

## Investment Management

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### **United States Department of Justice Obtains First Insider Trading Conviction Based Exclusively on the Use of a Trading Plan and Signals More to Come**

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#### **Summary**

A federal jury in Los Angeles recently convicted the former CEO of Ontrak Inc. (a publicly traded company), Terren Peizer, for engaging in an insider trading scheme using Rule 10b5-1 trading plans. The insider trading conviction was DOJ's first based exclusively on the use of a trading plan. But a representative from DOJ warned that this would not be "[DOJ's] last" conviction involving a Rule 10b5-1 trading plan. Indeed, DOJ's announcement of the conviction said that DOJ has established a "data-driven initiative" specifically designed to identify executive abuses of 10b5-1 trading plans. The announcement also said that DOJ received "substantial assistance [from] FINRA's Criminal Prosecution Assistance Group," signaling that DOJ is using self-regulatory organizations (SROs) as an investigative tool to find more cases of insider trading. Considering this increased scrutiny, you should consult your company's insider trading policies and procedures and consider contacting an attorney before executing trades via a Rule 10b5-1 trading plan.

#### **What is a Rule 10b5-1 trading plan?**

The regulation establishing Rule 10b5-1 trading plans is found at 17 CFR Section 240.10b5-1 and is commonly referred to as "Rule 10b5-1." That rule creates an affirmative defense to the "material nonpublic information" element of an insider trading charge. Specifically, the purchase or sale of securities "is *not* on the basis of material nonpublic information"<sup>1</sup> if the trade complies with the requirements of subsection (c) of Rule 10b5-1.

Trades subject to the subsection (c) carveout are those that were made (A) before the person became aware of any material nonpublic information, and (B) pursuant to, and in full compliance with,<sup>2</sup> a binding contract, instruction, or written plan to purchase or sell securities that either (1) specifies the amount of securities, their price, and the date of the transaction; (2) includes "a written formula or algorithm, or computer program" to determine the amount of securities, their price, and the date of the transaction; or (3) prohibits the person from exercising any subsequent influence over how, when, or whether to effect the transaction.<sup>3</sup> Of course, one must enter such contract, instruction, or plan (and act) "in good faith" and not to evade insider trading prohibitions.

In addition, directors or officers of the issuer in whose shares they are transacting are subject to a so-called "cooling-off" period, defined as the later of 90 days after the contract, instruction, or plan is adopted or two days following the disclosure of the issuer's Form 10-Q for the fiscal quarter in which the contract, instruction, or plan was adopted. Directors or officers must also certify that they are not aware of any material nonpublic information about the security or issuers and are adopting the plan in good faith and not to avoid the insider trading prohibitions. Those who are not directors and officers are subject to a 30-day cooling-off period.

The Rule 10b5-1 carveout is also subject to other requirements and exceptions. For specific guidance on whether a plan complies with Rule 10b5-1, please reach out to your contact at Lowenstein or to the authors of this article.

## The trades at issue

DOJ's insider trading charge against Peizer arose out of trades Peizer made through two Rule 10b5-1 plans.<sup>4</sup> The first plan became effective eight days before one of Ontrak's biggest customers, Cigna, informally notified Ontrak of its intent to cancel the parties' \$90 million contract. Under the first plan, Peizer exercised stock warrants to acquire approximately 585,000 shares of Ontrak and then began selling those shares. Peizer's second plan came into effect six days before Ontrak publicly announced that Cigna terminated its contract with Ontrak. The second plan increased the daily number of Peizer's shares sold from 11,000 to 15,000 per day. DOJ claimed all the sales were made based on Peizer's knowledge of the material, nonpublic fact that Cigna was going to cancel its contract with Ontrak. The jury convicted Peizer of insider trading. Ultimately, DOJ's evidence that Peizer possessed material nonpublic information when he entered into his plans overcame the following evidence that Peizer offered:

- Peizer made the trades through Rule 10b5-1 plans.<sup>5</sup>
- Peizer had certified that his entrance into the plans was not based on material nonpublic information.<sup>6</sup>
- The stocks that Peizer sold through the plans were acquired through expiring warrants.<sup>7</sup>
- Ontrak's insider trading compliance officer concluded that Peizer did not possess material nonpublic information.<sup>8</sup>
- Peizer consulted with counsel prior to entering into the plans.<sup>9</sup>
- Ontrak made a series of public disclosures about the problems it was having with its major customers generally, but which did not specifically name Cigna.<sup>10</sup>

## Takeaways

Peizer's conviction was the first insider trading conviction based solely on trades made through a Rule 10b5-1 plan. The conviction serves as a reminder that executives must enter into such plans in good faith and without material nonpublic information. DOJ's announcement of the conviction also signals DOJ's heightened focus on trading through Rule 10B-5-1 plans. The announcement indicated that DOJ has established a "data-driven initiative" and is coordinating with SROs to target alleged executive abuses of 10b5-1 trading plans.

## Next steps

For further information, guidance, and clarity on the requirements for Rule 10b5-1 plans and insider trading compliance programs, please contact the authors or reach out directly to your regular Lowenstein Sandler contact.

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<sup>1</sup> Emphasis added.

<sup>2</sup> For example, one cannot change the amount, price, or timing of the transaction. Nor can one enter into or alter a corresponding or hedging transaction with respect to the same securities.

<sup>3</sup> Any person who exercises such subsequent influence must not be aware of the material nonpublic information when effecting the transaction.

<sup>4</sup> See *generally First Superseding Indictment*, Doc 105 at \*15-16, 2:23-cr-00089-DSF.

<sup>5</sup> *Id.* at \*2 ¶ 4.

<sup>6</sup> *Id.* at \*9 ¶ 11(e).

<sup>7</sup> See *Motion to Dismiss First Superseding Indictment*, Doc 113 at \*10, 2:23-cr-00089-DSF.

<sup>8</sup> *Motion in Limine No. 2*, Doc 146 at \*11, 2:23-cr-00089-DSF.

<sup>9</sup> *Id.*

<sup>10</sup> See *Motion to Dismiss First Superseding Indictment*, Doc 113 at \*15-16, 2:23-cr-00089-DSF.

# Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

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