

THE SHAPE OF THINGS TO COME: INSTITUTIONS, ENTREPRENEURS, AND THE CASE OF HEDGE FUNDS

Pamela S. Tolbert and Shon R. Hiatt

ABSTRACT

Foundational work on institutional theory as a framework for studying organizations underscored its relevance to analyses of entrepreneurship, but entrepreneurship research has often ignored the insights provided by this theoretic approach. In this chapter, we illustrate the utility of institutional theory as a central framework for explaining entrepreneurial phenomena by discussing three primary questions for entrepreneurship researchers: Under what conditions are individuals likely to found new organizations? What are key influences on the kinds of organizations they found? And what factors determine the likelihood of the survival of new organizations? We describe the kinds of answers that an institutional perspective provides to these questions, illustrate some of our arguments by drawing on a recent field of entrepreneurial endeavor, hedge funds, and discuss the implications of our analysis for further work by entrepreneurship researchers.

As others in this volume have noted, the relevance of institutional theory to understanding entrepreneurial phenomena seems, at least at first blush,

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moot. Resting on a fundamental sociological premise that individuals' decisions and actions are strongly constrained by social norms and commonly held behavioral expectations (Durkheim, 1938), an institutional perspective contrasts sharply with the classic economic perspective that underpins a significant amount of extant work on entrepreneurship, one that treats individuals' decisions and actions as the result of independently conducted calculations of costs and benefits (von Hayek, 1939; von Mises, 1936). The apparent disjuncture between institutional theory and entrepreneurship research has been reinforced by the fact that empirical research carried out under the banner of institutional theory has focused largely on the diffusion of structures and practices across established organizations, and given little attention to the generation of new organizations and areas of economic activity, the central concern of entrepreneurship research (Tolbert, David, & Sine, 2010).

Although this evidence seems to suggest a clear disconnect between these literatures, it is notable that early work by Meyer and Rowan explicitly identified entrepreneurship as an area of study for which an institutional perspective was relevant. As they observed (1977, p. 345):

The growth of rationalized institutional structures in society makes formal organizations ... both easier to create and more necessary. After all, the building blocks for organizations come to be littered around the societal landscape; it takes only a little entrepreneurial energy to assemble them into a structure. And because these building blocks are considered proper, adequate, rational and necessary, organizations must incorporate them to avoid illegitimacy.

Our aim in this chapter is to amplify these claims, by illuminating how a variety of questions of interest to entrepreneurship researchers are usefully addressed through an institutional perspective, and identifying some of the major questions for further research that this theoretic application suggests need to be addressed. We organize our discussion around three issues that we see as central to the field of entrepreneurship studies, viz.: Under what conditions are individuals likely to found new organizations? What are key influences on the kinds of organizations they found? And what factors determine the likelihood of the survival of new organizations? We begin by offering a general theoretical analysis of the kinds of answers institutional theory suggests to these questions, then discuss the relatively new entrepreneurial area of hedge funds as a case to illustrate and provide anecdotal support for our claims of the utility of institutional theory as a framework for studying new ventures. In conclusion, we identify a number of key lines of research that are suggested by our arguments.

SCOPE CONDITIONS: THE DEFINITION OF ENTREPRENEURSHIP

Having taken a strong stand on the importance of institutional theory for entrepreneurship research, we now need to backpedal a little, and acknowledge that this importance depends partly on how one defines the domain of the latter. Work on entrepreneurship offers a vast soup of definitions of its central construct. Aldrich and Ruef (2006) note at least four broad definitional approaches, ranging from ones that draw on Schumpeter's (1934) concept of creative destruction to set the parameters of "entrepreneurship" (effectively reserving the term for only a very small subset of new ventures, ones that result in the replacement of existing markets with new ones), to those that award the label exclusively to new ventures that have the core objective of rapid growth and that require high capitalization for success (thus, suggesting contemporary high-technology companies as the appropriate objects of study for entrepreneurship scholars), to those that reflect a big-tent orientation, including all efforts to establish new, independent organizations (with, perhaps, the exception of foundings that represent new units of existing firms or the government).

For work that emphasizes the creation of new markets as a defining attribute of entrepreneurship, the utility of an institutional perspective may be more limited, at least in terms of explaining foundings. (We think that it's very relevant to explaining the structure of new firms and their survival, however, even within the restricted framework of this approach.) In our view, institutional theory is *not* a useful framework for explaining when deviance from established patterns is likely to occur or why. Thus, we agree with Aldrich's assertion (see Chapter 11 in this volume) that institutional theory is unlikely to provide useful insights for explaining the occurrence of "black swans" and that other perspectives, such as social psychological studies of creativity (e.g., Goncalo & Staw, 2006), may be much more relevant to such problems. Institutional theory cannot provide a comprehensive framework for studying all possible facets of entrepreneurial phenomena – but we do not believe that any single theoretical framework *can* fulfill that charge.

However, although many, if not most scholars, pay some homage to the Schumpeterian view of entrepreneurship, it's not clear this definition dominates the field. Indeed, a substantial body of work in this area is devoted simply to understanding factors that affect founding rates of new organizations (e.g., Aldrich, 1990; Aronson, 1991; Mezas & Kuperman, 2001; Shane, 1996), regardless of the novelty of their form, suggesting that a

broader definition of entrepreneurship is often favored in practice. And institutional theory is, we argue, highly relevant to explaining foundings when broader definitions are employed.

