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DOJ and SEC Charge Healthcare Executive With Trading on Negative Information Known at the Time of Adopting Rule 10b5-1 Trading Plans

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On March 1, 2023, the US Department of Justice (DOJ) and the US Securities and Exchange Commission (SEC) charged a healthcare executive with insider trading based on material, non-public negative information known to the executive at the time he adopted two Rule 10b5-1 trading plans. (See here and here.) In so doing, the DOJ and SEC alleged that the executive avoided more than $12.7 million in losses by selling shares in advance of the public release of the material information. The DOJ noted that this prosecution "represents the first time that the [DOJ] has brought criminal insider trading charges based exclusively on an executive's use of 10b5-1 trading plans." The actions came during the same week that the mandatory "cooling-off" periods imposed by the SEC pursuant to amendments to Rule 10b5-1 took effect. We previously issued guidance on the adoption of these limitations, available here.

IN DEPTH

The DOJ's and SEC's actions focus on allegations that the executive had learned that his company's relationship with its then-largest customer was increasingly tenuous at the time he adopted his first Rule 10b5-1 plan and sold nearly 600,000 shares worth more than $19.2 million. Even more compelling are the allegations that at the time the executive adopted a second plan, he learned that the same relationship with this significant customer was on the verge of being terminated. The SEC complaint is replete with quotations from emails detailing the customer's eventual dissociation with the executive's company.

The executive's sale of shares under the second plan included 45,000 shares for total proceeds of approximately $2 million that occurred within days before his company publicly announced that the customer terminated its contract with the executive's company. The actions allege that the Rule 10b5-1 plans adopted by the executive did not include a cooling-off period before trades under the plan could commence. The executive allegedly shopped for a broker who would set up the plan

without a cooling-off period since a cooling-off period was not required by the rules at the time. In this regard, SEC Chairman Gary Gensler's prior push for reforms was prescient, particularly with respect to the minimum 90-day cooling-off period for directors and officers adopted by the SEC. Chairman Gensler previously expressed concern that the lack of a cooling-off period is viewed by "some bad actors…as a loophole to participate in insider trading" and advocated that a mandatory cooling-off period would help alleviate insider trading concerns since the information would either become stale or publicly disclosed by the time the cooling-off period expired. The minimum 90-day cooling-off period, had it been in place at the time of the executive's adoption of his second plan, would have delayed the sale of his shares until after his company disclosed the termination of the material contract.

The absence of the affirmative defense of Rule 10b5-1 serves as an underpinning of the actions. According to Rule 10b5-1(c)(1)(ii), the affirmative defense is only available if the trading arrangement was entered into at a time when the insider was not aware of material, non-public information, in good faith and not as part of a plan or scheme to evade the prohibitions of the rule. Based on the facts alleged in the actions, the executive established the two trading plans while he was aware of material, non-public information about his company and did not adopt the plans in good faith but as part of a scheme to evade insider trading prohibitions.

KEY TAKEAWAY

A key takeaway from the above actions is that prosecutors will be vigilant in probing abuses of the purported shield against exposure from insider trading offered by Rule 10b5-1. To ensure the continued availability of the affirmative defense against allegations of insider trading, we recommend that companies review and update their insider trading policies to address the treatment of Rule 10b5-1 plans, particularly focusing on preclearance procedures designed to provide reasonable assurance that insiders who adopt Rule 10b5-1 plans do so at a time when they do not possess material, non-public information.

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