

## LENIENCY PROGRAMMES

### PIŞMANLIK PROGRAMLARI

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#### **Abstract**

*The fight against cartels is one of the most important tasks of competition agencies. Although competition agencies (CAs) continue to increase their efforts to break down cartels, they have still continued to form and operate. Because the fight against cartels is a challenging task due to their secret nature, more powers are required to gather enough evidence to detect, prove and prosecute infringement. That is why leniency programs, which have a complex nature, are clearly becoming increasingly important to breaking down cartels.*

*The purpose of this article is survey the basis for leniency programs which have been used in several jurisdictions around the world and explain why the leniency programs are necessary, how they work, what their prerequisites are.*

*The article is structured in the following way: Section 1 provides an introduction to the cartels and aim of cartel policy. Section 2 discusses the reasons to implement a leniency programme. Section 3 discusses the mechanisms of leniency programme to work. Section 4 puts forward the pre-requisites of a successful leniency programme and section 5 concludes.*

**Key Words:** *Cartel, hard-core cartel, leniency programmes, amnesty, cheating*

#### **Öz**

*Kartellerle mücadele, rekabet otoritelerinin en önemli görevlerinden biridir. Rekabet otoritelerinin kartelleri yıkma çabalarına rağmen, hala karteller kurulmaya ve işlemeye devam etmektedir. Zira, kartellerin gizli*

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*yapısı, tespit edilmesi, ispatlanması ve kovuşturması için yeterince delil bulmaya daha fazla yetki gerektirmesi nedeniyle kartellerle mücadele çok zorlu bir görevdir. Bu nedenle pişmanlık programları, kartelleri yıkmakta gittikçe daha önemli hale gelmektedir.*

*Bu makalenin amacı, dünyada pekçok hukuk düzeninde kullanılan pişmanlık programlarını araştırmak ve pişmanlık programları neden gereklidir, nasıl çalışır, önkoşulları nelerdir gibi konuları açıklamaktır.*

*Makale şu bölümlerden oluşmaktadır: 1. bölüm karteller ve kartel politikasına ilişkin bir giriş sağlayacaktır. İkinci bölümde pişmanlık programı uygulamanın sebepleri tartışılacaktır. Üçüncü bölümde ise pişmanlık programının çalışma mekanizması ele alınacaktır. Dördüncü bölümde başarılı bir pişmanlık programının ön koşulları ortaya konacak ve beşinci bölümde makale sonuçlandırılacaktır.*

**Anahtar Kelimeler:** Kartel, hard-core kartel, pişmanlık programı, af, aldatma

## 1. THE PURPOSES OF CARTEL POLICY

Cartels can generally be defined as an agreement between competitors not to compete or to reduce the level of competition, with the object of increasing prices and profits.<sup>1</sup> Spagnolo<sup>2</sup> describes cartels as “*a form of illegal activity involving the joint, coordinated effort of several agents aimed at restricting competition by fixing prices, allocating market shares, preventing entry, and so on.*” They are a kind of organized crime.

Of all anti-competitive agreements, cartels are the most inconsistent with the principles of a free market economy. There is almost universal consensus that cartels are the most harmful type of anti-competitive activity because cartels force the consumers to substitute a less desirable product at a higher price, since they reduce output and increase prices above the competitive level. Cartels cause wealth transfer from consumers to cartel members, misallocation of resources, and reductions in innovation, and thus dynamic efficiency.<sup>3</sup> In short, they waste resources, cause inefficiencies, and steal money from consumers. Cartels also have such a great effect over the international economy that just during the interwar period, international cartels controlled nearly 40% of world trade between 1929 and 1937.<sup>4</sup> On the other hand, they offer no valid economic or social benefits that would rationalize or mitigate the damage that they cause. Since the harmful effects of cartels are well understood, they are generally acknowledged to be the top priority for competition agencies (CAs) and they are prohibited in all competition laws; in some countries they are even regarded as a crime.<sup>5</sup>

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<sup>1</sup> OFFICE OF FAIR TRADE (2005), Predicting cartels, OFT Report OFT773, London, UK, accessible at [http://www.of.gov.uk/shared\\_of/reports/comp\\_policy/of773.pdf](http://www.of.gov.uk/shared_of/reports/comp_policy/of773.pdf), last visited 01 April 2009, p.18.

<sup>2</sup> SPAGNOLO, G. (2006), “Leniency and Whistleblowers In Antitrust”, Discussion Paper No. 5794, accessible at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=936400](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=936400), last visited 01 April 2009, p. 3.

<sup>3</sup> OECD (2002), Report On The Nature and Impact Of Hard Core Cartels and Sanctions Against Cartels Under National Competition Laws, OECD, Paris, accessible at <http://www.oecd.org/dataoecd/16/20/2081831.pdf>, last visited 01 April 2009, p. 6.

<sup>4</sup> LEVENSTEIN, M.C. and SUSLOW, V.Y. (2002), “What Determines Cartel Success?”, University of Michigan Business School Working Paper No. 02-001, available at <http://www.ssrn.com/abstract=299415>, last visited 01 April 2009.

<sup>5</sup> OECD 2002, p.5.

