Rule 10b5-1 gets an upgrade and drives scrutiny of Ontrak, SVB execs

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Rule 10b5-1 was originally established in 2000 by the Securities and Exchange Commission (SEC) to prevent corporate insiders from trading securities related to material nonpublic information (MNPI), such as quarterly earnings, mergers and acquisitions, or customer contract terminations. Because of insiders' privileged positions within companies, the SEC used 10b5-1 to clarify that trades made on the basis of MNPI would be considered insider trading, where "on the basis" meant simply that the trader was aware of the MNPI at the time they sold or purchased the securities. See 17 CFR § 240.10b5-1.

However, the rule also set forth an affirmative defense to allow corporate insiders to trade by creating predetermined trading plans, also known as 10b5-1 plans.

Individuals creating and trading under these plans would be able to avoid liability if they entered into the plan in good faith and met three requirements:

(1) The plan was entered into at a time when the corporate insider was not aware of any MNPI. The plan for trading securities could be in the form of a binding contract, instructions given to a third party (i.e., a broker), or a prearranged written plan.

(2) The plan either predetermined the specifics of the securities to be bought or sold (amount, price, frequency, date, etc.) or included a fixed algorithm to determine these specifics, without any subsequent influence exercised by the corporate insider.

(3) The trade that occurred was pursuant to the plan without change or influence from the corporate insider.

While not an actual requirement, a best practice that arose in conjunction with the 10b5-1 rule was to allow for "cooling off" periods, i.e., a span of elapsed time between the adoption of and the actual commencement of the trading plan. These self-imposed cooling off periods (which typically ran around 30 to 90 days) could help insulate executives from allegations of trading on the basis of MNPI.

Over roughly the last two decades since the rule's enactment, however, there have been calls for reform to the rules amidst evidence that corporate insiders have indeed been exploiting gaps in the regulations to trade on the basis of MNPI, while disingenuously claiming the protections granted by 10b5-1 plans. The SEC began the process of modernizing 10b5-1 in December 2021 with proposed rule amendments, which were formally adopted in December 2022 and went into effect February 2023.

Among other things, the new amendments have established mandatory cooling off periods and certain enhanced disclosures related to 10b5-1 plans.

These changes came on the heels of a multitude of studies investigating abuse under the old 10b5-1 rule. A Stanford study that examined over 20,000 10b5-1 plans between January 2016 and May 2020 found that the presence of certain "red flags" indicated when a 10b5-1 plan would perform better than its counterparts. These "red flags" included shorter cooling off periods; plans that covered only a single transaction; and plans that were adopted and executed right before a company announced its quarterly earnings.

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The study concluded that plans with these characteristics "systematically avoid[ed] losses and foreshadow[ed] considerable stock price declines over the subsequent six months." See "Gaming the System: Three "Red Flags" of Potential 10b5-1 Abuse," Stanford Closer Look Series. (Jan. 19, 2021).

Additionally, an investigation by the Wall Street Journal analyzed 75,000 prearranged stock sales by corporate insiders from 2016 through 2021. The analysis found that approximately one-fifth of these plans commenced within 60 days of their adoption and that these trades often preceded a downturn in share price, while the "insiders who sold within 60 days reaped $500 million more in profits than they would have if they sold three months later..." See "CEO Stock Sales Raise Questions About Insider Trading." Wall Street Journal. (June 29, 2022).

Two recent events have also highlighted the flaws inherent in the (now former) 10b5-1 rule.

On Feb. 24, 2023, the Department of Justice (DOJ) indicted Terren Peizer in what it called the "first insider trading prosecution based exclusively on use of rule 10b5-1 trading plans." See "CEO of Publicly Traded Health Care Company Charged for Insider Trading Scheme," Press Release 23-228. Justice.gov. (March 1, 2023). The SEC also filed a parallel complaint charging Peizer with insider trading for selling over $20 million in stock on the basis of MNPI. See *SEC v. Peizer et al*, No. 2:23-cv-01511 (C.D. Cal. filed March 1, 2023).

Peizer was the Executive Chairman and Chairman of the Board of Directors for Ontrak, Inc., a publicly traded, California-based health care company with shares listed on NASDAQ. The suits allege that in March 2021, Peizer became aware that Ontrak's then-biggest customer, Cigna, was considering terminating its contract with Ontrak.

As the relationship between Ontrak and Cigna deteriorated and re-negotiations of their contract were proving fruitless, Peizer established two 10b5-1 plans with a broker, one in May and one in August of 2021. Although the broker warned Peizer that observing at least a 30-day cooling off period was an industry best practice, Peizer opted to begin selling his shares immediately for both plans.

When Ontrak publicly announced the loss of its largest customer on August 19, its stock price fell almost 44%. The suits estimate that Peizer avoided somewhere between $12.5-$12.7 million in losses by dumping his shares prior to the announcement. Both the SEC and DOJ argue that Peizer clearly did not meet the requirements for the affirmative defense under 10b5-1 because he adopted and executed his trading plans while aware of MNPI.

In even more recent news, the SEC and the DOJ are investigating the failure of Silicon Valley Bank (SVB), which collapsed on March 10 after a run on the bank the previous day depleted it of $42 billion in deposits. As part of the investigative probes, the regulatory bodies are looking into securities sales made by SVB's top executives in the weeks leading up to the bank's crash.

According to filings, both the CEO and CFO of SVB sold significant numbers of shares through their 10b5-1 plans the week before the bank failed. The trades occurred just 30 days after the plans were adopted — a feature permissible under the old 10b5-1 rules but not under the new regulations.

Still, if the investigations reveal that the executives were aware of MNPI at the time they entered into their trading plans, they will not be able to claim the affirmative defense. See Justice Department, "SEC Investigating Silicon Valley Bank's Collapse," Wall Street Journal. (March 14, 2023).

As of Feb. 27, 2023, the SEC's new rule changes pertaining to 10b5-1 have officially been in effect. See "Insider Trading Arrangements and Related Disclosures," Release Nos. 33-11138; 34-96492; File No. S7-20-21. SEC.gov. Among other things, the amended rule alters the requirements for the affirmative defense, with the intention of preventing situations akin to that of the *Peizer* case (and potentially the SVB debacle).

Some of the major changes include:

- Required cooling off periods between the adoption and the commencement of trading plans (90 days for directors and officers and 30 days for other corporate insiders).
- A representation certifying that directors/officers entering into a plan are not aware of any MNPI and are adopting the plan in good faith, not as part of a "scheme."
- Limitations on multiple overlapping plans (so that individuals cannot selectively cancel plans to their advantage once they become aware of MNPI).
- Limiting of single-trade plans to just one per every 12-month period.
- The condition that all individuals utilizing 10b5-1 plans must do so in good faith.
- Enhanced disclosures by securities issuers regarding their policies and procedures on insider trading, as well as the use of 10b5-1 plans among the issuers' directors and officers.

These rule changes, in concert with the various pending cases and investigations, indicate that the SEC and DOJ are cracking down on the abuses committed under 10b5-1 plans. A likely sign that these types of enforcement actions and investigatory probes won't be the last.

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