CEP POLICY BRIEF

Proposed EU Digital Services Act (DSA):

Provisions concerning auditing and recommendations for strengthening this mechanism

Counter Extremism Project (CEP) Germany

Dr. Hans-Jakob Schindler

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COUNTER EXTREMISM PROJECT

About CEP and the author

The Counter Extremism Project (CEP) is an international, not-for-profit policy organization that has been engaged in efforts to effectively regulate social media and video sharing companies since 2015. Our focus lies on extremist ideologies and on illegal and terrorist content online. CEP advisors have been working with EU institutions and EU Member States for the past several years on some of the key issues the DSA aims to regulate.

Dr. Hans-Jakob Schindler is Senior Director at CEP and head of its Berlin/Germany office. He is the former Coordinator of the ISIL, Al-Qaida and Taliban Monitoring Team of the United Nations Security Council.

Please direct inquiries regarding this paper to Marco Macori, CEP Research Fellow: mmacori@counterextremism.com

I. Recommendations

The new audit regime that the Digital Services Act (DSA) envisions for very large platforms mirrors in significant aspects audit regimes already deployed in other industries, in particular the financial industry. Given that the audit regime is envisioned to play a key role in ensuring compliance with the provision of the DSA at very large platforms, the following improvements could be contemplated:

a) Revision of the definition of very large platforms in Art. 25 to include additional platforms in the audit regime

b) Including provisions that require platforms to allow auditors access to all relevant information during annual and additional audits by moving the relevant provisions from the preamble to Art. 28.

c) Strengthening of the position of the compliance officer in very large platforms by dropping the provision that this function can be fulfilled on a contractual basis and requiring this function to be a full staff position in Art. 32.

d) Ensuring commercial independence of auditors by creating an industry wide auditing fund from which auditors are going to be compensated in Art. 28.

e) Strengthening the independence of auditors by requiring the rotation of auditing mandates every several years to avoid an integration between auditors and clients through long term cooperation which risks limiting the auditor's flexibility to make negative findings in Art. 28.

f) Requiring separation of auditing and consulting mandates in order to avoid commercial incentives for positive audit results in an effort to protect consultancy mandates in Art. 28.

g) Strengthening role of Commission and the European Board for Digital Services in developing and defining effective auditing standards in Art. 34.

II. Envisioned auditing system

II.I. Structure and function of audit regime

The proposed text of the DSA currently envisions an auditing system fairly similar to auditing regimes employed in other industries. In its current version, audit regimes only apply to very large platforms.[1]

Article 28 outlines the central provisions of the functioning of the audit regime for such platforms:

a) The audits done annually and are financed by the platforms themselves (Art. 28.1.).

b) The audits encompass all relevant obligations of the DSA (Chapter III) and any codes of conduct (Art. 35) that the respective platform joins (Art. 28.1.a and b.).

c) Auditors are required to be independent, have proven expertise and objectivity (Art. 28.2. a., b. and c.).

d) The audit report, apart from identifying information of the platform and the auditor, must include information which specific elements were audited, what methodologies were used and what the main findings were (Art. 28.2. a. to d.).

e) The audit report must include an opinion whether the respective platform conformed with its obligation and if it is not the case also include operational recommendations on specific measures to achieve compliance (Art. 28.2. e. and f.).

f) The platform should take these recommendations into account, take action and one month after the audit report submit adopt an audit implementation report, outlining what measures were taken and – in case recommendations were not followed – why this is the case and what alternative measures were taken (Art. 28.2.i.).

g) Due diligence and auditing standards are planned to be developed by relevant European and international standardization bodies and the commission will support their development and update (Art. 34).

Furthermore, the current version of the DSA explains that each very large platform has to appoint a compliance officer that is – among other duties – responsible to organize the audit activities (Art. 32.3.b.). Interestingly, while the compliance officer is required to report directly to the top management of a platform (Art. 32.6.), as is the case for compliance officers the financial industry, Art. 32 allows that such an individual can work as a contractor/consultant (Art. 32.2.).

At the European Union level, the European Board for Digital Services, consisting of high-level personnel of the Commission, the national Digital Services Coordinators (DSCs), as well as other relevant authorities (by invitation) (Art. 48.1.) is also tasked with supporting national authorities to analyze the results of audit reports (Art. 49.a.)

