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Meridian Client Update

SEC Civil Action and First-Ever DOJ Criminal Charges Related to Improper Use of Rule 10b5-1 Trading Plan

The Securities and Exchange Commission and Department of Justice brought parallel civil and criminal actions against an executive officer who allegedly engaged in insider trading using Rule 10b5-1 trading plans.

Key Takeaway

The SEC's and DOJ's complaints allege that the CEO of Ontrak, Inc. established and traded through two Rule 10b5-1 trading plans shortly after obtaining material nonpublic information ("MNPI") in violation of insider trading laws. These complaints highlight the critical importance for corporations to ensure that Rule 10b5-1 trading plans are properly established and administered through appropriate oversight, procedures and controls.

Background on Rule 10b5-1 Trading Plans

A Rule 10b5-1 trading plan allows corporate insiders to establish pre-arranged transactions in company securities. Generally, a properly structured trading plan under Rule 10b5-1 provides an insider with an affirmative defense to insider trading charges. However, the defense is unavailable *if* the executive is in possession of MNPI at the time he or she enters into the trading plan. Additionally, the defense does not protect the executive *if* the trading plan was not entered into in good faith or was entered into as part of an effort or scheme to evade insider trading rules.

Rule 10b5-1 trading plans have come under increased scrutiny over the past several years due to claims of perceived abuses. In response, the SEC late last year adopted rules that impose significant restrictions on the use of such trading plans. On the heels of these new rules, the DOJ for the first time has brought criminal charges for insider trading based exclusively on an executive's alleged misuse of a 10b5-1 trading plan. The DOJ investigation is part of a data-driven initiative led by the DOJ's fraud division to identify executive abuses of 10b5-1 trading plans.

DOJ and SEC Complaints Against Ontrak, Inc. CEO

The SEC and DOJ complaints allege Terren Peizer, the CEO and Chairman of the Board of Directors of Ontrak Inc., a publicly traded health care company, entered into two 10b5-1 trading plans while in possession of MNPI. Mr. Peizer established the first trading plan after he learned that the Ontrak's then largest customer had expressed serious reservations about continuing its contract with Ontrak. Mr Peizer established the second trading plan approximately one hour after Ontrak's chief negotiator for the contract confirmed to Peizer that the contract likely would be terminated.

Peizer allegedly did not engage in any "cooling-off" period – a time-frame between when he entered into the trading plans and when he sold stock – despite warnings from two brokers. Instead, Peizer allegedly began selling shares of Ontrak on the next trading day after adopting each plan. Peizer allegedly avoided

\$12.7 million in losses by executing the two trading plans before Ontrak announced that its customer had terminated the contract. Ontrak's stock price declined by more than 44% after the announcement.

The DOJ has charged Peizer with one count of engaging in a securities fraud scheme and two counts of securities fraud for insider trading. The basis of the allegations is that Mr. Peizer was in possession of MNPI at the time he established both trading plans and traded in company securities based on such MNPI. Therefore, Mr. Piezer's use of a pre-arranged trading plan did not shield him from allegations of insider trading.

If convicted, Mr. Piezer faces a maximum penalty of 25 years in prison on the securities fraud scheme charge and 20 years in prison on each of the insider trading charges. The SEC's complaint seeks permanent injunctive relief, disgorgement of ill-gotten gains with prejudgment interest, and civil penalties. The SEC also seeks to bar Peizer from serving as an officer and director of a public company.

Meridian comment. The SEC and DOJ actions against Peizer reflect federal enforcement priorities to curb Rule 10b5-1 trading plan abuses. Public company executives should be mindful of their obligations to comply with the SEC new rules on Rule 10b5-1 trading plans, which imposes new conditions and disclosure requirements on trading plans effective April 1, 2023 (refer to Meridian Client Update dated December 29, 2022). Among other things, the SEC's new rules require a cooling-off period, or mandatory delay, between trading plan adoption, modification or termination and initial trades.

Similarly, public companies should ensure controls and procedures are in place to avoid inadvertent or intentional circumstances under which an executive establishes a Rule 10b5-1 trading plan while in possession of MNPI.

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