Health Economics Series
No. 2017-01

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March 28, 2017

JEL Codes: G11, G12, G13, G22, G23, G31, I18, K23, L65, O32
Keywords: Healthcare Finance, R&D Investments, Drug Development, FDA Approval, Idiosyncratic Risk, Risk Sharing, Hedging

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This Draft: 28 March 2017

Abstract

The high cost of capital for firms conducting medical research and development (R&D) has been partly attributed to the government risk facing investors in medical innovation. This risk slows down medical innovation because investors must be compensated for it. We propose new and simple financial instruments, Food and Drug Administration (FDA) hedges, to allow medical R&D investors to better share the pipeline risk associated with FDA approval with broader capital markets. Using historical FDA approval data, we discuss the pricing of FDA hedges and mechanisms under which they can be traded and estimate issuer returns from offering them. Using various unique data sources, we find that FDA approval risk has a low correlation across drug classes as well as with other assets and the overall market. We argue that this zero-beta property of scientific FDA risk could be a main source of gains from trade between issuers of FDA hedges looking for diversified investments and developers looking to offload the FDA approval risk. We offer proof of concept of the feasibility of trading this type of pipeline risk by examining related securities issued around mergers and acquisitions activity in the drug industry. Overall, our argument is that, by allowing better risk sharing between those investing in medical innovation and capital markets more generally, FDA hedges could ultimately spur medical innovation and improve the health of patients.

Keywords: Healthcare Finance, R&D Investments, Drug Development, FDA Approval, Idiosyncratic Risk, Risk sharing, Hedging

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· We would like to thank Frederico Belo, Mark Egan, Ralph Koijen, Colin Ward, and seminar participants at the Milken Institute for helpful comments and discussions. Any errors are our own.
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1. Introduction

Biopharmaceutical and medical device companies typically invest very large amounts of money in order to develop a treatment. For example, recent estimates suggest that the cost of developing a single new drug in the biopharmaceutical sector is $2.6 billion (DiMasi, Grabowski, & Hansen, 2014). However, this development process is also quite risky, not only due to the inherent scientific risk of developing new compounds for humans, but due to the risk involved in regulatory approval processes as well. Companies undertaking drug development in the U.S. are subject to the Food and Drug Administration's (FDA) approval process. As a result, given the high cost of development, failure due to either scientific or regulatory risk during any part of the FDA approval process can have a highly adverse impact on a company undertaking drug research. Significantly, this risk is borne only by those investing in the particular treatment under consideration by the FDA and cannot easily be shared by other investors in the general capital market. Some have argued more generally that government uncertainty ultimately slows down medical innovation and hurts future patients (Koijen, Philipson, & Uhlig, 2016).

To overcome this problem, Philipson (2015a,b) suggested financial instruments that allow those investing in medical innovation to better share scientific and policy-related development risks with outside investors. We call these types of instruments "FDA hedges." In this paper, we discuss the pricing of FDA hedges and mechanisms under which they can be traded and estimate issuer returns from offering them. In addition, we examine their risk characteristics and evaluate some unique evidence suggesting a proof of concept that these risks can be traded in capital markets.

If FDA hedges were exchange-traded, there would be direct risk-sharing benefits to developers who are able to lay off some development risks to other parts of capital markets. We therefore consider exchange-traded FDA binary options, which pay a fixed amount of money in the event of a trigger. Binary options are well-known and regularly traded on various exchanges.[6] In the case of an FDA binary option, the triggering event would be the failure of a specific drug in the FDA approval process. We provide details of how such a binary option would be priced and use historical data on drug development success rates by phase and drug type to calculate what the typical price of an FDA binary option would be for a drug in each therapeutic area.

While the insurance value of FDA hedges is clear to drug developers, the question remains of what the value will be to the issuer. In the absence of exchange-traded FDA hedges, we consider over-the-counter (OTC) issuers who might offer a portfolio of FDA contracts across developers. We simulate the return distribution of such portfolios by calibrating the data to historical FDA approval rates and estimate the risk/reward profiles that they imply and how they vary depending on different assumptions related to the underlying contracts.

A potential advantage of FDA hedges to issuers is that they only depend on pure scientific risk and do not aim to insure post-approval market risk of a compound. This makes assessing the risk of these options easier and reduces their correlation to traditional asset classes such as stocks and bonds. To investigate the correlation patterns of FDA options, we make use of a novel dataset of project-level time-series estimates of the likelihood of eventual FDA

[6] One difference between bond and FDA option markets in that options do not need to be rated. This facilitates market-making and trading relative to other types of structures.

approval for thousands of drugs and biologics. We use these data to construct a panel dataset of the implied prices and returns of FDA options if they were priced as predicted. We examine the nature of the risk of these synthetic FDA options and find that the risk is largely idiosyncratic and unrelated to systematic factors. Since the prices of these hedges are uncorrelated with the broader market or other factors, we argue that the risk associated with FDA hedges may appeal to investors and issuers interested in diversification.

Indeed, this zero-beta property could be the main source of gains from trade between issuers looking for diversified investments and developers looking to offload the approval risk. It may generally hold if the inherent scientific risk of molecules working in humans that drive the FDA approval risk were not correlated with other asset classes. A broader implication of our empirical findings is that the risk of R&D projects is, in general, idiosyncratic, since the value of FDA options is directly tied to the underlying R&D projects. To our knowledge, our paper is the first to provide project-level evidence of this point, which has been posited by a number of papers (e.g. Pastor and Veronesi (2009), Fernandez, Stein, and Lo (2012), Thakor and Lo (2015)).

Given these risk patterns, we examine how well issuers may be able to hedge the risk of offering FDA options. We consider the hedge of shorting the stock of the underlying firm whose drug is going through the FDA approval process and examine the implied value of such hedges given the prices of the synthetic FDA hedges and the underlying stocks.

Finally, we consider some evidence that FDA risk can be traded, and propose an indirect measure of the covariance of this type of risk with the broader market. In particular, we argue that several exchange-traded Contingent Valuation Rights (CVRs) issued in connection with pharmaceutical mergers implicitly offer evidence about the market acceptance and

covariance properties of FDA hedges. The fact that similar risks have been traded with great liquidity is useful evidence because it negates potential theoretical arguments that trade may be infeasible due to asymmetric information between developers and issuers. We consider the price and volume data for these CVRs and examine their risk. We show that the CVR contracts have no significant exposure to the overall market and other factors, which provides further evidence that FDA hedges would be attractive as zero-beta assets to issuers interested in diversification.

Our paper relates most closely to the emerging literature on measuring and analyzing the economic implications of policy uncertainty on economic activity (Davis (2015)). It also relates to an emerging literature on the interaction between real- and financial health care markets and the importance of government risk in slowing down medical innovation (Koijen, Philipson, & Uhlig, 2016; Thakor, Anaya, Zhang, Vilanilam, & Lo, 2016). We extend the existing literature by suggesting new financial innovations to try to limit the economic distortions imposed by policy uncertainty. Our work is also related to the literature that argues that alternative innovations are needed to mitigate underinvestment in medical innovation (Fernandez, Stein, & Lo, 2012; Thakor & Lo, 2017).

We start in Section 2 with a discussion of the pricing of FDA binary options and simulate their prices given historical FDA approval rates and the time they remain in each FDA phase. In Section 3, we examine the return distributions of pools of FDA hedges offered by potential over-the-counter issuers. In Section 4, we examine the risk characteristics of FDA hedges using a panel dataset of FDA approval probabilities and explore how this risk may be hedged by issuers. In Section 5, we provide the proof of concept of market acceptance of FDA hedges

through CVR contracts and analyze the correlation of the FDA risk with the broader market. We conclude in Section 6 with a summary of our findings and discuss future research.

2. FDA Binary Options

In this section, we consider exchange-traded FDA binary options and we derive and calibrate prices for these options in various therapeutic areas.

2.1 Binary FDA Options

Binary options are simple contracts that are currently traded on several exchanges. Using this concept as a template, we define an FDA binary option as a financial contract that is sold for a certain price, entitling the holder to be paid a pre-specified amount in the event that a certain drug fails a given phase of the FDA approval process (or the entire FDA process), and nothing in the event that it succeeds. An FDA option may be issued at the start of a given phase for the approval outcome of that phase. Without loss of generality, we assume it pays one dollar if the drug is not approved, and zero if it is.

Throughout, our pricing formulas will use actual probability estimates to compute expected values which are then discounted at the risk-free rate. The motivation for this approach is the fact that the risk associated with FDA approval is unlikely to be correlated with priced factors such as stock market returns or aggregate consumption. Therefore, the risk inherent in FDA option payoffs should be solely idiosyncratic, in which case the equilibrium price should be given by the expected discounted value of the payoff, discounted at the risk-free rate of return. We shall test and confirm this key property explicitly in Section 4.

Assuming that approval risk is purely idiosyncratic, the price of a binary FDA option is simply the present value of the probability of non-approval. The two uncertainties is the outcome of the approval decision itself as well as time when the approval decision is made. If the approval time is distributed according the frequency $f(t)$, and the probability of non-approval is p, the price at the start of the phase is given by:[7]

$$P = \int e^{-rt} pf(t)\, dt,$$

where r is the risk-free rate. Clearly, the sooner the decision is made, and the larger the chance of non-approval, the higher is the price.

2.2 Calibrated Prices of FDA Options

We estimate the prices for binary FDA options using recent evidence on FDA approval rates. *Table 1* below reports the average historical phase failure rates for different disease groups.[8]

[7] This assumes that there is no correlation between the time of the approval decision and the chance of non-approval. If there is a dependence, we would model the probability as a non-constant function $p(t)$ of time.
[8] These failure rates are from Thomas et al. (2016), based upon data from 2006-2015.

Table 1: Probabilities of Phase Failure by Disease Group

The table shows the average probability of failing each phase of the FDA drug development process, broken down by disease groups. These failure rates are from data from 2006-2015, and are taken from Thomas et. al. (2016).

