FDA Chemist Charged With Trading On Confidential Information Related To Drug Approvals

The Securities and Exchange Commission ("SEC") and the Department of Justice ("DOJ") announced on March 29, 2011, that civil and criminal proceedings are being brought against Cheng Yi Liang, a chemist employed by the Food and Drug Administration ("FDA"), for alleged insider trading. The complaints allege that Liang acquired confidential information about upcoming FDA drug approvals through his employment with the FDA, and that he traded on that information prior to public announcements concerning the status of drug reviews. According to the SEC, Liang traded on material nonpublic information related to 27 different FDA drug reviews, earning over $3.6 million in illicit profits. The SEC complaint asserts liability under SEC Rule 10b-5, promulgated pursuant to Section 10(b) of the Exchange Act, and Section 17(a) of the Securities Act. Criminal complaints filed against both Liang and his son, Andrew Liang, allege that the two conspired to commit securities fraud and wire fraud, and committed securities fraud and wire fraud. All of the complaints were filed in the U.S. District Court for the District of Maryland.

Liang was employed by the FDA's Center for Drug Evaluation and Research ("CDER"), which is responsible for reviewing applications for new drugs and either approving the drug or identifying problems in the application. CDER's review of drug applications is nonpublic. The FDA only discloses information related to the review of a drug when the drug is approved. According to the SEC's complaint, Liang had access to a computer database detailing the review process for each drug. He routinely accessed that database to obtain material nonpublic information immediately prior to trading in companies with applications pending. Liang purchased shares in those companies shortly before positive announcements, and shorted or sold shares before negative announcements.

The case against Liang reflects just how sophisticated the monitoring of suspicious securities transactions has become. Despite Liang's elaborate efforts to conceal his trading by using numerous accounts held by other individuals—some of whom reside in China and Japan—the government was able to trace all of the trades to Internet Protocol ("IP") addresses associated with Liang. The government also employed sophisticated techniques to monitor Liang's access to confidential information. For example, the criminal complaint against Liang describes how the Department of Health and Human Services, Office of the Inspector General, installed software on Liang's work computer to monitor and take "screen shots" of the information he viewed. Through such monitoring the government learned that Liang repeatedly accessed the application history for a particular drug immediately before trading in the shares of the company seeking approval.

The allegations against Liang are premised on the "misappropriation" theory of insider trading liability. The Supreme Court approved of this theory of liability in *United States v. O'Hagan*, 521 U.S. 642 (1997), holding that it is encompassed within the scope of Rule 10b-5. According to the Court, a defendant is liable for insider trading "when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." Thus, the Court held that an attorney could be liable under Rule 10b-5 for trading on material nonpublic information "in breach of a duty of trust and confidence" owed to his law firm and its client. Following the Court's decision in *O'Hagan*, the SEC codified a non-exhaustive list of circumstances in which a duty of trust and confidence is deemed to exist. Pursuant to Rule 10b5-2, such a duty exists whenever a person agrees to maintain information in confidence, whenever the parties have a pattern or practice of sharing information in confidence, and between immediate family members.

The SEC's complaint asserts that Liang owed a duty of trust and confidence to the FDA based on his explicit agreement to maintain information in confidence. Liang, like all FDA employees, received a copy of the "Standards of Ethical Conduct for Employees of HHS," which provides that employees shall not use confidential information acquired through their employment with the government for private financial gain. Liang certified that he understood those ethical obligations, and that he was personally responsible for complying with them. The SEC's complaint also alleges that Liang expressly agreed to comply with the FDA's policy prohibiting certain employees from holding a financial interest in companies that are "significantly regulated" by the FDA. At least 15 of the companies whose stock Liang traded in are listed by the FDA as being "significantly regulated."

In addition to Liang, the SEC's complaint names six other individuals—including Liang's wife, son, and mother—as relief defendants from whom disgorgement of illegally obtained funds is sought. According to the SEC, Liang established brokerage accounts in the names of those individuals in an effort to conceal his trading. Although the accounts were established under different names, all allegedly were controlled by Liang and accessed through IP addresses associated with Liang's personal internet accounts.

Interestingly, although the government apparently does not believe the relief defendants—apart from Andrew Liang, who is named in a criminal complaint—are sufficiently culpable to be charged with insider trading as tippees, it nevertheless seeks to recover from them any profits obtained as a result of Liang's unlawful conduct. In the case of some relief defendants for whom Liang controlled brokerage accounts, the SEC may be seeking only to recover the funds held in such accounts. But Liang's wife is named as a relief defendant despite not being named as the holder of any accounts Liang used for trades. The complaint suggests that the SEC seeks to recover illicit profits transferred to her from the accounts controlled by Liang.

The case against Liang highlights that the threat of exploitation of confidential corporate information comes not only from employees and financial professionals, but also from government officials exposed to such information. But, as the SEC emphasized in announcing the charges against Liang, "[t]he insider trading laws apply to employees of the federal government just as they do to Wall Street traders, corporate insiders, or hedge fund executives."

If you have any questions about this alert, please contact the Ropes & Gray attorney that usually advises you.