Institutional Investor Power and Heterogeneity

Implications for Agency and Stakeholder Theories

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This article examines the implications of the escalation in institutional investor power and heterogeneity for two dominant theories of corporate governance: agency theory and stakeholder theory. From this analysis, a new view of the agency relationship between institutional investors and their portfolio firms emerges, which recognizes the institutions' market power, complex role as financial intermediaries, and possible involvement in simultaneous and opposing agency contracts. We also conclude that stakeholder theorists should reconsider these newly empowered shareholders' moral standing in relation to their portfolio firms, and they should reexamine the identities and goals of these modern investors. To that end, we demonstrate that a novel, intragroup application of Mitchell, Agle, and Wood's stakeholder framework to heterogeneous institutional investors illuminates their varying levels of stakeholder salience.

Keywords: *corporate governance; institutional investors; agency theory; stakeholder theory; socially responsible investing; theory of the firm*

Since the era of Berle and Means (1932/1991), most corporate governance theories have been based on assumptions of diffused, inattentive stockholders and powerful managers with the discretion to (mis)direct the assets of the firm. Historically, theorists have argued that efficient-market solutions to the problem exist (Jensen & Meckling, 1976; Manne, 1965) and that government intervention is necessary to correct this market "failure" (Berle & Means, 1932/1991; Dodd, 1932). More recent stewardship

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theorists continue to adopt the image of diffused, inattentive shareholders in their claim that managers do in fact act as responsible stewards toward their firms' absentee owners (Davis, Schoorman, & Donaldson, 1997).

However, none of these approaches to corporate governance explicitly accounts for the recent transformation of the nature of corporate ownership in the United States (Davis & Thompson, 1994). In a trend that is expected only to escalate ("Shareholder frustration brings," 1999), the last 2 decades have brought an enormous consolidation of investor holdings into the hands of increasingly activist institutional fund managers: More than 61% of U.S. public equity is now held by institutional investors (Securities Industry Association, 2002). However, the relationships among the three members of the corporate governance triad—investors, managers, and directors—are changing not merely because of the greater concentration and, hence, increased power that is associated with institutional investors, but they are also changing because of the complexity that results from the institutions' positions as financial intermediaries between beneficial owners and corporate managers and from these institutions' varying characteristics and roles.

Academic researchers across fields—including Useem (1993, 1996) in management, Roe (1994) and Black (1992) in law, and even O'Barr and Conley (1992) in anthropology—have described the general trend of institutional investing and have attempted to raise awareness concerning the impact of institutional investor power on managerial discretion and accountability. However, discussions of institutional investors have tended to treat them monolithically (e.g., Sundaramurthy, 1999; Westphal & Zajac, 1998), belying their true heterogeneity (Del Guercio & Hawkins, 1999). Empirical studies that have tried to measure the effect of institutional ownership on corporate affairs have come away with mixed results, partly as a result of not distinguishing among the members of this varied group. Institutional investor heterogeneity has been recognized in the practitioner press (Brancato, 1997) and has been analyzed recently in the management literature (Ryan & Schneider, 2002), but it has not yet been reflected in the corporate-governance canon.

In this article, we integrate and build on this existing work by identifying and addressing the need for governance theories to reflect the profound contextual change caused by recent trends in institutional investing. We argue that they should be modified to reflect not only the existence of institutional investors overall but also the heterogeneity inherent in this enormous investor class and the complexity that results from their role as financial intermediaries.

We begin by outlining the similarities and distinctions among several categories of institutional investor. The implications of the recent fundamental shift in investor power and the complexity it brings are then presented for two major corporate governance theories: agency theory and stakeholder theory. We juxtapose these theories not only because they are influential and disparate but also because they exemplify the broader debate contrasting organizational economics and management theory (Barney, 1990; Donaldson, 1990). Agency theory stands as the paradigmatic view of the firm in finance and economics and leads among the many contenders in management. Stakeholder theory, on the other hand, wields growing influence in the management literature. Given their very different underlying assumptions and views of the firm, fruitful analyses of these two theories in light of the new reality of institutional investing would suggest that similar analyses of other, more moderate theories are also in order.

THE INSTITIONALIZATION OF INSTITUTIONAL INVESTMENT

With the advent of public equity markets in the early 20th century, the composition of business ownership largely shifted from proprietors, whose assets in the firm include both intangible and human capital, to investors, whose assets in the firm are limited to financial capital. This change led to a split between diffused ownership and concentrated management and was argued to have resulted in "managerialism" (Berle & Means, 1932/1991), in which professional managers became empowered and gained great discretion with few checks and balances.

However, over the latter decades of the 20th century, because of the institutionalization of pensions and the appeal of professional management, individual investors increasingly channeled their investments through financial institutions (Sellon, 1994). This shift resulted in a more concentrated and powerful ownership base (Mintzberg, 1983) and has been heralded as the foundation of "institutional capitalism" (Useem, 1993) or "investor capitalism" (Conrad, 1988; Useem, 1996). It is thus an appropriate time to reexamine the assumptions underlying theories of corporate governance that were developed in the earlier era of diffused individual shareholders.

In addition to the significance of increasing investor power, we argue that the heterogeneity of this newly dominant investor class has implications of its own for these theories. Therefore, before analyzing agency and stakeholder theories, we briefly review six distinct types of institutional investor, each with different potential effects on corporate governance

Table 1
Equity Holdings by Institutional Investor Type

	Institutional Ownership (2001)	
Type	*Dollars (in Billions)*	*% U.S. Equity*
Private pension plans	1,905	20.5
Public pension plans	1,216	13.1
Mutual funds	2,836	30.5
Insurance companies	905	9.7
Banks	226	2.4
Foreign ownership	1,698	18.2
Other	526	5.6
Total institutional ownership	9,312	100.0%
Total household ownership[a]	5,888	
Total ownership	15,210	

Source: Securities Industry Association (2002)
a. Includes nonprofit organizations.

(Ryan & Schneider, 2002). Table 1 presents the recent equity holdings of these varying types.

Pension Plans

Pension plans are financial institutions with a legal obligation to provide retirement income to participants (Kidwell, Peterson, & Blackwell, 1993). In defined-benefit plans, investment risk is borne by plan sponsors, who promise employees a given annuity at retirement (Andrews & Hurd, 1992; Bodie, Marcus, & Merton, 1988; Bodie & Papke, 1992). In defined-contribution plans, employees have more investment control but are burdened with the associated risks. Fund portfolios can be actively managed where individual securities are evaluated and buy-or-sell decisions are made (O'Barr & Conley, 1992), or they can be passively managed ("indexed") where the portfolio emulates a market composite, such as the Standard and Poor's 500 ("ERISA Turns 20," 1994).

