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## LEVERAGING FOREIGN INSTITUTIONAL LOGIC IN THE ADOPTION OF STOCK OPTION PAY AMONG JAPANESE FIRMS

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**Research summary:** We investigate why Japanese firms have adopted executive stock option pay, which was developed with shareholder-oriented institutional logic that was inconsistent with Japanese stakeholder-oriented institutional logic. We argue that Japanese managers have self-serving incentives to leverage stock ownership of foreign investors and their associated institutional logic to legitimize the adoption of stock option pay. Our empirical analyses with a large sample of Japanese firms between 1997 and 2007 show that when managers have elite education, high pay inequality with ordinary employees, and when firms experience poor sales growth, foreign ownership is more likely associated with the adoption of stock option pay. The study shows the active role of managers in facilitating the diffusion of a new governance practice embodying new institutional logic.

**Managerial summary:** Why have Japanese firms adopted stock option pay for executives? Inconsistent with Japanese stakeholder-oriented tradition in corporate governance, such pay has been believed to prioritize managerial attention to the interests of shareholders over those of other stakeholders. However, to the extent that shareholders' interests are legitimate in the Japanese context, executives who have self-serving incentives to adopt such pay can leverage the need to look after shareholders' interest in their firms to legitimize their decisions. In a large sample of Japanese firms, we find that foreign ownership (representing shareholders' interests) is more likely to be associated with the adoption of stock option pay when managers are motivated to receive such pay, such as when they have elite education, high pay inequality with ordinary employees, or poor sales growth. Copyright © 2015 John Wiley & Sons, Ltd.

### INTRODUCTION

Institutional logic (Friedland and Alford, 1991; Lounsbury, 2007; Westphal and Zajac, 1994) in the national corporate governance represents distinctive and stable system in each country in terms of the codes of good governance, the conception of firms, and the appropriate role, rights and power of various

stakeholders (Aguilera and Jackson, 2003; Fligstein, 1996; Guillén, 2000; Whitley, 1999). Laden with such institutional logic, governance practices such as the board of directors and executive compensation function differently in different contexts, and the practices that have been historically taken for granted in one context may be perceived as inappropriate in another (Fiss and Zajac, 2004; Sanders and Tuschke, 2007). However, the rising presence of global institutional investors in distant economies that have dissimilar institutional logic may lead to the coexistence of multiple institutional logics in a single institutional context (Ahmadjian

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Keywords: corporate governance; institutional logic; foreign ownership; stock option pay; practice adoption

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and Robbins, 2005; Campbell, 2004; Desender *et al.*, 2014; Useem, 1998). To the extent that the prescriptions of different logics are incompatible, varying logics inevitably generate challenges and tensions for organizations exposed to them (Greenwood *et al.*, 2011). The complex interaction of incompatible institutional logics in terms of the organizational adoption of foreign-originated or contentious practices has been examined in many contexts, such as the adoption of the U.S.-style governance practices in Germany (Fiss and Zajac, 2004; Sanders and Tuschke, 2007) and Japan (Desender *et al.*, 2014), employee downsizing in Japan (Ahmadjian and Robbins, 2005; Ahmadjian and Robinson, 2001), and corporate restructuring in Taiwan (Chung and Luo, 2008a, 2008b). Organizations have been found less likely to adopt new or contentious practices if they are heavily embedded in existing institutions or have powerful constituents resisting new institutional logic.

Despite the importance of the process by which organizations respond to multiple or incompatible institutional logics, our understanding of why and how organizations respond remains selective (Pache and Santos, 2010; for a review see Greenwood *et al.*, 2011). Recent studies have focused on the role of human agencies (e.g., managers) that, despite being embedded in the existing institutional field, are aware of and receptive to the new logic and thus become change agents in adopting novel practices embodying new or even conflicting institutional logic (Chung and Luo, 2008a; Fiss and Zajac, 2004; Sanders and Tuschke, 2007). These studies focus on the impact of managers' beliefs about the added value of new practice for the business operation in the prevailing institutional environment. Although researchers have discussed the role of change agents' self-interests in adopting new practices (Capron and Guillén, 2009; Clemens and Cook, 1999), insufficient attention has been given to examine the process by which change agents advance their self-interests when multiple institutional logics coexist and how such behavior influences the diffusion of new practices in an institutional context. Put differently, new practices and institutional logics may be adopted not because managers believe they are superior or value-added for the firm, but because they are useful for managers to gain personal benefit that is not possible with the prevailing institutional logic. According to a large and growing literature on the behavioral theory of corporate governance (for a review see

Westphal and Zajac, 2013), managerial behavior is contingent on the social context and how managers interpret and take advantage of the prevailing institutional logic to realize their personal agendas. For example, CEOs may put themselves in a favorable light by changing the explanation for their compensation plans or performance in the proxy statement according to whether the prevailing institutional logic is "corporate logic," "agency logic," or "neo-corporate logic" (Westphal and Park, 2012; Zajac and Westphal, 1995, 2004). However, very few studies have applied this perspective to examine managerial behavior under multiple institutional logics.

We aim to close this research gap by examining how a foreign governance practice has been adopted in a local institutional context through the attempts of institutionally embedded managers to pursue their self-interests. In particular, we investigate the adoption of stock option pay for executives from 1997 to 2007 with a large sample of Japanese firms. Japan provides a unique context with coexistence of alternative institutional logics in corporate governance; majority of domestic institutional owners follow stakeholder logic that protects the interests of stakeholders (e.g., employees and business partners), whereas increasing foreign institutional investors promote shareholder logic that prioritizes the interest of shareholders (Ahmadjian and Robbins, 2005; David *et al.*, 2010). Stock option pay is consistent with shareholder logic because it links executive compensation to the future stock price and therefore provides financial incentives for managers to increase the stock price that serves shareholders' interests (Jensen and Meckling, 1976; Westphal and Zajac, 1994). Although one may expect this new practice as not fully compatible with stakeholder logic, the diffusion of it was not much contested in Japan (Ahmadjian, 2003). We suggest that this is because stock option pay is aligned with managerial interest that can be better served with alternative institutional logic. To pursue their self-interests but to avoid repercussion from prevailing stakeholder logic, change-minded managers can leverage foreign ownership to justify the adoption of stock option pay because it is legitimate to serve the interest of foreign owners in the Japanese context where stakeholder logic prescribes a balanced view of accommodating the interests of all stakeholders including return-oriented investors. Consistent with this view, our empirical analyses show that the positive effect of foreign ownership

on the adoption of stock option pay is more pronounced when Japanese managers possess greater human capital, or when the current pay scheme and firm's growth prospect require a better justification for additional executive pay. Joining the growing literature on socially embedded change agency and institutional logic (e.g., Greenwood and Suddaby, 2006; Greenwood *et al.*, 2011; Westphal and Zajac, 2013), we provide a new perspective: that powerful constituents of firms (e.g., foreign investors) embodying alternative institutional logic have to be combined with managerial self-interest to influence the diffusion of a new practice that is originated from a foreign institutional context.

## THEORY AND HYPOTHESES

### Corporate governance and institutional logic

The stable interactions between organizational actors and institutional environment facilitate the development of institutional logic of corporate governance in a national context (Friedland and Alford, 1991; Lounsbury, 2007). It is composed of assumptions, norms, values, beliefs, rules, and practices in an institutional field that structure a collective understanding of how actors' interests, organizational goals, and salient issues are formulated, and what means or solutions are regarded as appropriate to achieve these. For instance, the institutionalized agency logic depicts the firm as an entity owned by shareholders and therefore the long-term incentive plan for executives is a legitimate practice because it ostensibly motivates them to increase shareholder value (Zajac and Westphal, 1995, 2004).

Although many institutional studies have focused on dominant logic within a country, more recent ones emphasize the existence of multiple and even competing logics in an institutional field (e.g., Greenwood *et al.*, 2010; Lounsbury, 2007; Thornton, 2004). This new focus is pertinent to research on international corporate governance because the globalization of the capital market entails the coexistence of multiple logics in terms of how firms are governed in many countries. Large institutional investors who invest globally often play an important role in bringing the distinct logic from their home countries to other institutional contexts (Useem, 1998). These institutional investors have been accumulating stocks outside

their home countries in order to diversify risk and maximize return. When these global investors carry shareholder logic with them, corporate governance practices and systems in many countries are increasingly influenced by institutional logic from the shareholder-oriented corporate governance model (e.g., Fiss and Zajac, 2004; Meyer and Hollerer, 2010; Sanders and Tuschke, 2007).