The most harmful cartels, which are “hard-core cartels”, are anti-competitive agreements that employ harmful tactics such as price fixing, bid rigging, output restrictions or market sharing. Hard-core cartels have been characterized, in the OECD Council Recommendation as “*the most egregious violations of competition law and ... they injure consumers in many countries by raising prices and restricting supply, thus making goods and services completely unavailable to some purchasers and unnecessarily expensive for others.*”<sup>6</sup>

When CAs fight against cartels, there are generally three stages: discovery, prosecution and punishment. If an antitrust authority can successfully discover, prosecute and penalize cartels, existing cartels can be dismantled and new cartels may be deterred.<sup>7</sup> However, cartel members always try to conceal the cartel, since cartels are illegal, even criminal in some countries. The secret nature of cartels makes detecting and proving infringements pretty difficult for CAs.<sup>8</sup> Therefore information and evidence sources are very more important.

Introducing a leniency program is one of the tools of cartel enforces to obtain evidence and to increase the probability of detection of cartels. In the appropriate atmosphere, a leniency policy can be very helpful as an “*efficient and effective means of detecting, investigating, and prosecuting or adjudicating cartel conduct.*”<sup>9</sup> Leniency policy can fight against collusion in four ways:<sup>10</sup> First, it can help to convict cartels by

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<sup>6</sup> OECD (1998), Recommendation of the Council Concerning Effective Action Against Hard Core Cartels, OECD, Paris, accesible at <http://www.oecd.org/dataoecd/39/4/2350130.pdf>, last visited 01 April 2009, p.2.

<sup>7</sup> HARRINGTON, J.E (2006), “Corporate Leniency Programs and the Role of the Antitrust Authority in Detecting Collusion”, International Symposium on Towards an Effective Implementation of New Competition Policy, Tokyo, accesible at <http://www.econ.jhu.edu/People/Harrington/Tokyo.pdf>, last visited 01 April 2009, p. 2.

<sup>8</sup> ICN (2005), “Defining Hard Core Cartel Conduct Effective Institutions Effective Penalties: Building Blocks for Effective Anti-Cartel Regimes”, Working Group on Cartels, Bonn, Germany, accesible at [http://www.internationalcompetitionnetwork.org/media/library/conference\\_4th\\_bonn\\_2005/Effective\\_Anti-Cartel\\_Regimes\\_Building\\_Blocks.pdf](http://www.internationalcompetitionnetwork.org/media/library/conference_4th_bonn_2005/Effective_Anti-Cartel_Regimes_Building_Blocks.pdf), last visited 01 April 2009, p.5.

<sup>9</sup> ICN (2006), “Anti-Cartel Enforcement Manual: Enforcement Techniques, Chapter 2: Drafting and Implementing an Effective Leniency Program”, Working Group on Cartels, Capetown, South Africa, accesible at [http://www.internationalcompetitionnetwork.org/media/library/conference\\_5th\\_capetown\\_2006/FINALFormattedChapter2-modres.pdf](http://www.internationalcompetitionnetwork.org/media/library/conference_5th_capetown_2006/FINALFormattedChapter2-modres.pdf), last visited 01 April 2009, p.10.

<sup>10</sup> Harrington 2006, p.4.

providing evidence, thus resulting in more probable prosecution. Second, it can help with the detection of cartels. Third, it can make them less profitable and thus deter cartel formation. And, fourth, it can make cartels more unstable and thus make them more likely to break down by themselves. Hinloopen and Soetevent state the effects of leniency programs on cartels as follows<sup>11</sup>: “*Leniency programs have an ambiguous effect on internal cartel stability. On the one hand, the incentive to cheat on the cartel is enhanced as defecting cartel members face a reduced fine when they report the cartel. In this way, leniency programs increase the risk of being cheated upon by other cartel members. As Spagnolo (2004, p.6) puts it: ‘breakdowns in trust are the most important reason why even moderate leniency programs may have deterrence effects.’ On the other hand, leniency programs reduce the cost of punishing a defecting cartel member as well. In this way, leniency programs potentially the internal stability of cartels.*”

As well as punishing firms guilty of collusion in the present, it is important to prevent the formation of new cartels in the future so as to prevent the harm they would cause avoided. The central aim of cartel policy must be deterrence and break-up of cartels.<sup>12</sup> According to Spagnolo, cartel policy can take at least two forms:<sup>13</sup>

- the first and most important aim is “ex ante or general deterrence” i.e. stop cartel creation with the threat of severe sanctions, along with other tools that make cartels either unprofitable or unstable;
- a second aim is “ex post deterrence or abandonment”, i.e. if CAs fail to achieve ex-ante deterrence, they force cartel members to abandon the cartel by the threat of more severe sanctions or by other stronger mechanisms.

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<sup>11</sup> HINLOOPEN, J. and SOETEVENT, A.R. (2005), An Experimental Investigation of the Effects of Leniency Programs for Antitrust Enforcement, accessible at [http://www.fep.up.pt/conferences/earie2005/cd\\_rom/Session%20IV/IV.G/Hinloopen\\_Soetevent.pdf](http://www.fep.up.pt/conferences/earie2005/cd_rom/Session%20IV/IV.G/Hinloopen_Soetevent.pdf), last visited 01 April 2009.

<sup>12</sup> FRIEDERISZICK, H.W. and MAIER-RIGAUD, F.P. (2007), “The Role of Economics in Cartel Detection in Europe”, Working Paper No: 014/03/2007, accessible at [http://www.esmt.org/fm/312/Role\\_of\\_Economics\\_in\\_Cartel\\_Detection\\_in\\_Europe.pdf](http://www.esmt.org/fm/312/Role_of_Economics_in_Cartel_Detection_in_Europe.pdf), last visited 01 Apr 2009, p.9; Spagnolo 2006, p.8.

