This paper empirically investigates the relationship between institutional holdings and capital structure. Institutions may affect capital structure through their monitoring and information-gathering roles. At the same time, institutions may gravitate toward firms with specific capital structures, forming leverage-based investment clienteles. Using implied trades generated from mutual fund outflows as an instrument for institutional holdings, and a semi-natural experiment in which addition to the S&P 500 Index provides an exogenous shock to institutional holdings, we find that institutional holdings are a significant determinant of firms’ capital structures: A change in institutional holdings causes an opposite change in leverage. Moreover, using dynamic panel estimation, we find that while institutions affect capital structure decisions, changes in leverage do not affect institutional holdings, and there is no evidence of a clientele effect. Finally, we find that firms lower their leverage in response to increased institutional holdings by becoming more likely to issue equity, and less likely to increase debt. While our findings are consistent with models in which institutions substitute for debt by monitoring and reducing information asymmetry problems, further evidence suggests that the effect on asymmetric information dominates.