A Study on the Inhibitory Effect of Inquiry Letters on the Hollowing out of Shareholders in Non-Punitive Supervision: Taking Nanjing Xinbai Company as an Example

Jingwei Cai[1,*] and *Hanjun* Qiu[2]

[1]Business School, Chengdu University of Technology, Chengdu, 610059, China
[2]International Business Management Department, Fujian Hwa Nan Women's College, Fuzhou, 350108, China

Abstract. The continuous evolution of regulatory methods in the capital market underscores the significance of regulatory inquiries as a primary tool for exchanges. Over the years, the frequency of inquiry letters has risen, demonstrating a growing level of professionalism and detail in questioning. This trend has garnered considerable attention from scholars globally. Recent incidents, particularly involving listed companies facing financial crises, highlight the serious disruption caused by major shareholders hollowing out these firms. Therefore, understanding how regulatory inquiries govern the phenomenon of shareholder hollowing is crucial for enhancing market order and refining regulatory mechanisms. This study focuses on the case of Nanjing Xinbai, analyzing the hollowing-out process of its major shareholders. It investigates the governance mechanisms, inhibitory effects, and economic consequences of regulatory inquiries on such hollowing-out incidents. The case analysis reveals that inquiry letters, by posing questions, alleviate regulatory and public opinion pressure, leveraging intermediary agencies' synergies to deter inappropriate behavior by listed companies. Simultaneously, regulatory inquiries encourage companies to enhance internal controls, safeguarding the interests of small and medium-sized shareholders in the face of potential major shareholder misconduct. The findings underscore the dual role of regulatory inquiries in releasing pressure and prompting positive corporate behavior, while also addressing shortcomings in the inquiry letter mechanism for the benefit of policymakers, investors, and listed companies.

1 Introduction

This article mainly studies how to inhibit the hollowing out behavior of major shareholders of listed companies in corporate governance. In fact, as early as 2001, many exchanges had begun to use annual inquiry letters to assist in the supervision of major listed companies. In 2013, the exchange expanded the scope of inquiry letters and more standardized the application of inquiry letters, increasing the number of questions asked by the inquiry letters on listed companies. At the end of 2014, the Shanghai Stock Exchange began to disclose the status of inquiry letters to listed companies. Therefore, the supervision of inquiry letters was adopted by the Shanghai Stock Exchange as a first-line supervision method. Therefore, when a listed company is suspected of predatory capital operations, capital occupation and other hollowing out situations, the exchange often issues inquiry letters for supervision and monitors and supervises the information disclosure of listed companies. So, does the exchange's hollowing out of major shareholders have a governance effect, and can it inhibit the hollowing out of major shareholders? If supervision is effective, it is worth studying the governance mechanism and economic consequences of exchange inquiry supervision as a front-line supervision method for regulatory authorities.

This article studies the governance of inquiry letter supervision on the hollowing-out behaviour of major shareholders, analyses the regulatory mechanism and economic consequences, discovers the shortcomings of the current inquiry mechanism during the research process, and puts forward suggestions for improvement of exchanges to further improve the supervision of exchange inquiries. Effectiveness is conducive to strengthening the external governance of the hollowing out behaviour of major shareholders of listed companies. At the same time, the case study can present the entire process of inquiry and supervision of the hollowing out of major shareholders, provide rectification reference for listed companies that have received relevant inquiries, and warn listed companies that have not yet experienced problems, so that they can improve the quality of the company's internal control and reduce the risk of being questioned. Hole-out risks and prevent regulatory inquiries due to hollow-out events [1].

2 Related concepts and theoretical basis

* Corresponding author: cai.jingwei@student.zy.cdut.edu.cn

2.1 Related concepts

In corporate governance, the large proportion of company shares held by major shareholders gives them significant influence in the company's decision-making. Major shareholders can both improve corporate governance and may also damage corporate governance. First of all, the interests of major shareholders are closely connected with the interests of the company. They usually do not stand by and just passively enjoy the improvement of the company's performance like some small and medium-sized shareholders. First of all, the interests of major shareholders are closely connected with the interests of the company. They usually do not stand by and just passively enjoy the improvement of the company's performance like some small and medium-sized shareholders. On the contrary, large shareholders are more inclined to actively participate in corporate governance to ensure the healthy development of the company, because this is also crucial to their own interests. Major shareholders usually cannot control the company and have direct cash flow rights at the same time, so they may transfer the company's profits, assets or resources to themselves or related entities by abusing the company's internal resources and related transactions, and may ignore the interests of other shareholders [2].