<sup>13</sup> Spagnolo 2006, p.8.

## 2. WHY IS LENIENCY NECESSARY?

Leniency can be described as any reduction of a penalty in exchange of information and cooperation. The most complete form of leniency is “amnesty;” that means no penalty to the first party to submit themselves to the CA and obey the requests of the agency. Since leniency is a more general concept, amnesty is contained within the meaning of leniency, so when this paper discusses leniency, it should also be read to included amnesty. In jurisdictions imposing criminal sanctions for cartels, “leniency” can mean immunity from prosecution.<sup>14</sup>

The penalties that are reduced by leniency programs could be any penalties that can be imposed by a CA: “*finer on companies, fines on individuals, director disqualification and/or imprisonment.*”<sup>15</sup>

Leniency programs must be designed and implemented carefully. Poorly-designed and poorly-implemented leniency programs might have a negative effect on cartels.<sup>16</sup> Because a leniency program reduces the expected fines for cartel members, and thus decreases the expected cost of infringement, leniency programs can have a lessening effect on the level of fines and thus have an adverse effect on deterrence. Unnecessary fine reductions should be avoided and the limitations of leniency should be determined carefully. Leniency should only be granted to secret, horizontal cartels which are the kind of infringement that are the most difficult to detect.<sup>17</sup> “*A priori, therefore, it would be difficult to conclude that a leniency program unambiguously increases welfare, without considering which policies are implementable and desirable.*”<sup>18</sup>

However, experience shows that these programs work. Kovacic defined the contribution of leniency programs as follows: “*Their impact*

<sup>14</sup> OECD (2001), “Report On Leniency Programmes to Fight Hard Core Cartels”, Paris, France, accessible at <http://www.oecd.org/dataoecd/49/16/2474442.pdf>, last visited 01 April 2009, p.5.

<sup>15</sup> WILS, W.P.J. (2007), “Leniency in Antitrust Enforcement: Theory and Practice”, World Competition, No:30(1), also available at [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth.cfm?per\\_id=456087](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=456087) last visited 01 April 2009, p.1.

<sup>16</sup> BUCCIROSSI, P. and SPAGNOLO, G. (2005), “Optimal Fines in the Era of Whistleblowers. Should Price Fixers Still Go to Prison?”, Lear Research Paper 05-01, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=871726](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=871726) last visited 01 April 2009, p.47.

<sup>17</sup> Wils 2007, p.27.

<sup>18</sup> MOTTA, M. and POLO, M. (2003), “Leniency Programs and Cartel Prosecution”, International Journal of Industrial Organization, No: 21(3), p.347-379.

*can be seen in the recent increase in successfully prosecuted cartels. For example, an amnesty program allowed the Antitrust Division to secure more fines in 1999 alone, than the total sum of fines imposed under the Sherman Act since its adoption more than a century before. And in only 19 months during 2002 and 2003, the European Commission took 19 decisions, involving more than 100 companies, for a total amount of fines of almost 3 billion Euros.”<sup>19</sup>*

Pursuant to the US leniency program, only the first firm can gain amnesty, all or nothing, and following firms receive nothing. However, partial leniency is possible through plea bargaining.<sup>20</sup> The US Department of Justice (DOJ) revised its initial Corporate Leniency Policy of 1978 with its current Corporate Leniency Policy in 1993. Thus, amnesty either before or after an investigation became available and amnesty before an investigation became automatic, thus prosecutorial discretion was eliminated. Amnesty was automatically broadened to cooperating individuals applying together with the corporation to the leniency program. DOJ also offered its leniency policy for individuals independently of their firms beginning in 1994. In 2004, the Antitrust Criminal Penalty Enhancement and Reform Act limited liability for firms that received leniency to single (actual) damages instead of treble damages.<sup>21</sup>

In 1996, the European Commission of the European Union (EU) issued its first Leniency Notice, which was inspired by the US Corporate Leniency of 1993, and then revised it in 2002. Immunity became automatic, and fine reductions became more closely aligned to the time of submission. Immunity is granted if a firm delivers evidence first and the European Commission (EC) can carry out an inspection or, if an inspection already ongoing, if the firm provides evidence to help (allow) the EU to find an infringement. Otherwise the firm can receive leniency only if it provides evidence setting forth "significant added value," which gives the EC prosecutorial discretion. So a firm must provide evidence

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<sup>19</sup> AUBERT, C., REY, P. and KOVACIC, W.E., (2006), "The Impact of Leniency and Whistle-Blowing Programs On Cartels", *International Journal of Industrial Organization*, No:24(6), p.1241-1266.

<sup>20</sup> Plea bargaining is a tool used by American prosecutors to obtain guilty pleas in exchange for reduced sentences or charges.