FOUNDING ORGANIZATIONS: ENTREPRENEURSHIP AS AN INSTITUTION

In its initial formulation, institutional theory was offered as a way of explaining commonly observed patterns of structural homogeneity that characterized sets of organizations (Meyer & Rowan, 1977; Zucker, 1977; DiMaggio & Powell, 1983), an explanation that contrasted with the then-dominant theoretical frameworks by emphasizing cultural demands instead of efficiency demands (Scott, 1987). There were two central premises on which this explanation rested. The first was that elements of formal structure – departments, offices, job titles, policies, etc. – can come to be commonly accepted (i.e., institutionalized) as necessary parts of efficient and effective organizations. Whether such elements objectively enhance efficiency and effectiveness is immaterial, in this theoretical formulation. Indeed, Meyer and Rowan's discussion of decoupling suggested that institutionalized structures often are inefficient, something organizational decision-makers recognize, though they adopt them anyway.¹ This brings us to the second key premise, viz., once structures become institutionalized, organizations adopt them *because* they are understood to be necessary elements of well-run organizations (Tolbert & Zucker, 1983). Thus, institutional theory suggests that formal organizational structure reflects, at least in part, cultural prescriptions about how to organize rather than independent calculations of the costs and benefits of adopting each element of structure (Scott, 2004).

We argue that these sorts of cultural prescriptions not only affect the structural form of organizations (including those taken by new ventures, as discussed below), but also determine individuals' propensity to found new organizations. In this context, institutional theory provides a useful framework for addressing one of the key questions studied by entrepreneurship researchers: What factors determine variations in rates of new organization founding? Research on differences in entrepreneurial proclivities across ethnic groups and variations in founding rates across geographic areas provides strong support for the claims that entrepreneurship can be treated as an institution in its own right, and that variability in the presence

and strength of this institution is key to explaining patterns of new organization formation (Tolbert et al., 2010).

Research has shown that immigrants to the United States often have significantly higher rates of entrepreneurship than nonimmigrants (Collins & Moore, 1970; Borjas, 1986), a finding that is typically explained in terms of immigrants' blocked opportunities for employment and mobility within existing organizations due to discrimination and prejudice (Bonacich, 1973). However, research also highlights notable variation among immigrant groups (e.g., Light & Rosenstein, 1995; Zhou, 2004), both in their overall propensity to found new business organizations and in the specific kinds of business that they are inclined to create. According to Zhou (2004), groups with above-average propensity to found new businesses include Japanese, Koreans, Chinese, Iranians, and Cubans; by comparison, Mexican and Filipino immigrants are much less likely to start their own businesses. This sort of between-groups variation provides a general indication that entry into entrepreneurship is driven by more than just blocked opportunities; it suggests the critical effects of cultural differences among ethnic groups – social understandings that make founding a new firm a more readily grasped option. It is these sorts of understandings that constitute entrepreneurship as an institution.

Work on cross-national and regional variations in founding rates suggests geographic as well as ethnic boundaries to the institution of entrepreneurship. A good example is provided in a study by Saxenian (1994), exploring two areas in which computer companies were established early in the industry's development, Silicon Valley in California and Route 128 in Massachusetts, and focusing on differences between these areas in terms of the subsequent founding of other new companies. Despite seemingly similar resources and opportunities in the two locations in the early 1980s, Route 128 proved to have limited incubation capacity for new firms in the industry, while Silicon Valley spawned hundreds and hundreds of new firms. Entrepreneurship became institutionalized in the California region, but not in Massachusetts. In her comparison of these two cases, Saxenian identifies some of the historical and emergent forces importantly implicated in this institutionalization process, including differences between key universities in the two regions in their openness to relations with commercial enterprises, the relative willingness of West and East Coast law firms to play financial brokering roles, variations in patterns and rates of personnel flows across firms, and so forth.

These and other conditions affecting the institutionalization of entrepreneurship have been further explored in more recent work on regional

clusters of new firm foundings (e.g., Khessina & Carroll, 2008; Romanelli & Khessina, 2005; Sine & Lee, 2009; Sorenson & Audia, 2000). Like the work on ethnic entrepreneurs, this work underscores the key role of shared, cultural understandings of entrepreneurship as an important influence on individuals' decisions to create new businesses (Hiatt, Sine, & Tolbert, 2009).

Dimensions of the Institution of Entrepreneurship

The juxtaposition of these two streams of literature suggests two main dimensions of entrepreneurship as an institution: normative acceptance of self-employment as a viable, even desirable career option; and shared information and cognitions about the processes involved in starting and running new organizations – tacit, recipe-knowledge that is difficult (if not impossible) to formalize. As we discuss below in our analysis of the case of hedge fund organizations, the latter dimension – specifically, the existence of a nucleus of key actors who create and disseminate knowledge about setting up and running new firms – is likely to be particularly important in increasing rates of founding in emerging industries and markets. In these circumstances, potential founders face especially high levels of uncertainty in terms of choosing viable technologies, effective marketing strategies, appropriate standards for selecting qualified personnel, and so forth. Without accessible, credible sources of information to assist in making these choices, would-be entrepreneurs are likely to find the decision-making processes of setting up an enterprise to be overwhelming (Aldrich & Fiol, 1994), and the perceived riskiness to be untenable (Sine, Haveman, & Tolbert, 2005). As noted by a range of theorists, institutional prescriptions not only constrain but also enable action, by limiting the number of choices individuals have to make (Barley & Tolbert, 1997; Giddens, 1976; Sewell, 1992; Simon, 1947). In new markets, where relevant prescriptions are not widely diffused, the presence of a few key actors who provide such information can strongly shape the propensity of nascent entrepreneurs, in Aldrich and Ruef's (2006) terms, to become active entrepreneurs (see Hiatt, 2010).

