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Leave Sam and Martha Alone

by Sheldon Richman

One of the latest “business scandals” involves alleged insider trading by people close to Samuel Waksal, the founder of the drug company ImClone Systems and its recently resigned CEO. The government says Waksal told family members and friend Martha Stewart that the Food and Drug Administration (FDA) was about to decline the firm’s application for its hope-inspiring cancer drug, Erbitux. This supposedly enabled them to dump their shares before the knowledge became public and the stock price plummeted.

Some people get satisfaction from seeing a businessman taken handcuffed into custody by FBI agents. Waksal, a 54-year-old immunologist-turned-entrepreneur, fills the bill perfectly.

As far as can be determined, no FDA staffer has been arrested. Why should anyone from the FDA be pinched? Because the agency creates the conditions under which such events can occur.

No drug may be marketed without approval of the FDA. Before it makes a decision it requires lengthy clinical trials. Since a company’s fate hinges on those trials, any information from the FDA is highly coveted. The stock sales that allegedly were motivated by negative FDA insider information occurred in late December. Yet, according to the Wall Street Journal, “Starting in late November and continuing through mid-December, the FDA repeatedly gave discouraging news to ImClone, say people familiar with the communications.” On December 28, ImClone announced that the FDA wouldn’t review the company’s application.

The Journal noted that “in the pharmaceutical business, crucial information about new drugs can remain within a tight circle much longer [than information in other businesses]. Data from clinical trials take months to compile and present. FDA evaluators may conclude that a new-drug application has serious problems long before they come out with the official thumbs-down.”

This situation sets off a race for inside information. The newspaper quoted stock-fund manager Sam Isaly as saying, “We get [doctors’] phone numbers and we call.” Inevitably, some investors will have information that others lack. But what’s new about that?

But this raises some interesting questions. Anyone who was thinking about buying ImClone stock in December would have known that the Erbitux application was pending with the FDA. Why buy before the official announcement? It is no use pointing out that the company was praising the drug. What company derogates its products? And even if Waksal hinted that the FDA was likely to approve the drug, why did anyone risk big money on a dubious assurance from an interested source?

The people buying ImClone stock in late December knowingly made a highly risky investment. We must assume they knew what they were doing.

Anyone who decides to buy a stock of course expects the price to go up. Why else buy it? Contrariwise, anyone who sells most likely expects the price to go down, or at least not to perform as well as others. Surely the optimistic buyer has reason to believe that the seller is a pessimist. If they were both optimists, there could be no sale. Thus potential ImClone buyers had grounds to suspect that ImClone sellers feared a turn-down by the FDA. If the buyers' eyes weren't open, they should have been.

This undeniable fact undermines the apocalyptic warnings about insider trading, which isn't even defined in the law. No one who ventures into the stock market believes that everyone possesses the same information. Furthermore, everyone knows that there are gains to be made by acquiring information before the rest of the market has it. Add to those truths that an offer to sell clearly signals negative expectations and we must conclude that insider-trading law is just a cudgel used by ambitious federal regulators and prosecutors who are striving to make names for themselves by beating businessmen into submission.

Is there any socially constructive function in insider trading? Yes. It assures that stock prices incorporate the latest relevant information as soon as possible. That's what inspires confidence in the market. Thwarting the communication function of the price system, which is what trading prohibitions accomplish, is bad for market confidence.

ImClone's stockholders may have a case against Waksal for his selective distribution of information. But if anything is to be investigated, it should be the FDA, which by nature interferes with the development of new drugs and keeps prices high. Now we see that it also plays favorites in the stock market.

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