	Probability of Failing Phase Conditional on Reaching It				
Disease Group	**Phase 1**	**Phase 2**	**Phase 3**	**NDA/BLA Approval Phase**	**Overall Probability of Failure**
Hematology	27%	43%	25%	16%	74%
Infectious Disease	31%	57%	27%	11%	81%
Ophthalmology	15%	55%	42%	23%	83%
Other Disease Groups	33%	60%	30%	12%	84%
Metabolic	39%	55%	29%	22%	85%
Gastroenterology	24%	64%	39%	8%	85%
Allergy	32%	68%	29%	6%	85%
Endocrine	41%	60%	35%	14%	87%
Respiratory	35%	71%	29%	5%	87%
Urology	43%	67%	29%	14%	89%
Autoimmune/immunology	34%	68%	38%	14%	89%
Neurology	41%	70%	43%	17%	92%
Cardiovascular	41%	76%	45%	16%	93%
Psychiatry	46%	76%	44%	12%	94%
Oncology	37%	75%	60%	18%	95%

Given these probabilities of failure, we calibrate the prices of the FDA binary options that pay off one million after a given phase if the drug fails that phase. We compute these prices for contracts structured as single-phase and multiple-phase options. For our calculations, we assume an annual risk-free interest rate of 1%.

In order to calibrate the timing of FDA decisions (f), we report in *Table 2* the average duration of each phase of the FDA approval process, taken from DiMasi and Grabowski (2007). The estimates for the phase lengths are different for biotech firms and pharma firms. We therefore use the average phase length for biotech and pharma firms in our calculations.

Table 2: FDA Approval Process Phase Lengths

This table shows the average length of each phase in the FDA approval process for the biotech and pharma sectors. Phase length is in months (years in parentheses). Estimates come from DiMasi and Grabowski (2007).

Average Length of time in months (years)					
Sector	**Phase 1**	**Phase 2**	**Phase 3**	**NDA/BLA Approval Phase**	**Total Length of Time**
Biotech	19.5 (1.6)	29.3 (2.4)	32.9 (2.7)	16.0 (1.3)	97.7 (8.1)
Pharma	12.3 (1.0)	26.0 (2.2)	33.8 (2.8)	18.2 (1.5)	90.3 (7.5)
Average	15.9 (1.3)	27.65 (2.3)	33.35 (2.8)	17.10 (1.4)	94.0 (7.8)

Combining the data on approval rates and the timing of FDA decisions, *Table 3* reports the implied prices (if purchased at the beginning of the indicated phase) for single-phase FDA binary options—options that pay off $1 million if there is failure in the indicated phase, and nothing otherwise. For the purpose of simplifying our calculations and more directly conveying the intuition behind the prices of these FDA options, we do not make distributional assumptions on f and treat the phase length as deterministic by using the average phase lengths from *Table 2* directly in discounting the payoffs of the options. In other words, the payoff of a single-phase FDA option in *Table 3* is given by the following formula:

$$P = e^{-rT} pX,$$

where X is the promised payoff of the option, p is the probability of non-approval, and T is the average phase length taken from *Table 2*. We use a risk-free interest rate of 1% in our calculations. In our simulation results later in the paper, we will make explicit distributional assumptions on f in our pricing.

Table 3: Price of Single-Phase FDA Binary Options

The table shows the prices of single-phase FDA binary options, which are issued at the start of each phase and pay off in the event of failure in that phase. Prices are in thousands of dollars.

Price of FDA Option that Pays $1m in a Given Phase ($ thousands)				
Disease Group	**Phase 1**	**Phase 2**	**Phase 3**	**NDA/BLA Approval**
Hematology	$263	$424	$243	$158
Infectious Disease	$301	$560	$266	$111
Ophthalmology	$150	$541	$406	$222
Other Disease Groups	$329	$589	$296	$114
Metabolic	$384	$536	$278	$219
Gastroenterology	$241	$628	$383	$76
Allergy	$320	$660	$278	$61
Endocrine	$406	$585	$340	$138
Respiratory	$342	$693	$281	$53
Urology	$423	$658	$278	$141
Autoimmune/immunology	$338	$667	$368	$138
Neurology	$404	$687	$414	$166
Cardiovascular	$406	$742	$433	$156
Psychiatry	$455	$746	$431	$119
Oncology	$367	$737	$583	$174

For example, in Hematology it would cost $243,000 to buy insurance for a $1 million insurance policy. The prices of the single-phase options correspond directly to the failure rates in each phase. In particular, the price to purchase an option at the beginning of phase 2 to insure against phase 2 failure is significantly higher than the price to purchase options at the beginning of the other phases. This reflects the fact that the failure rates in the development process for the various disease groups are the highest in phase 2. By contrast, the prices are much lower in the final FDA approval phase, where the failure rates are the lowest.

We next calculate the prices of multiple-phase FDA binary options, which pay off if there is failure in any subsequent phase of the FDA process. We discuss the pricing of these options

in the Appendix. *Table 4* reports the prices of these options if purchased at the beginning of a given phase, thereby providing insurance against failure in any of the remaining phases.[9]

Table 4: The Price of Multiple-Phase FDA Binary Options, for Payoff in each any Subsequent Phase

This table shows the prices of multiple-phase FDA binary options, which are issued at the start of each phase and pay off in the event of failure in any subsequent phase. Prices are in thousands of dollars.

Price of FDA Option that Pays $1m for Failure in Subsequent Phases ($ thousands)				
Disease Group	**Phase 1**	**Phase 2**	**Phase 3**	**NDA/BLA Approval**
Hematology	$714	$622	$358	$158
Infectious Disease	$784	$704	$344	$111
Ophthalmology	$797	$773	$531	$222
Other Disease Groups	$812	$734	$373	$114
Metabolic	$821	$726	$430	$219
Gastroenterology	$821	$778	$428	$76
Allergy	$828	$761	$321	$61
Endocrine	$843	$753	$428	$138
Respiratory	$847	$783	$318	$53
Urology	$862	$778	$376	$141
Autoimmune/immunology	$862	$807	$451	$138
Neurology	$890	$834	$507	$166
Cardiovascular	$907	$863	$517	$156
Psychiatry	$913	$860	$495	$119
Oncology	$921	$893	$650	$174

There are a few noteworthy patterns in the table. First, naturally the price to insure against *any* phase rises with non-approval rates. Second, the price of the multiple-phase option goes down as one advances to subsequent phases, since the conditional probability of the drug failing in the future goes down over time. However, the price that one would pay

[9] The details of how these prices are calculated are provided in the Appendix.

for the multiple-phase option only goes down slightly from phase 1 to phase 2, dropping much more significantly from phase 2 to phase 3, due to the high failure rates in phase 2. Since the failure rate is much higher in phase 2 relative to all other phases, most of the cost of the option in phases 1 and 2 will be to insure against failure in phase 2. Once failure in phase 2 has been averted, the price of the option drops significantly, since failure is relatively less likely going forward.

3. Risk/Reward Profile of FDA Hedges via OTC Issuers

The insurance value of FDA hedges is clear to drug developers, but the question remains of what the value will be to those holding the other side of the trade, i.e., the issuers. In this section, we therefore consider the value to over-the-counter (OTC) issuers that offer FDA contracts to investors. In order to do so, we simulate the risk and return distributions of pools of FDA hedges offered by issuers.

3.1 Risk/Reward Profile of Pools of FDA Options

We first empirically investigate the risk and return tradeoff of a pool of FDA option contracts. We examine a portfolio of N contracts, each linked to a particular FDA application. If the FDA rejects the application at any t prior to the contract maturity date T, the issuer pays the insurance buyer \$1. The precise timing of the FDA's approval decision f is unknown; we model the time until an FDA decision as an exponential distribution with rate parameter λ. When the FDA reaches a decision before the contract expires, we assume that the application i is rejected with probability p_i, and in our base calculations we assume that there is no correlation between the rejection probabilities of two different applications, p_i and p_j.

In other words, if each contract represents an FDA option based on the failure/success of a different drug, the probabilities of failure of each drug are independent. *A priori*, this assumption of no correlation across contracts will hold if a larger probability of one molecule working in humans does not increase the chance of another. This will likely be the case, except when molecules work within the same indication or mechanism of action, in which case a correlation may occur.[10] In Section 5, we provide evidence that seems to suggest that the assumption of no correlation between the contracts would hold in practice.

In our benchmark simulation results, we vary the number of contracts while fixing other parameters, in order to explore the potential diversification benefits of adding additional contracts to the issuer's portfolio. More specifically, we simulate portfolios of $N = 1$, $N = 10$, $N = 50$, and $N = 100$ contracts. We assume a contract maturity of $T = 5$ years, and $p_i = 30\%$. We choose a rate parameter of $\lambda = 1/3$ for the time until an FDA decision is made, in order to match a mean FDA decision time of three years. For robustness, in *Table A1* in the appendix, we provide the portfolio payout distribution characteristics for alternative choices for the size of the portfolio N, the rejection probability p_i, the correlation across draws ρ, and the arrival rate λ.

We examine the risk-return tradeoff that the issuer faces by calculating the Sharpe ratios of the portfolios. Consider an issuer who has issued N contracts priced at price $\$P$ with expected payouts $X_1, \ldots, X_N$. He invests $\$NP$ at the risk-free rate with the return:

$$R = \frac{[NP(1 + r) - \sum X_i]}{NP} = (1 + r) - \frac{\bar{X}}{P}$$

[10] A correlation would also occur if the FDA decision-making process across molecules is tied together due to regulatory behavior. In the Appendix, we explore how our results are affected when this assumption is relaxed and we allow for correlation between drug applications.

where $\bar{X} = (\frac{1}{N})\sum X_i$. The Sharpe ratio is calculated by dividing the markup by the standard deviation of the portfolio:

$$SR = \frac{\mathrm{E}[R] - r}{\sigma(R)} = \frac{P - \mathrm{E}[X]}{\sigma(\bar{X})}$$