Although the informational dimension of the institution of entrepreneurship may be especially important for understanding variations in founding *rates* in new economic sectors, it is also likely to be relevant to understanding variations in the *types* of organizations that different groups are apt to found. That is, as members of an ethnic or geographically defined group gain and share knowledge about founding and operating a particular

kind of enterprise (e.g., fast-food restaurants, technology research firms, garment manufacturing businesses, etc.), this affects the propensity of other group members to found similar enterprises (Dowell & David, 2007).

The normative dimension has been given less explicit attention in existing work, but studies of ethnic entrepreneurship, in particular, suggest its importance. Thus, for example, Goldscheider (1986) makes a case that the relatively high rates of entrepreneurial activity among Jews in the United States reflect a shared value of occupational independence, a value fostered and reinforced by anti-Semitic discrimination in Europe. Similarly, Rajiman and Tienda's (2000) comparative study of ethnic entrepreneurs indicates that while founding and operating a small business is considered an acceptable career choice for first-generation Korean immigrants, subsequent generations are expected to find other career opportunities with greater mobility; in contrast, Hispanics have a more favorable view of continuing a family-founded business as an intergenerational career strategy.

Research on regional variations in foundings of the firms can also be interpreted as suggesting geographic variation in the normative dimension of the institution of entrepreneurship. Saxenian's (1994) work on regional variations in the founding rates of firms in the computer industry strongly suggests that the concatenation of material circumstances supporting entrepreneurship in Silicon Valley probably reflected, in part, the existence of greater normative acceptance in California for starting one's own company, compared to Massachusetts. In line with this, Sine and Lee's (2009) analysis of the creation of new wind power enterprises showed that California had a much higher rate of founding in the industry's early years than Texas, despite the greater presence of key resources (wind) in the latter state. They attribute this to the higher levels of activity by environmental movement organizations in California, which aimed at encouraging would-be entrepreneurs to enter the industry, but it is possible that such variation also partly reflected geographic variations in the acceptability of entrepreneurship as a career option.

Of course, the normative and informational aspects of institutionalized entrepreneurship are likely to co-vary, since the existence of cognitive templates about how to create and operate new organizations that are shared across sets of individuals makes entrepreneurship easier to support as a viable career choice, and normative support for the pursuit of entrepreneurial efforts fosters efforts to create and pass along such templates. More specific evidence of the existence and nature of these templates comes from research on sources of new ventures' formal structure.

DESIGNING ORGANIZATIONS: INSTITUTIONAL SOURCES OF STRUCTURE

The fit between an organization's formal structure and specific conditions confronting it (technological demands, environmental predictability, number of organizational members, etc.), and the consequences of such fit for organizational prosperity and survival, have been key foci of traditional studies of organization (Lawrence & Lorsch, 1967; Weber, 1947; Woodward, 1958). However, with few exceptions, surprisingly little research on entrepreneurship has focused on the determinants of the formal structure of new organizations or its consequences.

Yet there is evidence that, as in established organizations, variations in formal structure are likely to be highly consequential for the fate of new ventures. For example, Sine, Kirsch, and Mitsuhashi (2006) showed that the survival chances of new ventures providing internet service were significantly enhanced when they had relatively high levels of structural formalization, specialization, and administrative intensity, and that formalization was particularly important for organizations with larger founding teams. These findings are consistent both with extant arguments about the particular importance of reliability to the survival of new organizations, and with traditional work linking structural arrangements to greater organizational reliability. Ecologists and others (see Stinchcombe, 1965) have posited that demonstrating reliability is of critical importance for new firms, because such firms typically lack established reputations and trust with customers and suppliers (Zucker, 1983); problems of reliability are used to explain increased chances of failure associated with fundamental reorganizations of older firms, as well as the comparatively high rates of failure among newly founded firms. In this context, classic organizational studies showing that higher levels of bureaucratization are often the key to achieving reliability and stability in performance (see Tolbert & Hall, 2009) are clearly relevant to entrepreneurship studies. Along similar lines, other studies have indicated that the formal structure of new firms has important effects on a variety of performance-related outcomes, including management turnover and likelihood of going public (Baron, Hannan, & Burton, 2001; Burton & Beckman, 2007; Beckman & Burton, 2008). Thus, the question of what determines the formal structure of new enterprises appears to be an important one, and it is one that institutional theory is apt to be particularly useful in addressing.