<sup>21</sup> Otherwise 15 U.S. Code §15 allows injured parties to obtain three times actual damages in antitrust suits.

first and before an inspection in order to obtain immunity. Although immunity can be granted after an inspection, it is not guaranteed. Unlike the US Leniency program, ring leaders can obtain leniency if they did not coerce others to join cartels. The 2006 amendment of the Leniency Notice makes it more transparent and predictable.<sup>22</sup>

Leniency policies may raise cartel deterrence directly, by preventing cartel formation or dismantling an existing cartel with the decrease in trust, as leniency program requires those seeking leniency to confess and report other cartel members in order to benefit from it.<sup>23</sup> It may also deter cartels indirectly by shortening the duration and costs of investigations and by increasing the probability of conviction in return for a reduction of fines.<sup>24</sup>

Hinloopen and Soetevent note that the aims of CAs in introducing leniency programs are threefold: *“First and foremost, they want to deter cartel formation. Second, they want members of established cartels to defect and to report their violations to the antitrust authority. Third, antitrust authorities hope that the (more accurate) information received from cartel members themselves helps them to reduce the time and costs of investigation.”*<sup>25</sup>

As mentioned before, a leniency program is one of the tools to detect cartels, due to their inherently secret nature. Moreover CAs have limited resources and are therefore unable to prevent the formation of cartels. That is why help from insider is very crucial to the fight against cartels.

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<sup>22</sup> For detailed information see; Wils 2007, Harrington 2006 and “Commission Notice on Immunity from fines and reduction of fines in cartel cases”, OJ C 298, 8.12.2006, p.17–22, accessible at [http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/c\\_298/c\\_29820061208en00170022.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/c_298/c_29820061208en00170022.pdf), last visited 01 April 2009.

<sup>23</sup> BUCCIROSSI, P. and SPAGNOLO, G. (2007), Antitrust Sanction Policy In The Presence of Leniency Programs, accessible at <http://www.gianca.org/PapersHomepage/Buccirossi%20Spagnolo%20-%20Antitrust%20Sanction.pdf>, last visited 01 April 2009, p.3.

<sup>24</sup> Motta and Polo 2003.

<sup>25</sup> HINLOOPEN, J. and SOETEVENT, A.R. (2005), An Experimental Investigation of the Effects of Leniency Programs for Antitrust Enforcement, accessible at [http://www.fep.up.pt/conferences/earie2005/cd\\_rom/Session%20IV/IV.G/Hinloopen\\_Soetevent.pdf](http://www.fep.up.pt/conferences/earie2005/cd_rom/Session%20IV/IV.G/Hinloopen_Soetevent.pdf) last visited 1 April 2009, p.2.



## **2.1. Cartels Are Secretive and Hard To Detect**

Cartels are frequently verbally formed and secretly operated because the members know that their behavior is illegal. The cartels try to conceal themselves and their members usually do not co-operate with CAs except through a leniency program. Even after an investigation has been initiated, gathering sufficient evidence to prosecute cartel members successfully may be difficult. In such a situation, detection may only be possible with information or evidence supplied by cartel members themselves. Without an insider, it is difficult to discover, prove<sup>26</sup> and punish the cartels because of their secrecy. Therefore it is necessary to offer various incentives to make cartel members reveal their prohibited agreement.

A leniency policy assumes that some firms that are joined in a secret agreement would be willing to cease their membership and report the cartel but refrain from doing so because of the possible fines. The leniency policy gives such firms an opportunity because the CA concerned will compensate the firm's cooperation with the full or partial reduction of those fines.

## **2.2. Competition Authorities Have Limited Resources**

Competition authorities can only carry out a limited number of investigations because of their resource constraints. If a CA cannot easily obtain information and evidence about cartels, it becomes difficult to discover, prove and punish the cartels, thereby decreasing the probability of detection and requiring long investigations that would increase investigation costs. Furthermore, long investigations prevent the initiation of another investigation and decrease the deterrent effect of CAs. Collecting reliable evidence is crucial to revealing the secret cartels. In such a case, the leniency program is valuable to collect information to increase probability of detection since an insider provides information that an agency could not otherwise obtain without incurring huge costs.<sup>27</sup> In other words, a leniency policy is a precious way of increasing the probability of detection without requiring an increase in costs while saving

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<sup>26</sup> It is difficult to prove secret cartels, especially in the oligopolistic markets whose structure is more suitable for collusion. For example, without any hard evidence, parallel prices are not sufficient to prove price fixing agreement; plus factors are required.

<sup>27</sup> OECD 2001.

investigation time and resources.<sup>28</sup> So if the CA is unable to stop the formation and operation of cartels ex-ante since they have limited resources, they can increase the probability of breaking cartels and shorten the investigations by using leniency programs.<sup>29</sup>

Leniency programs are very valuable as a source of information and evidence. As a matter of fact, competition authorities have a limited number of sources to obtain information and evidence. They can gather the necessary information and evidence mainly from three sources.<sup>30</sup> First, the CA can monitor information and data from the markets, monitor publicly available sources, and possibly conduct economic analysis of these data to detect and prove infringements. But generally for cartels, economic evidence is not sufficient to prove collusion, and screening for cartels appears to be difficult. Second, a CA can obtain information from third parties, such as customers or competitors, who have been damaged by competition infringements as well as current or former employees of cartel members. Finally, companies and individuals that have participated in the competition infringements themselves can be the best source of information. Cartel members and their staffs may be the only source of the information and evidence that the CA needs to detect and punish the infringements.

A CA can obtain information from the companies and individuals that have participated in the competition infringements in three ways: direct force, compulsion and leniency.<sup>31</sup> First, a CA can gather evidence from the companies by using inspection powers – the so-called ‘dawn raids’ at business premises and private homes – or carry out directed surveillance or use covert human intelligence sources subject to the jurisdiction. However if existing documents or evidence can only be obtained without help from the companies concerned, it is very expensive for the CA to go through many documents, files or records to find the relevant information.