Some reports pointed out that my country’s listed companies have a high degree of equity concentration and imperfect corporate governance mechanisms [3]. The means of hollowing out major shareholders include related transactions, asset transfers, financial engineering, etc., especially parallel transactions implemented through abuse of influence, to transfer company resources to themselves or related parties, and to seek illegal or improper economic benefits. In addition, abnormal dividend distribution methods such as abnormal cash dividends are also one of its methods of hollowing out. Major shareholders usually adopt a variety of means, such as related transactions, false statements and illegal asset transfers, to comprehensively weaken the company's financial strength [4]. The key to studying the complexity of major shareholder hollowing out behaviour lies in a deep understanding, which requires a comprehensive investigation of the company's financial statements, transaction records, related party relationships and other information to grasp the essence [5]. Regulators, investors, and researchers need to work together to detect and respond to this complex hollowing out behaviour.

The risk of major shareholder hollowing out has a profound impact on a company's economic performance, shareholder value and governance. First, by abusing company resources, major shareholders may cause the financial situation to deteriorate and affect the company's economic operations. Secondly, this behaviour directly harms the rights and interests of small shareholders and affects the company’s stock price and market value [6]. The hollowing out of major shareholders reveals problems with corporate governance mechanisms, including imperfect supervision mechanisms and opaque information disclosure. In order to mitigate risks, companies need to strengthen internal supervision and ensure the independence and transparency of the governance structure to prevent the hollowing out of major shareholders and improve the level of corporate governance.

Non-punitive supervision is a regulatory method in which regulatory agencies guide and regulate market entities and use preventive means such as information disclosure, self-regulatory organizations, training, etc. to reduce market risks, improve transparency, maintain market order and protect the rights and interests of investors [7]. Compared with traditional punitive regulation, non-punitive regulation emphasizes long-term mechanism construction and provides more flexible and effective regulatory means for the healthy development of the market by stimulating compliance, emphasizing education and win-win cooperation.

Non-punitive regulatory mechanisms include various tools such as inquiry letters, guidance letters and self-regulatory rules. Inquiry letters directly ask questions of listed companies, prompting companies to more proactively disclose information, enhance transparency, and strengthen market supervision. Guidance letters are specific guidance documents issued by regulatory agencies, explaining the details and implementation requirements of regulations and policies, and providing clear guidance to market entities. Self-regulatory rules are formulated independently by industry associations or organizations to standardize industry behaviour, improve governance levels, and strengthen market self-discipline.

These non-punitive regulatory tools work together to build a comprehensive and diverse regulatory system. Among them, the inquiry letter directly interacts with the company, promotes compliance operations and standardizes industry behaviour, and plays a unique and important role.

2.2 The role of inquiry supervision as non-punitive supervision

Inquiry letter supervision is a non-punitive regulatory tool that raises concerns to listed companies through regulatory agencies, prompting companies to proactively disclose information, enhance market transparency, and protect the rights and interests of investors. Its definition and purpose are to guide information disclosure, risk identification, corporate governance supervision and regulatory interaction [8]. Through inquiry letters, regulatory agencies can understand the company's true operating conditions on the basis of prior guidance and prevention, promote active rectification, reduce potential violation risks, achieve positive interaction between supervision and enterprises, and provide a powerful tool for maintaining market order and reducing risks.

