is important that insiders understand the reality that the government has high expectations for the insider's conduct. Even when others are involved in vetting a trade, as was the case in Peizer, the government will scrutinize the conduct of the individuals.

This is an important fact to communicate to insiders, because there are instances where the executives themselves have more information than in-house teams concerning the corporate issue at the heart of material nonpublic information analysis.

To communicate the importance of the issue, in-house teams can conduct periodic trainings on insider trading. This training could also highlight to executives the rationale for the SEC's new explicit requirement of good faith.

In the end, Rule 10b5-1 can still serve as a safe harbor to executives. For example, if executives are able to plan ahead, such plans may enable them to provide an orderly process to sell their options before they expire. To get the full benefit of that safe harbor, though, it will be important for executives and companies to take steps to document that they are using Rule 10b-1 plans as intended and otherwise acting in good faith.

Footnotes

[1] https://www.justice.gov/opa/pr/chairman-publicly-traded-health-care-company-convicted-insider-trading.

[2] https://www.sec.gov/files/33-11138-fact-sheet.pdf.

[3] https://www.sec.gov/newsroom/press-releases/2023-42.

[4] https://www.sec.gov/files/litigation/complaints/2023/comp-pr2023-42.pdf.

[5] https://www.jenner.com/print/v2/content/50907/client-alert-doj-and-sec-used-data-analytics-to-target-insider-trading-with-10b5-1-plans.pdf.

[6] https://www.justice.gov/opa/press-release/file/1570711/dl.

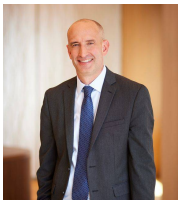
[7]

[7] https://www.law360.com/corporate/articles/1850416?nl_pk=fd813a49-0840-408f-b0e1-d21200e5c3e0&utm_source=newsletter&utm_medium=email&utm_campaign=corporate&utm_content=1850416&read_more=1&nlsidx=0&nlaidx=0.

[8] https://www.jenner.com/en/news-insights/publications/client-alert-sec-adopts-amendments-regarding-rule-10b5-1-insider-trading-plans-and-disclosures-for-equity-awards-and-gifts.

[9] https://www.jenner.com/en/news-insights/publications/client-alert-sec-adopts-amendments-regarding-rule-10b5-1-insider-trading-plans-and-disclosures-for-equity-awards-and-gifts.

Related Attorneys



Charles D. Riely
Partner
criely@jenner.com
+1 212 891 1686

Brandon D. Fox
Managing Partner, Los Angeles and Century City
bfox@jenner.com
+1 213 239 5101

Related Capabilities

Investigations, Compliance, and Defense

Related Locations

Century City

Los Angeles

New York

San Francisco

Stay Informed →