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<sup>28</sup> STEPHAN, A. (2006), “The Bankruptcy Wildcard in Cartel Cases”, CCP Working Paper 06-5, Norwich, UK, accessible at <http://www.ccp.uea.ac.uk/publicfiles/workingpapers/CCP06-5.pdf>, last visited 01 April 2009, p.7.

<sup>29</sup> Motta and Polo 2003.

<sup>30</sup> Wils 2007.

<sup>31</sup> Wils 2007.

Another way a CA can make companies and individuals cooperate in providing the information is by threatening sanctions for non-cooperation. Although this method is not limited to obtaining information only in existing documents and is less costly by using the help of the company and its staff to locate or bring together such documents, information obtained under compulsion may be unreliable and incomplete.

Lastly, leniency as a method to obtain information has obvious advantages. It can be used to obtain all kinds of information, not just existing documents. Like the second method, it saves on search costs in that the collection of relevant information is prepared by the company and its staff, who are most familiar with it. But contrary to the second method, leniency is more reliable, because leniency applicants risk losing the benefit of leniency if they provide untruthful or incomplete information.

Moreover, according to C. Aubert, P. Rey and W.E. Kovacic,<sup>32</sup> leniency programs also give an incentive for cartel participants to keep more evidence as a precaution for the future. The larger amount and better quality of evidence increases the possibilities for the CA to obtain evidence through other ways as well as save investigation costs and resources of the CA. Aubert, *et al*, also recommend offering positive rewards for insiders in addition to partial or full amnesty, since fine reductions may be not enough to fully deter collusion.

### **3. HOW DOES LENIENCY WORK?**

When cartel members reach agreements and monitor each other for compliance with the agreement, they often leave evidence that may be brought to the CA by insiders. The main problem with leniency programs is the ability to create incentives to force them confesses their activity and to diminish the trust among the members of the cartel. Leniency programs have two effects on cartels: providing a direct incentive to report and decreasing trust among cartel members (which gives an added incentive to report). Both effects work together to make quick reporting the reasonable decision for cartel members.<sup>33</sup>

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<sup>32</sup> Aubert, Rey and Kovacic 2006.

<sup>33</sup> LESLIE, C.R. (2004), "Trust, Distrust, and Antitrust", *Texas Law Review*, No:82(3), accessible at <http://www.utexas.edu/law/journals/tlr/abstracts/82/82leslie.pdf>, last visited 01 April 2009, p.642.

### 3.1. Incentives

Setting up and maintaining a cartel is designed to create additional profits, but cartels cannot normally survive a long time. The main reason for instability within a cartel is the opportunity for members to cheat.<sup>34</sup> When firms agree to restrict competition by increasing prices or limiting output, one member may have an incentive to cheat by undercutting or overproducing, thereby increasing its own profits. Stigler<sup>35</sup> (1964) argues that the leading threat to successful cartel activity is the possibility of members having incentives to cheat on the agreement. The repeated interruption and re-forming of cartels demonstrates the effects of such cheating and internal instability that are characteristic of cartels.

According to Leslie,<sup>36</sup> defection from a cartel agreement can occur in two ways: cheating and/or confession. Azevedo<sup>37</sup> notes that, in the view of the confessor firm, both cheating and reporting of cartel activity together, could gain in three ways:

- by raising profits in the short-run due to increased sales;
- by starting an investigation and creating the conditions under which it will become harder for other cartel members to punish its deviation in the medium term; and
- by avoiding all or most of the fines that may cripple its erstwhile cartel colleagues.

A successful cartel must take into consideration the incentive to defect and must create mechanisms to increase the cost of defection by “*making cheating more observable; making cheating more difficult to undertake; [and by] creating mechanisms to punish cheating.*”<sup>38</sup> Thus they can prevent members from undermining the cartel. On the other hand, it is usually hard to settle upon an unfailing detection mechanism and this

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<sup>34</sup> AZEVEDO, J. P. (2003), “Crime And Punishment In The Fight Against Cartels: The Gathering Storm”, E.C.L.R., 24(8), 400-407, p. 5.

<sup>35</sup> STIGLER, G. (1964), “A Theory of Oligopoly.” Journal of Political Economy, 72, p.44-61.

<sup>36</sup> Leslie 2004.

<sup>37</sup> Azevedo 2003.

<sup>38</sup> EVENETT, S.J., LEVENSTEIN, M.C. and SUSLOW, V.Y. (2001), “International Cartel Enforcement: Lessons from the 1990s”, The World Economy, No:24 (9), also accessible at <http://www3.interscience.wiley.com/journal/118991795/abstract>, last visited 01 April 2009, p.1221-1245.

is why many cartels are unstable.<sup>39</sup> In other words, cartels can only work if the members are able to deter defection by monitoring and threatening credible retaliation, because when deciding on cheating or not, a cartel member compares the expected benefits of remaining in the cartel with the expected punishment for cheating – the expected retaliation from the other cartel members if the cheating is detected.<sup>40</sup> If the expected benefit of remaining in the cartel is greater than expected punishment for cheating, the cartel can be viable. *“This condition, necessary for any cartel or illegal agreement to be sustainable, because of the impossibility to use explicit contract, is called “incentive compatibility” or “self-enforcing” constraint. It differs from the “participation” constraint on which the theory of law enforcement focuses, that requires the expected additional profits participants would earn from entering a cartel to be positive. ... Both the participation and the incentive constraints must be satisfied simultaneously for all members of a cartel or of another organized criminal activity for this to be viable (so that if at least one of the two is violated for at least one member the cartel is deterred).”*<sup>41</sup>