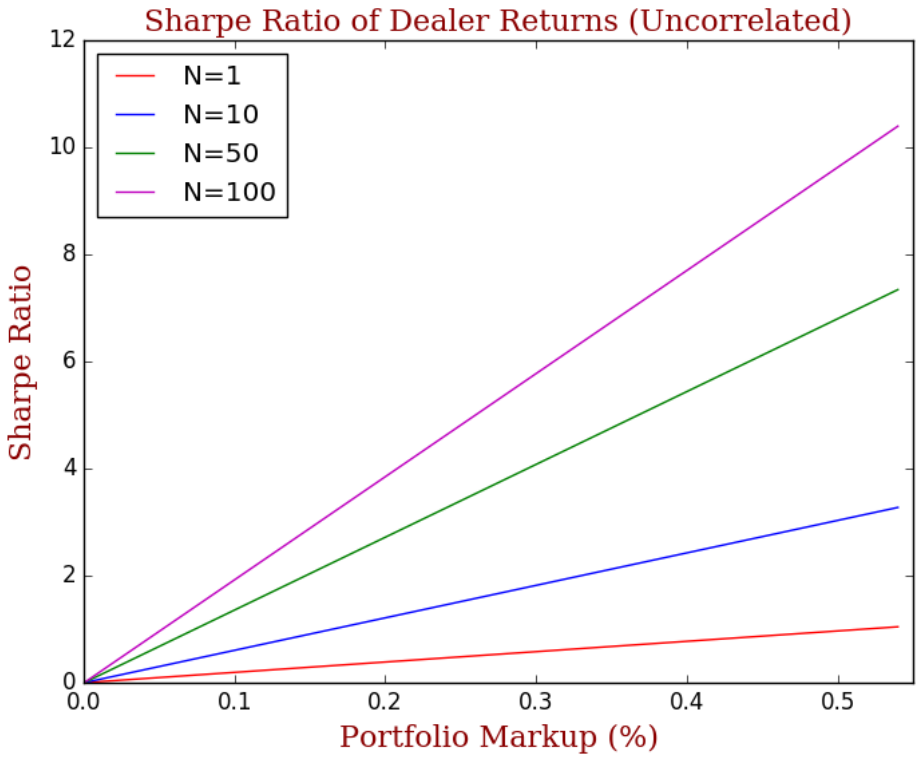
In order to calculate the Sharpe ratios in this setting, we assume contract fees of 2% of the expected payout of the portfolio, and a risk-free rate equivalent to the current five-year Treasury yield. We vary the portfolio markup, up to a maximum markup of 50% over expected portfolio return.

Figure 1 below presents the values of the Sharpe ratio for various values of N as a function of the portfolio markup. For example, for a portfolio of $N = 10$ contracts, the expected payout is estimated to be \$2.04, and the standard deviation of the portfolio is estimated to be 0.449. With a price given by a 35% markup over the expected payout, contract fees of 2%, and risk-free rate of 1.22%, the Sharpe ratio is calculated to be 1.5546. As the figure shows, the Sharpe ratio intuitively improves as the markup increases, but an increase in the number of contracts also consistently improves the Sharpe ratio. Thus, in the case of independent payoffs amongst the contracts, a larger number of contracts improve the issuer's returns. The underlying intuition is the same as that of portfolio diversification. With any portfolio of assets, introducing uncorrelated assets will reduce the volatility of the portfolio through diversification.[11]

Figure 1: Sharpe Ratios

[11] In Section A.2 of the Appendix, we provide the results for the Sharpe ratios assuming a correlation between the contracts.

This figure plots the Sharpe ratios of dealer returns as a function of the portfolio markup % for various values of *N*, the number of contracts offered in the pool. These calculations assume no correlation between the payouts of the contracts.



3.2 Risk-Return Distributions for Disease Groups

The results above show the risk-return tradeoff faced by issuers for general pools of FDA option contracts. It is informative to examine in more detail how this tradeoff varies depending on the particular disease group the FDA Options are based upon, since different disease groups can have very different success probabilities. *Table 5* provides the expected payout, variance, and Sharpe ratio for a portfolio of FDA options based on a drug project in each respective disease group (assuming $N = 50$ contracts in the pool), using the average probabilities of failure in Phase 3 for each group that were shown in *Table 1*.

Table 5: Expected Payouts of Portfolios of *N* = 50 Contracts

This table provides the simulation results for the mean portfolio payout and variance of payout for different disease groups, assuming $N = 50$ contracts.

Disease Group	Probability of Approval in Phase III	Expected Payout	Variance	Sharpe Ratio
Hematology	75%	$0.51	0.003	2.39
Infectious Disease	73%	0.50	0.003	2.22
Ophthalmology	58%	0.40	0.003	1.91
Other Disease Groups	70%	0.48	0.003	2.33
Metabolic	71%	0.64	0.004	2.99
Gastroenterology	61%	0.42	0.003	2.08
Allergy	71%	0.48	0.003	3.16
Endocrine	65%	0.44	0.003	2.19
Respiratory	71%	0.48	0.003	2.86
Urology	71%	0.48	0.003	2.36
Autoimmune/immunology	62%	0.42	0.003	2.11
Neurology	57%	0.39	0.003	1.98
Cardiovascular	55%	0.38	0.003	1.94
Psychiatry	56%	0.38	0.003	1.96
Oncology	40%	0.27	0.002	1.51

As can be seen from the table, the portfolio payouts vary between disease groups, depending on the probability of approval. In particular, the expected payouts by the issuer are higher if the probability of approval is lower (i.e. the probability that the option will pay out is higher), with the highest expected payout being in oncology. The variance of the payouts also increases as the probability of approval decreases. The Sharpe ratio for the issuer is also generally higher for disease groups with a higher probability of success. For example, issuers will find that issuing pools of FDA options are more attractive for drugs in Hematology than for drugs in Oncology, since drugs in Oncology are more likely to fail and therefore necessitate payouts by the issuer. Overall, the relatively high Sharpe ratios for all of the disease class reinforce the notion that FDA options may be attractive for issuers. For

example, the Sharpe ratio of the S&P 500 SPDR ETF over the past five years was 1.32, which is substantially lower than the Sharpe ratios presented above.

While the analysis above provides a view into the risk-return tradeoff faced by issuers of FDA options, the risk that these issuers are exposed to may be further reduced if issuers are able to hedge the risk of these options. We explore this issue further in the next section.

4. The Risk of FDA Options

In this section, we return to the issue of the nature of the risk of FDA hedges that issuers face. FDA hedges may have diversification appeal to investors and issuers if the returns to these securities are uncorrelated with the broader market or other factors, that is, if the risk of the hedge is idiosyncratic and not systematic. We explore whether this is empirically the case using a novel dataset of the approval process of drugs. Given this risk, we then examine the circumstances under which issuers may be able to hedge the risk of FDA options.

4.1 Dataset Description

We use a novel dataset on the drug approval process from the BioMedTracker Pharma Intelligence database. This database contains detailed drug trial information for pharma and biotech companies, including historical approval success rates, development milestone events, progress updates, and, most importantly, estimates of the likelihood of future FDA approval for individual drugs in development by each company. The database provides information on 11,587 drugs across 2,893 different companies. Although the dataset contains information on a handful of development events prior to 2000, it has full coverage from 2000 to 2016, and we therefore focus on this period for our analysis.

More specifically, we use the reported likelihood of future FDA approval provided by BioMedTracker in order to construct hypothetical prices for FDA options on a wide variety of drugs. For each drug and for a given date, BioMedTracker provides an estimate of the probability that the drug will ultimately be approved by the FDA. These probabilities are updated each time there is any announcement or other development-related event related to the particular drug.[12] In order to determine likelihood of approval (LOA) probabilities, BioMedTracker uses a combination of historical approval rates and analyst adjustments based on development events. More specifically, when a drug development project is initially started, BioMedTracker assigns an LOA probability to it based on the historical approval rates of drugs in the particular disease group that the drug belongs to. BioMedTracker then adjusts the LOA probability for the drug each time a development event occurs. If the event conveys no relevant information as to the eventual development success of the drug, then the LOA is unchanged. However, if the event contains relevant information (for example, trial results), then the LOA is adjusted either up or down by BioMedTracker depending on whether the information is positive or negative. The magnitude of the change in LOA is determined by analysts, who evaluate the information content of the event and assign a change size based upon pre-specified criteria.

As an example, according to BioMedTracker, an event in Phase III that "[m]et primary endpoint, but with marginal efficacy or no quantitative details; failed primary endpoint but strong potential in subgroup; some concern with efficacy vs. safety balance" will cause an increase in the LOA between 1% and 5%. In contrast, an event which posted "[m]odest Phase

[12] These include a wide variety of events broadly related to the company and drug under development, including trial results and progress updates, regulatory changes, litigation, and company news.

III results or positive results in non-standard subgroup; met primary endpoint but concerns over safety profile or study design" causes a decrease in the LOA between 1% and 5%. BioMedTracker provides evidence that its LOA estimates have predictive ability in terms of the eventual success/failure of the drug under development. More specifically, BioMedTracker notes that, from 2000-2015, 87% of drugs that were eventually approved had been classified as having an above-average (relative to the disease group) LOA. Similarly, 75% of the drugs that eventually moved from Phase II to Phase III from 2000-2015 had been assigned an above-average LOA. 80% of the drugs that were eventually suspended during the same period had a below-average LOA.

4.2 Risk Exposure of FDA Options

We use this time series data on probabilities of future approval (LOA) to empirically verify whether the risk of FDA options is idiosyncratic—and thus related only to scientific risk—or systematic and related to the broader market or other factors. Specifically, we construct a time-series of synthetic FDA multi-phase binary option prices using the LOA probabilities described in the previous section. At any given time t, we set the price $F_i(t)$ of the synthetic FDA option on a given drug project i which pays off $1 if the project fails as:

$$F_i(t) = \exp(-r_t(T - t))\left(1 - LOA_{i,t}\right)$$

where LOA_t is the LOA probability at time t, r_t is the risk-free interest rate at time t, and $T - t$ is the expected duration of the contract. For simplicity, we use the expected remaining development time of the drug as a proxy for the expected duration of the contract. We estimate this using the average development times for each phase from *Table 2*.[13] As before,

[13] For example, for a contract currently in Phase 3, we set $T - t = 4.204$ years.

we use actual probabilities to compute expectations and then discount the expected value by the risk-free rate because the risk is assumed to be purely idiosyncratic. We later provide evidence that justifies this assumption. Using this time-series of constructed prices, we compute the returns for these synthetic options for all drugs in the BioMedTracker database. We exclude LOA probabilities that are either 0 (the drug has been suspended) or 1 (the drug has been approved), since there is no future development uncertainty for the drug at those time points.

With these returns, we run regressions to estimate CAPM and Fama and French (1993) 3-factor betas over the period from 2000-2016, and examine whether these betas are significant. We run these regressions at the option level, as well as the portfolio level by combining the options into an equally-weighted portfolio. We first use daily data to estimate the betas. While using daily data has the potential advantage of increasing the precision of the beta point estimate, one possible concern with using daily data in this setting is that there is typically no information on each drug between event days, and thus the return for the FDA option will be zero for those days. While the lack of correlation due to few events may indeed be valuable to an issuer, for robustness we also provide the beta estimates using monthly data.