Inquiry letter supervision is based on the regulatory agency's ongoing assessment of the operating conditions of listed companies. Once potential violations, opacity, or high-risk situations are discovered, detailed questions will be raised through written inquiry letters. This process includes steps such as identifying issues of concern, asking questions to the company, and the company responding. It emphasizes the interaction and cooperation between supervision and enterprises, prompting companies to actively respond to regulatory concerns, and maintain market transparency and compliance operations [9]. With the gradual advancement of the information disclosure express train of the Shanghai and Shenzhen Stock Exchanges, in addition to disclosing public information such as annual reports and announcements of listed companies, at the end of 2014, the Shenzhen Stock Exchange and the Shanghai Stock Exchange also began to publicly disclose inquiry letters and replies from listed companies to the public. Various inquiry letters from the exchanges differ in terms of letter names, letter characteristics, inquiry matters and inquiry reasons, and the types of inquiry letters from the two major securities exchanges in Shanghai and Shenzhen are also different.

By collecting and sorting the inquiry letters disclosed by the Shanghai and Shenzhen Stock Exchanges, as shown in Table 1, it is found that the inquiry letters issued by the Shanghai Stock Exchange are divided into inquiry letters, major asset restructuring plan review opinion letters, and periodic report information disclosure regulatory inquiry letters. Three categories; the inquiry letters issued by the Shenzhen Stock Exchange are subdivided into seven categories: letters of concern, annual reports/semi-annual reports/non-licensed restructuring, and inquiry letters [10].

Among them, the number of company department letters and regulatory functions is small (only 4), and the number of attention functions is the largest (4628). Once the exchange discovers signs of hollowing out of listed companies when conducting various information reviews, it will initiate inquiries in the corresponding inquiry letters. Therefore, various inquiry letters can be used to supervise the hollowing out behaviour of major shareholders of listed companies.

Table 1. Issuance of inquiry letters from the Shanghai and Shenzhen Stock Exchanges from 2014 to 2020.

	Type	2014	2015	2016	2017	2018	2019	2020	2021	2022
Shenzhen Stock Exchange	letter of concern	0	88	448	388	793	710	1118	1083	748
	Annual report inquiry letter	0	114	188	206	311	447	562	469	179
	Third quarter report inquiry letter	0	0	1	0	0	1	2	7	16
	Semi-annual report inquiry letter	0	25	4	14	55	62	55	74	43
	Licensing Reorganization Inquiry Letter	0	181	297	170	138	100	86	44	30
	Non-licensed restructuring inquiry letter	3	64	67	77	61	46	53	44	29
	Inquiry letter	0	13	34	38	116	155	132	15	7
	Subtotal	3	485	1040	896	1474	1521	2008	1736	1052
Shanghai Stock Exchange	Inquiry letter	0	0	6	195	145	251	148	158	147
	Periodic report post-audit opinion letter	0	0	0	142	145	201	30	38	33
	Review opinion letter for major asset restructuring plan	0	0	0	113	113	94	99	58	55
	Subtotal	0	0	6	450	403	546	277	254	235

Data source: Shanghai and Shenzhen Stock Exchanges

3 Case analysis

Nanjing Xinbai Co., Ltd., founded in 1952, originated from the Nanjing Xinjiekou store of China Department Store Jiangsu Branch. It is the first state-owned department store in Nanjing. It was successfully listed on the Shanghai Stock Exchange in 1993 with stock code 600682. Focusing on the human life cycle, it has developed four core businesses: health care, biomedicine, cord blood stem cell storage and application, and modern business. While maintaining the traditional department store retail business, it will expand diversified businesses.

Nanjing Xinbai's main business income has declined year by year since 2018, and has rebounded slightly in 2021. The operating income in 2020 has dropped by 40.47% compared with 2019. The reason is that, on the one hand, due to the transformation of the traditional retail industry into the large health sector with low turnover and high profits, Nanjing Xinbai's sales profit margin has increased and the overall operating income has decreased year by year. On the other hand, the subsidiary HOFUKI entered bankruptcy proceedings due to poor management and was no longer included in the consolidation scope of financial statements, resulting in a significant decline in operating income. At the same time, the company's net profit has fluctuated greatly in the past six years, reflecting the company's instability in the process of strategic change. Nanjing Xinbai's operating income and profits from 2017 to 2022 are shown in Figure 1.