[1] Article 25 in its current form defines „very large platforms" as having an "average monthly active recipients of the service in the Union equal or higher than 45 million", See Article 25.1., https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020PC0825&from=en (referred to below as DSA-Proposal).

II.II. Consequences of serious negative findings in audit reports

In case audit reports point towards serious and continuous infringements of a platform's obligations under the DSA., an investigation against the platform can be opened. In this case:

a) Auditors are required to submit information to the national DSCs (Art. 41.1.a.).

b) In case the "enhanced supervision system" (Art. 50) for a platform is enacted,[2] the national DSC of the jurisdiction in which the platform is established can request additional audits, at the expense of the platform, to assess the effectiveness the platform is taking to end the infringement of its obligations. These audit reports are then sent to the DSC, the Commission and the Board for Digital Services (Art. 50. 3.).

c) The Commission also has specific rights related to audits. It can request information concerning infringements both from the auditors as well as the platforms (Art. 52.1.), take interviews and statements for natural and legal persons in the framework of an investigation into infringements (Art. 53)[3] and carry out on-site inspections with the support of auditors (Art. 54.) as well as appoint auditors to assist it in its monitoring of platforms under enhanced supervision (Art. 57).

d) The investigation and enhanced supervision systems are enforced by the imposition of fines (Art. 41.2.c.) and periodic penalty payments (Art. 41.2.d) by the national DSC. These fines and payments are defined by the individual EU Member States (Art. 42). The Commission can also impose fines in case of non-compliance (Art. 59.1.) to punish refusal by a platform of its requests and decisions (Art. 59.2.) or periodic penalty payments to further enforce its decisions and requests (Art. 60.1.)

e) In cases where an infringement may cause a threat to life or the safety of persons the national DSC can also ask the judiciary of its EU Member State to order the temporary restriction of access to the respective service (Art. 41.3.b.). These restrictions are renewable as well repeatable (Art. 41.3.b.b.)

III. Potential to strengthen auditing regime and increase independence of auditors

III.I. Opportunities for general improvements

The envisioned audit system parallels in general audit systems deployed in other industries. The fact that it will only apply to very large platforms according to the definition in Art. 25 is justified with their particular significant impact on society.[4] The threshold of 10% of the

[2] This is the case if the DSC of the jurisdiction in which the respective platform is established (Art. 50.1.) finds that the platform has violated its obligations under Section 4 of Chapter III of the DSA (risk assessments, risk mitigation, audits, general transparency provisions, specific transparency of recommender system, data access to vetted researchers). The Commission, the European Board for Digital Services or a group of at least three national DSCs can also request

[3] However, crucially only if these persons agree to be interviewed, meaning the Commission cannot require interviews or statements, only the provision of information is a requirement and penalties can be levied if incorrect or misleading information is provided (Art. 52.2. and Art. 59.2.a.).

[4] DSA proposal, page 3

European Union population[5] could be lowered to include more platforms being required to be audited. Defining such a threshold mirrors a similar provision in the German Network Enforcement Act (NetzDG).[6] It seems generally useful to avoid stifling regulatory obligations on start-up companies.

Given the crucial role that auditors are envisioned to play in the general monitoring of the compliance of very large platforms with the obligations under the DSA, it is surprising that access of these auditors to all relevant information is not included in the current provisions of Article 28. While it must be assumed that it is in the general interest of a platform to provide its auditors the necessary access, it cannot be guaranteed that this will always be the case. Therefore, it may be advisable to move the relevant provisions from the preamble of the proposed DSA text to Art. 28 to ensure that it becomes a legal obligation.[7]

Finally, the provision that the compliance officer of a very large platform can also be based on a contract rather than on a staff position (Art. 32.2.) is unusual when it comes to large scale industry players. A contract-based relationship is generally weaker than a staff arrangement. Therefore, it may not give the compliance officer the necessary standing in the internal hierarchy of a very large platform to effectively fulfil this function. Therefore, it may be advisable to drop this provision and require that the Compliance Officer is a fully employed staff member of the respective platform.