The coexistence of multiple institutional logics has important implications on how organizational actors mobilize their power and resources to achieve their goals. Combining the institutional logic perspective (e.g., Friedland and Alford, 1991; Lounsbury, 2007) with the embedded change agency perspective (e.g., Greenwood and Suddaby, 2006; Westphal and Zajac, 2013) can provide a useful theoretical angle for understanding how key organizational actors (e.g., managers) can utilize foreign institutional logic to advance their own interests that might have been suppressed in an existing institution (Seo and Creed, 2002). A certain institutional environment can either constrain or empower certain organizational actors. For instance, German workers can advance their interests in a stakeholder-oriented system through board representation, which is normally lacking in the U.S. context, where the rights of shareholders are more emphasized (Capron and Guillén, 2009; Schnepfer and Guillén, 2004). If the interest of an organizational actor cannot be maximized with the prevailing institutional logic, the introduction of a new and alternative logic may provide opportunities, thus increasing his or her motivation for change (Clemens and Cook, 1999; Seo and Creed, 2002). However, these change-minded actors continue to face the pressures to conform to the existing institutional logic. As such, it is important to understand how these potential change agents can solve the "paradox of embedded action"; i.e., "how can actors change institutions if their actions, intentions, and rationality are all conditioned by the very institution they wish to change?" (Holm, 1995: 398; Seo and Creed, 2002: 223).

Empirically, some studies have focused on how the varying embeddedness of an organization or its stakeholders in a particular institutional environment results in different constraints to change that, in turn, can influence these actors' incentive to initiate change (e.g., Ahmadjian and Robbins, 2005; Yoshikawa, Tsui-Auch, and McGuire, 2007). Other studies have focused on the varying levels of awareness and acceptance of new alternatives by

key corporate leaders due to their educational background, exposure to the new logic, or connections to organizations that have adopted new logic (Chung and Luo, 2008b; Fiss and Zajac, 2004; Sanders and Tuschke, 2007). Extant studies have also suggested that new and divergent institutional logic may provide an opportunity for change agents to explore nontraditional means and give them more latitude to justify such exploration (e.g., Chung and Luo, 2008a; Clemens and Cook, 1999). We extend the latter line of inquiry and examine how a key change agent (i.e., managers) utilizes the presence of powerful organizational constituents (e.g., foreign owners) who promote a new and alternative institutional logic to justify the adoption of a new corporate governance practice that will help realize their private goals, at the same time facilitating the diffusion of the new practice. Next, we apply this theoretical perspective to Japanese corporate governance and examine the interplay between Japanese executives and foreign owners on managerial decision to adopt stock option pay for executives.

### **Institutional logic and Japanese corporate governance**

Japanese corporate governance has been institutionalized to empower some organizational actors (e.g., domestic institutional owners and employees) and constrain others (e.g., arm's-length investors). In the Japanese stakeholder-oriented model, domestic institutional owners like banks and nonfinancial firms own shares in other firms to ensure sales and business transactions (e.g., buyer–supplier relationship or loan borrower–lender relationship), thereby allowing them to protect the interests of important stakeholders, such as employees and business partners (Aoki, Jackson, and Miyajima, 2007; Gedajlovic and Shapiro, 2002; Sheard, 1994). As such, these domestic institutional owners, also called relational owners, tend to value long-term growth and expanding market share, which provide greater benefits to key stakeholders, rather than short-term profitability or higher share price, which benefits return-oriented shareholders (Ahmadjian and Robbins, 2005; Gerlach, 1992).

Nevertheless, foreign investors have become an emerging presence in the Japanese capital markets since the 1990s, when the economic downturn made it difficult for financially troubled domestic owners to maintain historic levels of ownership and, foreign investors often stepped

in to purchase shares, resulting in a net shift of ownership toward greater holdings by foreign investors (Hoshi and Kashyap, 2001). These foreign owners are predominantly institutional investors from the U.S. and the U.K., which accounted for 32 and 39 percent, respectively, of all foreign shareholdings in Japanese firms in 1997 (Bank of Japan, 2008). (We use foreign institutional investors and foreign owners interchangeably in this paper.)

Prior studies (Ahmadjian and Robbins, 2005; David *et al.*, 2010 for Japanese firms; Fiss and Zajac, 2004 for German firms) assumed foreign institutional investors tend to follow shareholder logic and found confirming evidence. Such logic treats the primary objective of the firm as to “maximize shareholder value” and other stakeholders as the means for serving the ultimate interests of shareholders (Fligstein, 1996; Useem, 1998; Westphal and Zajac, 1994). While the dominant foreign investors in Japanese firms are from the U.S and the U.K. that likely follow shareholder logic, there are foreign investors from other countries where different logics may prevail (e.g., Hall and Soskice, 2001). We suggest, however, that the assumption used in previous studies can still be applicable here for several reasons. First, foreign investors tend to be active traders of their shareholdings.<sup>1</sup> Therefore, the influence of shareholder logic represented by American and British institutional investors can be dominating. Second, relative to domestic institutional owners, who have various relationships with the firm, foreign investors lack means to gain benefit other than stock returns from their investment (David *et al.*, 2010). Therefore, even though they may come from countries with different institutional logics, they are very likely to adopt shareholder logic that focuses on investment return (Desender *et al.*, 2014). Moreover, we found evidence from the annual reports of Japanese firms that top management often associated foreign owners with the pressure for higher share prices, even though none of them mentioned the country origin of foreign owners. This suggests that foreign ownership as a whole is perceived to impose strong pressure on managers to pay close attention to shareholder interests.

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<sup>1</sup> For example, foreign investors accounted for more than 50 percent of the total trading in the Tokyo Stock Exchange in 2007 even though their total shareholding was less than 20 percent (Tokyo Stock Exchange, 2008).

Despite the relatively small shareholding of foreign investors, they tend substantially to affect the share prices and potentially the strategic decisions of Japanese firms because they buy and sell shares more frequently than domestic owners and they like to communicate with top management directly (e.g., Ahmadjian and Robbins, 2005; Colpan *et al.*, 2011; Desender *et al.*, 2014; Yoshikawa *et al.*, 2005). However, in the Japanese context, these return-oriented shareholders have been normally treated as just one of multiple stakeholders of a firm whose interests need not be prioritized (Aguilera and Jackson, 2003; Hall and Soskice, 2001). Contrasting the rising influence of foreign investors and domestic Japanese firms embedded in the local system that emphasizes relational ties with key stakeholders, Ahmadjian and Robbins (2005) call it a “crash of capitalisms” because of their distinctively different institutional logics. Such contrast is also echoed in other studies (Guillén, 2000; Hall and Soskice, 2001).

### **Adoption of stock option pay and powerful owners in Japanese firms**

In 1997, stock option pay was first legalized in Japan, and Japanese firms gradually began to adopt this practice. Prior to the legalization, Japanese managers were mainly paid a fixed salary with an annual or semi-annual cash bonus (Yoshikawa, Rasheed, and Del Brio, 2010). The new practice was actually requested from the business community. When the *Keidanren*, the Japanese Business Association representing the interests of large firms, pressed for the legalization of stock option pay (Colpan and Yoshikawa, 2012). After the legalization, stock option pay diffused among Japanese firms fairly soon without much resistance (Ahmadjian, 2003).

According to agency theory, to align the managerial interest with that of shareholders, a firm can use outcome-based mechanisms, such as stock option pay, to forge a common economic bond between managers and shareholders (Fama, 1980; Jensen and Meckling, 1976). Stock option pay encourages managers to take on projects that positively affect the future stock price of a firm because the value of stock options depends on the stock price of the firm in the future (Sanders, 2001; Sanders and Hambrick, 2007). Although there remain some debates on the pay–performance relationship (Dev-ers *et al.*, 2007), many empirical studies have shown

that such incentive-based pay is positively related to share price performance, suggesting the motivational effect of stock option pay for managers. Indeed, stock option pay can lead managers to pay greater attention to the stock price and prioritize the interests of shareholders over those of other stakeholders, even in the Japanese context. For example, Kato *et al.* (2005) found that the adoption of stock option pay in Japanese firms was associated with increased stock performance post-adoption, suggesting the shift of managerial attention.

As such, return-oriented foreign investors would favor stock option pay. For example, it has been found that foreign investors from the U.S. regard stock option pay favorably in Japanese firms because such pay is common in their home country (Miyoshi and Nakao, 2011). Stock option pay is not only a legitimate practice for foreign investors but also important for assurance of their investment return when they lack access to alternative mechanisms of control such as active board monitoring (Charkham, 1994; Desender *et al.*, 2014). When foreign institutional investors become more powerful with greater shareholding, they are more capable of promoting the practice for their benefit (Fiss and Zajac, 2004; Sanders and Tuschke, 2007). Thus, our baseline prediction is that Japanese firms with large foreign ownership will face greater pressure to adopt stock option pay.