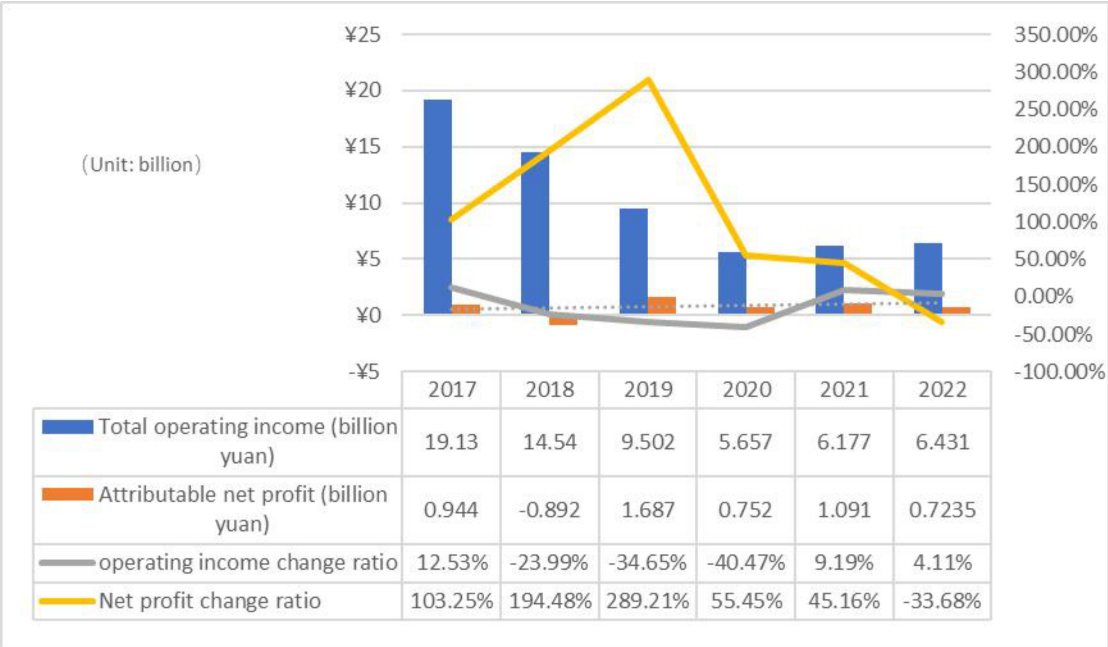

Fig. 1. Operating income and profits (Photo/Picture: Original).

The 2017 annual report of Nanjing Xinjiekou Department Store Co., Ltd. disclosed the non-operating capital occupation by major shareholders. As of December 31, 2017, major shareholders had occupied the funds of the listed company through borrowings and payment of fees. The balances of the occupied funds were RMB 730,000 at the beginning, RMB 335,800 newly incurred, and RMB 21,000 at the end of the period. The highest cumulative occupation during the period was 1.065-million-yuan, accounting for 0.13‰ of net assets. The inquiry letter requires the company to explain whether there are other undisclosed non-operating fund occupations and other related fund transactions, conduct an audit and express opinions.

As of April 29, 2023, the "Special Instructions for Non-operating Fund Occupation of Nanjing Xinbai in 2019" issued by Suya Jincheng Accounting Firm shows that Nanjing Xinbai's non-operating funds occupied by major shareholders in 2019 amounted to 50.2-million-yuan, accounting for 0.38% of the net assets of listed companies. As of December 31, 2022, of the funds raised by Nanjing Xinbai, 226 million yuan was reflected in the book as prepayments, of which 52.99 million yuan of prepayments had been recovered in April 2023. From 2018 to 2022, Nanjing Xinbai Company has been inquired by the exchange many times. The company's annual report involved multiple inquiries, mainly focusing on the occupation of funds by major shareholders, the rationality of the high valuation of the acquisition of Xuzhou Sanpower, and the concealment of related relationships. Capital increase: Whether Hongtu Real Estate will increase funds from major shareholders and the accuracy of information on Nanjing Xinbai Fund Investment Project and other important financial and business matters.