Private pension plans. In 1995, approximately 87.5 million employees, or 78% of full-time private-sector employees in the United States were members of private pension plans (U.S. Dept. of Labor, 1999). The Employee Retirement Income Security Act (ERISA) of 1974 was intended to regulate these traditionally defined-benefit plans (Brancato, 1997), but its exclusion of corporate liability for defined-contribution losses may have contributed to private funds' recent shift toward more defined-contribution and hybrid plans (Andrews & Hurd, 1992; Bodie & Crane, 1999; Bodie & Papke, 1992).

Private fund managers tend toward a lack of involvement in corporate governance (Useem, Bowman, Myatt, & Irvine, 1993), perhaps because of a norm of "mutual forbearance," and they avoid voting against other firms' management for fear of retaliation (Brown, 1998; Conrad, 1988; Roe, 1994). Funds that do business with their portfolio firms may also forgo activism because of "pressure sensitivity," or a conflict of interest caused by their dual roles as investor and supplier (Brickley & Smith, 1988). Their strict regulatory environment, including ERISA, may further discourage activism among private defined-benefit plans (Blair, 1995; David & Kochhar, 1996; Gordon, 1994).

Private multiemployer plans. A subset of private pension plans, multiemployer plans are generally administered by their members' labor unions across groups of sponsors. Taft-Hartley multiemployer pension plans control about $400 billion in investments (Cleeland, 1999). Some are aggressive activists (O'Connor, 1999; Schwab & Thomas, 1998), publicizing executive compensation levels, targeting underperforming companies, and casting their proxy votes against management positions (Schwab & Thomas, 1998).

TIAA-CREF, the largest fund in the United States (Pellet, 1998), is a multiemployer system for academics. Its defined-contribution plans (Wisniewski, 1999) are invested with a primarily financial agenda, but they extend to social goals on behalf of members who invest in their social fund (TIAA-CREF, 2002). TIAA-CREF has demonstrated a pattern of pressing for corporate governance improvements through such means as proxy voting, shareholder resolution sponsorship, and quiet diplomacy (Byrne, 1999; Carleton, Nelson, & Weisbach, 1998).

Public pension plans. In 1996, approximately 8.7 million federal employees and 15.2 million state and local employees participated in public pension plans (Employee Benefits Research Institute, 1999), covering nearly all full-time public employees. Because no federal-level regulations govern them, state plans face varying legal environments (Martin, 1990; Woods, 1996). They tend to be passively managed (Brancato, 1995), and, reflecting their civil-service environment (O'Barr & Conley, 1992), they remain largely defined benefits. Public funds, including the California Public Employees' Retirement System (CalPERS), have been more active in pressing for governance and performance improvements than have other types of institutional investor (Useem, 1993, 1996; Useem et al., 1993), and they are more likely than many others to focus on social issues (Romano, 1993). Public plan managers may also face political pressures to invest in local communities (Kieschnick, 1979; Litvak, 1983; Romano, 1993).

Mutual Funds

Mutual funds are open-ended investment companies that issue shares in diversified portfolios (Radcliffe, 1990); those funds with equity investments are classified as institutional investors. The mutual fund industry is highly competitive, characterized by many funds, great rivalry, and much public information regarding fund performance (Fredman & Wiles, 1998). Mutual funds face a Securities and Exchange Commission mandate for liquidity (Johnson, 1993) that may also promote tendencies toward short-term thinking and passivity toward portfolio firms. Yet, mutual-fund managers are moderately activist (Useem, 1993), particularly managers of socially screened mutual funds, who exhibit greater activism regarding their causes (Davis & Trent, 1993; Roosevelt, 2000). Mutual-fund activism may also be on the increase, with several influential fund managers' recent formation of the Federation of Long-term Investors (Singhania, 2003).

Insurance Companies and Banks

Insurance companies and banks have received little attention as institutional investors because of their low profile and relatively small aggregate size. Both may find it easy to liquidate their small equity positions, which may encourage sale over activism, and both derive much of their business from corporations, which may make them "pressure sensitive" to the potential loss of business risked by engaging in activism with firms who are also customers (Brickley & Smith, 1988). Insurance companies tend to invest primarily in bonds and mortgages; therefore, they may view their limited equity holdings with a short-term horizon, discouraging them from intervening with portfolio firms (Eng, 1999).

As banks have not traditionally been allowed to own equities other than through their trust function, they account for a small percentage of equity holdings (Barth, Brumbaugh, & Wilcox, 2000). However, this proportion may change with the repeal of the Glass-Steagall Act (Kirsch, 1997; Kuttner, 1999). Although banks' conservative interpretation of fiduciary responsibility (Del Guercio, 1996) may also lead to passivity, they may be more activist than insurance companies (Brancato, 1997).

In the following sections, in addition to addressing the broad impact of the general escalation of institutional-investor power, we will examine the importance of this institutional investor heterogeneity for agency and stakeholder theories.

AGENCY THEORY AND INSTITUTIONAL INVESTMENT

Emanating from law and financial economics, agency theory has become well established in the management literature (Boatright, 1992; Bowie & Freeman, 1992; Eisenhardt, 1989). In the agency framework, one party, the principal, contracts the services of another party, the agent. It is assumed that self-interest will tend to motivate the agent to deviate from wholly fulfilling the contractual obligation to the principal. Agency costs, which are borne by the principal, come from the agent's tendency to engage in self-serving behavior (Arrow, 1985). Principals attempt to minimize agency costs by monitoring agents and by implementing incentive systems that align agents' interests with their own (Pratt & Zeckhauser, 1985).

Fundamental Assumptions

One of agency theory's traditional applications is the owner-manager relationship (Jensen & Meckling, 1976). Agency theory relies, in part, on market mechanisms to respond to issues related to the separation of ownership and control (Williamson, 1985), such as the market for corporate control (Manne, 1965). These market mechanisms may have contributed to the renewal of shareholder activism, as evidenced by the pivotal role of institutional investors in many of the takeover battles of the 1980s (Anderson, 1991; Davis & Stout, 1992). The concentration of control in institutional representatives' hands actually supports agency theorists' call for shareholder action in aligning managerial and owner interests. Thus, it could be concluded that agency theory applies well to institutional investment without modification.