Table 6 below provides the results of these factor regressions. As can be seen from the table, the coefficients (betas) are insignificantly different from zero for the CAPM and Fama-French factors, using both daily and monthly data as well as running the regressions at both the option and portfolio levels. Moreover, the intercept (alpha) estimates are also insignificant. This provides evidence that the risk of FDA options is idiosyncratic and not related to systematic factors, and thus issuing them may be valuable for diversification

purposes. At a broader level, since the value of FDA options are directly tied to the underlying R&D projects, this provides evidence that is consistent with the risk of R&D projects being idiosyncratic, a point that has been posited by a number of papers (e.g. Pastor and Veronesi (2009)).

Table 6: Systematic Risk of FDA Options

This table gives the results of CAPM and Fama-French 3-factor regressions of the excess return of FDA options on the market, size, and value factors. Regressions are run at the option level or portfolio level using either daily or monthly return data from 2000 to 2016, as indicated. Robust standard errors are in parentheses, and are clustered by date when run at the option level. * indicates significance at the 10% level, ** indicates significance at the 5% level, and *** indicates significance at the 1% level.

Dependent Variable: $R_{i,t} - rf_t$

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
$(Mkt - rf)_t$	-0.0003	0.010	-0.0007	0.010	-0.059	-0.0003	-0.061	-0.029
	(0.0069)	(0.008)	(0.008)	(0.008)	(0.051)	(0.059)	(0.055)	(0.059)
SMB_t			-0.0003	0.015			0.074	0.130
			(0.012)	(0.025)			(0.062)	(0.091)
HML_t			0.002	-0.026			-0.077	-0.102
			(0.019)	(0.021)			(0.076)	(0.111)
Constant (α)	0.00003	0.00003	0.00003	0.00003	0.0008	0.0001	0.0007	0.0001
	(0.00008)	(0.0001)	(0.00008)	(0.0001)	(0.0018)	(0.0022)	(0.0018)	(0.0021)
Regression Level	Option	Portfolio	Option	Portfolio	Option	Portfolio	Option	Portfolio
Data	Daily	Daily	Daily	Daily	Monthly	Monthly	Monthly	Monthly
Obs	20,690,864	3,918	20,690,864	3,918	1,008,291	192	1,008,291	192
R^2	0.0000	0.0003	0.000	0.0012	0.0003	0.0000	0.0006	0.0460

4.3 A Direct Test of Idiosyncratic Risk

A potential concern with our factor regressions is that the lack of significance of the factors may be due to how we discount the payoffs of the options. In particular, if the risk of FDA approval is, in fact, not purely idiosyncratic, then our option pricing formula is incorrect. In such cases, we should be using the stochastic discount factor to compute option prices,

which amounts to discounting option payoffs using risk-neutral probabilities instead of actual probabilities to compute expectations. It is therefore possible that we do not find significant correlation with priced factors because we are not properly accounting for the pricing kernel.

To address this concern, we examine whether the market return has any significant predictive power on the success or failure of drugs. The idea behind this test is that any correlation between FDA option returns and factors such as the market should also manifest itself in whether drugs ultimately succeed or fail (and thus the FDA option expires worthless or pays off). Since the success or failure is simply a binary outcome, examining whether the market return is a factor in predicting this outcome is therefore a way to test the robustness of our results above without having to discount or rely on estimation of the pricing kernel. Specifically, we run a logit regression at the drug level where the dependent variable is a binary variable which equals to one if the drug succeeded (passed U.S. regulatory approval) on the given day and equals to zero if the drug failed (development suspension) on the given day. We run this success/failure variable on the contemporaneous market return, as well as the lagged and forward 20-, 60-, and 90-day cumulative market returns.

The results of these regressions are given below in *Table 7*. As can be seen from the table, the market return is insignificant at every horizon, indicating that the market return does not have predictive power on the success or failure outcomes of drugs. This provides further evidence that the risk of FDA approval is purely idiosyncratic.

Table 7: Drug Success/Failure Outcomes and the Market Return

This table gives the results of logit regressions of drug success or failure outcomes on market returns over different time periods. The dependent variable is equal to one if the drug succeeded on the given day and zero if the drug failed on that day. The market returns are cumulative returns between the indicated lagged or forward date and the day *t*. Regressions are run at the drug level using daily data from 2000 to 2016. Robust standard errors are in parentheses, and are clustered by date. * indicates

significance at the 10% level, ** indicates significance at the 5% level, and *** indicates significance at the 1% level.

Dependent Variable: Drug Success/Failure									
Market Return Window:	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Contemporaneous, *t*	-5.201								
	(4.272)								
Lagged, *t* – 1 to *t*		1.656							
		(3.182)							
Lagged, *t* – 20 to *t*			-0.214						
			(1.066)						
Lagged, *t* – 60 to *t*				-0.314					
				(0.717)					
Lagged, *t* – 90 to *t*					-0.626				
					(0.510)				
Forward, *t* to *t* + 1						-1.765			
						(3.002)			
Forward, *t* to *t* + 20							0.338		
							(1.235)		
Forward, *t* to *t* + 60								-0.127	
								(0.770)	
Forward, *t* to *t* + 90									-0.464
									(0.626)
Obs	9,678	9,678	9,678	9,678	9,678	9,676	9,628	9,553	9,474
Pseudo-R^2	0.0007	0.0001	0.0000	0.0001	0.0008	0.0002	0.0000	0.0000	0.0003

4.4 Hedging the Risk of FDA Options

In this section, we outline the extent to which an issuer of FDA risk can hedge by trading the stock of the underlying drug developer. The idea is that any significant movements in the value of the underlying project that an FDA option is based upon will also affect the stock price of the developing firm. To illustrate in a simple manner, consider a single FDA option that the issuer hedges by shorting the underlying firm. Let the value of the firm be *V* before

the approval decision is made, and V_1 if approved and V_0 if not approved. These approval-contingent values may be written as:

$$V_1 = X_1 + A$$
$$V_0 = X_0 + 0$$

where (X_0, X_1) are the value of the assets of the firm due to other factors than the drug under consideration, and A is the value of the drug under consideration conditional on approval (and thus equal to zero after non-approval). If X_0 and X_1 differ, there is a correlation between the approval decision and the value of the firms due to other factors. Before the approval decision, the value of the firm is:[14]

$$V = pV_1 + (1 - p)V_0$$

This equation implies that the price increase due to approval is larger when the probability of non-approval is larger. Likewise, price drops due to non-approval are smaller when the probability of non-approval is smaller.

Consider when the issuer of the FDA option shorts the underlying developer to hedge the FDA option. Consider the case when there is independence between the approval decision and the other factors driving firm value:, $X_1 = X_0$. The payoff of the issuer hedge after non-approval is then:

$$V - V_0 + P - 1$$

The first term is positive because the firm loses value and the second term is negative because the payout on the option is larger than the price charged for it. The payoff after approval is:

$$V - V_1 + P$$

[14] This ignores the possibility that the stochastic discount factor may differ across the two approval states.

The first term is negative because the firm gains value, and the second term is positive because of the revenue from selling the option comes without a payout.

As an illustrative example of how this issuer hedging may work in practice, consider the case of Poniard Pharmaceuticals, a firm with a lead drug known as Picoplatin under development, which is designed to tackle platinum resistance in chemotherapy. While Picoplatin was under development for a number of different indications, one of its main indications was small cell lung cancer. According to drug trial data from the BioMedTracker, Picoplatin for small cell lung cancer was in phase III of the FDA approval process as of late 2009, when it had a probability of eventual FDA approval of 35%. Suppose that an issuer had sold a multi-phase FDA binary option as of this point in time, which pays off in the event that the drug fails any subsequent stage of the development process or is not approved. Ignoring discounting for simplicity, the price of an FDA option with a $100 face value will be approximately $100 $\times$ (1 - 0.35) = $65.

Now, phase III trial data for Picoplatin for small cell lung cancer was released on 11/16/2009, and the results precipitated a drop in the likelihood of approval for the drug of 20%, from 35% to 15%. Since the drug was then less likely to be approved, this would in turn imply an increase in the price of the FDA option from $65 to $100 × (1 - 0.15) = $85, or a return of -30.7% from the perspective of the issuer's position. However, suppose that the issuer also had a short position in the underlying Poniard stock. In the 10 days surrounding the trial data release date, Poniard's stock posted a return of -70.8%, thus yielding a return of the short position of 70.8%.[15] As a result, on a one-for-one basis, the short position in the

[15] One could alternatively examine *abnormal* returns for the stock, i.e. returns that are attributed to the idiosyncratic movement of the stock (related to the stock's fundamentals) and not to the market or other

stock more than offsets the increased liability from the FDA option from the perspective of the issuer. A full hedge in this case would therefore involve a portfolio with a roughly 50% weight in the short stock and a 50% weight in risk-free assets.

More generally, we can use the time-series of approval probability data as well as stock return data in order to estimate the optimal number of underlying stocks needed for issuers to hedge the risk of FDA options. Let $F(t)$ be the price of the FDA option at date t that is given by our previous formulas. Denote the underlying stock price return by $S(t)$ and let n be the number of shares of the underlying stock that issuers hold in order to hedge the FDA option. The optimal number of shares that minimizes the overall variance of the issuer satisfies the well-known formula:

$$n^* = \left(\frac{\sigma_F}{\sigma_S}\right)\rho_{F,S}$$

where σ_F is the standard deviation of the FDA option price, σ_S is the standard deviation of the underlying stock price, and $\rho_{F,S}$ is the correlation between the prices of the FDA option and the underlying stock.

In order to more clearly illustrate how this hedging may work in practice, we obtain the approval probability data for the 30 companies in the BioMedTracker database with the lowest market capitalizations, since these companies are likely to have the fewest number of drugs or indications in development. We then obtain daily stock price data for these companies. We eliminate companies for which there are either no drug trial events or for

systematic factors. Doing so by calculating abnormal returns relative to the market factor yields an even larger drop of 74.8%. The very large drop may indicate that investors viewed the disappointing trial results as an indication that Picoplatin may fail some of its trials for other indications. As a result, in this case it is likely that the drug under consideration is correlated with the other assets of the company.

which there is an insufficient amount of drug trial or stock data. This leaves 19 companies for which we run our estimation results for.