The response to the post-audit inquiry letter of Nanjing Xinbai's 2017 annual report revealed a number of non-operating transactions with Sanpower Group, Mingshan Technology, Hongtu Commercial Management, Hongguo Industrial and other companies, including payment of fees, loans, and lease deposits, warranty deposits, etc., as Table 2 shown.

Table 2. Specific dates, occupation matters and reasons for the occupation of non-operating funds.

Name of the party occupying the funds	The relationship between the occupier and the listed company	Accounting accounts for listed companies	Balance of funds occupied at the beginning of 2017	Cumulative amount of occupation in 2017 (excluding interest)	Cumulative amount of repayment in 2017	Balance of funds occupied at the end of 2017	Causes of occupation	Nature of occupation
Sanpower Group Co., Ltd.	Company controlling shareholder	Other receivables		114,811.20			Payment on behalf of others	Non-business occupation

Jiangsu Mingshan Technology Development Co., Ltd.	Companies controlled by controlling shareholders	Other receivables	730,000.00	3,300.00		3,300.00	Loan and rental deposit 3,300	Non-business occupation
Nanjing Hongtu Business Management Co., Ltd.	Companies controlled by controlling shareholders	Other receivables		200,000.00			loan	Non-business occupation
Hongtusanbao High-tech Co., Ltd.	Companies controlled by controlling shareholders	Other receivables		10,000.00		10,000.00	Warranty deposit	Non-business occupation
Jiangsu Hongtu Property Management Co., Ltd.	Companies controlled by controlling shareholders (transferred in 2017)	Other receivables		7,722.00		7,722.00	Payment on behalf of others	Non-business occupation
Hongguo Industrial Group Co., Ltd.	Companies controlled by relatives of the ultimate controlling party	Other receivables	1,140,000.00	5,847,350.69	6,987,350.69		loan	Non-business transactions
Total			1,870,000.00	6,183,183.89	8,032,161.89	21,022.00		

Data source: Nanjing Xinbai reply letter on June 1, 2018

Nanjing Xinbai Company's response to the inquiry letter for the 2018 annual report pointed out that the company has a major internal control flaw regarding the overseas operating entity HOF. The company should add the following information to the disclosure: (1) Detailed arrangements for borrowings, including time and purpose, amount, repayment situation, exchange rate, etc.; (2) Explain why it is commercially reasonable to continue to provide working capital support after HOF's bankruptcy; (3) What measures the company has taken to address the above major deficiencies.

In the reply to the inquiry letter for Nanjing Xinbai's 2017 annual report, the company detailed the corrective measures taken to address the issues mentioned in the inquiry letter.

(1) The company will solve the problem of small transactions in the next reporting period and ensure timely rectification.

(2) For capital transactions such as lease deposits and warranty deposits, the company promises to promptly recover them after the expiration of the agreement to maintain the normal operation of capital flow.

(3) For the occupation of funds caused by borrowing, the company will implement it in accordance with the agreement, requiring the other party to repay the loan and pay interest on the bank loan in the same period to protect the interests of small and medium-sized investors. The company responded quickly, attached great importance to the problem of non-operating capital occupation, and took practical rectification measures to standardize capital transactions with shareholders and related parties to prevent recurrence.

In the reply to the inquiry letter for Nanjing Xinbai's 2018 annual report, the company has taken a series of corrective measures to deal with the major defects discovered. This includes strengthening the corporate governance layer's understanding of risks, raising the risk prevention awareness of all employees, strengthening information communication between departments, improving internal control systems and management, and adjusting the responsible persons for relevant positions. These measures are designed to effectively solve existing problems and improve the company's overall risk management level. The specific performance of duties is shown in Table 3.

Table 3. Whether the directors appointed by the company can perform their duties normally and their specific performance.