Indeed, the most fundamental assumptions of agency theory—the behavioral assumption of self-interest (Assumption 1) and the related emergence of agency costs (Assumption 2)—are retained in this analysis (see Table 2). That is not to say that these assumptions are without criticism: Critiques of them abound (Dees, 1992; Nilakant & Rao, 1994; Noorderhaven, 1992; Perrow, 1993). These two assumptions evidence the deductive and positive qualities that are associated with economic models, which are considered problematic by some theorists (Seth & Thomas,

Table 2
Assessment of Agency Theory's Assumptions in its Application to Institutional Investment

Assumption	*Assessment*
1. Individuals are motivated by self-interest.	Maintained.
2. Agency costs to the principal will tend to emerge.	Maintained.
3. A contractual approach to relationships is appropriate.	Maintained, but the dyadic nature of the contact is at issue. Two alternative multi-party models have been developed. We present a third model of dual and opposing contracts.
4. Economic-based contractual solutions will reduce agency costs.	Power between the parties must also be addressed, for it influences the emergence of agency costs and the efficacy of agency controls.
5. The monitoring of agents and the alignment of principal-agent interests will tend to be adequate forms of control.	Continued information/power asymmetries may render these controls to be less efficacious.
6. Contract outcomes are measured in terms of financial criteria, for example, maximizing shareholder value.	Some institutional investors, particularly the more activist, favor both financial and social performance criteria.
7. Markets tend toward efficiency.	A market for agents may not readily exist, which empowers the agent. The price-pressure hypothesis indicates that market friction may make the market less efficient. Market inefficiency empowers institutional investors with long-term investment horizons.
8. A narrow focus on the contract itself is appropriate.	The context of the contract should be included, for it may influence the contract's terms.

1994). Nevertheless, these characteristics also contribute to agency theory's parsimony and strong predictive ability relative to other theories and are therefore of benefit in developing the theory's application to institutional investment.

The Contract and Its Execution

Many of agency theory's other assumptions do require some modification in its application to institutional investment. First, although we find that the contractual approach remains appropriate, at issue is the assumption of a dyadic contract (Assumption 3). Some agency theorists hold that the dyadic contractual approach can be applied to any complex phenomenon by thinking of it as a series of such contracts, for example, the firm as "a nexus of contracts" (Fama & Jensen, 1983; Jensen & Ruback, 1983). Others have disagreed with this position and have developed two models based on the belief that the dyadic contractual approach is insufficient for capturing the parties and interests associated with ownership through financial intermediation.

The first model argues for a two-tier agency structure, with individual or beneficial owners as principals, with institutional investors as agents to their beneficial owners and as principals to corporate managers, and with corporate managers as agents (Bricker & Chandar, 2000). The two-tier structure suggests that institutional investment brings about new agency costs that do not appear in contracts between individual investors and corporate managers, as the institutional managers may be undermonitored. The second model involves a multiparty contract, which includes other stakeholders of the intermediaries, whose interests might influence the intermediaries away from honoring those of their beneficial owners (Schneider, 2000). It suggests that increased emphasis should be placed on the governance of financial institutions.

While acknowledging the contributions of these two models, we propose an alternate model that further addresses the role of power in the institutional-investor principal/agent contract under consideration in Assumption 3. Agency theory has tended to assume that conflict resolution occurs through the alignment of economic incentives rather than through the means of power and politics (Assumption 4)(Barkema & Pennings, 1998; Eisenhardt, 1989). However, several researchers have recently overcome this limitation in the application of the theory to antitakeover provisions (Sundaramurthy, 2000) and managerial compensation (Barkema & Pennings, 1998; Stoughton & Talmor, 1999). In this vein, we propose that a more overt inclusion of power will yield more accurate predictions regarding the emergence of agency costs and the efficacy of agency controls in the theory's application to institutional investment.

A primary factor in assessing power in the institutional investor agency contract is that it is often not the only contract among the parties. An institutional investor may be in two opposing agency contracts with a portfolio firm, simultaneously acting as its principal and its agent. For example, an insurance company may be the insurance agent to one of its portfolio firms, so the portfolio firm's buyer power in the insurance contract might limit the insurance company's investor power in the ownership contract. The existence of two such contracts is most clearly the case for pressure-sensitive institutional investors, but other institutional investor types might also face this situation. For example, whereas Brickley and Smith (1988) have designated public pension plans as pressure-insensitive, they may simply face pressure of a different type: that is, political pressure to invest in the local community, to support local businesses, and to create jobs (Eaton, 2002; Romano, 1993). Thus, a public plan may be pressured by a third party—the government—to endorse a local firm while also being one of its owners. Clearly, such a conflict of interest could inhibit its tendency toward investor activism with portfolio firms. The dual opposing contract approach indicates that prediction of an institutional investor's behavior must take into account its potential role as an agent to its portfolio firms.

The power dynamic in the agency relationship has also been analyzed in terms of information flows or knowledge, with the assumption that the agent may have an informational advantage over the principal (Assumption 5). A precontract condition of adverse selection may occur as the result of incomplete knowledge, and a postcontract condition of moral hazard may occur as the result of hidden action or hidden knowledge by the agent (Rasmusen, 1989). Institutional investing raises the separate but related issue of the impact of professional knowledge in professional agency contracts. The agent is hired based on specific professional knowledge or expertise and is trusted to use this expertise on behalf of the principal (Sharma, 1997). When an agent has highly specialized knowledge as well as autonomy and independence, monitoring becomes difficult and incentive alignment becomes critical (Tosi & Gomez-Mejia, 1989). Thus, professional agency contracts illustrate another source of information asymmetry and, therefore, power asymmetry that may favor the agent.

Some institutional investors' information asymmetries may lead to greater agency costs than others. For example, the competitive dynamics in the mutual fund industry, characterized by low switching costs, significant rivalry, and much public information regarding fund performance (Fredman & Wiles, 1998), may result in moral hazard for individual investors in the individual-investor/institutional-investor agency relationship. Because the funds' management fees are based on total assets under management, mutual funds might quietly adopt investment policies that favor enticing new investors rather than maximizing after-tax returns to current investors (Barclay, Pearson, & Weisbach, 1998). In their zeal to top the ratings lists to attract new investors, mutual funds may thus take on a greater level of investment risk than they convey to their current investors (Wyatt, 1996).

Although institutional investors have increased the power of owners through their consolidation of equity shares and their activism, the institutional-investor/firm agency relationship continues to embody power and information asymmetries. The more broadly defined shareholder/corporate manager agency application is considered to be one of moral hazard with hidden knowledge (Rasmusen, 1989). Accordingly, the agent (corporate manager) may intentionally hide relevant knowledge from the principal (institutional investor).

