Feedback on draft EU Delegated Regulation Ares (2023) 3171302 on the Performance of Audits of Very Large Online Platforms and Very large Search Engines

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Consultation response from the

Centre for Competition Policy

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This consultation response has been drafted by named academic members of the Centre, who retain responsibility for its content.

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Draft EU Delegated Regulation Ares (2023) 3171302 on the Performance of Audits of Very Large Online Platforms and Very large Search Engines

Comments from the Centre for Competition Policy, UEA

Summary

The effective, transparent and inclusive auditing of very large online platforms and very large online search engines will be crucial to ensuring that the Digital Services Act (DSA) meets its policy objectives in relation to preventing societal harms. However, the market for auditing at such levels of scope and complexity is concentrated, with problems experienced because of this in other sectors. At the same time, the benchmarks for what constitutes systemic crisis or failure have not yet been established for the broad risk areas set out it the DSA, nor have the negative effects that are supposed to be assessed and mitigated by the digital service providers been thoroughly defined. In this response we argue that there are risks of concentrating standard setting power in the hands of a few auditing organisations, and that these could be low or otherwise problematic due to the potential for collusion and the incentive structure. We suggest a few amendments to the draft Designated Regulation aimed at increasing the transparency and inclusivity of the standard setting points in the process and adding an additional protection against damaging effects of the incentive structure.

Comments

1. The EU's Digital Services Act requires the providers of services that have been designated as very large online platforms (VLOPs) or very large online search engines (VLOSEs) to be subject to independent audit for compliance, at their own expense and at least annually. These audits must cover all the obligations in Chapter 3 of the DSA. This would include the general ones on representation and transparency in section 2 and the ones for certain types of services in sections 2,3, & 4. The most challenging will be auditing of the systemic risk assessment and mitigation obligations set specifically for very large online platforms and very large search engines in section 5. They also must cover the implementation of the codes of conduct covered in Articles 45 and 46.

2. Given the complex nature of the systemic risk areas set out in Art 34, and the aim set out in recital 137 of the DSA of building "Union expertise and capabilities" in a very inclusive manner, it is useful that the Delegated

Regulation notes at the outset that independent audits represent one among many sources of information for regulators. Nevertheless, it is precisely because the risk areas are broad and complex that the audit reports will likely play a very important standard setting role in the enforcement of the DSA. As we will point out in a report on systemic risk as applied in the DSA, due to be published on 13 July 2023 by the Centre on Regulation in Europe, one of the significant challenges in assessing risk is the lack of clear definitions of what constitutes systemic failure or crisis in each of the risk area. We argue that this is where the involvement of broad Union expertise is especially needed.

3. The assessment and mitigation of risk the broad areas of societal harm set out in the DSA will necessarily be an iterative process involving feedback loops and learning. In these, the audit reports will likely be crucial tools for arriving at understandings of what constitutes "negative effects" to fundamental rights, to civic discourse, or the health of minors and the general public, among others. The auditors will need to have some benchmark of failure or crisis to determine what effects are negative and therefore need to be assessed for potentiality and severity and suitably mitigated.

4. In response to a 'negative' audit report, a VLOP or VLOSE provider must prepare an audit implementation plan stating how they will implement the recommendations in the audit or an alternative way of achieving compliance. This will necessarily contribute heavily toward establishing the standard for "good" risk assessment and "sufficient" risk mitigation in relation to important areas of harm to society and individuals covered by the DSA's Art 34. According to the Designated Regulation as draft, it seems the auditors would be expected to establish the "materiality thresholds" for "deviations" and "misstatements" that would determine the outcome of the audit findings, conclusions and opinions. Determining such important benchmarks should be an inclusive and transparent process and thresholds may vary across the risk areas.

5. As drafted, the Designated Regulation would have auditors analysing whether mitigation measures are reasonable, proportionate and effective with particular consideration of those related to fundamental rights. In the implementation of new policy, there is first mover advantage in terms of establishing standards, defining concepts and benchmarks, and even the language used in relation to the policy goals. The auditors will be in this position unless other work in this direction is done ahead of time that draws on Union expertise as defined in the DSA's recitals.

6. These audits will be highly complex and require a varied expertise. The DSA aptly requires auditors to have the necessary expertise in the risk area and technical competence. This will require significant initial "fixed costs" borne by auditors and it is likely to create a significant limitation in terms of the number and variety of auditing companies that will be able to fulfil those

requirements. The draft Delegated Regulation and the DSA itself have solid criteria for independence that include no other services provided to the company and regular rotation. Nevertheless, the fact that there is a limited pool from which the auditors can be drawn poses some particular problems. This is an outstanding and very well-known issue of financial reporting auditing. The requirements for both services (auditing of financial reporting and systemic risk assessment, respectively) will, on the one hand, unavoidably exacerbate the issue for both "markets", and, on the other hand, increase the likelihood of collusion. This can have an impact on both fees and the quality of reporting, given that auditors are given some sort of normative power in relation to DSA-required reporting.