CAs have utilized the “incentive compatibility” problems confronted by cartels by means of the introduction of leniency programs. Indeed leniency programs can deter cartels by causing the incentive/self-enforcing constraint to not be satisfied, proposing reduction of penalties to the companies that come forward with evidence of cartel activity and thus stimulating cartel members to defect from cartel agreements.<sup>42</sup> Therefore leniency programs deter cartels by increasing members' incentives to confess their cartel activity.

### 3.2. Trust

Trust is an essential element of cartel activity, like in all organized crime. Cartel members must assure each other that they will not do two things: cheat on their agreement or confess their activity to the CA.<sup>43</sup> As mentioned before, cheating and confessing represent two different types of defection from the cartel.

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<sup>39</sup> Azevedo 2003, p.5.

<sup>40</sup> Azevedo 2003.

<sup>41</sup> Buccirosi and Spagnolo 2005, p.26.

<sup>42</sup> Evenett, Levenstein and Suslow 2001, p.15.

<sup>43</sup> Leslie 2004.

Prosecutors traditionally use this element “by shaping private incentives to play one party against the other.”<sup>44</sup> A similar approach is successfully employed to prosecute Mafia members with the help of inside witnesses. This is the main driver of leniency programs – undermining trust between cartel members by creating a risk of betrayal in order to secure the benefits of the leniency program. In other words, cartel members “*find themselves in a situation as close as possible to a “Prisoner’s Dilemma,” their long-term relationship notwithstanding.*”<sup>45</sup>

Even though the firms are better off collectively if they cooperate, each firm has a strong incentive to cheat, like in the prisoner’s dilemma negotiation game. Each firm must decide whether to cooperate or to defect. If other firms are cooperating, a firm can maximize its profit by cheating.<sup>46</sup> “*In this game, each firm is contemplating whether or not to apply for leniency and there are at least two solutions (or equilibria) to it. One solution is for all firms to not apply for leniency in the hope that the government will not discover collusion or, if they have discovered it, their case will fail. To the dismay of the cartel members but the delight of the antitrust authority, there is always another solution in which firms race to report to the antitrust authority because each thinks one or more other firms intend to do so. If a firm expects some firm to receive leniency, it’ll prefer that it be the one to get it and thus will try to preempt other firms. If firms are at the “no report” equilibrium then a challenge of policy is to shift firms to the “race to report” equilibrium.*”<sup>47</sup>

The problem can be solved in the easiest way if the cartel members make an enforceable contract to cooperate, and not to cheat. However, the laws do not allow for an enforceable agreement. Accordingly, cartel members do not have any option other than trusting each other to

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<sup>44</sup> LELIEFELD, D. and MOTCHENKOVA, E. (2007), “To Protect In Order To Serve, Adverse Effects Of Leniency Programs In View Of Industry Asymmetry”, TILEC Discussion Paper No:2007-007, accessible at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=963110#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=963110#PaperDownload), last visited 01 April 2009.

<sup>45</sup> SPAGNOLO, G. (2004), “Divide et Impera: Optimal Leniency Programs”, CEPR Discussion Paper No:4840, accessible at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=716143](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=716143), last visited 01 April 2009, p.5.

<sup>46</sup> Leslie 2004, p.525.

<sup>47</sup> Harrington 2006, p.10.

cooperate in the absence of enforceable agreements.<sup>48</sup> For that, cartels must create a mechanism, such as monitoring or retaliation in order to prevent defection and to maintain trust among the members. In the absence of legally enforceable agreements, current cooperation may thus only be sustained by the threat of future punishment in the event of a defection.<sup>49</sup>

The possibility of a defector to apply for leniency increases the retribution of cheating, thus making collusion more difficult to sustain. It increases uncertainty, making it more difficult for cartel members to come to an agreement, reducing trust among them, and increasing the necessity of monitoring and thus the cost of collusion.<sup>50</sup> For instance, although technology has made progress in communications very rapid lately, cartels still prefer meeting each other in directly, face-to-face, in order to eliminate these challenges.<sup>51</sup> Therefore it would be much easier to trust each other if they observe others' gestures, expressions, and words<sup>52</sup>. Consequently leniency programs cause an increase in the cost to form cartels.

Trust is undermined not only by the incentive to cheat but also by the illegality of the activity.<sup>53</sup> In the absence of legally binding agreements, cooperation in the present may therefore only be sustained by the threat of future punishment in the event of a defection.<sup>54</sup>

Additionally, while CAs create short-term distrust among current cartel members, they can spread distrust more generally by means of a leniency program. Reputation and cartel experience are two important factors used by cartels to trust one another more easily, but the leniency

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<sup>48</sup> Leslie 2004, p.528.

<sup>49</sup> Ofit 2005, p.20.

<sup>50</sup> Wils 2007, p.23.

<sup>51</sup> LEVENSTEIN, M.C. and SUSLOW, V.Y. (2006), "Determinants of International Cartel Duration and the Role of Cartel Organization", University of Michigan Business School Working Paper No:1052, accessible at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=936912](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=936912) last visited 01 April 2009, p.3.

