

securities in which each may invest, and the Bond Account, with its emphasis on investment grade securities, will afford shareholders of the High Yield Account an opportunity for continued, if reduced, investment exposure to high yield securities.

(b) The contract owners will have ample opportunity to consider their investment options because they will be given notice prior to the substitution and will have an opportunity to reallocate accumulation value among other available Divisions without the imposition of any transfer charge or limitation as a result of the Free Transfer Right. Contractowners who wish to maintain a higher investment exposure to high yield securities than is possible through the Bond Division may elect to reallocate accumulation value to the Fidelity High Income Division available under the Contract.

(c) The costs of the substitution will be borne by Principal Life and will not be borne by the Funds or the contractowners.

(d) The substitution will be at net asset values of the respective shares, without the imposition of any transfer or similar charge and with no change in the amount of any contractowner's accumulation value under the Contract.

(e) The substitution will not cause the fees and charges under the Contract currently being paid by contractowners to be greater after the substitution than before the substitution.

(f) Within five days after the substitution, Principal Life will send to contractowners written confirmation that the substitution has occurred.

(g) The substitution will in no way alter the insurance benefits to contractowners or the contractual obligations of Principal Life.

(h) The substitution will in no way alter the tax benefits to contractowners.

(i) To the extent that the annualized expenses of the Bond Account exceed, for each fiscal quarter during the two-year period following the substitution, the 2002 net expense level of the High Yield Account, Principal Life will, for each Contract outstanding on the date of the substitution, make a reduction in (or reimbursement of) the Bond Division expenses on the last day of each such fiscal period, such that the sum of the net expenses of the Bond Account and the net expenses of the Bond Division will, on an annualized basis, be no greater than the sum of the net expenses of the High Yield Account and the net expenses of the High Yield Division for the 2002 fiscal year. In addition, for the two-year period following the substitution, Principal Life will not

increase asset-based fees or charges under the Contract.

4. Section 17(a) of the Act provides, in pertinent part, that it is unlawful for any affiliated person of a registered investment company, or any affiliated person of such an affiliated person, acting as principal, knowingly to sell any security or other property to such registered company or to purchase from such registered company any security or other property. Section 2(a)(3) of the Act defines the term "affiliated person" of another person to include in pertinent part "(A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with such other person; \* \* \* (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof."

5. Each of the Funds was sponsored by Principal Life. Principal Life may be deemed an affiliated person of an affiliated person of each of the Funds because it is under common control with PMC, which serves as the investment adviser to the Funds. Moreover, Principal Life is the owner of all the outstanding shares of the Bond Account and all of the outstanding shares of the High Yield Account. As a result of these relationships, the Funds might be deemed to be under common control and, therefore, affiliated persons of each other for purposes of the prohibitions set forth in section 17(a) of the Act. Thus, absent exemptive relief, consummation of the substitution using the In-Kind Transaction could result in a violation of section 17(a) because the transaction would involve the purchase from and sale of securities to an investment company by an affiliated person, or an affiliated person of an affiliated person, of that investment company.

6. Section 17(b) of the Act provides that the Commission may exempt any transaction from the prohibitions of section 17(a) if the evidence establishes that:

(a) The terms of the proposed transaction, including the consideration to be paid or received, are fair and reasonable and do not involve overreaching on the part of any person concerned;

(b) The proposed transaction is consistent with the policy of each

registered investment company concerned, as recited in the registration statements and reports filed under the Act; and

(c) The proposed transaction is consistent with the general purposes of the Act.

7. Applicants assert that the terms of the proposed In-Kind Transaction are reasonable and fair and do not involve any overreaching on the part of any person concerned. The substitution will be accomplished on the basis of the relative net asset values of each of the Funds and, therefore, will have no economic impact on the interest of any contractowner.

8. Applicants assert that the substitution is consistent with the investment objective of each of the Funds in that both Funds seek a high level of income through investing in fixed-income securities. Although the funds differ significantly in the credit quality of the securities in which each principally invests, there is substantial overlap in the range of the credit qualities of the securities in which each may invest, and the Bond Account, with its emphasis on investment grade securities, will nonetheless afford contractowners with an interest in the High Yield Division an opportunity for continued, if reduced, investment exposure to high yield securities. In addition, contractowners with an opportunity to transfer their interest, without charge, to any other Division, including the Fidelity High Income Division.

9. Applicants assert that the substitution is consistent with the general purposes of the Act. Section 1(b)(2) of the Act declares that the public interest and interest of investors are adversely affected when investment companies are organized and managed in the interest of affiliated persons, rather than in the interest of the company's security holders. The substitution does not result in any of the self-dealing abuses that the Act was designed to prevent. Principal Life will pay all expenses incurred in connection with the substitution. The substitution will be effected by Principal Life in accordance with the terms of the Contract. The substitution will eliminate a small fund that has never been able to attract significant investor interest, will provide contractowners with an interest in that fund with an interest in a fund that has similar, although not identical, investment objectives and policies as well as a lower expense ratio and superior historical performance, and should benefit the shareholders of both Funds by providing economies of scale that