The recent wave of management scandals provides vivid examples of moral hazard that affected all investors, including institutions. Andrew Fastow's construction of complex off-balance-sheet financing techniques at Enron illustrates that agents can use professional knowledge to promote their self-interest as opposed to fulfilling their contractual obligation to principals. Although institutional investors had the power to more closely monitor and control Enron and similar firms, they did not employ it effectively in these cases. However, we suggest that the scandals were, in part, the result of information asymmetries that gave the management of portfolio firms some level of countervailing power compared to even the most assiduous fund managers.

Agency theorists have also assumed that contract outcomes will be stated in terms of financial criteria, or financial gain to the principal, rather than in terms of financial and social performance (Assumption 6). Shareholder wealth maximization is a central assumption of agency theory and the broader field of financial economics (Seth & Thomas, 1994). It has been assumed that maximizing shareholder wealth is the goal of the firm and that managerial incentives should, in part, be based on it. "The change in shareholder wealth is the appropriate measure of the principal's objective in the CEO-shareholder agency relationship" (Jensen & Murphy, 1990, p. 245).

The agency assumption that contract outcomes are evaluated strictly on financial measures is frequently violated with institutional investment. Many institutions, particularly private pension plans, the majority of mutual funds, and banks, may favor strictly financial outcomes of their portfolio firms (Ryan & Schneider, 2002). However, a sizeable group of institutions—particularly public pension plans and the large number of socially screened mutual funds—favor social as well as financial measures of performance. Similarly, institutional investors such as TIAA-CREF view good corporate governance practices as a requisite outcome.

Market and Institutional Forces

As discussed above, agency theory relies on market mechanisms, such as the market for corporate control (Manne, 1965). The theory assumes that markets will tend to operate efficiently (Assumption 7) based on aggregate individual preferences: "Thus, although an individual security holder may not have a strong interest in directly overseeing the management of a particular firm, he has a strong interest in the existence of a capital market which efficiently prices the firm's securities" (Fama, 1980, p. 292). However, the market can also be subject to friction (Hill & Jones, 1992; Williamson, 1985). The first source of friction involves the degree to which markets for agents do or do not exist within the dual-agency contract arrangement, that is, the degree to which each party in its role as principal can or cannot find readily substitutable agents. Disparity in the existence of markets for agents will influence the relative power of the parties. For example, a bank that both services and invests in an unusually high-performing portfolio firm may have few equivalent investments available, but the portfolio firm may have ready access to many banks to service its banking needs, rendering the portfolio firm to be powerful relative to the institutional investor. In addition, a market for agents might bring forth monitoring devices, such as ethical codes among agents, which benefit principals by curbing agents' self-serving tendencies (Varian, 1990). The lack of a market for agents will therefore tend to lead to higher agency costs.

A second source of friction involves the pricing of the portfolio firm's equity, as suggested by the above quote. Under an efficient market—that is, one with a large number of buyers and sellers, none of whom is large enough to affect price—the "exit" strategy of selling a firm's equity may make financial sense compared to the "voice" strategy of activism (Davis & Thompson, 1994; Hirschman, 1970). However, studies suggest that the efficient-market hypothesis has given way to the price-pressure hypothesis, for equity prices tend to change temporarily when demand curves shift (Harris & Gurel, 1986; Lynch & Mendenhall, 1997). "Exit" may have thus become a costly strategy as the current concentration of ownership may lead to financial losses for the seller. Yet, the high portfolio turnover associated with some types of institutional investor, particularly mutual funds (Brancato, 1997), suggests that some tend to sell sooner and accept losses rather than delay their sale and risk even greater losses.

Thus, market friction must also be modeled into agency theory's application to institutional investment as it affects individual agency contracts. For example, based on the price-pressure hypothesis, indexed funds with a long-term perspective might have more power with management than actively managed funds that have coercive power based on their threat to sell, because indexed funds have more incentive to intervene with portfolio firms' management. It has been suggested that, among institutional investors, long-term relational investing, or "voice," may be better suited to mitigating moral hazard problems compared to other agency controls (Ayres & Cramton, 1994). Therefore, long-term investors—those with lower portfolio turnover, such as public pension plans—may reduce agency costs for all investors.

In keeping with their tendency to ignore market friction, agency theorists tend to focus narrowly on the agency contract (Perrow, 1993) and discount the effect of contextual or institutional variables (Assumption 8). For example,

> It makes little or no sense to try to distinguish those things which are "inside" the firm (or any other organization) from those things that are "outside" of it. There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output. (Jensen & Meckling, 1976, p. 485)

Agency theory should instead reflect a range of contexts (Eisenhardt, 1989) and address external factors that influence the contract (Noorderhaven, 1992). Although all U.S. institutional investors must comply with fiduciary law, they face heterogeneous legal and regulatory environments. Little federal law covers public pension plans; they are primarily affected by their state legal environments, some of which are inadequate and contribute to public-pension-plan funding problems (Romano, 1993). Similarly, life insurance companies are largely covered by state laws, which tend to restrict the percentage of their funds that they can allocate to stock, often to 10% of assets (Fabozzi, 1995). Banks have also historically been barred from holding equity for their own accounts, although this prohibition is changing with the repeal of the Glass-Steagall Act (Barth et al., 2000). Thus, institutional context should be considered when applying agency theory to institutional investing, particularly in the global arena, for markedly different institutionalized patterns are reflected among national ownership systems (LaPorta, Lopez-De-Silanes, & Shleifer, 1998; Rubach & Sebora, 1998).

Review of Findings

We have found that many of the basic assumptions of agency theory hold well in our application of the theory to institutional investment. However, some have been superceded, at least to some degree, such as market efficiency, contract outcomes based solely on financial criteria, and the extraneousness of the contract's institutional context. As our analysis concludes that the traditional dyadic agency contract is inadequate for describing the dynamics of institutional investment, we propose a model of two simultaneous, opposing contracts that may exist among institutional investors and their portfolio firms. The dual-contract model helps to better pattern the dynamics of power between some institutional investors and corporate managers.

The heterogeneity of institutional investors has greater impact on our assessment of some assumptions than on others. It is a particular factor regarding Assumption 5 concerning information and power asymmetries, Assumption 6 pertaining to their expectations of the scope of corporate performance, and Assumption 8 on the institutional (legal/regulatory) environment. For Assumption 4, we found that power affects agency contract execution for all institutional investors but that this phenomenon is more overt for pressure-sensitive ones. We will now turn to an examination of how these same characteristics—institutional investor power and heterogeneity—affect a very dissimilar perspective on corporate governance.