### **Managers as embedded agents in adopting stock option pay**

What is puzzling is that, despite the small shareholding by foreign investors relative to domestic owners and shareholder-serving stock option pay that is not entirely consistent with stakeholder logic, many Japanese firms still opted to adopt stock option pay after its legalization in 1997 (Ahmadjian, 2003). Indeed, it has been found that foreign practice tends to be resisted in an environment with incompatible institutional logic. For instance, Ahmadjian and Robbins (2005) and Ahmadjian and Robinson (2001) found that downsizing, well accepted in the U.S. context, faced strong resistance in Japanese firms with large domestic owners because it challenged the core value of permanent or long-term employment in Japan. Similarly, Chung and Luo (2008b) found that family-controlled business groups in Taiwan did not smoothly adopt corporate refocusing, which is consistent with shareholder logic. Fiss and Zajac (2004) and

Sanders and Tuschke (2007) also found that the new executive compensation plan faced opposition from powerful domestic owners in the German context, which valued stakeholder logic.

We propose that the legalization and diffusion of stock option pay did not face strong resistance among Japanese firms because it was aligned with managerial interests even in a stakeholder-oriented context such as Japan. Japanese managers may have been motivated to adopt stock option pay for additional financial gains if they could justify the adoption to other stakeholders. We suggest that this situation is due to several contextual characteristics of the Japanese corporate environment.

First, in the Japanese context, managers can enjoy higher discretion in their decision-making as long as it does not jeopardize the interests of key stakeholders. While it is normal for the board of directors to make decisions on executive compensation in U.S. firms, the top managers in Japanese firms have a significant influence on their own compensation because directors of Japanese firm are mostly insiders and most firms do not have the remuneration committee (Charkham, 1994). In addition, stock option pay is usually granted to all directors, who are mostly executives themselves, hence they do not normally object to the CEO's compensation proposal (Colpan and Yoshikawa, 2012; Miyoshi and Nakao, 2011). Further, large domestic owners usually do not intervene in the management of their affiliated and business partner firms as long as it conforms to general norms, even in recent years when firm performance has shown decline (Lincoln and Gerlach, 2004). Therefore, managers have high discretion in proposing the adoption of stock option pay as long as it comes with reasonable justification.

Second, stock option pay in Japan is more likely to provide significant upside financial gain for managers. Stock option pay can potentially increase the uncertainty of financial gain and personal risk for managers when it is paid as a substitute for other compensation components (Sanders, 2001). In the U.S. context, managers have been found to prefer a lower proportion of stock options in their pay package, because stock option pay increases uncertainty in future managerial income and decreases managerial autonomy to pursue their self-interests (e.g., Tosi and Gomez-Mejia, 1989; Westphal and Zajac, 1994). However, stock options are usually granted in addition to, not of as a substitute for, existing salaries and cash bonuses of executives in Japanese

firms (Colpan and Yoshikawa, 2012). Kubo (2010) found that regular managerial pay and bonus did not decline after the adoption of stock option pay, suggesting that stock options are granted on top of executives' current pay. Therefore, such compensation ensures Japanese managers with potential financial gains with limited risk of income uncertainty. The incentives of managers to adopt stock option pay are thus increased. Our personal interview with an ex-CEO of a large Japanese firm has confirmed that managers are motivated by potential financial gains from stock option pay.<sup>2</sup>

Third, the stakeholder-oriented institutional logic in Japan can actually provide the justification needed for managers to adopt stock option pay, which is normally thought to privilege the interests of shareholders over those of other stakeholders. Although shareholders should be treated as just one of the multiple stakeholders of a firm under stakeholder logic (Aguilera and Jackson, 2003; Hall and Soskice, 2001), such logic normally takes a balanced view among the interests of multiple stakeholders (Fiss and Zajac, 2004). Therefore, the interests of foreign investors are also legitimate in this logic. The implication of this balanced view is that managers can be justified in taking actions to serve the interests of shareholders to the extent that the stake of return-oriented shareholders is significant in a firm, as long as such action does not jeopardize the interests of other significant stakeholders.

In summary, these contextual characteristics of Japanese corporate governance provide latitude for managers to leverage the coexisting shareholder and stakeholder logics to advance their own interest. For that purpose, managers may behave as the embedded agency constrained by the local institutional logic, and yet have partial autonomy to act on their interests (Greenwood and Suddaby, 2006; Thornton and Ocasio, 2008). To realize their interests, however, managers need to alleviate the tension between the new practice based on shareholder logic and the prevailing stakeholder logic (Oliver, 1991; Thornton, 2002; Thornton and Ocasio, 2008). The alternative institutional logic can provide necessary opportunities for embedded agencies to cope

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<sup>2</sup> The CEO mentioned that managers can be motivated by financial gains through stock option pay ("The reason I had decided to adopt the stock option plan then was that I thought that stock price was one of the important indicators for management. ... I wanted to use the plan as financial incentives to executives so that we could improve the quality of management. ...").

proactively with institutional constraints (Greenwood *et al.*, 2010). Indeed, we found that it is typical in the announcement of the adoption of stock option pay to use firm performance and shareholder interest to justify this additional pay.<sup>3</sup> In the following sections, we will identify situations under which managers are likely to face a higher tension between their self-interest and institutional constraints, and hence are more likely to utilize the presence of foreign ownership to justify the adoption of stock option pay, making the effect of foreign ownership more salient.

### Managerial educational background

We suggest that managers have greater incentives to adopt stock option pay for additional financial gains if they are highly talented (i.e., possessing

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<sup>3</sup> We found that the typical rationale described in the annual reports for the adoption was usually twofold. One rationale is that the incentive pay will motivate managers to improve corporate performance. For example, stock option pay was used “in order to provide managers with an incentive to achieve the 2003–2005 medium-term management plan and improve general corporate performances” (2003), or to make managers and directors “interested in and determined to improve TMC’s performance and enhance TMC’s international competitiveness” (1997). Another annual report mentioned, “Lawson will continue its stock option program for executive officers to provide greater incentive for them to excel. The conditions for exercising stock options are set so as to motivate executive officers to increase Lawson’s corporate value over the medium and long terms” (2002)”

The other rationale is explicitly that stock option pay was utilized to motivate the top management team to pay attention to increase the shareholder value creation (i.e., higher stock price). Here are several typical quotes from annual reports: “The Company has introduced a stock option plan for its directors to further motivate them to consider growth in investors’ value as their chief management goal and to otherwise manage in a manner that is in the best interest of shareholders (1998),” “The scheme aims to further encourage directors and associate directors to enhance mid-to-long-term corporate value by aligning their perspectives with those of shareholders” (2000), “For the purpose of enhancing the connection between the stock price and the results of operation, and the remuneration to the Directors (other than outside Directors), and inducing the Directors of the Company to share the interest associated with the fluctuation of the stock price of the Company’s shares with all the shareholders of the Company and to further encourage their desire and morale to contribute to the enhancement of the corporate value of the Company (2007),” “Kyocera will use a new incentive stock option program to align the interest of shareholders with those of Kyocera management and employees” (2000).

Some annual reports provided both rationales simultaneously: “The intention of MCC is to make the compensation scheme for the Directors and Officers which increases connectivity to the business performance of MCC and shareholder value (2005),” or “which will increase linkage of compensation to the business performance of the Company and shareholder value” (2005).

high human capital). Managers with greater talent and competence are able to create higher value for the firm. However, Japanese compensation culture tends to emphasize equality between employees, including senior managers, rather than pure meritocracy (Abegglen and Stalk, 1985; Clark, 1979). Employees collectively are regarded as contributing to the value of the firm and therefore should be compensated in an egalitarian manner. Moreover, Japanese seniority-based compensation culture favors managers with a longer tenure in the firm but not necessarily for their individual contributions (Abegglen and Stalk, 1985). Thus, top managers with greater talent might not be fairly compensated for what they have contributed to the value of the firm and stock option pay provides a new opportunity for them to realize their contributions (e.g., Chung and Luo, 2008a).

We can use educational background to gauge the human capital and talents of managers (e.g., Perez-Gonzalez, 2006). Educational background shapes not only the perceptions of professional managers (DiMaggio and Powell, 1983), but also the cognitive models as well as the caliber of managers in the business field. For example, educational background in economics or business is found to have different effects on the decision-making style of managers compared with other disciplines (e.g., Fiss and Zajac, 2004; Sanders and Tuschke, 2007). Managers with graduate degrees may be trained to handle complex information and find solutions effectively (Young, Charns, and Shortell, 2001). CEOs graduated from elite schools may be more capable of learning new and more efficient organizational practices (e.g., Palmer, Jennings, and Zhou, 1993). Similarly, we suggest that managers who graduated from elite universities are more likely to have greater talent and competence for managing and creating value for their companies (Chang and Shim, 2014). But the Japanese egalitarian- and seniority-based corporate culture provides limited opportunities for them to increase pay based on their contributions. Hence, these managers may have greater incentives to adopt stock option pay, but they still need to find reasonable justification for their action especially as they may draw greater attention due to their elite status. The presence of large foreign ownership provides one such justification for managers because Japanese stakeholder logic allows managers to take actions to serve the interests of shareholders. We therefore suggest that the positive effect of foreign ownership on the adoption



of stock option pay will be greater when managers are more motivated to leverage the presence of large foreign ownership to justify their actions.