Sources of Taken-for-Granted Organizational Design

Existing studies of the form taken by entrepreneurial firms provide evidence of the way in which the structure of new ventures reflects institutionalization processes, although scholars do not always explicitly recognize the affinity of their arguments with this general theoretic approach. Thus, for example, based on surveys and interviews with founders of over 170 startup computer firms in northern California in the mid-1990s, research undertaken as part of the Stanford Project on Entrepreneurial Companies (SPEC) defined a number of distinctive “blueprints” (or archetypes, in Greenwood and Hinings’s, 1988 terminology), based on particular combination of compensation, control, and staffing practices (Baron, Burton, & Hannan, 1999). These included “engineering,” “star,” “bureaucracy,” and “commitment,” each type reflecting founders’ conceptions of effective organizational form. Research suggests a number of different potential sources of these structural prescriptions, including both established firms with which new firm founders were previously affiliated (Beckman & Burton, 2008), as well as organizations formed specifically to advise and support fledging businesses (Hiatt, 2010; Hiatt & Sine, 2008; David & Strang, 2006).

Previous experiences as organizational employees can strongly shape entrepreneurs’ perceptions of how to design their own organization, by providing templates that they often follow quite closely (Burton & Beckman, 2007). Sorensen’s (2007) finding that smaller and younger firms are more likely to serve as incubators for entrepreneurs than older and larger ones is readily interpretable in this context. Because the processes and routines in younger, smaller firms are more readily generalized by former employees to startup firms than those of larger, more established, more bureaucratic organizations, employees from the former types of firms are likely to have more confidence in their knowledge of how to start their own enterprise, and feel enabled to become entrepreneurs. Thus, the formal structure of existing firms is often transmitted to new enterprises via founders’ experiences with those firms (Phillips, 2002).

However, the formal structure of previous employers is not the only institutional source of influence on nascent entrepreneurs’ choices of organizational design. In many industries, organizations created to represent the common political interests of organizations in the industry, such as trade associations or more specific sets of consortia, also serve as important sources of institutionalized models of organizing. One of the common functions of such organization is the provision of general

information about the industry to the public, and in carrying out this function, they often importantly influence entrepreneurs' understandings of the kinds of technologies and structures that are feasible and "best" for firms in this industry. Perhaps inadvertently, this may limit the amount of structural variations among new firms.

In line with this, Sine et al. (2005) found that the formation of state associations for independent power producers significantly increased the likelihood that new firms would be created around more conventional technologies rather than innovative ones. To explain this finding, they noted that the leadership of such associations is typically drawn from wealthier, more established firms (see Gouldner, 1954). In the independent power sector, such firms tended to rely on conventional technologies; hence, consonant with the backgrounds of the leaders, the associations fostered environments in which conventional technologies were seen as preferable – whether by intent or not.

Likewise, research by Hiatt (2010) on new firms in the biodiesel fuel industry found that states with a single, dominant association promoting a given type of biodiesel fuel had less variation in the types of firms founded than those in which competing associations vied for entrepreneurs' attention. Moreover, he found that in the latter states, new firms were more likely to assume innovative forms, ones based on a combination of different technologies, than those in states with a single key promoter of a given technology. This is consistent with other work by institutional theorists, suggesting that the existence of different, competing institutional prescriptions can be a source of behavioral innovation, and thus lay the groundwork for the emergence of new institutions (Barley & Tolbert, 1997).

However, it is important to remember that innovation – or deviation from existing prescriptions – is not always successful, and indeed, may (often?) have fatal consequences for organizations. This leads us to the third question for entrepreneurship research that institutional theory may offer a useful framework for studying, the determinants of the survival of new firms.

MAINTAINING ORGANIZATIONS: INSTITUTIONAL INFLUENCES ON SURVIVAL

Although innovativeness is often celebrated as a desirable organizational property by entrepreneurship researchers (as noted, this property is sometimes asserted to be a defining element of the phenomenon), there are

a large number of studies on new firms suggesting that enterprises that venture too far from existing institutionalized practices and technologies may actually put themselves in jeopardy of failure. That is, even in such a seemingly innovation-favoring context as entrepreneurship, conformity with institutional prescriptions can be key to the survival of new organizations. The more radically different the product or technology of a new organization, the longer the customers are likely to take to recognize its utility and the greater the likelihood that the organization will fail before such recognition occurs. Likewise, new organizations, even those based on established technologies and products, rarely, if ever, possess the social capital (experience-based trust of suppliers and customers) to allow them to vary significantly from institutionalized patterns organizational design. However, entrepreneurs may be able to address these limitations in part by strategically adhering to some institutional prescriptions even while straying from others, and by making alliances with actors that have credibility in an accepted institutional order. A number of studies provide empirical support for these arguments.

Institutions and the Creation of New Markets

Although one line of work on entrepreneurship rests on the explicit assumption that market opportunities exist, unseen, prior to their discovery by especially sharp-eyed and sharp-witted entrepreneurs (Kirzner, 1973; Shane & Venkataraman, 2000), extant work suggests that such opportunities are created rather than “discovered,” and that those involving new markets, in particular, take a very great deal of creative effort. The engaging description of Edison’s work to gain the public’s acceptance of his technological innovation, electric lighting, provided by Hargadon & Douglas (2001) illustrates this well. Their catalog of Edison’s efforts to persuade consumers to replace the established gas lighting with electric includes high-profile demonstrations of the new technology’s potential, such as illuminating the boardroom at the elite financial company of Drexel, Morgan and Co., and design decisions to make early electric lights to look like gas lamps, complete with flame-shaped light bulbs. At every step, Edison consciously sought to build the new market for electricity with the support of and in line with key existing institutions. They suggest his strategies indicate recognition that (2001, p. 478):

Without invoking existing understandings, innovations may never be understood and adopted in the first place. Yet by hewing closely to existing institutions, innovators risk

losing the valued details, representing the innovation's true novelty, that ultimately change those institutions. Success, then, requires entrepreneurs to locate their ideas within the set of understandings and patterns of action that constitute the institutional environment in order to gain initial acceptance, yet somehow retain the inherent differences in the new technology that ultimately will be needed to change those institutions.