IMPLICATIONS OF INSTITUTIONAL INVESTMENT FOR STAKEHOLDER THEORY

Compared to agency theory, stakeholder theory embodies a fundamentally different response to the separation of ownership and control. Whereas the former strives to minimize managers' discretion and align their behavior with shareholders' interests, stakeholder theorists instead advise managers to take advantage of their discretion to advance the interests of nonshareholder constituencies.

The broad and varied stakeholder literature has been reviewed thoroughly elsewhere (Donaldson & Preston, 1995; Mitchell, Agle, & Wood, 1997). More recent work in the area has applied agency-based explanations to stakeholder relationships (Boatright, 2002; Hill & Jones, 1992), considered the importance of relationship dynamics with stakeholders (Andriof, Waddock, Husted, & Rahman, 2003), examined stakeholder importance at different stages of the organizational life cycle (Jawahar & McLaughlin, 2001), and discussed the possible merger of the normative and social-science branches of the theory (Donaldson, 1999; Jones & Wicks, 1999; Treviño & Weaver, 1999).

However, we will keep our focus on the theory's underlying fundamentals and examine two important implications of institutional power and heterogeneity. First, stakeholder theorists have long questioned shareholders' moral standing in relation to their firms because of the separation of ownership and control (Boatright, 2002; Donaldson & Preston, 1995). We will argue that their moral standing has been reinvigorated by the concentration of institutional-investor power and investors' active intervention with their portfolio firms (Ryan, 2000). Second, we will suggest that the shareholder profile applied in stakeholder theory should be reconsidered. Not only is it arguably out of date, given the shift from individual to institutional investing, but it also neglects the significant differences among investors themselves. As it does with all stakeholder groups, the theory generally treats shareholders as a monolithic bloc whose members deserve equal consideration (Donaldson & Preston, 1995; Mitchell et al., 1997). Instead, in a novel, intragroup application of Mitchell et al.'s (1997) stakeholder salience framework, we will demonstrate that the heterogeneity among institutional investors outlined above also distinguishes their salience as stakeholders.

Shareholders' Rejuvenated Moral Standing

The stakeholder literature takes three forms: descriptive, where scholars depict managers' actual behavior toward various stakeholder groups; instrumental, where researchers advise managers to treat their stakeholders well as a means of achieving some corporate goal, such as enhancing profits for shareholders; and normative, where managers are admonished to treat their nonshareholder stakeholders well even at the expense of profits because it is the moral thing to do (Donaldson & Preston, 1995). The advent of institutional investor power has little impact on the first two research streams, given descriptive theory's value-neutral stance and investors' potentially central role in the instrumental version of the theory. However, institutional investing has caused a radical change in the normative theory's context, necessitating a reexamination of a key underlying assumption concerning shareholders.

Like agency theory, normative stakeholder theory has its roots in the influential managerialist arguments concerning the separation of ownership and control. Indeed, Dodd (1932) and Berle and Means (1932/1991) made early statements of stakeholder theory. Originally, on-site owners' moral rights to the profits of their firms were unquestioned. However, according to managerialist theory, with the advent of the corporate form, shareholders' diffusion and disinterest in corporate affairs eliminated their property rights to the maximized profits of their firms, thus reducing their moral standing (Berle & Means, 1932/1991, p. 312). This change left the ethical door ajar for other groups, such as customers, employees, and communities, to claim greater benefits than their contracts called for (Williamson, 1985). More recent, explicit descriptions of normative stakeholder theory make much the same claim (Donaldson & Preston, 1995). Donaldson and Preston note specifically that this argument demonstrates the moral weakness of stakeholder theory's "principal competitor"—

stockholder theory—strengthening the former's relative position (1995, p. 81). Thus, a core assumption of normative stakeholder theory is that shareholders' reified role in the corporation is morally unfounded.

However, the two characterizations underlying the "weak-shareholder" argument—diffused, disinterested shareholders and managers with uncurbed discretion—both fade in the light of recent investor concentration and activism and of recently imposed constraints on managers. The majority of shares in the United States are now held by a consolidated shareholder base whose representatives take an active interest in the performance of portfolio firms, a shift that has been argued to reinforce investors' property rights and their moral claim on the residual profits of the firm (Ryan, 2000).

In addition, after the institutional-investor wake-up call of the 1980s and early 1990s, many shareholders discovered and increasingly acted on their newfound power to curb managers' discretion, both through influencing SEC regulations (Hawthorne, 1993) and through such direct intervention as activism (Romano, 1993) and CEO firings (Ward, 1997). The cultures of many American board rooms and executive suites became more collaborative and transparent as a result (Monks & Minow, 2001).

Some executives clearly managed to retain their broad discretion despite these newly empowered investors, as evidenced by the Enron scandals. However, in their wake, the trend toward increased investor activism and decreased executive discretion promises only to increase. For example, shareholders filed a record-setting number of proxy proposals in 2003 (Blaue, 2003), in addition to increasing behind-the-scenes negotiations between institutions and portfolio firms (Ryan & Schneider, 2002). Activist institutional investor organizations are also on the rise. The newly formed National Coalition for Corporate Reform, made up of institutional investors, labor unions, and government officials, intends to pressure companies to improve their corporate governance practices (McGeehan, 2003). Similarly, the formation of the Federation of Long-Term Investors noted above, which consists primarily of indexed mutual funds, suggests the impending activism of a previously dormant group of powerful investors (Singhania, 2003). At the same time, Sarbanes-Oxley reforms both escalate and legally enforce investor-initiated curbs on managerial discretion (Schlesinger, 2002). The weak-shareholder argument thus clearly deserves reexamination.

Donaldson and Preston (1995) offer a second argument to support shareholders' reduced moral standing as compared to other stakeholders. Over the course of the 1970s and 1980s, the courts increased the breadth of the Business Judgment Rule, which denotes the legal limits of managerial discretion. If the law increasingly supports managers' right to consider nonowner stakeholders when making decisions, they argue, shareholders' moral standing must be waning. Notably, 21 states have such "constituency statutes" on their books (Windsor, 2002).

However, the latest decade of legal decisions and regulatory changes has reduced the scope of the Business Judgment Rule, significantly limiting managerial discretion in the interests of investors (Brossman & Tatman, 1998). Constituency statutes, for one, have recently been argued to be moot: From their inception in 1986 through 1999, the courts consistently upheld the centrality of shareholders' claims in states with such laws (Springer, 1999). Indeed, the leading U.S. incorporation state, Delaware, does not even have such a statute (Fairfax, 2002; Springer, 1999).