*Hypothesis 1: The more a firm's executives who graduated from elite Japanese universities, the stronger the positive relationship between foreign ownership and the adoption of stock option pay for executives.*

### **Deviant practice experience**

Even in the egalitarian culture of Japanese firms, the pay inequality between top managers and average employees still exists. Talented managers who contribute more to the firm may still be rewarded with higher pay in some firms, and such rewards are usually in the form of cash bonuses (Yoshikawa *et al.*, 2010). Given that Japanese institutional norms generally do not support differential pay with significant inequality, the presence of inequality in pay between managers and average employees likely suggests that managers may have developed an organizational environment where some deviations from the norms are acceptable. Previous adoption of another institutionally contested practice may smooth the way for subsequent adoptions and therefore firms with deviant practice experience are more likely to do so again (Sanders and Tuschke, 2007). For instance, the adoption of the international accounting standards is a predictor of change to a more market-oriented and shareholder-oriented corporate governance in Germany (Fiss and Zajac, 2004; Tuschke and Sanders, 2003). Japanese managers that had already adopted a deviant pay scheme (i.e., high pay inequality) may thus have incentives to continue the momentum and adopt stock option pay.

But managerial compensation with increasing inequality is not aligned with Japanese norms and hence is likely to attract close attention in the egalitarian environment. Given that these managers are already receiving larger compensation relative to other employees, they will need further justification if they choose to adopt stock option pay, which is poised to widen the pay gap even further.<sup>4</sup> Again,

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<sup>4</sup> Japanese firms can grant stock options to both executives and employees. We found that most companies that had awarded stock options to employees did so only to those above mid-management level positions, not to all employees. Also, the amounts granted to individual employees were usually far smaller than those granted

the presence of large foreign ownership provides such an opportunity because stock option pay can be justified as serving the legitimate interests of shareholders even if it is also aligned with the personal interests of managers.

*Hypothesis 2: The greater pay inequality between top managers and average employees in a firm, the stronger the positive relationship between foreign ownership and the adoption of stock option pay for executives.*

### **Firm growth**

Economic performance of firms is also likely to influence the decision of managers to adopt stock option pay. Low efficiency and effectiveness can motivate organizations to reassess their respective institutionalized practices (Oliver, 1991) and, in turn, may lead those organizations to adopt new practices (Greenwood and Hinings, 1996; Kraatz and Zajac, 1996). In firms undergoing declining performance or stagnant sales growth, greater managerial efforts are expected to redesign their structure or strategy. Studies show that poor firm performance leads to the dissatisfaction of stakeholders, subsequently decreasing their commitment and triggering political conflicts over existing arrangements (Child and Smith, 1987). In the Japanese context, foreign owners are concerned mainly about profitability, whereas domestic Japanese owners emphasize stability and growth (David *et al.*, 2010; Gerlach, 1992; Yoshikawa *et al.*, 2005). When managers cannot maintain satisfactory growth, serving the interests of domestic stakeholders becomes difficult. However, stock option pay is used to motivate managers to increase future share price, which might not be of the best interest of relational domestic stakeholders. As such, managers who are motivated to adopt stock option pay need to provide stronger justification to these concerned stakeholders.

Nevertheless, while poor performance increases the subjective uncertainty for managers in making decisions, it also permits managers who are less committed to prevailing governance to discuss legitimately and promote alternative configurations (Greenwood and Hinings, 1996; Oliver, 1991). Indeed, poorly performing firms tend to be earlier

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to executives. So in most cases in Japan, stock option pay usually widens the pay gaps between executives and average employees.

adopters of new practices (Chizema, 2010). Moreover, managers can be creative in utilizing the prevailing institutional logic to create justification for their behaviors. For example, Westphal and Park (2012) find that, facing poor performance, CEOs tend to assert the quality of firm leadership and managerial decisions by asserting the quality of the independent board of directors in their company. Such rhetoric draws on the well accepted agency or shareholder logic of governance that emphasizes board independence (Westphal and Zajac, 2013). Similarly, we suggest that managers facing slow growth and pressure from relational stakeholders may cite the interests of foreign investors to justify the adoption of stock option pay. Therefore, we suggest the impact of foreign ownership becomes greater when a firm's growth rate is low.

*Hypothesis 3: The lower a firm's sales growth rate, the stronger the positive relationship between foreign ownership and the adoption of stock option pay for executives.*

## METHODS

### Sample

Prior to 1997, Japanese firms were prohibited by law from issuing stock options to their management and employees. The Commercial Code was amended to allow firms to grant stock option pay as compensation to managers and key employees effective from June 1, 1997. Therefore, our primary data consist of all adoptions of stock option plans following the legal amendment by all firms listed in the first section of the Tokyo Stock Exchange (TSE) between 1997 and 2007. The number of firms in this section ranges from 1,475 in 1997 to 1,642 in 2007 and exiting firms were due to mergers, acquisitions, or delisting rather than bankruptcy. Data on ownership, management compensation, financial data, monthly share-prices, and other firm characteristics were collected from *Nikkei Needs* database, *Kaisha Shikiho* (Japan Company Handbook), and *Yuka Shoken Hokokusho* (Report on Securities that each listed firm is required to file with the Ministry of Finance). Since we lagged one year for all the independent variables in the analyses, we collected the data from 1996. Data on stock option plans between 1997 and 2003 were obtained from Daiwa

Securities SMBC Co. Ltd. and the data between 2003 and 2007 were obtained from Mizuho Securities Co. Ltd. Both companies collected the stock option information from the complete TSE securities reports. Seven hundred thirty-one firm-year observations could not be used in the analyses because of substantial missing data in key variables. The final sample consists of 1,547 firms out of which 584 firms had adopted stock option pay for executives by 2007.

### Dependent variable and estimation method

Our dependent variable is the adoption of *stock option pay for executives*, which is a dummy variable denoting the announcement of stock option plan by a firm in a year. The firm was removed from the sample after its initial adoption of the stock option plan. The annual number of announcements increased till 2000 and dropped afterwards. According to Daiwa Securities SMBC, approximately 38 percent of all Japanese public firms had adopted stock options as of March 2005. The figure is almost identical to the adoption rate of 37.8 percent (584/1,547) in our sample.

We used discrete-time event history analysis to model adoption process. The adoption of stock option pay can happen at any time within a year, but we updated the observation annually and actually grouped the events into year intervals. Since we did not have any a priori assumption about the baseline hazard rate of stock option adoption in Japan, we employed the Cox proportional hazards model with the form:  $h(t) = q(t)\exp[bX(t)]$  (Blossfeld, Golsch, and Rohwer, 2007; Cleves *et al.*, 2010):  $h(t)$  is the hazard rate of a firm to initialize stock option plan in year  $t$  given that it has not done so by year  $t$ ;  $q(t)$  is the unspecified function of time dependence giving the baseline hazard of adoption occurring in a year.  $X(t)$  is a vector of independent variables, including both time invariant variables (for instance industry dummies) and time variant variables (for instance firm age), and their interactions, while  $b$  is a vector of the coefficients to be estimated. One unit change in  $X_k$  increases the hazard rate by  $\exp(b_k)$  in the multiplicative term:  $h(t, X_k + \Delta X_k, X)/h(t, X_k, X)$ . The event-history model is good at handling right-censoring when the event occurs after the study period, but a limitation of the Cox model is in dealing with left-censoring when the event occurs before the study period. Our sample begins with the year 1997, coinciding

with the onset of legalization of stock option pay in Japan and left censoring is not a serious issue in our analysis.

### Independent variables

*Foreign ownership* is the percentage of shares held by foreign investors in a firm's total outstanding shares. Firms do not disclose the identity of these foreign owners and we use their aggregated shares. Although the ownership structure in our sample is stable temporally and our interest is the impact of ownership structure on a firm's decision to adopt a stock option plan, owners may change their shareholdings in a firm after the adoption because agency cost can vary depending on the influence of such pay (Fama, 1980; Jensen and Meckling, 1976). To account for this reversed causality problem, we lagged all independent variables by one year.