Using the time-series data on changes in approval probabilities for different drugs to estimate the prices of multiple-phase FDA binary options written on those drugs, as well as stock price data for the underlying company stocks, below we estimate the parameters needed to determine the optimal hedge and the amount of variance reduction it implies for different drugs. The prices of the FDA options are calculated in the way described in Section 4.2. *Table 8* below presents the optimal hedge for various drugs. The first three columns correspond to the three parameters above, and the fourth column to the optimal number of shorted stocks. The fifth column calculates the reduction in variance enabled by optimal hedging.[16]

Table 8: Optimal Issuer Hedges for FDA Options on Different Drugs

This table gives, for various drugs, the standard deviation of the price of an FDA binary option σ_F based upon that drug, the standard deviation of the researching company's stock price σ_S, the

[16] Variances and correlations are calculated based on the sample period for which there is data for each drug. For simplicity, we assume a risk-free interest rate of 0 and we ignore the fact that the timing of the FDA approval decision is uncertain. Accounting for this uncertainty will require additional distributional assumptions.

correlation between these prices $\rho_{F,S}$, the optimal number of underlying stocks to purchase n^* in order to hedge the option risk, and the reduction in variance implied by the hedge.

Company Name	Drug	σ_F	σ_S	$\rho_{F,S}$	n^*	Variance Reduction
Acusphere Inc.	AI-128 for Asthma	14.13	26.78	-0.42	-0.22	17%
Acusphere Inc.	CEP-33222 for Breast Cancer	15.02	26.78	-0.37	-0.21	13%
Advanced Life Sciences Holdings	ALS-357 for Melanoma	2.96	38.63	-0.54	-0.04	10%
Advanced Life Sciences Holdings	Restanza for Respiratory Tract Infections	4.07	38.63	-0.93	-0.10	82%
ARYx Therapeutics	ATI-9242 for Schizophrenia	4.32	2.27	-0.74	-1.42	53%
ARYx Therapeutics	Naronapride for Chronic Idiopathic Constipation	12.29	2.27	-0.84	-4.53	70%
ARYx Therapeutics	Naronapride for Gastroesophageal Reflux Disease	12.23	2.27	-0.84	-4.51	69%
Bone Medical Ltd	Capsitonin for Osteoporosis / Osteopenia	2.75	84.04	-0.61	-0.02	4%
Boston Therapeutics	BTI-320 for Diabetes Mellitus, Type II	0.63	84.04	-0.24	0.00	0%
Taxus Cardium	Generx for Angina	0.72	84.04	-0.25	0.00	0%
diaDexus	AIDSVAX for HIV Prevention	1.70	0.34	0.00	-0.02	1%
diaDexus	PreviThrax for Anthrax Infection (Antibacterial)	10.01	20.40	-0.81	-0.40	65%
Entia Biosciences	ErgoD2 for Renal Disease / Renal Failure	5.10	20.40	-0.73	-0.18	53%
MultiCell Technologies	MCT-125 for Multiple Sclerosis (MS)	0.27	108.04	0.57	0.00	8%
Neuro-Hitech	Huperzine A for Alzheimer's Disease (AD)	9.48	108.04	-0.51	-0.04	23%
Neurobiological Technologies	Xerecept for Cerebral Edema	1.13	0.37	0.24	0.75	0%
Nuo Therapeutics	ALD-201 for Coronary Artery Disease	11.87	0.65	-0.76	-13.86	20%
Nuo Therapeutics	ALD-401 for Ischemic Stroke	10.21	2.74	-0.94	-3.51	88%
Nuo Therapeutics	ALD-451 for Brain Cancer	4.54	1.03	-0.69	-3.02	41%
Ore Pharmaceutical Holdings	ORE10002 for Inflammatory Disorders	1.03	1.10	0.13	0.13	1%
Ore Pharmaceutical Holdings	ORE1001 for Ulcerative Colitis (UC)	0.31	1.10	0.01	0.00	0%
OncoVista Innovative Therapies	OVI-237 for Breast Cancer	0.54	1.10	-0.10	-0.05	0%
OncoVista Innovative Therapies	OVI-237 for Gastric Cancer	7.01	0.37	-0.80	-15.10	64%
OncoVista Innovative Therapies	P-AAT for Acute Coronary Syndrome (ACS)	0.54	10.67	0.29	0.01	0%
OncoVista Innovative Therapies	P-AAT for Diabetes Mellitus, Type I	2.09	10.67	0.50	0.10	1%
Poniard Pharmaceuticals	Picoplatin for Colorectal Cancer (CRC)	7.39	0.55	-0.83	-11.07	60%
Poniard Pharmaceuticals	Picoplatin for Ovarian Cancer	8.50	0.55	-0.78	-11.96	45%
Poniard Pharmaceuticals	Picoplatin for Prostate Cancer	0.84	0.55	0.20	0.31	1%
Poniard Pharmaceuticals	Picoplatin for Small Cell Lung Cancer (SCLC)	10.46	1094.51	-0.71	-0.01	8%
Poniard Pharmaceuticals	Skeletal Targeted Radiotherapy for Breast Cancer	13.53	1094.51	-0.81	-0.01	11%
Poniard Pharmaceuticals	Skeletal Targeted Radiotherapy for Multiple Myeloma	13.30	1094.51	-0.35	0.00	5%
Stromacel	UMK-121 for Liver Failure / Cirrhosis	13.44	1094.51	-0.81	-0.01	11%
Proteo	Elafin for Coronary Artery Bypass Graft (CABG)	12.66	1094.51	-0.74	-0.01	12%
Rock Creek Pharmaceuticals	Anatabine citrate for Alzheimer's Disease (AD)	0.98	1094.51	0.78	0.00	12%
Rock Creek Pharmaceuticals	Anatabine citrate for Autoimmune Disorders	2.66	1094.51	0.52	0.00	6%
Rock Creek Pharmaceuticals	Anatabine citrate for Multiple Sclerosis (MS)	0.67	352.99	0.10	0.00	0%
Rock Creek Pharmaceuticals	Anatabine citrate for Traumatic Brain Injury (TBI)	2.19	2.39	-0.21	-0.19	1%
VioQuest Pharmaceuticals	Lenocta for Anti-Parasitic and Anti-Protozoal	0.87	2.39	-0.29	-0.11	2%
VioQuest Pharmaceuticals	Lenocta for Solid Tumors	0.77	2.39	-0.29	-0.09	2%
VioQuest Pharmaceuticals	VQD-002 for Multiple Myeloma (MM)	14.63	2.39	-0.31	-1.88	3%

VioQuest Pharmaceuticals	VQD-002 for Solid Tumors	0.59	41.71	0.10	0.00	1%

However, in a number of the other cases, the variance reduction is low—on the magnitude of 5% or less. There are a few reasons for this. One reason is that, for some drug indications, there are only a few dates with any news, and moreover there is no change in the probability of success for many of these dates. Because of this, the price of the FDA option will remain constant (ignoring discounting) for many dates, and the variance of the FDA option will be small because the price only changes when there is an event. This may lead to imprecise inputs into the optimal hedge calculation, and therefore a low variance reduction. The second reason is that certain drugs or indications make up a relatively small proportion of the value of a company's overall drug portfolio. For example, a company may test a certain compound for efficacy in treatment areas that are different from the drug's primary target, and expect a very low likelihood of success. The company's overall value will therefore relatively unaffected by clinical news about this indication. As a result, for these particular types of drugs or indications in development, the underlying stock of the company may not offer an ideal hedge against an FDA option issued on that drug. But as noted, for other drugs/indications which make up a substantial portion of the company's portfolio, the reduction in variance can be substantial for the issuer.

6. Proof of Concept via CVR Contracts

There are several potential theoretical arguments against the liquidity of FDA hedges. For example, one may argue that trading FDA hedges is infeasible due to asymmetric information between sellers and buyers, preventing the market from functioning.

Because of these potential objections, in this section we discuss an interesting traded instrument that provides a "proof of concept" of the liquidity in markets trading FDA risks. It is similar in many respects to FDA hedges, and the instrument is liquid and follows predicted pricing and volume patterns. This instrument is a particular version of an exchange traded contingent valuation rights (CVR) issued in mergers and acquisitions (M&A) deals, which pays investors pre-specified amounts when certain milestones are met as part of a M&A deal structure. As these milestones many times include FDA approval decisions, these traded contracts contain implicit FDA options.

However, one proviso should be kept in mind. Almost all current biopharma CVR's are "impure" with respect to FDA approval decisions, as they often include non-FDA related milestones in addition to FDA approvals. For example, these milestones may include sales or marketing targets. Due to these additional non-FDA milestones, the daily price movements of the CVR's may be driven by other factors not related to FDA approval. However, this also suggests that the CVR itself is not an adequate hedge against FDA approval risk, and thus there is need for more pure FDA hedges.

6.1 Contingent Valuation Rights with FDA Options

The contingent valuation right (CVR) is a shareholder right, often given to the selling shareholders during a merger or an acquisition, which gives the holder a cash payment if certain milestones are achieved. Just as listed companies can be traded on the NYSE or NASDAQ, CVRs can also be traded on these exchanges. An example of a CVR that was traded

on the NASDAQ is the CVR issued by Celgene on its acquisition of Abraxis. Celgene issued the Celgene CVR contract, with the holder of the contract entitled to milestone and sales payments. For the milestone payments, the holder of the CVR was entitled to a fixed sum of money ($250 million divided by the number of CVRs outstanding) upon FDA approval of the drug Abraxane for use in the treatment of non-small cell lung cancer by a certain date. In addition, the holder of the CVR was entitled to another sum of money ($400 million divided by the total number of outstanding CVR contracts) if the drug Abraxane achieved FDA approval for use in the treatment of pancreatic cancer. These milestone payments can be viewed as binary FDA options.