7. The concentration in the provision of auditing thus raises several flags that should be considered and accounted for as much as possible in the Delegated Regulation. Firstly, it puts the standard setting power described above into the hands of a few large global companies that have clear commercial incentives. Auditing of compliance has a long history in many sectors and is becoming more and more relevant for financial services corporations with impacts on financial markets. As written above, the auditing of financial services market is highly concentrated, and the quality of service has not always been high. Scandals[1] have arisen leading to consumer harm, impact on financial markets, and loss of confidence – to mention some of the negative outcomes. Moreover, in recent times both market participants and policy makers are increasingly requiring sustainability disclosure, which, in turn, will increases the demand of auditing services, albeit it is a different segment of auditing. This is especially the case of listed companies and, due to EU Sustainable Finance Disclosure Regulation (SFDR[2]), required of all financial services companies that offer financial products to customers.

8. Secondly, there is a risk of collusion. The same few large auditing companies will be competing in at least two concentrated market, (the market for auditing VLOPs and VLOSEs, and the market for auditing financial services), which increases their potential gain from colluding. The rule against offering multiple services simultaneously to the same, would normally be a wise approach as it would be an attempt to avoid potentially higher rental extraction[3], improper practices, and misbehaviours. However, it could lead to both markets being like "timed" monopolies, which would undermine the effectiveness of this rule. Though this issue is really structural, it is key to address it as much as possible. In the short run, a way to limit (but not

[1] In 2001 the famous "Enron scandal" led to the default of Enron Corporation and the dissolvement of its auditing company, Arthur Andersen (at that time it was one of the Big 5 auditing companies) in 2022. Since then, the auditing market is dominated by the so called Big 4 companies.
[2] Please refer to the legislation: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088
[3] Research carried out on auditing markets would suggest that this could be the likely outcome. See, for example, Numan & Willekens (2012) for additional theoretical and empirical details.

completely avoid) this potential issue would be to require a more frequent rotation of companies for auditing VLOPs and VLOSEs than for financial auditing, which is normally a 3-year cycle. In the medium/long run, the proper incentives can be set to modify the market structure of auditing market so that the number of competitors among auditing companies is increases, their market power decreases and all the previously stated vicious cycle becomes a virtuous one with positive spillovers on lower fees, higher auditing quality, fewer scandals, and better consumer protection, (to list some of the multiple positive outcomes). One option could be to allow, or even encourage, VLOP and VLOSE providers to engage different auditing organisations for different risk areas, allowing for specialisation and encouraging market entry, perhaps by consortia or even by non-profit entities.

9. Thirdly, related to the previous concerns, there is a risk of standards lowering due to the incentives of both the audited and the auditors to keep costs low and the exclusivity of the knowledge that would be held within a small group of companies. This potential issue may also lead to lower efforts in risk assessment and mitigation from VLOP and VLOSE providers, which may somewhat agree (i.e., collude) to do so. This would be exacerbated and, ultimately compounded, if auditing organisations are conducting both the audit of risk assessment and of risk mitigation.

Recommendations

10. The significant capacity needed for the implementation of these audits is unavoidable. The likelihood of new players entering the market any time soon for auditing with such high requirements for providing the service is probably small. Therefore, we suggest the following amendments to the draft Delegated Regulation:

    a. Article 2 should include a definition of what is understood to be a "deviation" as mentioned in point 12 in the definition of "materiality threshold" or the definition in point 12 should be expanded to include a qualification that identifies from what a deviation could be, or what type of deviation makes up part of the threshold.
    b. Article 4 should include an additional clause that states that auditing organisation should not be selected to conduct both audit of risk assessment and risk mitigation in the same or the following two consecutive years, or at the very least that selected auditing organisations are required to ensure and demonstrate functional separation between the auditing of risk assessment and risk mitigation. Importantly, frequency of auditing companies' rotation should be asymmetric across the different auditing services (at least until auditing market structure becomes more competitive).

c. Because the contracts will form part of the package made available as part of the report, Article 7 (a) should be expanded to add a requirement that the exhaustive list of audited obligations and commitment include statements of how each are interpreted by the contracting parties. These can then be reviewed by regulators and revised in future contracts if needed.
d. In Article 10.2(a) should be expanded to include a requirement to detail the evidence base used to establish the materiality threshold. We also suggest that an additional clause, perhaps 2a, be included encouraging auditing organisations to engage with wide array of experts and stakeholders in establishing criteria and materiality thresholds and provide information on those included and the process as part of their methodology. This could be done through formative workshops, establishing external advisory or steering committees, or other means.
e. As some of the evidence that might be required for auditing may involve personal data of users, Article 12.2 should include a final point (f) compliance with GDPR.

11. Audit reports will be crucial to the enforcement of the DSA by the Commission, which oversees those designated as VLOPs or VLOSEs. They are to be considered among other sources of evidence in decisions and become particularly relevant in the enhanced supervision mechanism following any non-compliance or infringement decision as outlined in Article 75. The Commission and Board for Digital Services have wide ability to engage experts for inspections, consideration, and other functions related to monitoring and enforcement. It will be crucial that this broad convening power be used to: 1) establish core understandings for each of the risk areas to inform the work of the auditors, namely in relation to characterising negative effects, the nature of risks and relevant threshold, and 2) to critically examine the work of auditing organisations and the quality of audit reports.