To gauge the difference in top managers' educational background, we measure *Elite managers* as the proportion of executives or directors (i.e., top managers in Japan), who graduated from prestigious Japanese universities. Japan has two clearly differentiated types of universities. Elite former imperial universities are widely known as more rigorous and selective than other universities in their student selection. Seven imperial universities (Tokyo, Kyoto, Tohoku, Osaka, Kyushu, Hokkaido, Nagoya), and two other elite universities (Hitotsubashi and Kobe) conduct their own rigorous entrance examinations for admission that depends solely on students' academic performance and talents (Mehrotra *et al.*, 2013). Admission to these elite universities is merit-based and very competitive regardless of the family background of the applicants. A degree from one of these prestigious universities reliably implies a high level of intelligence, personal ability, and a network of high capability alumni after graduation. A top management team with more graduates from elite Japanese universities indicates higher human capital. Data on educational background of managers/directors were collected from *Yakuin Shikiho* (Director Handbook).

For the previous deviant managerial practices, we measure *Pay inequality* as the ratio of average compensation to executives over the average compensation to nonexecutive employees. We collected information on compensation paid to top management teams and all employees from *Nikkei Needs* database and *Kaisha Shikiho* (Japan

Company Handbook). We divide the compensation to the entire top management team by the number of managers to obtain the average compensation to executives, and divide the compensation to all employees (less top management) by the total number of employees (less top management team) to obtain the average compensation to nonexecutive employees. The pay inequality varies across industries; we adjust this measure by dividing it by the three-digit industry average pay inequality. Higher value of this variable indicates executive pay more deviant from the industry norm.

*Sales growth* is calculated as the annual growth rate in total sales. High sales growth indicates promising market demand and future growth opportunities (David *et al.*, 2010). To test the moderating effect according to Hypotheses 1–3, we create interaction variables between *Foreign ownership* and *Elite managers*, *Pay inequality*, and *Sales growth*.

Following prior research on corporate governance (e.g., Ahmadjian and Robinson, 2001; Fiss and Zajac, 2004; Sanders and Tuschke, 2007; Westphal and Zajac, 1994) and recent studies on stock option pay in Japan (e.g., Kato *et al.*, 2005; Miyoshi and Nakao, 2011; Nagaoka, 2005), we use several control variables that may correlate with both dependent and independent variables. *Firm size* is the natural logarithm of the total assets of the firm. *Firm age* is the age of the firm from its incorporation year. *Profitability* is the profit before taxes divided by total assets. *Debt/asset* is the ratio of total debt to total assets. *Volatility* is the standard deviation of a firm's stock returns for the past 24 months adjusted by the average share price. *Domestic ownership* is the percentage of shares held by Japanese domestic financial institutions (i.e., large local banks and insurance companies) and nonfinancial firms in total outstanding shares.<sup>5</sup> *Managerial ownership* is the percentage of shares held by the top management team in total outstanding shares. *Executive bonus ratio* is the cash bonus received by top executives divided by their total compensation, exclusive of the stock option pay. To account for the cash constraint of a firm and the shareholders' rights, we use

<sup>5</sup> We did not include the domestic individual ownership in this measure. Some Japanese investors, including investment trust firms (similar to mutual funds), are more transaction-oriented and return-oriented, like foreign institutional investors. As shareholdings by these Japanese owners are small (their average shareholding is less than 2.6% in our sample firms) and our focus is domestic relational investors, we did not include these types of investors in measuring domestic ownership.

the dummy variable *Dividend*, taking a value of 1 if the firm paid a dividend in a year. *Keiretsu* is a dummy variable indicating the firm belongs to one of the large Japanese Keiretsu or business groups. The data on Japanese Keiretsu were collected from *Nihon no Kogyo Group Souran* (Japanese Keiretsu Directory) and *Yuka Shoken Hokokusho* (Security Report). *Subsidiary* is a dummy variable indicating the firm is a subsidiary of another firm. *Management controlled* is a dummy variable indicating the aggregate ownership by managers is higher than 50 percent of the total ownership of the firm. Managers with controlling ownership may have high latitude in promoting stock option pay. To control for the institutional pressure, we measure *Prevalence of stock option adoption* as the number of firms that started to adopt stock option pay in a particular year. More firms adopting the new practice can increase the legitimacy of the practice in existing institutional context, facilitating additional adoption (Ahmadjian and Robinson, 2001). Finally, since our sample is broadly cross-sectional in the Japanese economy, we use a series of three-digit industry dummies to control for the fixed industry effects.

## RESULTS

Table 1 provides descriptive statistics for main variables used in the model. Most firms (>99.5%) in the sample have much higher domestic ownership than foreign ownership, indicating these firms' high embeddedness in the Japanese business system. In addition, we removed some outliers with extreme values (e.g., extremely high sales growth or pay inequality). Dropping these outliers does not change the regression results.

Table 2 reports the results of the event history analyses for the hypotheses. Only Model 1 includes all the control variables, including the moderator variables such as *Elite managers*, *Pay inequality*, and *Sales growth* in Model 1; but we find no significant independent effects from them except for *Elite managers*. The coefficients in Model 1 and other models consistently show that young firms, firms with volatile stock prices, and firms paying dividends are more likely to adopt stock option pay. Firms with higher managerial ownership or a controlling management team also have higher adoption rate. These results are consistent with

previous studies on the stock option adoption in Japan (Hassan and Hoshino, 2008; Kato *et al.*, 2005; Nagaoka, 2005; Uchida, 2006). It is also evident that the *Prevalence of stock option adoption* is positively related to a focal firm's adoption decision. We also find that firms with more domestic institutional owners tend to resist adopting stock option pay. But the negative effect disappears in other models. Some domestic owners (e.g., financial institutional) might be more shareholder-oriented (e.g., Ahmadjian and Robbins, 2005). We split the domestic ownership into financial domestic ownership and corporation domestic ownership and rerun the model, but we find both types of ownership have negative but insignificant coefficients.

Model 2 is used to test our baseline prediction by adding *Foreign ownership*. The coefficient (1.97,  $p < 0.1\%$ ) suggests that foreign institutional investors favor stock option plans. The coefficient is significantly different from the negative coefficient of *Domestic ownership* ( $p < 0.1\%$ ). An increase of 10 percent of foreign ownership in a firm will increase multiplicatively the hazard rate of adopting stock option pay for executives by 121.7 percent (i.e.,  $\exp(0.1 \times 1.97)$ ).

To test Hypotheses 1–3, we add the interactions between *Foreign ownership* and moderator variables in the subsequent models. Model 3 adds the interaction term *Foreign ownership*  $\times$  *Elite managers* with a positive coefficient (3.027,  $p < 1\%$ ), supporting Hypothesis 1. Model 4 shows a positive coefficient for the interaction term *Foreign ownership*  $\times$  *Pay inequality* (0.714,  $p < 10\%$ ), supporting Hypothesis 2. Model 5 shows the negative coefficient ( $-0.191$ ,  $p < 0.1\%$ ) for the interaction term *Foreign ownership*  $\times$  *Sales growth*, supporting Hypothesis 3.

Model 6 has all three interaction terms and we interpret the coefficients of interaction terms based on this full model. The interpretation of interaction effect on the change in the dependent variable in nonlinear models is complex because the effect depends on the value of both interacting variables and other variables (Ai and Norton, 2003; Hoetker, 2007). However, it is not feasible in the Cox model to make statements on absolute quantities in change of hazard rate without estimating the baseline hazard. It is most natural to interpret the coefficients in the Cox model in terms of multiplicative effect that does not vary with the baseline hazard rate and other variables due to the exponential formula in

Table 1. Descriptive statistics and correlations between main variables

Variables	Mean	Standard deviation	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1. Foreign ownership	0.082	0.097	1.000															
2. Elite managers	0.149	0.175	0.093	1.000														
3. Pay inequality	0.972	0.530	0.111	0.026	1.000													
4. Sales growth	0.119	5.641	0.025	0.009	0.008	1.000												
5. Firm size	11.387	1.368	0.368	0.432	0.103	0.014	1.000											
6. Firm age	55.233	20.957	0.006	0.194	-0.020	-0.042	0.250	1.000										
7. Profitability	0.043	0.049	0.131	-0.107	0.082	0.001	-0.161	-0.303	1.000									
8. Debt/asset	0.545	0.234	-0.212	0.154	-0.070	-0.001	0.224	0.165	-0.322	1.000								
9. Volatility	0.150	0.100	0.007	-0.045	-0.030	0.005	-0.149	-0.141	0.015	0.080	1.000							
10. Domestic ownership	0.558	0.166	-0.152	0.162	-0.044	-0.018	0.274	0.167	-0.144	0.099	-0.150	1.000						
11. Managerial ownership	0.052	0.108	-0.092	-0.243	0.060	0.001	-0.374	-0.438	0.385	-0.140	0.132	-0.545	1.000					
12. Executives bonus ratio	0.109	0.132	0.160	-0.076	-0.168	-0.005	0.047	-0.081	0.279	-0.226	-0.093	0.056	0.055	1.000				
13. Dividend	0.769	0.421	0.121	-0.034	0.096	-0.015	0.081	0.001	0.204	-0.252	-0.045	0.022	0.036	0.201	1.000			
14. Keiretsu	0.158	0.365	0.081	0.165	0.001	-0.006	0.212	0.192	-0.084	0.078	-0.006	0.168	-0.180	-0.043	-0.032	1.000		
15. Subsidiary	0.115	0.319	-0.109	0.021	-0.072	-0.005	-0.046	-0.116	0.003	0.053	0.019	0.338	-0.135	0.040	-0.004	0.016	1.000	
16. Management control	0.012	0.109	-0.054	-0.060	0.005	0.002	-0.165	-0.180	0.192	0.000	0.074	-0.259	0.561	-0.008	-0.024	-0.048	-0.040	1.000
17. Prevalence of stock option adoption	51.611	42.747	-0.071	0.002	-0.016	-0.005	0.007	0.037	-0.033	0.017	-0.015	-0.020	-0.027	-0.032	0.224	0.004	0.001	-0.028