Efforts to play up the physical similarity of technological innovations to existing products and practices provide one reflection of the way in which institutions shape entrepreneurial outcomes. Another is provided by work on the financial liabilities firms incur when they fail to conform to standard categories or models held by external evaluators. For example, Zuckerman (1999) showed that firms with products that do not neatly fall into industrial categories used by stock market analysts are often not evaluated, and this lack of attention by analysts leads to lower stock values. One would expect this sort of "categorical imperative" – the need to assume an organizational form that is widely recognized and accepted – would be particularly important for new firms, which often lack the level of capitalization required to support the sort of market creation activities in which Edison engaged.

Institutional Bridges and New Firm Survival

Although the pressures on entrepreneurs to conform to institutional prescriptions are powerful, and despite the fact that entrepreneurs who fail to conform may face even higher-than-normal risks, it should also be noted that a number of studies suggest that existing institutions can also serve as resources, even for entrepreneurs who are pioneering new areas of economic activity. For example, in a study of the advent of *nouvelle cuisine*, a key innovation in the French restaurant industry, Rao, Monin, and Durand (2003) note that the success of this innovation rested on the involvement of a number of chefs with high status, well-established reputations, who provided a connection between existing gastronomical traditions and the new approach. One implication of this finding is that ties to existing actors who have credibility and thus can provide legitimacy by proximity may serve as an institutional bridge for entrepreneurs, a strategy that may be useful to all entrepreneurs, but may be particularly important for those in new industries or areas of economic activity (Zucker, Darby, & Brewer, 1998).

Research on daycare centers by Baum and Oliver (1992) provided some early evidence of the effects of ties to established actors on firms' survival. Their analysis demonstrated that centers with collaborative agreements with

the provincial government or existing community-based organizations had significantly lower rates of failure than other childcare centers that lacked such ties. A variety of resource-exchange mechanisms through which ties affect survival rates have been identified in subsequent studies (see Jones, Hesterly, & Borgatti, 1997), but a recent study by Sine, David, and Mitsuhashi (2007) underscores the importance of nonmaterial, legitimating effects. This research examined the efforts by entrepreneurs in the developing, independent power sector to get a government agency that was responsible for reviewing entrepreneurs' proposed plans to build power-producing organizations to create an "official commission certification." The agency initially resisted on the grounds that information on the agency's responses to plans (i.e., information on a firm's qualifying status) was easily available through other means and that such a certification was both redundant and meaningless. However, the entrepreneurs persevered and the agency ultimately gave way to their pressure and created an official certificate. Strikingly, the researchers found that, despite limited informational value and lack of any attached resources, certification significantly enhanced firms' chances of moving from planning to operating phase. Their study thus provides strong evidence that signs of acceptance by institutionally recognized actors can serve to enhance the survival chances of new organizations, independent of any actual material benefits provided. It recalls the apocryphal tale of Baron de Rothschild who, in response to a petitioner's request for a loan, reputedly replied (Cialdini, 1989, p. 45), "I won't give you a loan myself; but I will walk arm-in-arm with you across the floor of the [London] Stock Exchange, and you soon shall have willing lenders to spare."

HOW INSTITUTIONS SHAPE ENTREPRENEURIAL ENTERPRISES: AN ILLUSTRATION

To provide more concrete illustrations of some of the points from the preceding theoretical discussion, in this section, we describe the historical emergence and contemporary organizational dimensions of a relatively new area of entrepreneurial activity, hedge funds. Hedge funds represent a form of financial investment organization that took root among U.S. investors around the mid-1960s, and gradually spread internationally. Although of comparatively recent origin, these organizations have proliferated in the last two decades, and have played a key role in many national economies.

They provide a particularly interesting context for considering the effects of institutional forces on entrepreneurship because they have been, to this point, explicitly exempted from certain requirements such as registration and reporting that have dominated most financial organizations since the Great Depression of the 1930s. Hence, institutional pressures in this case have operated almost entirely through informal influences on entrepreneurs' decision-making rather than through the actions of any formal regulatory bodies. We begin by exploring the historical circumstances that led to the creation and recent proliferation of these organizations,² then turn to consider forces that shaped their structure and operation, and continue to do so today.

Field Origins and Early Entrepreneurs

As suggested above, one of the defining features – perhaps *the* defining feature (see Hildebrand, 2007) – of hedge fund management companies is that they are largely shielded from the influence of regulatory institutions (e.g., the Securities Exchange Commission) that shape the majority of investing organizations today. These regulatory institutions were established by a succession of laws passed in the wake of the financial crisis of the 1930s, which were intended to prevent the sort of fraud and frenzied speculation that powered the crisis. Fundamental aspects of these institutions include requirements for mandatory disclosure of information to the public on organizational arrangements and investment activity, and restrictions on highly risky activities by investment firms. Hedge funds were made possible by loopholes (sometimes more positively referred to as “safe harbor provisions”) in these institutions, which were designed to free very wealthy investors from their requirements and restrictions, particularly in cases where investors were engaged in making private investments for their own family and close associates. As one of the engineers of the loopholes framed the issue (see Miller, 2009, p. 27):

You have the situation where there are personal holding companies. A family may have a substantial estate and has invested its money in marketable securities. In essence that is a *private* investment company, is it not? We do not want any part of it [proposed SEC regulation]; and so we have said that even though you engage in the same type of activity as an investment company ... if you have less than 100 security holders, you are not a public investment company and not within the purview of this legislation.