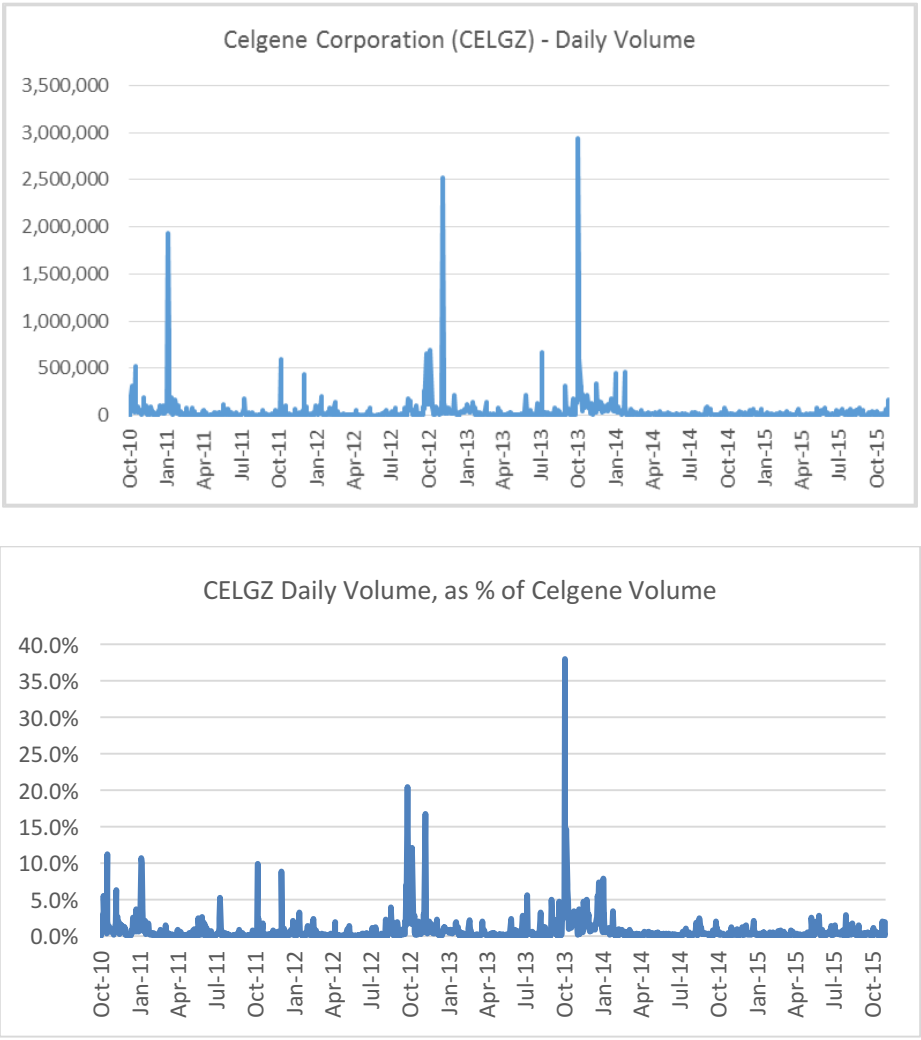
Figure 2 below shows the volume data of the Celgene CVR contract, while *Figure 3* shows the price data. In both figures, the top graphs show the volume and price of the CVR contract, while the bottom graphs show the volume and price normalized as a percentage of the underlying Celgene stock volume/price. Notice the jump in price around October 2012, when the FDA approved Abraxane for non-small cell lung cancer, and similarly in November, after a trial that showed promise for pancreatic cancer.

Even though the price of this CVR, by and large, has followed the FDA's decisions, it is still an "impure" FDA hedge. For example, it is an unsecured obligation of Celgene, and is junior to all other claims. It is also callable by Celgene, so there is optionality embedded into it. The CVR also has sales target payments in addition to milestone payments, which may in turn carry with it additional risk correlated to the overall market but not FDA risk. These additional features generate price movements that are orthogonal to any change in the

probability of FDA approval, and thus counteract the ability of the contract to act as a hedge against FDA risk.[17]

Figure 2: Celgene CVR Traded Volume

This figure plots the daily trading volume of the Celgene CVR contract, CELGZ, in number of shares (top figure) and as a percentage of the number of shares traded in the underlying Celgene stock (bottom figure).



[17] For this particular CVR, there were also mechanical price changes, such as a large price drop occurring in October 2013 due to the price going ex-dividend.

Figure 3: Celgene CVR Stock Price

This figure plots the stock price of the Celgene CVR contract, CELGZ, per share (top figure) and as a percentage of the stock price of the underlying Celgene stock (bottom figure).

An additional example is the CVR issued by AstraZeneca after its acquisition of Omthera Pharmaceuticals, Inc. in May 2013. This CVR ensured a payment for shareholders of $1.18 per share, provided that specific FDA approvals for investigational cholesterol drug Epanova

were received by July 31, 2014 and an exclusivity determination was received by September 30, 2014. An additional payment of $3.52 per share is to be paid if additional pre-specified FDA regulatory approvals are received by March 31, 2016.

6.2 Correlations and Betas for Contingent Valuation Rights

In Section 5.3, we showed that the risk in synthetic FDA hedges was idiosyncratic. We now explore whether this is also the case for CVR contracts that are actually traded. Below in *Table 9*, we report the CAPM and Fama-French betas of three CVR contracts—Celgene (CELGZ), Sanofi (GCVRZ), and Wright Medical Group (WMGIZ). We calculate these betas using both daily and monthly data, in order to ensure that the results are not due simply to a small time-series sample size. In general, the betas of the contracts are insignificant, even with features such as sales targets that may include some systematic risk.

For the Celgene CVR contract (Panel A), the market betas (columns (1) and (3)) are insignificant using both daily and monthly data. When incorporating the Fama-French factors, the market beta becomes negative and significant using daily data, but not when using monthly data. Thus there is weak evidence that the Celgene CVR carries some (negative) market risk. The betas of the Sanofi CVR contract (Panel B) are all insignificant using both daily and monthly data. Finally, the betas of the Wright Medical Group CVR contract (Panel C) are all insignificant when using daily data; when using monthly data, the HML beta becomes significant. However, there are only 37 months of data available for the WMGIZ contract, and thus the significant beta in column (4) may be an artifact of the small sample size. Overall, the regression results show that the betas of the CVR contracts are largely insignificant, which provides additional evidence that FDA hedges are also likely to

be uncorrelated with the market if traded in the market, and thus may have diversification appeal to investors.

Table 9: CVR Factor Regressions

This table provides CAPM and Fama-French 3-factor regressions of the excess return of CVR contracts on the market, size, and value factors. Regressions are run using either daily or monthly return data for the Celgene-Abraxane CVR contract (CELGZ) in Panel A, the Sanofi CVR contract (GCVRZ) in Panel B, and the Wright Medical Group CVR contract (WMGIZ) in Panel C. Standard errors are in parentheses. All regressions include a constant term (not reported). * indicates significance at the 10% level, ** indicates significance at the 5% level, and *** indicates significance at the 1% level.

Panel A: CELGZ Contract

Dependent Variable: $R_{i,t} - rf_t$

	(1)	(2)	(3)	(4)
$(Mkt - rf)_t$	-0.209	-0.282*	0.808	0.801
	(0.133)	(0.145)	(0.673)	(0.735)
SMB_t		0.350		-0.092
		(0.281)		(1.224)
HML_t		0.154		0.388
		(0.307)		(1.367)
Data	Daily	Daily	Monthly	Monthly
Obs	1,379	1,379	66	66
R^2	0.002	0.003	0.022	0.023

Panel B: GCVRZ Contract

Dependent Variable: $R_{i,t} - rf_t$

	(1)	(2)	(3)	(4)
$(Mkt - rf)_t$	-0.330	-0.270	-0.283	-0.568
	(0.220)	(0.238)	(0.820)	(0.888)
SMB_t		-0.345		1.068
		(0.468)		(1.534)
HML_t		0.020		1.582
		(0.508)		(1.677)
Data	Daily	Daily	Monthly	Monthly
Obs	1,257	1,257	61	61
R^2	0.002	0.002	0.002	0.026

Panel C: WMGIZ Contract

Dependent Variable: $R_{i,t} - rf_t$				
	(1)	(2)	(3)	(4)
$(Mkt - rf)_t$	0.757	0.771	0.332	0.386
	(0.786)	(0.798)	(1.720)	(1.673)
SMB_t		-0.205		0.206
		(1.400)		(2.305)
HML_t		-0.186		6.723**
		(1.591)		(2.800)
Data	Daily	Daily	Monthly	Monthly
Obs	774	774	37	37
R^2	0.001	0.001	0.001	0.150

While the betas of the CVR contracts generally are not significantly different from zero, it is possible that some other type of risk is common to all these contracts. For example, there may be a systematic factor other than the market or Fama-French factors that affect the prices and returns of these contracts. One possibility is regulatory risk, affecting multiple drugs simultaneously (Koijen, Philipson, & Uhlig, 2016). Another possibility is that CVR contracts may be based on companies working in similar therapeutic areas, in which case the success of a drug specific to one company may be correlated with the success of a similar drug under development by another company.

To explore these possibilities, we examine the correlations of the daily and monthly returns for the CVR contracts. This correlation matrix is shown in *Table 10* below. The table shows that the correlations between the different contracts are very low and insignificantly different from zero, suggesting that there is no other common factor is that driving the returns of the CVRs. This provides further evidence that the risk embedded in FDA hedges is likely idiosyncratic, related to the success of the underlying drugs.

Table 10: Correlation matrix of CVR Returns

This table provides correlations between daily (Panel A) and monthly (Panel B) stock returns for the Celgene-Abraxane CVR contract (CELGZ), the Wright Medical Group CVR contract (WMGIZ), and the Sanofi CVR contract (GCVRZ). * indicates significance at the 10% level, ** indicates significance at the 5% level, and *** indicates significance at the 1% level.

Panel A: Daily Returns

	CELGZ	GCVRZ	Observations
CELGZ			1,379
GCVRZ	0.015		1,257
WMGIZ	0.009	0.001	774

Panel B: Monthly Returns

	CELGZ	GCVRZ	Observations
CELGZ			66
GCVRZ	-0.134		61
WMGIZ	-0.009	0.107	37

The insignificant betas and low correlation between contracts also underscore an important point related to the appeal of FDA hedges to OTC issuers. In particular, the Sharpe ratios to OTC issuers of pools of FDA hedges are substantially lower when the payoffs of the contracts are correlated. These results provide evidence that the assumption of no correlation between the payoffs of contracts may be more applicable, and that the higher Sharpe ratios presented in Section 3.1 with uncorrelated contracts applies.

One alternate explanation for the low betas and covariances of these CVR contracts is that they have a low trading volume, and therefore they have zero covariance with anything, since the contracts are not traded. However, even if low trading volume is the cause of the low correlation, the correlation is still low which is valuable to issuers. That reasoning aside, *Table 11* below gives the yearly summary statistics for the trading volume of the three CVR contracts discussed above.