Table 2. The likelihood of the adoption of stock option pay for executives using Cox proportional hazards models

Variables	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Foreign ownership		1.970*** (0.384)	1.595*** (0.426)	1.186† (0.606)	2.020*** (0.383)	0.730 (0.653)
Foreign ownership × elite managers			3.027* (1.345)			3.306* (1.479)
Foreign ownership × pay inequality				0.714† (0.431)		0.733† (0.439)
Foreign ownership × sales growth					-0.191*** (0.046)	-0.261** (0.087)
Elite managers	0.513† (0.308)	0.391 (0.287)	-0.027 (0.359)	0.406 (0.288)	0.394 (0.286)	0.114 (0.378)
Pay inequality	0.103 (0.074)	0.078 (0.077)	0.083 (0.077)	-0.052 (0.110)	0.079 (0.077)	-0.043 (0.114)
Sales growth	0.003 (0.002)	0.003 (0.002)	0.003 (0.002)	0.003 (0.002)	0.053*** (0.012)	0.073** (0.023)
Firm size	0.071 (0.046)	0.003 (0.043)	-0.005 (0.044)	0.006 (0.044)	0.002 (0.043)	-0.016 (0.048)
Firm age	-0.012*** (0.003)	-0.012*** (0.003)	-0.012*** (0.003)	-0.012*** (0.003)	-0.012*** (0.003)	-0.012*** (0.003)
Profitability	0.282 (0.908)	-0.264 (0.793)	-0.313 (0.805)	-0.290 (0.826)	-0.257 (0.788)	-0.482 (0.848)
Debt/asset	-0.285 (0.234)	-0.209 (0.216)	-0.226 (0.216)	-0.220 (0.218)	-0.214 (0.215)	-0.154 (0.212)
Volatility	1.345*** (0.267)	1.262*** (0.262)	1.269*** (0.262)	1.293*** (0.264)	1.259*** (0.263)	1.271*** (0.270)
Domestic ownership	-0.908** (0.347)	-0.316 (0.347)	-0.284 (0.348)	-0.314 (0.347)	-0.331 (0.346)	-0.370 (0.366)
Managerial ownership	0.036 (0.509)	0.930† (0.509)	0.862† (0.511)	0.983† (0.509)	0.944† (0.507)	0.676 (0.530)
Executives bonus ratio	0.174 (0.326)	0.082 (0.316)	0.117 (0.316)	0.075 (0.315)	0.077 (0.316)	0.144 (0.322)
Dividend	0.707*** (0.167)	0.827*** (0.166)	0.810*** (0.167)	0.841*** (0.167)	0.821*** (0.166)	0.768*** (0.169)
Keiretsu	0.109 (0.146)	0.059 (0.135)	0.063 (0.135)	0.058 (0.135)	0.058 (0.135)	0.103 (0.146)
Subsidiary	-0.344† (0.177)	-0.252 (0.171)	-0.252 (0.172)	-0.259 (0.172)	-0.241 (0.171)	-0.306† (0.178)
Management controlled	0.479* (0.218)	0.390† (0.216)	0.407† (0.216)	0.368† (0.215)	0.382† (0.216)	0.392† (0.216)
Prevalence of stock option adoption	0.014** (0.005)	0.013* (0.005)	0.013* (0.005)	0.013* (0.005)	0.013* (0.005)	0.014** (0.005)
Industry effects	Yes	Yes	Yes	Yes	Yes	Yes
Log-likelihood	-3,883.359	-3,925.662	-3,924.243	-3,924.428	-3,923.992	-3,870.212

\*\*\* $p < 0.001$ ; \*\* $p < 0.01$ ; \* $p < 0.05$ ; † $p < 0.1$

Robust standard errors in parentheses. Five hundred eighty-four adoption for 1,547 firms between 1997 and 2007, 12,580 firm-year spells in the analysis.

these models (Buis, 2010).<sup>6</sup> Therefore, a 1 standard deviation increase in *Elite managers* (i.e., 0.175)

<sup>6</sup> Suppose the model is  $h(t) = h(\text{baseline}) \times \exp(\beta_1 x_1 + \beta_2 x_2 + \beta_{12} x_1 x_2)$ , then in the multiplicative term, the marginal effect of  $x_1$  on proportional change in the hazard rate  $h(t)$  is  $\exp(\beta_1 + \beta_{12} x_2)$ , depending on the value of  $x_2$ . In our case,  $x_1$  is the *Foreign ownership*, and the  $x_2$  is the moderator variable for example *Elite managers*.

will multiply the effect of *Foreign ownership* on the proportional change in hazard rate of adopting stock option pay by 178 percent (i.e.,  $\exp(0.175 \times 3.306)$ ). Similarly, a 1 standard deviation increase in *Pay inequality* (i.e., 0.53) increases multiplicatively the hazard rate by 147 percent (i.e.,  $\exp(0.53 \times 0.733)$ ). But a 1 standard deviation increase in *Sales growth* (i.e., 5.64) decreases multiplicatively the hazard rate

by 23 percent (i.e.,  $\exp(5.6 \times (-0.261))$ ). Figure 1 (G1–G3) shows the marginal multiplicative effect of *Foreign ownership* at different values of these moderating variables, averaged across all observations. While the coefficient of *Foreign ownership* is not significant in Model 6, possibly due to the multicollinearity in the model, Figure 1 indicates that the average effect of it is significantly positive (95% confidence interval above the zero line).

But the multiplicative effect in the Cox model cannot gauge the linear change in the probability of a firm in adopting stock option pay (Buis, 2010). Alternatively, we run an ordinary probit model. Although the probit model is not very suitable to this sample with the panel data structure, it gives quantitatively similar results (Model 6 in Table 3). Therefore, we use the coefficients in the probit model to interpret the linear change in the adoption probability. We follow the approach of Norton, Wang and Ai (2004) and calculate the actual interaction effect for different adoption probability associated with different value of all other variables (formally,  $\partial^2 F(u)/\partial x_1 \partial x_2$  where  $F(u)$  is the normal cumulative distribution function). Figure 1 shows the effects (G4–G6) and the z-statistics (G7–G9 corresponding to G4–G6). While there is variation in the interaction effects, they are generally consistent with the sign of the coefficients of the interaction terms. For instance, while the interaction effect of *Foreign ownership* and *Elite managers* changes when adoption probability increases (G4 in Figure 1), the interaction effect is always positive, as indicated by the sign of the coefficient (Model 6 in Table 3 and the line in G4). But this interaction effect is not significant when the probability is less than 0.2 (in G7 of Figure 1, the dots are not always higher than the line of 1.96, which indicates the 95% confidence interval). This suggests that in the initial stage of the diffusion, the interaction effect is not significant. The same thing can be said about the *Pay inequality* (G5 and G8 of Figure 1); while the overall interaction effect is positive, it is most significant when the adoption probability is higher than 0.2, after which the dots converge to be higher than the line of 1.645, which indicates a 90 percent confidence interval. For *Sales growth*, the interaction effect is negative and becomes more negative when the adoption probability increases (G6 and G9 of Figure 1). Again, the interaction effect is more pronounced when the probability is higher than 0.2 where the dots converge to be lower than the line -1.96, which indicates the 95 percent confidence interval.

## Robustness tests

In sum, we find supporting results for all our hypotheses. To check the robustness of our findings, we tested several additional variables as control variables: executive total compensation, ratio of executive compensation to earnings, proportion of tax payment over earnings, and whether the firm has a cross-listing in a foreign exchange. None of them is significant or has much impact on the main results. We also tested some industry related variables such as industry sales growth, growth volatility, average profitability, and two-digit industries dummies. These variables did not provide additional information to the fixed three-digit industry effects.