Thus, both of these influential arguments—that shareholders' property rights have been compromised and that the courts have increasingly recognized investors' reduced moral standing—deserve reexamination. If, indeed, shareholders' moral standing in relation to the firm is now stronger than stakeholder theory originally assumed, theorists must consider the implications of this change. For example, when analyzing the "salience" of various shareholder groups, Mitchell et al. (1997) found investors to be the corporation's one "definitive" stakeholder, requiring primary attention from corporate executives.

Enhanced status for shareholders need not be detrimental to the theory, however, given a clear understanding of the new investor profile. Berle and Means (1932/1991) assumed that diffused individual shareholders pursued dividends, an increasing share price, and a reasonable level of risk. As noted above, the assumption that shareholders' interests are purely monetary has been reinforced over the ensuing decades in the mathematical modeling formulas of financial economics (Jensen & Meckling, 1994; Seth & Thomas, 1994). However, modern institutional investors bear little resemblance to the individual shareholders of the last century. Many, including public pension funds, labor-union pension funds, and social-interest mutual funds, pursue social goals as well as financial ones (Ryan & Schneider, 2002). The social motivations and interests of this new class of investor could be found to be compatible with those of stakeholder theory.

A richer understanding of the modern investor could thus enhance stakeholder theory, both by allowing theorists to embrace institutional investors as powerful potential allies and by sending a signal to critics that stakeholder theorists recognize recent shifts in the economy. Financial economists (Jensen, 2001) and legal scholars (Jennings & Happel, 2003) have recently launched pointed attacks at the theory for its misunderstanding of market forces. Stakeholder theorists' recognition of a new investor profile, with all of its logical implications for the theory, would help to defuse such criticism. Indeed, in the following section, we suggest that it would behoove stakeholder theorists to understand not only institutional investors as a class but also their heterogeneity.

Shallow or Deep View?

As noted above, the stakeholder model of the firm considers the interests of a variety of constituencies, including, at the very least, customers, employees, and investors, but sometimes also including such diverse groups as communities, suppliers, and political groups (Donaldson & Preston, 1995). Researchers have invested considerable effort into arguing the relative merits of more inclusive or exclusive interpretations of the term "stakeholder," a discussion that has been characterized as taking a "broad or narrow view" of the term (Mitchell et al., 1997).

We argue, however, that as stakeholder theory grows more sophisticated, researchers must depart from this assumption of homogeneous stakeholder groups and consider the benefits of what we propose is a "deep" view of stakeholders, which acknowledges the significant heterogeneity within stakeholder groups, over the current more "shallow" view. Clearly, the collections of individuals commonly assumed to compose the stakeholder groups of a firm require additional scrutiny (Friedman & Miles, 2002). A company's customer base, for example, may consist of corporate accounts, wholesalers, and retailers, each deserving a different level of consideration as a stakeholder of the firm. Similarly, all investors are not equivalent, and their relative importance to the firm should be examined at a finer level of analysis.

Fortunately, Mitchell et al. (1997) have provided researchers with a framework to investigate the relative salience of different stakeholder groups. They recommend examining each stakeholder group's combination of power, legitimacy, and urgency to determine where it falls into one of seven categories, ranging from dormant stakeholders, who possess only power, to definitive stakeholders, who possess all three characteristics. Although the framework was originally developed to perform intergroup stakeholder analysis, we argue that it can be applied equally effectively at the intragroup level. We find that examining the six categories of institutional investor discussed above from the perspectives of power, legitimacy, and urgency illuminates their disparate roles and salience as stakeholders, supporting our assertion that stakeholder groups are not monolithic (see Table 3). Future applications of this framework to other types of investor—individuals, employee owners, and families—and to other stakeholder groups could be equally enlightening and serve to deepen the relevance of stakeholder theory to the modern firm.

Table 3
Institutional Investor Salience by Fund Type

	Power	*Legitimacy*	*Urgency*	*Overall Salience*
Private pension funds	Moderate	Moderate	High	Moderate
Private multiemployer funds	High	Moderate	High	High
Public pension plans	High	High	High	High
Mutual funds	Moderate	Moderate	High	Moderate
Insurance companies	Low	Moderate	Low	Low
Banks	Low	Moderate	Low	Low

Power. The most important shift brought about by institutional investing is the sudden surge in shareholder power, which has now been recognized and codified in law (Hawthorne, 1993; Schlesinger, 2002; Useem & Gager, 1996). Clearly, as shareholders, all six institutional investor types have the power to affect their portfolio firms. Following Mitchell et al.'s (1997) use of Etzioni's (1964) formulation that power has utilitarian, normative, and coercive sources, however, it becomes clear that their levels of power differ.

First, they vary in their *utilitarian power,* which affects their ability to dispense or withhold material rewards. Both the size of institutional investors' holdings and their liquidity requirements come into play. Institutions that hold large blocks of a company's stock are likely to have more influence over executives' compensation—directly by influencing board decisions and indirectly by affecting share price—and, therefore, over performance-based bonuses. Although all institutional investors have a fiduciary duty to diversify their portfolios, pension plans face less severe regulatory pressure to diversify than do mutual funds, insurance companies, and banks, so they are likely to become larger shareholders than other institutional investors (Ryan & Schneider, 2002). In addition, because multiemployer plans collect funds across companies, they often have a size advantage over other pension funds, along with a greater tendency to weight their portfolios toward firms that employ their workers (Schwab & Thomas, 1998). Mutual funds' liquidity requirements, on the other hand, make them more likely to sell a firm's stock and less likely to intervene with a given portfolio firm (Roe, 1994), reducing their utilitarian power as compared to pension plans. Thus, large pension funds, by virtue of their enormous financial resources and their relative freedom from diversification regulation and the need for liquidity, are the most likely to wield utilitarian power.

Similarly, in the modern “shareholder value” era (Rappaport, 1986), prestige and the esteem of executives’ peers rest partially in satisfying institutional investors, giving them *normative power* over managers as a class. However, public pension funds are likely to have the most leverage over managers’ image. Because they are the largest and most activist of institutional investors, their efforts are also the most visible to peer firms and other shareholders (Romano, 1993). These funds are also most likely to use the media to publicize their displeasure with specific firms (Del Guercio & Hawkins, 1999).

