

that the substitution has occurred. The confirmation will be accompanied by a notice describing the Free Transfer Right.

12. Applicants represent that Principal Life will pay all expenses and transaction costs of the substitution. Affected contractowners will not incur any fees or charges as a result of the substitution, nor will their rights or the obligations of Principal Life under the Contracts be altered in any way. The proposed substitution will not cause the fees and charges under the Contracts currently being paid by contractowners to be greater after the substitution than before the substitution. The proposed substitution will not have a tax impact on contractowners.

Applicants' Legal Analysis

1. Applicants request an order pursuant to section 26(c) of the Act approving the substitution. Section 26(c) of the Act makes it unlawful for any depositor or trustee of a registered unit investment trust holding the security of a single issuer to substitute another security for such security unless the Commission approves the substitution. The Commission will approve such a substitution if the evidence establishes that it is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

2. Applicants assert that the purposes, terms and conditions of the substitution are consistent with the principles and purposes of section 26(c) and do not entail any of the abuses that section 26(c) is designed to prevent. Substitution is an appropriate solution to the small size and higher relative expense of the MicroCap Account. Applicants believe that the SmallCap Account will better serve contractowner interests because of its larger size and lower expenses. Moreover, Principal Life has reserved the right to effect substitutions in the Contracts and disclosed this reserved right in the prospectus for the Contracts.

3. Applicants represent that the substitution will not result in the type of costly, forced redemption that section 26(c) was intended to guard against and, for the following reasons, is consistent with the protection of investors and the purposes fairly intended by the Act:

(a) The proposed substitution permits contractowners continuity of investment objectives and expectations. Both the SmallCap Account and the MicroCap Account seek long term growth of capital primarily by investing in value and growth oriented companies. Although the SmallCap Account and the MicroCap Account differ primarily in

the market capitalization of the companies in which they invest, with the SmallCap Account investing primarily in companies with small market capitalizations ranging approximately from \$150 million to \$1.4 billion, and the MicroCap Account investing primarily in companies with market capitalizations under \$1 billion, there is substantial overlap in the securities in which each may invest. The SmallCap Account, with its emphasis on investing in companies with small market capitalizations, will afford shareholders of the MicroCap Account an opportunity for continued investment exposure to companies with smaller market capitalizations.

(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.

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

(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 contract owner's accumulation value under the Contracts.

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

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

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

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

(i) To the extent that the annualized expenses of the SmallCap Account exceed, for each fiscal quarter during the two-year period following the substitution, the 2002 net expense level of the MicroCap Account, Principal Life will, for each Contract outstanding on the date of the substitution, make a reduction in (or reimbursement of) the SmallCap Division expenses on the last day of each such fiscal period, such that the sum of the net expenses of the SmallCap Account and the net expenses of the SmallCap Division will, on an annualized basis, be no greater than the sum of the net expenses of the MicroCap

Account and the net expenses of the MicroCap 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 Contracts.

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 Principal Management Corporation, which serves as the investment adviser to the Funds. Moreover, Principal Life is the owner of all the outstanding shares of the SmallCap Account and all of the outstanding shares of the MicroCap 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: