Takeaways From DOJ's Novel Insider Trading Indictment

By **Adam Fleisher, Tom Bednar and Matthew Solomon** (April 11, 2023)

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On March 1, the U.S. Department of Justice and the U.S. Securities and Exchange Commission announced insider trading charges against Terren Peizer, the CEO and chairman of Ontrak Inc., a California-based health care services company, for allegedly selling company securities while in possession of material, nonpublic information that one of the company's major customers was likely to cancel its contract.

When the news was disclosed, the company's stock dropped dramatically, and by trading ahead of the news, Peizer allegedly avoided more than $12.5 million in losses.

This is the first time the DOJ has brought criminal charges for insider trading based solely on an executive's use of a Rule 10b5-1 trading plan.

A Rule 10b5-1 trading plan provides an affirmative defense to insider trading through the use of a trading plan adopted when the trader is not in possession of material, nonpublic information, or MNPI, and allows the trader to make prescheduled trades pursuant to the plan so that executives, who may often be in possession of MNPI, may trade without violating the securities laws.

The SEC announced charges against Peizer and his personal investment vehicle, Acuitas Group Holdings LLC, in a parallel civil action the same week that SEC amendments to Rule 10b5-1 became effective.

This case highlights that both the DOJ and SEC will scrutinize trading by corporate executives to ensure that Rule 10b5-1 plans are set up in good faith.

This is not the first time the SEC has brought these types of charges — in September 2022, the SEC announced settled insider trading charges against executives of Cheetah Mobile Inc. for trading pursuant to Rule 10b5-1 plans set up while in possession of MNPI.

But the DOJ's position in U.S. v. Peizer is novel and appears somewhat aggressive given the heightened standard required to prove criminal intent.

Background

Customer Contracts

The DOJ and SEC make substantively similar factual allegations, which Peizer is contesting. The factual allegations are as follows:

- Peizer is the founder and longtime chair of the board of directors of Ontrak, a company that provides behavioral health services to members of insurance plans. He also served for many years as CEO, a post he resumed in August 2022.

- In late March 2021, Peizer first came to learn that the company's relationship with its then-largest customer, Cigna, was deteriorating and that the customer was considering terminating the contract.

- Earlier that same month, the company had announced the termination of a contract with another large customer, Aetna, and the stock price fell 46%. The company was allegedly relying on its contract with the remaining customer, Cigna, to replace the lost revenue from the departing customer.

- The SEC's complaint alleges that throughout April 2021, Peizer was "fixated" on saving the company's relationship with Cigna and was aware that the customer had raised concerns about the relationship and its ability to continue under the terms of the current contract.

Disclosure and Rule 10b5-1 Plan

The company disclosed in its May 6, 2021, Form 10-Q that its business depended on four large customers and "the loss of any one of such customers would have a material adverse effect on us."

- On May 10, 2021, Peizer allegedly set up a Rule 10b5-1 trading plan to sell shares of company stock through Acuitas and began sales the next day.

- According to the charging documents, the first broker Peizer approached to set up the plan told him that its policy required a 14-day cooling-off period.

- Peizer opted for another broker that did not require a cooling-off period — although that broker did inform him that the industry standard was 30 days — and sold shares from May 11, 2021, through July 20, 2021.

- The DOJ and SEC further allege that on May 18, 2021, Cigna informed the company of its intent to terminate the contract by the end of the year. Cigna also had dramatically reduced the number of its insurance plan participants that it referred to the company.

Continued Deterioration

From May to August 2021, the company's relationship with Cigna continued to deteriorate, and on Aug. 13, 2021, a company sales employee allegedly informed Peizer that he thought Cigna would terminate the contract.

- According to the government, on Aug. 13, 2021, Peizer entered into a second Rule 10b5-1 plan and sold additional company stock from Aug. 16, 2021, through Sept. 28, 2021.

- Prior to implementation of both plans, Peizer allegedly certified to the company's chief financial officer, in accordance with company policy, that he was not in possession of MNPI when he entered into the plans.

- Several days later, on Aug. 18, 2021, Cigna informed the company's CEO that it would terminate its contract effective Dec. 31, 2021, which Cigna confirmed in a certified letter the next day.

- On Aug. 19, 2021, the company filed a Form 8-K with the SEC announcing that Cigna had terminated the contract, and its stock price fell more than 44%.

- By selling company shares through his two Rule 10b5-1 plans, Peizer allegedly avoided losses of more than $12.5 million.

Rule 10b5-1 and Recent Amendments

In December 2022, the SEC adopted amendments to Rule 10b5-1 that became effective Feb. 27. The amendments impose a cooling-off period on Rule 10b5-1 plans of officers and directors lasting until the later of:

- 90 days following adoption or modification of the plan; or

- Two business days following disclosure of the issuer's financial results for the fiscal quarter in which the plan was adopted or modified, but not to exceed 120 days following plan adoption or modification.

The amendments also require an officer or director to include a good faith representation in a plan stating that they:

- Are not aware of MNPI about the issuer or its securities; and

- Are adopting the plan in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b-5.

Takeaways

This case provides several insights into the DOJ and SEC's focus on potential insider trading by corporate executives.

Exercise Caution When Entering a Plan

Now more than ever, in view of the new rule changes and the government's appetite to advance a novel criminal fraud charge, officers and directors should exercise caution when setting up Rule 10b5-1 plans during periods in which they could even arguably be in possession of MNPI.

This is particularly important given that the Rule 10b5-1 amendments now require officers and directors to certify that they were not aware of MNPI at the time of entering into the plan and are adopting the plan in good faith, which itself could form the basis of an independent allegation of wrongdoing.