Both of these sources of power are reinforced by all investors’ right to tap the *coercive power* of the courts and legislation if managers do not protect their interests. However, varying regulations also lead to disparities among institutional investors’ levels of coercive power. As noted above, many private pension funds are restrained by ERISA regulations in their activism efforts (Brancato, 1997; Hawksley & Wells, 1996), and mutual funds face serious regulatory restriction of their ability to hold large blocks of stock (Roe, 1994). In addition, insurance companies are largely precluded from intervening as equity holders because of bankruptcy laws (Brancato, 1997). Thus, although funds of these three types may hold utilitarian and normative power, their ability to enforce it is much more constrained than it is for public pension funds and multiemployer plans. Larger funds, which tend to be pension plans and mutual funds, also have greater resources and expertise to undertake legal remedies (Byrd, Parrino, & Pritsch, 1998). Public pension plans in particular have the added ability to influence governmental backing of firms based on their level of support for the funds’ initiatives (Romano, 1993).

Notably, Mitchell et al. (1997) do not mention the possibility of firms’ exercising their own influence over stakeholders, thus offsetting their power. As noted above, banks and insurance companies may suffer from pressure sensitivity as the result of their sponsor organizations’ ongoing business transactions with portfolio firms (Brickley & Smith, 1988). Similarly, it has been argued that private pension fund managers observe a “golden rule” of nonintervention with fellow corporations (Bird, 2001): The exercise of one corporation’s shareholder power over a fellow corporation’s managers could lead to future retaliation. Public pension plans appear to be least susceptible to these forms of countervailing power, leaving them free to exercise their influence.

Thus, as shown in Table 3, we conclude that public pension plans and multiemployer plans have the greatest power as stakeholders, whereas private pension funds and mutual funds have a moderate level, and insurance companies and banks have the least power as stakeholders of their portfolio firms.

Legitimacy. Although all six categories of institutional investor would generally be accepted by society as legitimate organizational stakeholders because of their shareholder standing, their representatives may be considered legitimate to varying degrees at the individual level (Wood, 1991). Managers, for one, have challenged the legitimacy of some institutional investors' claims on their portfolio firms. They have drawn a clear distinction between the moral control rights of pension fund managers who are explicitly aware of their beneficiaries' priorities and the lack of rights of those who are not (Useem, 1996). And, in questioning the management ability of fund managers who try to tell them how to run their corporations, executives have challenged the expertise-based legitimacy of fund managers in general (Donlon, 1998; Useem, 1996) and public-pension fund managers in particular (Norton, 1991; Taylor, 1990). Some managers also consider representatives of Taft-Hartley multiemployer plans to have less legitimate stakeholder status than other institutional investors, given their adversarial style and their mixed motives of advancing the interests of both fund beneficiaries and current union employees (Sweeney, 1996). Another type of mixed motive concerns those who claim that fund managers with a social agenda are using beneficiaries' concentrated financial power for inappropriately nonfinancial ends ("Financial economists roundtable," 1999; Whittington, 1994).

In addition to the individual-level legitimacy concerns voiced by corporate executives and critics, organizational-level distinctions exist. As noted above, society confers some measure of legitimacy on all shareholders because of their standing as owners of the firm. However, based on their defined-contribution versus defined-benefit status, a distinction can be drawn among pension funds' legitimacy based on such property rights (Ryan, 2000). In the defined-contribution plans favored by private pension funds, property rights to portfolio assets rest more clearly with beneficiaries, who bear the risk of variations in investment returns. Under the defined-benefit plans favored by public pension funds, the property rights of beneficial owners are more obscure, as the fund sponsors are the risk bearers and beneficiaries merely hold liens on sponsors' assets. Therefore, firms sponsoring defined-contribution plans have less legitimacy as shareholders of portfolio firms except when representing the explicit interests of beneficiaries. In addition, the social goals derided by some are lauded by others (Romano, 1993), lending public pension funds, in particular, heightened legitimacy.

Thus, as the result of their standing as shareholders, all six categories of institutional investor have at least a moderate level of legitimacy (see Table 3). However, public pension funds, because of their primarily defined-benefit status and broad interest in social goals, could be considered to have a higher level of legitimacy as stakeholders than other institutional investors.

Urgency. After decades of somnolence and dispersion, in the late 20th century, shareholders' rights became concentrated in the hands of institutional fund managers (Ward, 1997). These representatives reasserted investors' corporate standing through activism, making shareholders "definitive" stakeholders through the addition of urgency to their previous, "dominant" stakeholder status that was based on power and legitimacy (Mitchell et al., 1997). However, like legitimacy, although all six institutional-investor categories may sense urgency in their corporate claims, they vary in degree, this time based on their time sensitivity, or the extent to which delay is unacceptable to the stakeholder, and their criticality, or the importance of the claim to the stakeholder.

Investors who tend toward active portfolio management, such as most private pension funds and mutual funds, will have a more urgent claim than more captive shareholders who hold indexed portfolios or large stakes in the firm, such as public pension funds. Whereas both groups may share a sense that their need for managerial action is urgent, active investors may consider their demands to be more *time sensitive* because inaction on the executives' part may actually lead to the funds divesting the stock, thus incurring transaction costs and potentially accepting a depressed share price. Indexed fund managers may make the same demands but sense less time sensitivity, given their "captive" status as shareholders of the firm. Even among these passively managed funds, however, those with greater liquidity requirements and short-term performance pressure, such as indexed mutual funds, may be more likely to exhibit time sensitivity than are indexed pension funds with their longer time horizons. Insurance companies and banks, because of their relatively small equity holdings and the small proportion of their portfolios invested in stock (Ryan & Schneider, 2002), would tend to experience less time sensitivity than other institutional investors.

In addition, fund managers' career ladders and compensation systems may encourage time sensitivity among public pension and mutual fund managers. Public pension fund managers may face looming political reappointment dates when fund performance can affect their livelihoods (Romano, 1993). Similarly, mutual-fund managers' compensation systems are based on total assets under management on specified dates, which, as noted above, may encourage them to push for short-term increases in fund value to attract new investors (Brown, Harlow, & Starks, 1996).

Funds with larger investments in a given firm's stock may have more *critical* need for managerial attention, suggesting reduced urgency among highly diversified mutual funds and indexed, primarily public, pension funds, along with insurance companies and banks whose equity holdings are relatively modest. In addition, many socially conscious funds with "mixed" motives, such as public pension funds with both financial and social programs and Taft-Hartley plans that support both beneficiaries and current workers, may consider their needs to be more critical than those funds pursuing purely financial interests in portfolio firms.