Table 11: CVR Daily Trading Volume Summary Statistics

This table provides summary statistics for the daily trading volume for the Celgene-Abraxane CVR contract (CELGZ), the Wright Medical Group CVR contract (WMGIZ), and the Sanofi CVR contract (GCVRZ). All numbers represent the number of shares traded.

Panel A: Celgene CVR (CELGZ)

	Mean	Std. Dev.	p25	Median	p75
2015	17,012.6	20,114.9	3,875	10,950	20,850
2014	21,906.0	44,141.3	5,800	11,600	23,600
2013	67,625.4	216,749.9	4,225	18,000	68,075
2012	52,040.8	182,213.2	3,050	14,900	38,750
2011	35,493.7	140,553.7	2,325	8,950	28,000
2010	70,990.2	85,968.6	22,650	49,500	94,500

Panel B: Sanofi CVR (GCVRZ)

	Mean	Std. Dev.	p25	Median	p75
2015	664,032.1	2,055,218.4	110,900	235,250	516,275
2014	850,199.2	1,699,940.0	147,225	348,950	777,450
2013	1,177,137.3	4,337,753.0	74,150	237,050	624,700
2012	609,218.0	1,003,581.5	109,400	207,600	588,150
2011	2,321,230.4	4,181,025.7	529,300	1,054,800	2,424,800

Panel C: Wright Medical Group CVR (WMGIZ)

	Mean	Std. Dev.	p25	Median	p75
2015	18,037.3	47,647.4	1,100	4,300	17,700
2014	43,925.8	91,923.1	6,900	17,400	47,450
2013	108,033.8	335,577.3	10,900	33,800	88,625

As can be seen from the table, the mean trading volume each year is significant for all of the contracts. While the volume for CELGZ and WMGIZ are somewhat similar, the trading volume each year for GCVRZ is large, and significantly higher than the other two. This table shows that there is significant trading volume for the CVR contracts, and thus the correlations and betas shown above are likely not due to illiquidity of the contracts.

7. Conclusion

The high cost of capital for firms conducting medical R&D has been partly attributed to the risk of the regulatory approval process that investors must face in medical innovation (Koijen, Philipson, & Uhlig, 2016). We proposed new financial instruments, FDA hedges, to allow medical R&D investors to better share the pipeline risk associated with the FDA approval process with broader capital markets. Using FDA approval data, we discussed pricing of FDA hedges and mechanisms under which they can be traded and simulated their risk and return distributions. We then used a novel panel data set of FDA approval probabilities to empirically explore the nature of the risk inherent in these contracts and showed how issuers may effectively hedge this risk. We found evidence that the risk associated with offering FDA hedges faced by an issuer was largely uncorrelated with other asset classes. Finally, we offered proof of concept that this type of risk can be traded by examining related securities issued around M&A activity in the drug industry.

We believe the type of analysis conducted in this paper is a first step in demonstrating that FDA hedges would enable better risk sharing between those investing in medical innovation and capital markets more generally. By allowing such risk sharing, FDA hedges would ultimately help accelerate the development of new medical products and improve the health of countless future patients. Therefore, financial innovations like these may better spur medical innovation.

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Appendix A: Additional Results

A.1 Multiple-Phase Options

An FDA option may be structured to cover multiple phases of approval, so that it pays off if there is failure in any subsequent phase of the drug development process. As a simple example, consider the case where there are four discrete dates in the approval process: $t = 1$ (phase 1), $t = 2$ (phase 2), $t = 3$ (phase 3), and $t = 4$ (final FDA approval of a New Drug Application or Biologics License Application). In order to demonstrate the concept more simply, in the following we assume that each phase is the same length of time, thus removing the uncertainty related to the time when the approval decision is made. As before, we use actual probabilities to compute expected values which are then discounted at the risk-free rate due to the idiosyncratic nature of approval risk. If p_t is the probability that the FDA will approve the drug at time t, then the price of the FDA option at $t = 3$ will be:

$$P_3 = \exp(-rt)\left[(1 - p_4)X\right]$$

The option will be priced recursively at each stage. Therefore, the FDA option which has the payoff indicated by *Figure A-1* below, would be priced at the start $t = 0$ by:

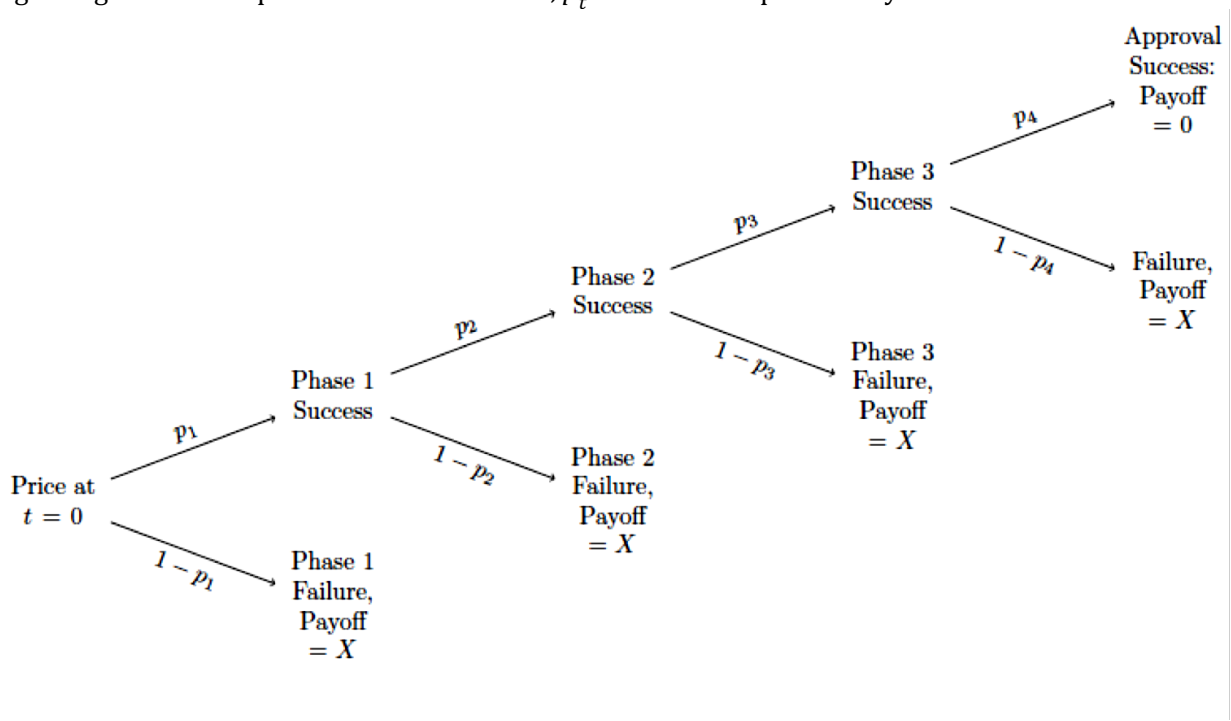
$$P_0 = \exp(-4r)\left[p_1 p_2 p_3 (1 - p_4)X\right] + \exp(-3r)\left[p_1 p_2 (1 - p_3)X\right] + \exp(-2r)\left[p_1 (1 - p_2)X\right] + \exp(-r)\left[(1 - p_1)X\right]$$

To give an example, suppose that a binary option is structured so that it pays off $1,000 whenever the drug fails the approval process. Assume that the riskless interest rate is 1% per year, and that the probability of success for each phase of the development process is the same at 60%. Then purchasing this contract at $t = 3$ will cost $\exp(-0.01)[(1 - 0.60)\times 1000] = \$396.02$. Purchasing this contract at $t = 0$, however, will cost

$854.10. The high price relative to payoff reflects the fact that the contract offers full insurance: it will pay off if the drug development fails during any phase. Alternatively, one could purchase a contract offering insurance against failure in a specific phase, which would thus be valued at a lower price. This latter contract may be valuable if the risks of failure for a particular type of drug are concentrated in a specific phase. For example, the probability of success for respiratory drugs is significantly lower in phase 2 than it is in any of the other phases of the drug development process (see Thomas et al. (2016)). As a result, a binary option that pays off in the event of failure only in phase 2 may be particularly valuable to a company or an investor that is funding such a drug.

Figure A1: Payoff Diagram of a FDA Binary Option at the Start of Multiple Phases

This figure shows the payoff structure of a multiple-phase FDA binary option, when viewed at the beginning of the R&D process. In each branch, p_t indicates the probability of success.



A.2 Correlated Payoff Calculations and Results

In the analysis in Section 3 of the paper, the payoffs of the individual contracts in the pool are assumed to be independent. However, as discussed previously, it is possible that there is some correlation between the outcomes of the various contracts. In this section, we thus examine the results when relaxing the assumption of independent outcomes, and introduce a correlation of 0.3 between the payouts of the N contracts.

To explore this, we simulate the $X_1,\ldots,X_{50}$ contracts as Bernoulli random variables, and we allow for pairwise dependence between all contracts by associating each contract with a random variable Z_i that is normally distributed with mean 0 and variance 1. Z_i is associated with X_i as follows:

$$X_i = \begin{cases} 1 & \text{if } Z_i < \alpha_i \\ 0 & \text{if } Z_i \geq \alpha_i \end{cases}$$

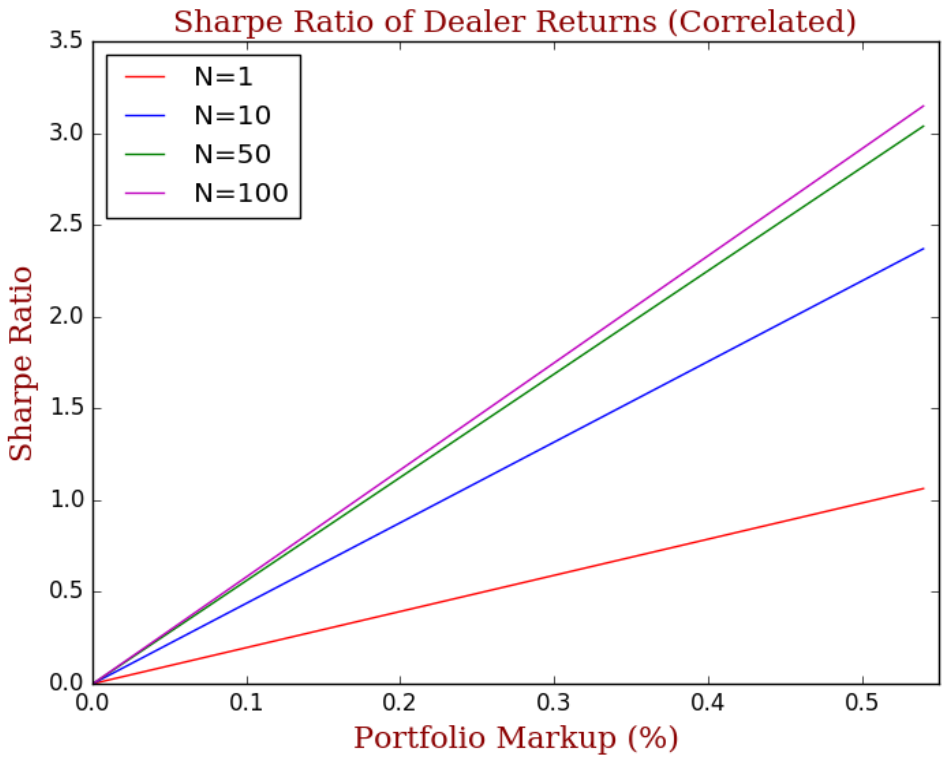
Here, letting $Z_1,\ldots,Z_{50}$ be distributed according to a multivariate standard normal distribution with covariance matrix $\sum$ allows the pairwise correlation among $X_1,\ldots,X_{50}$ to be captured by the pairwise correlation among the Z_i's.