Based upon these arguments and heavy lobbying by regulatory opponents, investment groups with fewer than 100 members (each of whom

could demonstrate that they met relatively stringent personal wealth requirements) that did not offer investment opportunities to the general public were exempted from the requirements of the Investment Company Act of 1940 and the Investment Advisers Act, passed in the same year.

This laid the legal groundwork that enabled the emergence of a new form of investment organization that came to be labeled as a “hedge fund,” although this form did not become a recognized cultural entity for nearly two decades. It was the publication of an article in the mid-1960s in *Fortune* (Loomis, 1966) on an investment manager named Alfred Jones that effectively led to this recognition.

Jones started out as a Ph.D. student in Columbia University’s sociology program, where he completed a dissertation in 1941 on differences among social classes in perceiving a distinction between individual and organizational property rights. Evidence suggests that while at Columbia, Jones became acquainted with Benjamin Graham, a professor in the business school at the University, who taught classes on statistics and who produced classic work on securities evaluation (Miller, 2009, p. 34). In later years, Jones became a financial writer for such magazines and *Time* and *Fortune*.

Based partly on his research in this role, in 1949, Jones formed a private investing company, A.W. Jones & Company, in line with the recently established regulatory requirements – that is, less than 100 investors, each possessing very sizeable assets and contributing a substantial initial investment. The firm relied on a particular investment strategy known as “hedging,” involving leveraging investment capital, and purchasing stocks expected to fall in value (for short selling) as well as those expected to increase in value. Its structure was similar in key ways to that of a number of pre-Depression investment firms, including the one founded by Benjamin Graham, the professor who was at Columbia University with Jones. Like the earlier firms, the structure of Jones’s firm provided the general partner (fund manager) with a very high level of flexibility, in part by restricting investors’ ability to withdraw their funds at will (at least for a year). It also entailed a particular, incentive-oriented compensation arrangement, in which the manager received 20 percent of the fund’s increased value. Later, Jones’ former fund managers, who left to start their own management hedge fund companies in 1964 and 1965, added a managers’ fee equal to 2 percent of the fund’s total annual investment value in addition to the 20 percent incentive fee.

This organization operated largely unnoticed until Loomis’ (1966) publication describing hedge funds, its management structure, as well as Jones’ investment strategy, and highlighting his impressive financial track

record. Two years prior to the publication of this article, two of Jones's original associates had left to form their own organizations, respectively, City Associates and Fairfield Partners, each based on essentially the same structural configuration as A.W. Jones. In 1966, two other Wall Street brokers who had done business with Jones also decided to start their own hedge fund (Loomis, 1966). Thus, evidence suggests that the form had begun to spread primarily through Jones's network, but after the publication of the *Fortune* article the number of organizations denoted as hedge funds grew rapidly, with nearly 200 being founded between 1966 and 1974. It appears that most of these closely modeled the form of A.W. Jones & Company, as described by Loomis – same compensation structure for managers, similar restrictions for investors' withdrawal of funds (Miller, 2009, p. 40) – although over time some began to experiment with riskier investment strategies. Market declines in the 1970s led to the demise of many hedge fund organizations, but market recovery and the publication of another article in the mid-1980s on these organizations in *Institutional Investor* (Rohrer, 1986) led to renewed growth.

Contemporary Hedge Funds

The number of hedge fund organizations worldwide at the end of 2008 was estimated at 10,000; however, because these organizations are not subject to reporting requirements, this number cannot be validated (IFSL, 2009). However, there are a number of directories of hedge fund organizations that provide general information on many funds. To investigate the typical organizational features of contemporary funds, we collected annual data from one such directory.

HedgeWorld's Hedge Fund Directory (for the period 2000–2005) contains data on a selection of funds with the largest assets, taken from each of the main investment categories listed in the TASS hedge fund database. The TASS database is one of five available hedge fund databases and, in 2005, included over 3,800 active hedge funds with over \$800 billion in assets. The HedgeWorld Directory provided a variety of information on each listed hedge fund organization, including the size of the fund in dollars (assets); names of fund managers and fund location; a number of performance measures; incentive and management fee structure; investment strategies; redemption frequency and notice periods; and the fund's inception date. To illustrate some of the theoretical points in the preceding discussion, we offer some descriptive statistics taken from the 2005 directory.

One of the most striking aspects of contemporary hedge fund organizations, evidenced by these data, is the high degree of structural similarity among them; the great majority still strongly resemble the form of the firm founded by A.W. Jones in the late 1940s, and that by Benjamin Graham in the pre-Depression years (which appears to have served as a model for Jones). For example, many hedge fund founders followed the compensation structure established in the firms of Graham, Jones, and Jones' former managers, involving (respectively) a "1 and 20" or "2 and 20" fee. This provides managers with a base compensation equal to 1 or 2 percent of the fund's total value, and performance compensation of 20 percent of the increased value gained through investments (see Tables 1 and 2). As shown in Table 1, over 52 percent of contemporary hedge funds have adopted either a 1 or 2 percent management fee structure, with an additional 30 percent of the firms taking the middle ground, charging a fee of 1.5 percent. Only 14 percent of the firms deviated from these three choices.