III.II. Potential improvements based on experience in other industries

The financial crisis of 2008 and the collapse of several large corporations in the past 20 years have demonstrated three basic structural flaws in existing audit systems that limit the independence of auditors and therefore weaken the early warning function of such control systems. These are the direct commercial relationship between the control mechanism and the client, the creation of a client relationship that is too close to allow critical assessments of the client's performance and the combination of auditing and consulting mandates. These basic flaws should be avoided when setting up a new audit regime under the DSA.

III.II.I. Strengthening auditor independence through separating payment

The current DSA text outlines that all costs for regular and specific audits fall to the respective platform, while at the same time, the auditors are required to be independent of the platform. This is also the case in audit systems in other industries. However, it may be advisable to consider the economic power balance between an auditor and a very large platform if the platform directly compensates the auditor for its services.

As demonstrated during the 2008 financial crisis, the fact that investment banks directly compensated credit rating agencies for ratings of their mortgage-backed securities (MBS) and collateralized debt obligations (CDOs). This is seen as one of the significant causes of the financial crisis in 2008. Such direct payments provided financial incentives for the credit rating

[5] DSA proposal, page 3
[6] Paragraph 1 NetzDG defines the threshold for Germany as 2 million users, see: https://www.gesetze-im-internet.de/netzdg/BJNR335210017.html
[7] See paragraph 60 of the preamble.

agencies to give more positive ratings for the respective MBS and CDOs as a positive rating would ensure that investment banks could sell the packages at higher prices on the market. Therefore, through positive ratings rating agencies ensured repeat business with investment banks.[8]

A similar financial incentive to issue positive audit reports may be created if very large platforms compensate their auditors directly. This is particularly the case as the annual audits of very large platforms will very likely be undertakings of significant size and therefore generate significant commercial interest and income for an auditor.

Therefore, it could be explored whether it may not strengthen the independence of an auditor if rather than direct payments, an industry-wide audit fund is created into which all platforms pay an annual membership fee based on their size. This fund would then reimburse the auditors, preventing a direct commercial relationship between a very large platform and an auditor.

III.II.II. Strengthening auditor independence through rotating audit mandates

The current version of Art. 28 does not include a limit how often a particular auditor can perform annual audits or provisions separating the functions of annual audits from those of the additional audits that the national DSCs or the Commission can require in the course of an investigation or the enhanced supervision system.

As the ENRON collapse in 2001 demonstrated, one aspect that prevented early detection of the highly unethical accounting practices and manipulation of its balance sheets through the misrepresentation of its earnings was its too close and long-standing relationship with the accounting firm Arthur Andersen LLP created through years of audits performed for ENRON exclusively by Arthur Andersen LLP.[9]

Therefore, it could be contemplated to ensure that annual audit mandates should be switched between auditors and that other business divisions of the auditors that conduct the annual audits cannot at the same time be employed as additional auditors during investigations and the enhanced supervision system. Given that annual audits of a very large platform will very likely be complex and require the building of specific capacities and expertise,[10] it seems advisable that this switching of auditors should only be required after several annual audits. For example, following the discovery of similar problems during the WIRECARD collapse in Germany, the German government is currently contemplating requiring rotating auditors once every 10 years.[11]

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[8] See for example: https://eu.usatoday.com/story/money/business/2013/09/13/credit-rating-agencies-2008-financial-crisis-lehman/2759025/
https://www.cfr.org/backgrounder/credit-rating-controversy

[9] See for example: https://www.nytimes.com/2002/01/15/business/enron-s-collapse-the-auditors-who-s-keeping-the-accountants-accountable.html
https://mpra.ub.uni-muenchen.de/1147/1/MPRA_paper_1147.pdf

[10] For which minimum industry standards for auditors should be agreed, including appropriate technical expertise. The Volkswagen emission scandal or “Dieselgate” demonstrated how challenging effective control of complex technical systems can be. See for example: https://www.bbc.com/news/business-34324772

[11] https://www.ft.com/content/2f5c9ce0-76f5-47cb-9835-fcc2524062b6

III.II.III. Strengthening auditor independence through separating audit from consulting mandates