<sup>52</sup> Leslie 2004, p.573.

<sup>53</sup> Levenstein and Suslow 2006.

<sup>54</sup> Ofit 2005, p.20.

program can damage these factors that have established trust among cartel members over the course of time.<sup>55</sup>

#### **4. PRE-REQUISITES TO CREATING AN EFFECTIVE LENIENCY PROGRAM**

Some factors have an important effect on the success of leniency program. Without severe sanctions and a sound enforcement program by the CA, there is no incentive for cartel members to report their competition infringement. Consequently, even a generous, well-designed leniency program cannot be effective if there is no fear of probable detection and prosecution. There is general agreement between most agencies that there are basically three pre-requisites to successfully implement a leniency program: severe sanctions, a high risk of detection and transparency/predictability.<sup>56</sup> These factors are discussed below.

##### **4.1. Severe Sanctions**

The severity of the possible sanctions, and thus the importance of the relief that leniency can provide, is an important factor.<sup>57</sup> Around the world, cartel activity is accepted as a crime in some jurisdictions and therefore individuals can be prosecuted as criminals also, while some jurisdictions do not have criminal sanctions. The degree of severity of sanctions varies also.

According to Hammond,<sup>58</sup> *“all else being equal, a jurisdiction without individual liability and criminal sanctions will never be as effective at inducing amnesty applications as a program that does.”* But an effective leniency program is possible even outside of a criminal antitrust regime, if the financial fines are severely and sufficiently punitive.

On the other hand, determination of the level of sanctions that is sufficient to deter cartels is very difficult. The OECD Report<sup>59</sup> notes that: *“Without doubt the sanctions should be severe. Many experts hold the*

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<sup>55</sup> Leslie 2004, p.643.

<sup>56</sup> ICN 2005, p.3.

<sup>57</sup> OECD 2001, p.25.

<sup>58</sup> HAMMOND, S.D. (2004), “Cornerstones of An Effective Leniency Program”, ICN Workshop on Leniency Programs, accessible at <http://www.usdoj.gov/atr/public/speeches/206611.htm> last visited 01 April 2009.

<sup>59</sup> OECD 2002.



*view that the gross amount of financial sanctions should be greater than the gain to the cartel, to account for the fact that not all cartels are discovered and punished. Multiples of two or three times the cartel gain are most often advanced for this purpose, but studies supporting larger multiples exist.”*

On the other hand, Spagnolo mentioned that the main objective of sanctions is efficient deterrence, and they do not have to be directly related to the gains to cartel members obtain nor do they have to be compensation for the harm the cartel causes. He emphasized that “[f]ines for firms that engage in cartels do not have to be related to their gains, nor to the losses caused to others: they just have to be sufficiently high to deter cartels while keeping to the minimum the cost of investigation and prosecution.”<sup>60</sup>

Similarly, the ICN Report<sup>61</sup> states that there is wide agreement that an effective sanction should be deterrent. When deciding sanctions, both the expected gains from the cartel and the probability of detection should be taken into consideration in order to establish an effective deterrent. However, the determination of these factors is difficult to apply in practice, due to the difficulty of assessing and proving the benefits obtained from cartel activities and determining the probability of detection. In sum, there is no secret recipe for an effective penalty.

In order to increase the probability of defection and to prevent collusion, increasing penalties raises distrust in two ways:<sup>62</sup> First, severe sanctions increase the potential harm of cooperation when detected, so it gives cartel members a direct incentive to report the cartel, in order to avoid even the risk of that high sanction and so as not to be the last “confessor” to benefit from the leniency program. Second, as a result of increasing incentives for reporting, the probability of confession will also increase. Also, the distrust among cartel members and probability of a severe sanction together make confession rational. As the probability of confession increases, the expected payoff of being a member of a cartel decreases dramatically. So, severe sanctions both deter cartel activity and

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<sup>60</sup> Buccirosi and Spagnolo 2005, p.13.

<sup>61</sup> ICN 2005.

<sup>62</sup> Leslie 2004, p.652.

create a successful leniency program.<sup>63</sup> An effective leniency program and severe potential penalties give strong “carrot and stick” incentives to be the first to reveal a cartel.<sup>64</sup>

#### **4.2. Detection**

If firms perceive the risk of detection by the CA to be high, then severe sanctions can deter cartel activity. Similarly, if cartel members do not fear detection, they will tend not to confess their collusion to the CA for the benefit of leniency program.<sup>65</sup> Since high probability of detection makes cartel members anxious about the fact that their cartel activity may be discovered by the CA, the more likely it is the cartel members will apply for the leniency program. *“If cartel members perceive a genuine risk of detection, then an amnesty program can build on that fear and create distrust and panic among the cartel members.”*<sup>66</sup> In this situation, the cartel members cannot trust each other any more. By undermining trust among cartel members, the CA decreases the expected gains and increases the expected costs of the cartel.<sup>67</sup> Consequently a race to be the first to the leniency program can be created.