Aggressive View of MNPI

In this litigation, the SEC and the DOJ have taken aggressive positions on what constitutes MNPI, particularly with respect to Peizer's May 2021 trading.

Although the government's allegations, if true, would likely establish that the loss of the Cigna contract would be material, the allegations do not clearly establish that the relationship actually had been lost when Peizer traded.

At the time he traded in May 2021, Peizer allegedly only knew that Cigna was considering terminating its contract, and the charging documents detail months of back-and-forth communications between the companies as Ontrak tried to salvage the relationship.

Only after Peizer had set up and started trading on his May trading plan did he learn that Cigna intended to terminate the relationship, which Ontrak responded to with continued sales efforts and fee concessions in an effort to save the contract.

Peizer can be expected to argue that he did not know at the time he traded that Cigna actually would terminate its contract, but rather that he thought Cigna was taking a hard negotiating line.

It was not until after Peizer traded that Cigna informed Ontrak that it was actually terminating the contract, which Ontrak disclosed the next day as required by securities regulations.

If the allegations are true, this argument may be more challenging as to the August trading, but by alleging that Peizer was in possession of MNPI all the way back in May, the government has taken an aggressive position with no clear limiting principle.

Few businesses have any guarantees that they will retain their customers forever, and it is

not at all clear how likely the loss of a key customer must be for the DOJ and the SEC to claim that it constitutes MNPI.

By contrast, DOJ insider trading cases typically involve defendants trading in advance of much more clear-cut triggering events.

For example, in July 2022, in U.S. v. Goel, prosecutors in the Southern District of New York charged an investment banker for allegedly tipping a friend about confidential merger and acquisition deals.[1]

In November 2022, in U.S. v. Rayapureddy, the DOJ indicted a pharmaceutical company executive for allegedly tipping a former colleague about a number of pending market-moving corporate announcements, such as FDA approvals and mergers.[2]

While those cases involved corporate events that were essentially decided but not yet announced, the case against Peizer may blur the line for corporate executives by focusing on the risk of a future event that arguably had not yet become a reality.

Corporate executives are frequently in possession of MNPI and seemingly will always be aware of numerous potential risks to their business.

More Criminal Rule 10b5-1 Cases Expected

Now that the DOJ has brought its first criminal case for executive insider trading using Rule 10b5-1 plans, we can expect to see more.

The allegedly unlawful trading was discovered through a data-driven initiative into executive trading, so the DOJ has the capability to spot more cases to go along with its likely newfound appetite to do so.

The timing of the announcement — the same week Rule 10b5-1 amendments became effective, and coinciding with the American Bar Association's National Institute on White Collar Crime — suggests it was meant to send a signal to corporate executives that they should exercise caution when entering into Rule 10b5-1 plans.

As noted, the DOJ's case is aggressive in that Peizer will be expected to argue that he acted in good faith by using Rule 10b5-1 plans, with the disclosure and visibility those entail, and therefore lacked the requisite criminal intent.

Peizer is also likely to argue that his good faith is demonstrated by the fact that he sold fewer than 650,000 shares at a time when he was alleged to own more than 9 million, meaning that he would have suffered far greater losses after the August 2021 disclosure than he avoided through his plan trading.

If Peizer can point to reasons for his trading unrelated to the alleged desire to avoid losses, such as a need for liquidity, and if he can point to a prior history of trading in company stock, he can further distinguish himself from the typical insider trading defendant, who often goes all in to trade on MNPI in a break from prior trading patterns.

Deviation from Rule 10b5-1 Signaling Criminal Intent

In typical insider trading cases, authorities often point to evidence that the traders sought to conceal their activity because they knew it was wrong, such as by trading in accounts

held in the names of others. In the charging documents, Peizer is not accused of doing anything to hide his trading.

Instead, the DOJ apparently will seek to prove Peizer's criminal intent in part by arguing he was in a rush to trade and shopped for a broker who would not force him to observe a cooling-off period.

Although a cooling-off period may have been industry best practice, as one of the brokers put it, it was not a legal requirement at the time of the trades, and the DOJ seems prepared to assert that his failure to do something he had no obligation to do demonstrates criminal intent.

The strength of the DOJ's argument will turn in large part on the quality of its evidence, including whether it has communications or other proof that Peizer's desire to trade on short notice was linked to the nature of the alleged MNPI.

Now that Rule 10b5-1 has been amended, including with cooling-off periods, the DOJ will be able to argue in future cases that any deviation from the stricter requirements of the rule demonstrates criminal intent.

Importance of an Insider Trading Policy

Finally, the SEC did not charge the company with any wrongdoing, and the complaint provides that the company had an insider trading policy that specifically prohibited trading or establishing a Rule 10b5-1 plan while in possession of MNPI.

This underscores the importance of such policies in protecting companies themselves from liability.

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[1] Press Release, DOJ, "U.S. Attorney Announces Charges In Four Separate Insider Trading Cases Against Nine Individuals, Including Former U.S. Congressman, Former FBI Agent Trainee, Tech Company Executives, And Former Investment Banker" (July 25, 2022), https://www.justice.gov/usao-sdny/pr/us-attorney-announces-charges-four-separate-insider-trading-cases-against-nine.

[2] Press Release, DOJ, "Chief Information Officer of Publicly Traded Pharmaceutical Company Charged for Insider Trading Scheme" (Nov. 10, 2022), https://www.justice.gov/opa/pr/chief-information-officer-publicly-traded-pharmaceutical-company-charged-insider-trading.