One of the well understood weaknesses of existing audit systems relating to large corporations, which limits the independence of auditors is the combination of auditing and consulting services, offered by the same company to the same client.[12] Consultancy mandates can be commercially far more lucrative than audit mandates and therefore, providing both functions to the same client may lead to a commercial incentive to provide the client with positive audit reports in order to ensure retention of existing and the procurement of new consultancy mandates. In order to counter this risk, the United Kingdom changed its regulations requiring the separation of audit and consultancy functions within large audit companies to limit such incentives.[13] An even stronger separation between auditing and consulting services, limiting the amount of consulting mandates an auditing company can perform for a client, is currently contemplated in Germany following the collapse of WIRCARD.[14]

Therefore, it may be advisable to include a provision in Art. 28 of the DSA that ensures that such a separation of auditing and consulting mandates for the same client is required. Including such a provision in combination with the rotation of auditing mandates (see above III.II.II.), would ensure that the commercial attractiveness of auditing mandates would be maintained as consulting services could be offered to all other very large platforms and consulting services could again be offered to a respective platform when the auditing mandate is rotated.

III.II.IV. Ensure effective standards and operational implementation for audit procedures

Effective standards and detailed operative implementation of regulations and control mechanisms are crucial for effective auditing and mitigation mechanisms. The events concerning Cum-Ex/Cum-Cum transactions,[15] which led to significant loss in tax revenues in Germany and several European countries,[16] made this clear. The German government was aware since 2002 that the so-called dividend stripping was ongoing,[17] but had difficulties in closing the relevant legal loopholes in the tax regulations. One reason for these difficulties was

https://www.wsj.com/articles/after-wirecard-germanys-proposed-audit-overhaul-worries-finance-executives-11617868813

[12] See for example: https://projekte.sueddeutsche.de/artikel/politik/deloitte-kmpg-pwc-ey-die-big-four-e945619/
https://www.ft.com/content/29a029a0-a7b2-11e8-8ecf-a7ae1beff35b

[13] See for example: https://www.washingtonpost.com/business/how-uk-audit-scandals-pushed-big-four-toward-split/2020/07/17/27eeb202-c817-11ea-a825-8722004e4150_story.html

[14] https://www.finance-magazin.de/banking-berater/wirtschaftspruefer/wirecard-was-bringt-eine-trennung-von-pruefung-und-beratung-2076281/
https://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetze_Gesetzesvorhaben/Abteilungen/Abteilung_VII/19_Legislaturperiode/2020-10-26-Finanzmarktintegritaetsstaerkungsgesetz/1-Referentenentwurf.pdf?__blob=publicationFile&v=3

[15] See for example: https://www.europarl.europa.eu/cmsdata/158435/2018-11-26%20-%20Information%20paper%20on%20Cum-ex%20-%20Cum-cum.pdf

[16] See for example: https://www.dw.com/en/cum-ex-tax-scandal-cost-european-treasuries-55-billion/a-45935370

[17] See for example: https://www.wiwo.de/finanzen/boerse/cum-ex-geschaefte-bund-wusste-seit-2002-von-steuertricks-mit-aktien-/10030984.html

the influence that relevant private sector stakeholders reportedly had on the drafting of new legal and regulatory provisions.[18]

Therefore, it may be advisable that the Commission and the European Board for Digital Services play a more active role in developing appropriate standards for platform due diligence and auditing processes. The envisioned role of the Commission in Art. 34 to only support and promote voluntary industry standards may be insufficient. A more active role is of particular importance since technical audits for very large platforms have not been attempted before.

Thus, the complete externalization of the development of effective standards may entail the risk that its significant reliance on private sector stakeholder expertise may weaken this important element of the envisioned control mechanism. One example of multilateral development of standards and detailed operational advice for implementation is the Financial Action Task Force (FATF) and its FATF-style regional bodies (FSRBs) through which governments are actively engaged in the development of global defense mechanisms against money laundering and terrorism financing. The European Board for Digital Services in cooperation with the Commission could act as such a multilateral structure to ensure the development of effective standards for due diligence requirements and audits in the framework of the DSA.

[18] See for example: https://www.zeit.de/wirtschaft/2020-08/cum-ex-affaere-bankenverband-razzia