Although we have adopted the lagged variables in the estimation, which has accounted for the reversed causality, our results may suffer from the simultaneity issue in which both the stock option pay adoption and foreign ownership are influenced simultaneously by some unobserved factors and therefore foreign investors are attracted to firms that are more likely to adopt stock option pay. For example, some industries have attracted a high volume of foreign investment, becoming more internationalized, and gradually more accommodating to new practices. We calculated the average foreign ownership in three-digit industries and used it in the model to replace the industry dummies. Indeed we found that in those industries with higher average foreign ownership (highest in petroleum and pharmaceutical industries, which normally have high profitability), firms are significantly ( $p < 1\%$ ) more likely to adopt stock option pay. But the main results based on moderators remain unchanged after controlling for this. We also controlled for the export and foreign sales, but they are not significant in models and our key results remain. Lastly, we rerun Model 6 with standard errors clustered for each firm to account for firm-specific unobserved factors. The result is almost identical. Moreover, we conducted the firm random-effect probit model (Model 7 in Table 3) to control for the unobserved firm factors and the results are consistent.

Another potential endogeneity issue is that stock option pay can be adopted to attract more foreign owners. We did find that foreign ownership on average increased in those firms that had adopted stock option pay. However, we also found that the change in foreign ownership one year after the stock option pay adoption can be both positive and negative.

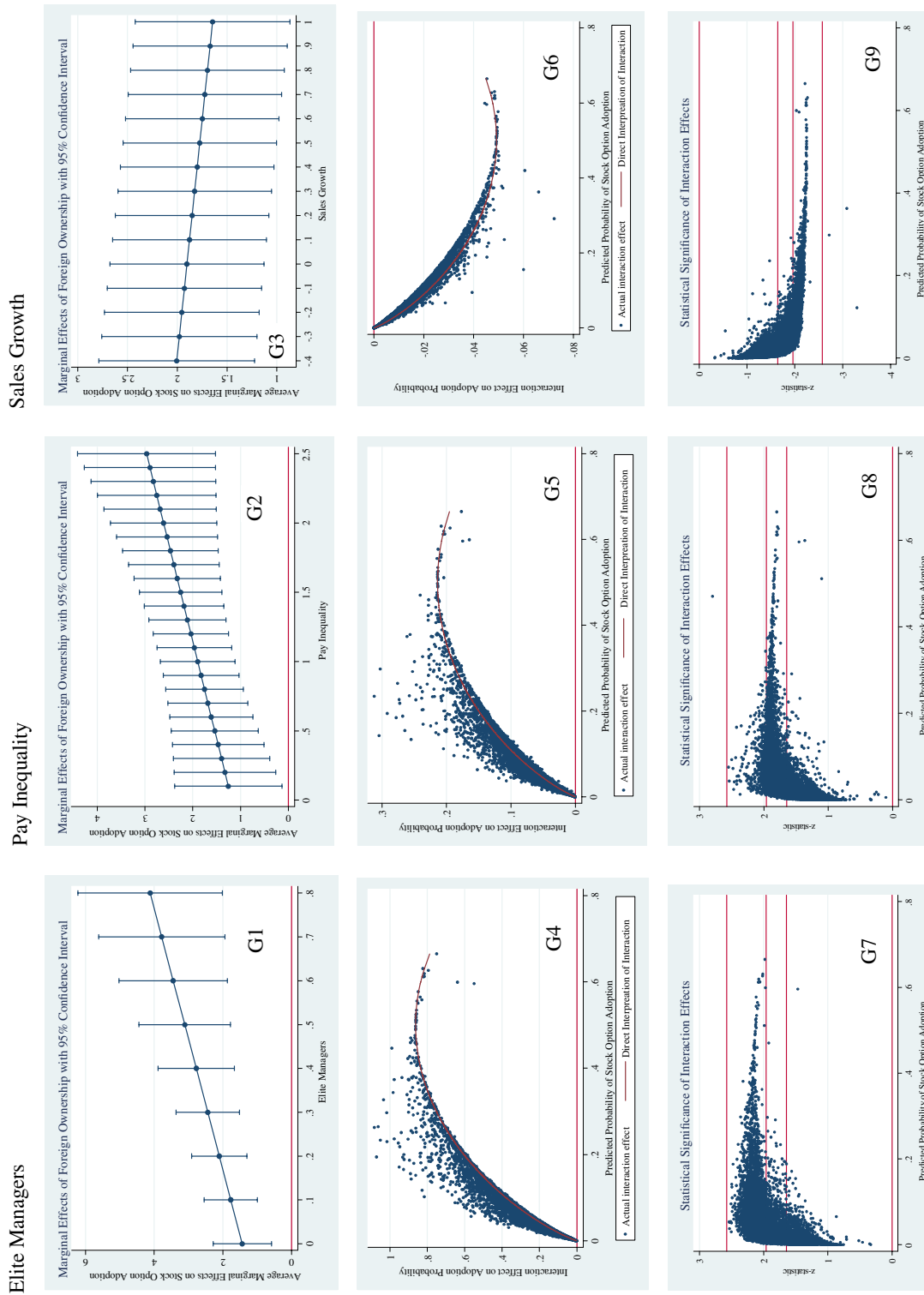


Figure 1. The effects of foreign ownership and its interaction terms on stock option adoption



Table 3. The likelihood of the adoption of stock option pay for executives using Probit models

Variables	Two-stage probit models					Ordinary probit model	Random effects probit model
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
Foreign ownership	1.129† (0.604)	-0.246 (1.001)	-0.299 (1.090)	1.124† (0.605)	-1.490 (1.331)	0.459 (0.434)	0.674 (0.519)
Foreign ownership × elite managers		7.898† (4.405)			7.705† (4.407)	2.311* (1.102)	2.315† (1.410)
Foreign ownership × pay inequality			1.436† (0.867)		1.278 (0.884)	0.513† (0.295)	0.610† (0.338)
Foreign ownership × sales growth				-0.235** (0.087)	-0.242** (0.087)	-0.171* (0.068)	-0.114 (0.075)
Elite managers	0.315* (0.160)	-0.479 (0.447)	0.321* (0.160)	0.310† (0.160)	-0.464 (0.448)	0.041 (0.207)	-0.024 (0.267)
Pay inequality	0.054 (0.040)	0.064 (0.040)	-0.152 (0.130)	0.055 (0.040)	-0.120 (0.129)	-0.029 (0.062)	-0.043 (0.077)
Sales growth	0.002 (0.003)	0.002 (0.003)	0.002 (0.003)	0.064** (0.022)	0.065** (0.022)	0.048** (0.018)	0.031 (0.020)
Firm size						-0.010 (0.027)	0.014 (0.033)
Firm age	-0.006*** (0.002)	-0.006*** (0.002)	-0.006*** (0.002)	-0.005** (0.002)	-0.006*** (0.002)	-0.005** (0.002)	-0.007*** (0.002)
Profitability	-0.160 (0.492)	-0.101 (0.493)	-0.282 (0.499)	-0.124 (0.497)	-0.171 (0.507)	-0.216 (0.507)	-0.461 (0.622)
Debt/asset	-0.091 (0.131)	-0.150 (0.136)	-0.093 (0.130)	-0.087 (0.131)	-0.146 (0.135)	-0.092 (0.119)	-0.285 (0.177)
Volatility	0.970*** (0.194)	1.003*** (0.195)	0.994*** (0.195)	0.976*** (0.194)	1.030*** (0.196)	0.975*** (0.194)	1.064*** (0.224)
Domestic ownership	-0.186 (0.208)	-0.220 (0.210)	-0.167 (0.209)	-0.201 (0.208)	-0.217 (0.211)	-0.147 (0.189)	-0.273 (0.262)
Managerial ownership	0.489 (0.347)	0.297 (0.365)	0.589† (0.351)	0.490 (0.347)	0.390 (0.369)	0.518† (0.296)	0.824* (0.393)
Executives bonus ratio	0.065 (0.185)	0.165 (0.194)	0.062 (0.185)	0.062 (0.185)	0.156 (0.195)	0.073 (0.182)	0.043 (0.216)
Dividend	0.403*** (0.096)	0.375*** (0.097)	0.431*** (0.097)	0.409*** (0.096)	0.407*** (0.099)	0.404*** (0.094)	0.568*** (0.125)
Keiretsu	0.036 (0.074)	0.026 (0.074)	0.032 (0.074)	0.039 (0.074)	0.025 (0.075)	0.031 (0.073)	0.013 (0.096)
Subsidiary	-0.160† (0.087)	-0.150† (0.087)	-0.167† (0.087)	-0.153† (0.087)	-0.150† (0.087)	-0.152† (0.086)	-0.135 (0.114)
Management controlled	0.311† (0.169)	0.338* (0.170)	0.278 (0.170)	0.303† (0.169)	0.301† (0.171)	0.295† (0.158)	0.231 (0.206)
Prevalence of stock option adoption	0.003** (0.001)	0.003** (0.001)	0.003** (0.001)	0.003** (0.001)	0.003** (0.001)	-0.004 (0.006)	0.004** (0.001)
Constant	-1.830*** (0.433)	-1.671*** (0.443)	-1.653*** (0.447)	-1.861*** (0.434)	-1.546*** (0.457)	-1.659*** (0.447)	-2.730*** (0.465)
Industry effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Model statistics		P value of the Wald test of exogeneity				Pseudo R <sup>2</sup>	Log-likelihood
	0.859	0.405	0.501	0.223	0.219	0.157	-1,984.411

\*\*\* $p < 0.001$ ; \*\* $p < 0.01$ ; \* $p < 0.05$ ; † $p < 0.1$   
Robust standard errors in parentheses.