Moreover, as shown in Table 2, approximately two-thirds of the firms offer managers a 20 percent incentive fee, thus exhibiting a remarkable degree of consistency on this structural element. Note that these arrangements are not required by any sort of regulatory requirements; they appear to have been adopted by some firms, like Graham's, in the pre-Depression years, a practice followed by Jones's firm, and have been followed by entrepreneurs founding hedge funds ever since.

Table 1. Management Fee Arrangements.

Management Fee	Percentage of Firms
1%	40%
1.5%	30%
2%	12%
Other	14%

Table 2. Incentive Fee Arrangements.

Incentive Fee	Percentage of Firms
20%	65%
10%	11%
Other	24%

Table 3. Investment Strategies.

Strategy	Percentage of Firms
Traditional equity hedging	40%
Directional bets	31%
Fund of funds	23%
Other	6%

The investment strategy referred to as “hedging,” pioneered by Graham and Jones, is still the most popular strategy used by hedge funds with over 40 percent of funds making it their key approach (see Table 3). However, there has been some notable variation in this organizational aspect over time. In the early 1980s, a number of hedge fund managers began experimenting with investment policies that represented significant departures from Jones’ strategy of leveraging long-term growth and hedging short-term stock. One firm that became well known for its novel investment strategy was Julian Robertson’s Tiger Fund, which focused on aggressive and market-directional investments using newly created over-the-counter derivatives and options, particularly in the domains of currencies, commodities, and interest rates. In one quarter, the fund made over \$14 million by shorting the dollar against European currencies (Rohrer, 1986). In the face of this remarkable performance, an increasing number of hedge fund managers began to adopt Robertson’s risky market-direction approach to investing.

Another investor adopting aggressive and market-directional investments was George Soros who, in 1990, sold short the United Kingdom’s sterling pound, requiring the government to spend 27 billion pounds to keep the sterling within the currency trading bands created by the new European rate market (ERM). In a commentary with *The Times*, Soros commented:

We must have been the biggest single factor in the market in the days before the ERM fell apart. Our total position by Black Wednesday had to be worth almost \$10 billion. We planned to sell more than that. In fact, when Norman Lamont [Chancellor of the Exchequer] said just before the devaluation that he would borrow nearly \$15 billion to defend the sterling, we were amused because that was about how much we wanted to sell. (Kaletsky, 1992)

The apparent success of these strategies helped gain acceptance for them, despite their marked deviation from the strategy that first gave these organizations their name. As shown in Table 3, while the majority of firms (40%) do still hold to the original strategy of equity hedging, the second

largest category of investment strategies today is the high-leveraged, market-directional approach popularized by Robertson and Soros (31%). Given the amount of media attention given to the successes of the latter, this fairly widespread change among hedge fund organizations may be less remarkable than the persistence of many funds in pursuing the traditional equity strategy.

Summary

This brief history illustrates a number of our main points about the importance of examining institutions in research on entrepreneurial phenomena. First, it instantiates our arguments about the importance of cognitive templates of organization for enabling entrepreneurial activity. The pattern of the very earliest hedge fund foundings maps closely on to personal connections between would-be entrepreneurs and individuals with some experience in this new area – from Graham to Jones, and from Jones to several of his associates. However, this slow process of individual transmission was speeded up considerably by a prominently placed publication, giving dispersed individuals relevant knowledge of how to organize in this area, even in the absence of personal ties to prior entrepreneurs, and providing normative validation for organizing efforts. The growth of mutual funds and other forms of investment organization during this period also probably provided a normative halo for these firms, even though they were outside the “appropriately regulated” sphere.

In addition, the pronounced effects of institutionalized structures on the forms taken by new ventures are clearly evidenced in the data on current firms. The degree of homogeneity among contemporary hedge fund organizations on a variety of dimensions of structure, including compensation systems and transaction rules, is quite striking, especially since (as we keep pointing out) there are no formal regulations to drive such similarity. Variation in investment strategies represents one interesting point of deviation from older, established practices. Our sense is that media coverage played an important role allowing and encouraging firms to innovate on this dimension, by not only publicizing but often implicitly valorizing such deviations. In this context, the fact that many firms continue to hew to the hedging strategy adopted by Jones and touted in Loomis’s early article may be as noteworthy as the changes in some funds’ strategy.

There have been a number of periods of rapid growth and subsequent large-scale failures in the hedge fund industry (e.g., between the mid-1960s

and mid-1970s, and again between the 1980s and the late 1990s). Unfortunately, because this is a less regulated area, historical records of organizations in this industry are difficult to come by, and the data we have do not provide even a glimpse of differences between failing and surviving firms. We speculate that those funds that adhered more closely to the institutionalized form were more likely to be in the latter category, but that speculation will have to await verification.

CONCLUSIONS: DIRECTIONS FOR FUTURE RESEARCH

The adoption of an institutional theory perspective on issues of entrepreneurship suggests a wide variety of issues that merit further attention by researchers. Below, we consider just a couple of what we think is likely to be a lengthy catalog of possible questions for study.