Thus, as shown in Table 3, most of the influences on fund managers lead to greater senses of urgency, with relatively few countervailing pressures, so that all pension funds and mutual funds are likely to exhibit high levels. Insurance companies and banks, on the other hand, are again at the more modest level.

Not surprising, then, public pension plans and multiemployer plans, particularly those that represent their beneficiaries' explicit interests, emerge as the most definitive stakeholders among institutional investors, rating highest on power, legitimacy, and urgency. This status has been reflected in these funds' recent success at intervening with their portfolio firms. Based on this analysis, private pension plans and mutual funds appear to rank next in terms of stakeholder salience, followed by the smaller insurance companies and banks.

Stakeholder theorists should consider not only the power inherent in the institutional-investor class but also its heterogeneity. The rise in institutional investing has consolidated shareholdings into a relatively small number of increasingly activist hands, strengthening shareholders' moral standing in relation to their portfolio firms. In addition, it is clear that institutional investors' heterogeneity leads to differing levels of stakeholder salience, suggesting that the theory could be enriched by a deeper understanding of shareholders as a class.

CONCLUSION

This article is intended to encourage researchers to examine existing theories of corporate governance in light of the recently heightened power and heterogeneity of the "investor" component of the corporate governance triad. We attempt to facilitate this task by clarifying the roles and environments of the various members of the complex world of institutional investing and by demonstrating the implications of this fundamental power shift and institutional investor heterogeneity for two highly disparate yet influential governance theories.

Clearly, these two theories take very different approaches to "solving" the problem of the separation of ownership and control. Because investors have always had a central position in economic theory, it is not surprising that agency theory is relatively easily modified to accept the resurgence of investor power. Similarly, descriptive and instrumental stakeholder theories are virtually unaffected, given the descriptive theory's observer stance and the already central role of investors in instrumental theory. Normative stakeholder theory, on the other hand, is grounded in the notion that shareholders' moral claim to the firm was sundered by the separation of ownership and control, an assumption that deserves reconsideration given the reconcentration of ownership and the resurgence of investor power.

Our evaluation of agency theory's application to institutional investment suggests that its two most basic assumptions, self-interest and the emergence of agency costs, hold well in this new context. However, we argue that the institutional investor agency contract is a complex, multiparty one and that issues of power between the parties must be incorporated into the theory to improve its predictive ability. We also find that investors may not measure the outcome of the contract, that is, corporate performance, solely by financial results. This application of agency theory to institutional investment helps us to develop better insight into corporate governance dynamics, particularly when the recommended modifications are made. We find that the self-interests of the various parties involved result in a need for better monitoring and governance of both corporations and investing institutions. In addition, we conclude that institutions are influenced by market friction and the regulatory environment above and beyond their agency contracts. Thus, although certain behaviors may be expected from institutional investors based on the agency contract, other behaviors may occur because of forces exogenous to the contract.

The growth in institutional investor power and heterogeneity also has important implications for stakeholder theory. We argue that shareholders' moral claims on corporations have been rejuvenated by the reconcentration of equity ownership and investors' increased activism with portfolio firms. We consequently call for stakeholder theorists to reexamine the role of investors in their theory and to consider the possibility that many modern institutional investors may be sympathetic with stakeholder theory, given their mixed financial and social performance expectations. In addition, our novel intragroup analysis of a stakeholder group based on Mitchell et al.'s (1997) framework demonstrates that institutional investors are not a monolithic stakeholder group but a collection of subgroups that vary in their power, legitimacy, and urgency and, thus, in their salience as stakeholders. Researchers and managers alike could reach a deeper understanding of firms' various constituencies by delving more deeply into the diverse interests and claims associated with their supposedly monolithic stakeholders.

The analysis of these two governance theories from the perspective of recent trends in institutional investing thus has implications for theory building. The simplicity of agency theory, although a virtue in terms of predictive power, is a weakness in terms of descriptive power. Our analysis, although it adds complexity to the theory, also increases its ability to account for real events facing practicing managers. Similarly, our analysis of stakeholder theory demonstrates its current lack of specificity. We propose that stakeholder theorists strengthen the theory by taking a deep view of stakeholder groups.

Significant opportunities exist for future research that will further highlight how the phenomenon of institutional investment affects the application of both theories. The heterogeneity of institutional investors suggests that they arrive at differing terms and conditions in their agency contracts with a common body of portfolio-firm managers. Areas for study include the impact of these varying, and at times conflicting, contracts on managerial decision making and on firm performance. Another promising area of research is the role of context or institutional environment in influencing institutional investors' shaping of the agency contract. The changing nature of the laws and regulations governing these institutions and increased cross-country equity ownership make this area particularly important.

The power, legitimacy, and urgency (Mitchell et al., 1997) of institutional investor types also provide a broad framework for study. We suggest that portfolio-firm managers be queried regarding their perceptions of these attributes for different institutional investors. We also encourage further use of deep stakeholder analysis. Those interested in pursuing such analysis could begin by examining individual, family, and employee shareholders, rounding out the current analysis of investors. A similar analysis of other stakeholder groups, such as employees and customers, would further enrich stakeholder theory. A careful evaluation of some employees' simultaneous roles as employee and investor stakeholders would be of particular value.

More broadly, the implications of institutional investor power and heterogeneity for other governance theories, such as transaction-cost economics (Williamson, 1985), stewardship theory (Davis et al., 1997), and managerialism (Berle & Means, 1932/1991), offer fertile ground for further study. Transaction-cost researchers may find that institutional investing changes the balance of transaction costs inherent in the governance equation and that activist investors now serve as an additional control on managerial opportunism. Although stewardship theory explicitly notes that shareholder desires vary (Davis et al., 1997), this theory could be strengthened through an examination of how institutional investors' presence in executive suites affects managers' proposed role as good-faith custodians of absentee owners' interests. Finally, researchers may find that the recent reconcentration of ownership and control spawned by institutional investing attacks managerialism at its core, making it an anachronism in the context of the modern firm.

The primary goal of this article is to focus management scholars' attention on a basic change in the practice of corporate governance that has not yet been integrated into the corporate governance canon. Like Conrad (1988) and Useem (1996), we conclude that the shift in investor standing and complexity witnessed over the last 2 decades is as fundamental to the modern corporation as that documented by Berle and Means (1932/1991) 7 decades ago. Although the corporate landscape has already been fundamentally transformed, firms are sure to continue evolving away from the traditional corporate governance model as the new century wears on.

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