The average change in foreign ownership in the adopting firms is not statistically different ( $p = 0.52$ ) from the average change in foreign ownership in the nonadopting firms.

To address this endogeneity issue further, we can treat foreign ownership as the endogenous variable and its interaction with moderator variables also endogenous in the estimation. Unfortunately, the Cox model does not have the capability to handle the endogeneity. We therefore resort to the next best alternative and used the two-stage probit model (“ivprobit” in Stata). The results (second-stage coefficients) are reported in Table 3 (Models 1–5). We use *Firm size* as the instrumental variable because it is highly correlated with *Foreign ownership* but unrelated to the adoption decision. We use the interaction between predicted foreign ownership from the first stage and moderating variables (e.g., *Elite managers*) as the new instrumental variable (Wooldridge, 2002). The results using this approach generated supporting evidence to our hypotheses as well.

It is possible that stock option pay was not used to pursue managerial self-interest, but to attract talented managers to the firm to improve firm performance. Even though hiring executive-level managers from the external labor market is not common in Japanese firms (Colpan and Yoshikawa, 2012), we checked whether stock option pay leads to CEO turnover. There were fewer than 20 firms of such cases, out of 584 adopting firms. Removing these firms from the sample does not change our empirical results.

## DISCUSSION AND CONCLUSION

This study aims to understand how and why local organizations adopt a corporate governance practice developed with foreign institutional logic that is not consistent with the prevailing local institutional logic. We have provided a new perspective focusing on how change-minded managers can navigate between alternative institutional logics to adopt the new practice to serve their self-interest, facilitating the diffusion of the practice. We argue that stock option pay is preferred by foreign owners, but also financially attractive to managers of Japanese firms. Therefore, to achieve their own private goals, managers may leverage foreign ownership and its associated shareholder logic to justify the adoption of this new pay scheme in the Japanese stakeholder

environment. We show empirical evidence that the effect of foreign ownership on the adoption of stock option pay is greater when Japanese managers have more elite educational background, higher pay inequality relative to other employees, or when the firm faces slower sales growth. The findings suggest that the diffusion of stock option pay can be facilitated when managers leverage the opportunity offered by an alternative institutional logic in the local institutional environment.

This study enriches research on the introduction of new or contentious corporate governance practices into an institutional context that follows different logic. In a globalized economy, the process by which practices are transferred across institutional boundaries is an important issue for theoretical inquiry (Dacin, Goodstein, and Scott, 2002). Although our understanding of how institution-embedded organizations respond differently in adopting these new practices has been greatly advanced by previous studies, this field still remains understudied (Greenwood *et al.*, 2011; Kraatz and Block, 2008; Pache and Santos, 2010; Seo and Creed, 2002). Some studies focused on the influence of powerful and resourceful organizational actors espousing different institutional logic (e.g., Ahmadjian and Robbins, 2005; Desender *et al.*, 2014; Fiss and Zajac, 2004; Sanders and Tuschke, 2007). More recent studies have taken a socio-political perspective and paid attention to the role of the embedded agencies (Greenwood *et al.*, 2010) who are receptive to the changing ideas or are motivated to change (Chung and Luo, 2008a; Fiss and Zajac, 2004; Kraatz and Moore, 2002), and thus manage to spread the new practices that are seemingly inconsistent with the dominant local logic. We join the latter line of inquiry on change agents but we depart from the existing literature in one important aspect; in particular, we suggest that motivated change agents (i.e., managers) can utilize other powerful actors (i.e., foreign owners) and their espoused institutional logic for the needed legitimacy in adopting a new practice. Therefore, this study not only provides one process to solve the “paradox of embedded action” (Holm, 1995; Seo and Creed, 2002), but also explores the conditions under which specific responses are mobilized under multiple institutional demands (Pache and Santos, 2010). This perspective can be extended to study the adoption of other practices, such as downsizing or an independent board, which have diffused across national institutional boundaries but have

been contested due to the incompatible institutional pressures from multiple institutional logics.

From a broader perspective, this study speaks to the growing behavioral governance research (Westphal and Zajac, 2013). It has been found that corporate leaders tend to navigate the prevailing institutional logic to manage their relationship with the external constituents of the firm or pursue their private benefit. For example, managers produce favorable justification for their behaviors and decisions through changing the explanation for their use of long-term incentive plans when the prevailing institutional logic of corporate governance changes from “corporate logic” to “agency logic” (Zajac and Westphal, 1995, 2004). When the institutional logic evolves to “neocorporate logic”, executives tend to use impression management to emphasize their distinctive talent and resource to justify the quality of leadership (Westphal and Park, 2012). Sometimes they refer to the conformation to the board of director independence to justify symbolically the quality of management even when the performance is less satisfactory (Westphal and Park, 2012). Our findings are consistent with this perspective and extend it to show how managers can proactively utilize the coexistence of alternative logics to justify their behaviors. Moreover, in the literature of symbolic management in corporate governance (Westphal and Zajac, 1994, 2013), corporate leaders may symbolically conform to the dominant institutional logic but decouple it from the actual implementation without realizing the value embodied in the institutional logic. We follow this train of thought and suggest that managers may adopt a new practice to realize their own interests, without necessarily accepting the superiority of its value and institutional logic.

This study also contributes to the research on embedded agencies by identifying the boundary conditions for their behaviors. Our theoretical arguments can be applied to other institutional contexts; however, we wish to highlight that the stakeholder-oriented context is a necessary condition for the inroad of shareholder logic into Japanese companies. Given that stakeholder logic prescribes a balanced view of accommodating the interests and requests of all influential stakeholders (e.g., Fiss and Zajac, 2004), it legitimizes the interest of arm’s length investors as well even if they are upholding shareholder logic. It is this balanced perspective underpinning stakeholder logic that makes the leveraging behavior of motivated

Japanese managers possible. This line of reasoning can be useful for future studies. It suggests that not all institutional logics are equally accommodating to foreign interests and to new practices carrying incompatible institutional logic. The diffusion of best practices in corporate governance may be more from shareholder logic to stakeholder logic. This can inform studies on the global convergence of corporate governance practices (e.g., Aguilera and Jackson, 2003), which have not yet fully examined the asymmetry of the infusion of one governance logic into another. Future studies can investigate the validity of this conjecture and examine other conditional factors that can impede or facilitate the infusion of shareholder logic into stakeholder logic. It is equally interesting to investigate how stakeholder logic can infuse into shareholder logic.

Future studies can help overcome the limitations in this study. First of all, without available data on the identity of each foreign owner, we had to use the aggregated measure and assumed that they all follow shareholder logic. The heterogeneity in foreign ownership may have potential impact on managerial behavior and the diffusion of a new practice. Second, we estimated the model based on the observables such as educational background and sales growth to infer the underlying managerial interests and behaviors. But the true motives for managers and how they leverage institutional logic can be heterogeneous, which can only be revealed through more direct measure using interviews or surveys. Third, we notice that the interaction effects in our sample are quite dispersed in the initial diffusion stage when the adoption probability is low. The investigation of this heterogeneity at different stages of adopting a new practice may help reveal more about how alternative or incompatible institutional logics interact and influence managerial behaviors. Furthermore, researchers can explore how alternative or competing institutional logics influence one another. For example, local stakeholders and managers may learn from foreign investors and their logic, leading to the gradual evolution of local institutional logic (Ahmadjian and Robbins, 2005). When the content of institutional logic increasingly resembles with one another, managerial response to the incompatibility between institutional logics may evolve as well. For instance, one interesting future direction can be the hybridization of competing logics in one organization (Ingram and Simons, 2000; Yoshikawa *et al.*, 2007). In addition, future studies can explore how stock option

pay that has been adopted as a result of managerial manipulation impacts the firm performance.

The increasing globalization of capital markets and institutional investment has facilitated the transfer of governance practices from one institutional context to another. Our study shows that managers play a crucial role in the diffusion of new practices in an institutional environment. These managers can either passively balance different demands based on different institutional logics, or can proactively leverage the multiplicity of institutional logics to serve their own interests. Our study shows the latter case.

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