1. An issue that we find particularly intriguing is: What determines the emergence and maintenance of entrepreneurship as an institution? This is an issue that many policy makers would most likely find of interest as well, since it might help understand when “enterprise zones” or other efforts to foster new business startups are likely to be effective. As we suggested at the outset, we do not view institutional theory as particularly well-suited to explaining where institutions come from or conditions under which they’re likely to emerge (Tolbert & Zucker, 1996); rather, its focus is on explaining the consequences of institutions for organizations. Hence, different lines of work and theoretical perspectives are likely to be needed to explain how and when entrepreneurship is apt to become institutionalized within a group.

Work on ethnic entrepreneurship offers some important insights into this problem, suggesting a number of group characteristics that encourage and facilitate entrepreneurial activities. One is the presence of dense social networks or patterns of frequent interaction among group members (Light & Rosenstein, 1995; Light & Gold, 2000). Dense networks support entrepreneurship for a number of reasons. Perhaps, most obviously, frequent interactions can facilitate flows of information among other members about potential entrepreneurial opportunities, along with the tacit “how-tos” required to take advantage of those opportunities (Anderson & Jack, 2002). Dense networks also are indicators of the sort of group solidarity that makes possible and encourages

sharing of resources, especially important to entrepreneurial activity among groups whose members generally have few resources; pooling resources may be the only means through which entrepreneurship can become “seeded” under such circumstances (Light, 1972). The formation of dense networks, in turn, have been linked to strong in-group identification, often associated with ethnic group membership (Light, 1972; Light & Rosenstein, 1995). It’s worth noting, however, that occupational membership can also serve this function (Barley & Kunda, 2004; Tolbert, 1996), at least under some circumstances. Hence, occupational enclaves (like that of computer technicians and scientists in Silicon Valley) may also provide conditions that facilitate the institutionalization of entrepreneurship.

These characteristics may provide fertile ground for the seeding of entrepreneurship as an institution, but it’s not clear that they are subject to social intervention, a problem of concern to policy makers interested in encouraging entrepreneurship (Peredo & Chrisman, 2006). Thus, from the latter standpoint, one important avenue for future research is identification of other characteristics of social groups that may similarly encourage the development of entrepreneurial institutions, and mechanisms for cultivating these. Can these be produced through educational efforts that promote entrepreneurship as a career option and that explicitly teach individuals about the role of network connections in this respect? Are there other organizations, such as trade associations or local political organizations, that might also be effectively harnessed?

2. A second question that is suggested by taking an institutional theoretic approach to understanding entrepreneurship is: What determines the degree of structural variability among newly founded firms? Given the existing work on the effects of previous employment experiences on entrepreneurs’ decisions about how to organize their new enterprises, one might expect that the more varied the backgrounds of founders (in terms of industry of previous employment or previous occupations), the greater the diversity in the forms that new firms take (Burton, Sorenson, & Beckman, 2002). However, work that has examined the impact of organizations specifically formed to encourage and facilitate the entry of new firms into an industry (Hiatt, 2010; Sine et al., 2005) also suggests that these organizations are apt to dampen the effect of such variability, and produce increased homogeneity among new firms. Understanding the persistence of variation in the sorts of templates entrepreneurs bring with them, as well as the forces that mitigate such influences and thus smooth variations in form, are important questions for understanding forces that

shape entrepreneurial activity and outcomes in different phases of industrial life cycles.

3. Finally, our analysis suggests that understanding the effects of institutional conformity on firm's survival is a particularly pertinent question for entrepreneurship researchers. As noted, the emphasis in the entrepreneurship literature on creativity and innovation neglects the questions of how firms can gain general recognition and acceptance of creative and innovative products and processes. Inertia is not just a property of organizations; that is, this organizational property is rooted in very fundamental human preferences for stability, and variety only within fairly narrow limits (Iyengar & Lepper, 2000). Thus, the processes and mechanisms involved in gaining public acceptance of truly innovative or creative outputs and practices by entrepreneurs warrant much more attention by scholars. In our discussion of hedge fund organizations, we speculated that, rather ironically, conformity to institutional prescriptions (such as exist) might be particularly crucial to organizations in new sectors because the level of uncertainty among the agents an organization transacted with about the sector could be offset, in part, by new organizations' efforts to signal their reliability through institutional conformity. However, this suggestion has to await empirical evidence.³

Overall, then, we think that the use of an institutional perspective in examining entrepreneurship offers the opportunity to consider and explore a variety of issues that are important to understanding entrepreneurship, and to expanding institutional theory as well.

NOTES

1. Tolbert and Zucker (1996) challenged Meyer and Rowan's arguments about decoupling, suggesting that these were logically inconsistent with other parts of their discussion. However, the concept of decoupling does make sense if adoption of structures is based on normative conformity, rather than informational conformity, a long-standing distinction in the small groups literature on conformity (Deutsch & Gerard, 1955). In this analysis, our view of institutional theory reflects a more phenomenological approach, which gives greater weight to informational conformity as the underlying psychological mechanism in organizational decision-making and organizational outcomes (see Tolbert, 2010).

2. This account relies heavily on the careful and thoughtful analysis of institutional entrepreneurs in creating the conditions for the rise of hedge funds by Justin Miller.

3. See Miller (2010) for recent research in this area.

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