Figure A2 presents the Sharpe ratios for various values of N as a function of the portfolio markup with this correlation assumption. In this case, the Sharpe ratios are lower than the case with independent contracts. Moreover, the improvement in the Sharpe ratio is not monotonic as the number of contracts increase. In particular, while there is a large improvement in the Sharpe ratio from $N = 1$ to $N = 10$, the Sharpe ratios are very similar between $N = 50$ and $N = 100$. The correlation between the contracts reduces the Sharpe ratio because the correlation increases the standard deviation of the portfolio. Since the standard deviation enters into the denominator of the Sharpe ratio, a larger correlation will cause the Sharpe ratio to decrease. In this case, introducing correlated assets *reduces* the diversification of the issuer's portfolio, thus reducing the Sharpe ratio. This analysis shows

that the benefit to the issuer of holding contracts critically depends on both the number of contracts, and on the correlation of the payouts between the contracts. However, as we previously discussed, a substantial correlation between contracts is not likely to hold in practice.

Figure A2: Sharpe Ratios, Equicorrelated Contracts

This figure plots the Sharpe ratios of dealer returns as a function of the portfolio markup % for various values of *N*, the number of contracts offered in the pool. These calculations assume a correlation of 30% between the payouts of the contracts.



A.3 Portfolio Payoff Simulation Results Across Varied Parameters

Table A1 below provides the portfolio payout mean, variance, and standard deviation when varying the parameters for the number of contracts N, the FDA decision arrive rate λ, probability of payout p, and correlation between contracts ρ. *Table A2* provides the portfolio payout mean, variance, and standard deviation for various numbers of contracts N across the different disease groups.

Table A1: Portfolio Distribution Attributes

This table provides the simulation results for the mean portfolio payout, variance of payout, and standard deviation of payout for various numbers of contracts N, arrival rate parameters λ, for various disease groups, and for probability, and varying correlation parameters.

Number of Contracts	λ	Mean	Variance	Std Dev
$N = 1$	0.20	0.15	0.105	0.32
	0.25	0.18	0.117	0.34
	0.33	0.20	0.132	0.36
	0.50	0.24	0.152	0.39
	1.00	0.27	0.176	0.42
	1.50	0.28	0.185	0.43
	2.00	0.29	0.191	0.44
$N = 10$	0.20	0.16	0.011	0.10
	0.25	0.18	0.012	0.11
	0.33	0.20	0.013	0.12
	0.50	0.24	0.015	0.12
	1.00	0.27	0.018	0.13
	1.50	0.28	0.019	0.14
	2.00	0.29	0.019	0.14
$N = 50$	0.20	0.16	0.002	0.05
	0.25	0.18	0.002	0.05
	0.33	0.20	0.003	0.05
	0.50	0.24	0.003	0.06
	1.00	0.27	0.004	0.06
	1.50	0.28	0.004	0.06
	2.00	0.29	0.004	0.06
$N = 100$	0.20	0.16	0.001	0.03

	0.25	0.18	0.001	0.03
	0.33	0.20	0.001	0.04
	0.50	0.24	0.002	0.04
	1.00	0.27	0.002	0.04
	1.50	0.28	0.002	0.04
	2.00	0.29	0.002	0.04

Number of Contracts	Probability	Mean	Variance	Std Dev
$N = 1$	$p = 0.2$	0.14	0.097	0.31
	$p = 0.3$	0.20	0.133	0.36
	$p = 0.4$	0.27	0.158	0.40
	$p = 0.5$	0.34	0.175	0.42
	$p = 0.6$	0.41	0.182	0.43
	$p = 0.7$	0.48	0.180	0.42
	$p = 0.8$	0.54	0.169	0.41
$N = 10$	$p = 0.2$	0.14	0.010	0.10
	$p = 0.3$	0.21	0.013	0.12
	$p = 0.4$	0.27	0.016	0.13
	$p = 0.5$	0.34	0.018	0.13
	$p = 0.6$	0.41	0.018	0.14
	$p = 0.7$	0.48	0.018	0.13
	$p = 0.8$	0.55	0.017	0.13
$N = 50$	$p = 0.2$	0.14	0.002	0.04
	$p = 0.3$	0.20	0.003	0.05
	$p = 0.4$	0.27	0.003	0.06
	$p = 0.5$	0.34	0.003	0.06
	$p = 0.6$	0.41	0.004	0.06
	$p = 0.7$	0.48	0.004	0.06
	$p = 0.8$	0.55	0.003	0.06
$N = 100$	$p = 0.2$	0.14	0.001	0.03
	$p = 0.3$	0.20	0.001	0.04
	$p = 0.4$	0.27	0.002	0.04
	$p = 0.5$	0.34	0.002	0.04
	$p = 0.6$	0.41	0.002	0.04
	$p = 0.7$	0.48	0.002	0.04
	$p = 0.8$	0.55	0.002	0.04

Number of Contracts	Correlation	Mean	Variance	Std Dev
$N = 1$	0.00	0.20	0.133	0.36

	0.05	0.20	0.133	0.36
	0.10	0.21	0.133	0.37
	0.15	0.21	0.133	0.37
	0.20	0.20	0.132	0.36
	0.00	0.20	0.013	0.12
	0.05	0.20	0.019	0.14
$N = 10$	0.10	0.21	0.025	0.16
	0.15	0.20	0.031	0.18
	0.20	0.20	0.037	0.19
	0.00	0.20	0.003	0.05
	0.05	0.20	0.009	0.10
$N = 50$	0.10	0.20	0.016	0.13
	0.15	0.21	0.022	0.15
	0.20	0.20	0.029	0.17
	0.00	0.20	0.001	0.04
	0.05	0.20	0.008	0.09
$N = 100$	0.10	0.20	0.014	0.12
	0.15	0.20	0.021	0.15
	0.20	0.20	0.028	0.17

Table A2: Portfolio Distribution Attributes Across Disease Groups

This table provides the simulation results for the mean portfolio payout, variance of payout, and standard deviation of payout for various numbers of contracts *N*, across different disease groups.

Number of Contracts	Disease Group	Mean	Variance	Std Dev
	Hematology	0.51	0.176	0.42
	Infectious Diseases	0.50	0.178	0.42
	Opthamology	0.40	0.181	0.43
	Other Disease Groups	0.48	0.180	0.42
	Metabolic	0.64	0.177	0.42
$N = 1$	Gastroenterology	0.42	0.182	0.43
	Allergy	0.48	0.179	0.42
	Endocrine	0.44	0.182	0.43
	Respiratory	0.49	0.179	0.42
	Urology	0.48	0.179	0.42

	Autoimmune	0.42	0.182	0.43
	Neurology	0.39	0.181	0.43
	Cardiovascular	0.37	0.180	0.42
	Psychiatry	0.38	0.180	0.43
	Oncology	0.27	0.158	0.40
$N = 10$	Hematology	0.51	0.018	0.13
	Infectious Diseases	0.50	0.018	0.13
	Opthamology	0.39	0.018	0.14
	Other Disease Groups	0.48	0.018	0.13
	Metabolic	0.64	0.018	0.13
	Gastroenterology	0.42	0.018	0.14
	Allergy	0.48	0.018	0.13
	Endocrine	0.44	0.018	0.14
	Respiratory	0.48	0.018	0.13
	Urology	0.48	0.018	0.13
	Autoimmune	0.42	0.018	0.14
	Neurology	0.39	0.018	0.13
	Cardiovascular	0.37	0.018	0.13
	Psychiatry	0.38	0.018	0.13
	Oncology	0.27	0.016	0.13
$N = 50$	Hematology	0.51	0.003	0.05
	Infectious Diseases	0.50	0.003	0.05
	Opthamology	0.40	0.003	0.05
	Other Disease Groups	0.48	0.003	0.05
	Metabolic	0.64	0.004	0.06
	Gastroenterology	0.42	0.003	0.05
	Allergy	0.48	0.003	0.05
	Endocrine	0.44	0.003	0.05
	Respiratory	0.48	0.003	0.05
	Urology	0.48	0.003	0.05
	Autoimmune	0.42	0.003	0.05
	Neurology	0.39	0.003	0.05
	Cardiovascular	0.38	0.003	0.05
	Psychiatry	0.38	0.003	0.05
	Oncology	0.27	0.002	0.04
$N = 100$	Hematology	0.51	0.002	0.04
	Infectious Diseases	0.50	0.002	0.04
	Opthamology	0.40	0.002	0.04
	Other Disease Groups	0.48	0.002	0.04

	Metabolic	0.64	0.002	0.04
	Gastroenterology	0.42	0.002	0.04
	Allergy	0.48	0.002	0.04
	Endocrine	0.44	0.002	0.04
	Respiratory	0.48	0.002	0.04
	Urology	0.48	0.002	0.04
	Autoimmune	0.42	0.002	0.04
	Neurology	0.39	0.002	0.04
	Cardiovascular	0.38	0.002	0.04
	Psychiatry	0.38	0.002	0.04
	Oncology	0.27	0.002	0.04