Director	Whether it is appointed by the company	Number of board meetings to attend in 2018	Number of in-person attendance	Communication method participation times	Number of delegated attendances	Start and end date of appointment*
Bu Jiangyong	Yes	4	3	0	0	2018.11.08-present
Xu Fang	Yes	4	4	0	0	2018.11.08-present
Wang Yuzhou	No	4	3	0	1	2017.12.29-present

Wang Tongyan	Yes	1	1	0	0	2018.11.08-present
Zhang Liguo	Yes	0	0	0	0	2019.2.28- present
James Caggiano	Yes	4	4	0	0	2018.11.08-present
Christopher Carr	Yes	4	3	1	0	2018.11.08-present

Data source: Nanjing Xinbai’s reply letter on June 26, 2019

During the inquiry letter supervision stage, Nanjing Xinbai Company’s performance fluctuated significantly. From 2017 to 2018, the total operating income dropped from 19.13 billion yuan to 14.54 billion yuan, and the attributable net profit dropped from 944 million yuan to -892 million yuan, which may be directly related to the non-operational occupation of funds by the major shareholders revealed in the inquiry letter. During the rectification process, from 2019 to 2020, the total operating income dropped to 5.657 billion yuan, and the attributable net profit fluctuated greatly, ranging from 1.687 billion yuan to 752 million yuan. However, from 2021 to 2022 after the inquiry, total operating income has gradually recovered, reaching 6.177 billion yuan in 2021, an increase of 9.19% over the previous year, and further increased to 6.431 billion yuan in 2022, an increase of 4.11%. In terms of attributable net profit, although there will be a decline in 2022, the overall trend is relatively stable, showing that the company's proactive business adjustment measures are gradually taking effect and performance is gradually stabilizing.

4 Limitations and challenges of supervision of inquiry letters

Although inquiry letter supervision has played a certain role in solving the problem of hollowing out of major shareholders, there are still some limitations and challenges. First, through a case analysis of Nanjing Xinbai Company from 2017 to 2022, it is found that during the inquiry letter supervision stage, the company's performance showed significant fluctuations, especially after the inquiry letter disclosed the non-operating use of funds by major shareholders. This reflects the regulatory role of the inquiry letter. Secondly, during the rectification process of Nanjing Xinbai Company, although the company adopted a series of rectification measures, its performance was still unstable, highlighting the limitations of inquiry letter supervision in guiding the company's long-term standardized operations. Inquiry letters mainly focus on problems that have occurred, and it is difficult to fully predict and prevent risks that may occur in the future, which makes it challenging to govern corporate behavior in the long term.

In order to more effectively prevent the risk of hollowing out by major shareholders, it is recommended to improve supervision methods and the inquiry letter system, including strengthening real-time supervision, introducing advanced technology, improving the transparency of information disclosure, especially related transactions, and clarifying the standards and scope of inquiry letters to ensure comprehensive coverage. Potential risks, promote timely response, improve effectiveness, and streamline regulatory processes to improve effectiveness.

5 Conclusion

Through an in-depth analysis of Nanjing Xinbai Company's performance data from 2017 to 2022, it was found that the company's performance fluctuated significantly during the inquiry letter supervision stage. From 2017 to 2018, the total operating income decreased and the attributable net profit decreased, which may be related to the non-operational occupation of funds by the major shareholders revealed in the inquiry letter. During the rectification process, performance showed instability, but from 2021 to 2022 after the inquiry, total operating income gradually recovered, showing the effectiveness of the company's active business adjustment measures. The conclusion is that the non-operating use of funds by major shareholders has a significant impact on the company's performance, and the supervision of inquiry letters has played a positive role in guiding the company's rectification.

In future research, it can further focus on the improvement of corporate governance mechanisms and innovation of regulatory means, conduct an in-depth exploration of the similarities and differences in the hollowing out of major shareholders in companies of different industries and sizes, and provide specific suggestions. Regarding the restrictions on the supervision of inquiry letters, it is necessary to strengthen supervision standards and the accuracy of inquiry letters to improve the effectiveness of supervision. Future research can also consider cross-national comparisons and study the impact of regulatory systems in different countries on the hollowing out of major shareholders.

Through these prospects, it can be confident that by continuously improving regulatory methods and improving corporate governance levels, it can more effectively prevent the risk of hollowing out by major shareholders and promote the healthy development of the capital market. This will also help provide more research directions and practical experience for future research.

Authors contribution

All the authors contributed equally and their names were listed in alphabetical order.

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