Wils discussed the risk which is perceived by cartel members by saying: *“The risk could be a specific one, where the competition authority is already collecting or receiving information of the antitrust violation by other means (or is believed to be doing so, or to be doing so in the near future) or a more general one, where a competition authority, as a result of many other recent cases of successful detection and prosecution, is believed to be good at it. In the case of collective violations such as cartels, and if leniency policies are well designed in that immunity is only granted to the first co-conspirator to come forward, and reductions in penalties are linked to the timing of the cooperation as compared to the other co-conspirators, companies and individuals may decide to cooperate out of fear that a co-conspirator may do so before them. Such a ‘race to cooperate’ may amplify the positive effects of leniency, but*

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<sup>63</sup> HAMMOND, S. D. (2000), “Fighting Cartels - Why And How? Lessons Common to Detecting and Deterring Cartel Activity”, Stockholm, Sweden, accesible at <http://www.usdoj.gov/atr/public/speeches/6487.htm> last visited 01 April 2009, p.3.

<sup>64</sup> OECD 2002, p.12.

<sup>65</sup> Hammond 2000.

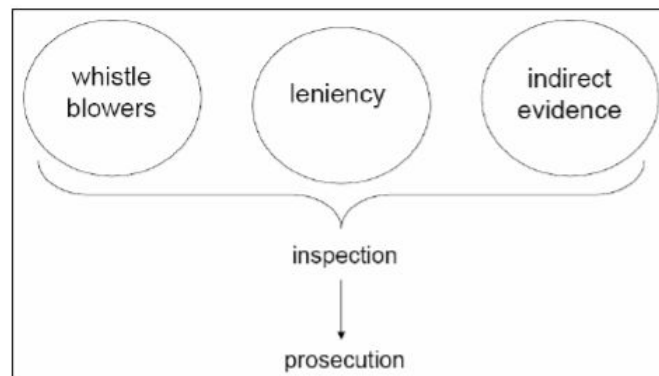
<sup>66</sup> Hammond 2004, p.10.

<sup>67</sup> Leslie 2004, p.651.

*again such a race can only start if there is a risk that the competition authorities will detect and establish the antitrust violation without recourse to leniency, or at least a belief by at least one of the conspirators that at least one of the other co-conspirators may believe that there is such a risk.”<sup>68</sup>*

So one should not forget that leniency cannot take the place of all of the other methods of obtaining information and evidence of competition infringements. Leniency can only work if there is a risk that the competition authorities will detect and prove the competition infringements without applying leniency. This means that CAs require access to every law enforcement power in order to attain a high rate of detection. Although detection of cartels is quite difficult because of their secret nature, a CA has some methods of detection to that end. Friederiszick and Maier-Rigaud<sup>69</sup> show these sources to be:

Figure 1: Instruments for cartel detection



Leniency applicants and whistle blowers, such as former employees, can submit direct evidence to the CA about the cartel i.e. “witness testimony, meeting notes, correspondence etc., complainants,

<sup>68</sup> Wils 2007.

<sup>69</sup> Friederiszick and Maier-Rigaud 2007.

such as competitors or customers of the alleged cartel and provide more indirect evidence on the existence of a cartel.”<sup>70</sup>

### **4.3. Transparency and Predictability**

Cartel members generally compare the costs and benefits of a leniency application. The result of transparency and predictability is that there can be more certain predictions by the firms about the consequences of whether to apply for leniency or not. Therefore transparency and predictability must be provided to the greatest extent possible in a cartel enforcement program, especially in setting fines. Accordingly, it is also necessary in the conduct of a leniency program that the CA needs to create the trust of applicants by consistent application of the program.<sup>71</sup>

Transparency must contain both explicit standards and policies as well as clear explanations of prosecutorial discretion in applying those standards and policies.<sup>72</sup> As Hammond mentioned: *“In order for an Amnesty Program to work, you need to do more than just publicize your policies and educate the public. It has to be willing to make the ultimate sacrifice for transparency - the abdication of prosecutorial discretion. If a corporation comes forward prior to an investigation and meets the program’s requirements, the grant of amnesty is automatic and is not subject to the exercise of prosecutorial discretion. ... Prospective amnesty applicants come forward in direct proportion to the predictability and certainty of whether they will be accepted into the program. If a company cannot accurately predict how it will be treated as a result of its corporate confession, our experience suggests that it is far less likely to report its wrongdoing, especially where there is no ongoing government investigation. Uncertainty in the qualification process will kill an amnesty program.”*<sup>73</sup>

## **5. CONCLUSION**

Cartel agreements are one of the most harmful infringements and therefore prohibited in all jurisdictions but they still are being formed and operated due to their secret nature. Following them only by government

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<sup>70</sup> Friederiszick and Maier-Rigaud 2007.

<sup>71</sup> ICN 2006, p.3.

<sup>72</sup> Hammond 2000, p.11.

<sup>73</sup> Hammond 2004, p.11.

investigation is a very expensive and ineffective way to combat them. As one of the most efficient tools to fight against concealed cartels, leniency programs can help detect, prosecute and deter cartels by providing direct and reliable evidence. Leniency programs create incentives to force cartel members to confess their activities and diminish the trust between the members. Thus leniency programs make cartels more likely to break down by themselves. On the other hand, leniency programs require some factors such as severe sanctions, a high risk of detection, transparency in the setting of fines and operating procedures, and predictability to ensure success. Therefore, the design and implementation of a leniency program should be made carefully to avoid possible adverse effects of a leniency program. Without establishing a suitable environment with severe sanctions, a high risk of detection, and transparency/predictability, when implementing a leniency program seems make it difficult to have a positive effect on the deterrence and detection of cartels; on the contrary, such an environment may encourage cartels.

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