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Mean-Field Leader-Follower Games with Terminal State Constraint

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Mean-Field Leader-Follower Games with Terminal State Constraint*

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Abstract

We analyze linear McKean-Vlasov forward-backward SDEs arising in leader-follower games with mean-field type control and terminal state constraints on the state process. We establish an existence and uniqueness of solutions result for such systems in time-weighted spaces as well as a convergence result of the solutions with respect to certain perturbations of the drivers of both the forward and the backward component. The general results are used to solve a novel single-player model of portfolio liquidation under market impact with expectations feedback as well as a novel Stackelberg game of optimal portfolio liquidation with asymmetrically informed players.

AMS Subject Classification: 93E20, 91B70, 60H30

Keywords: mean-field control, Stackelberg game, mean-field game with a major player, McKean-Vlasov FBSDE, portfolio liquidation, singular terminal constraint

1 Introduction and overview

Mean field games (MFGs) are a powerful tool to analyze strategic interactions in large populations when each individual player has only a small impact on the behavior of other players. Introduced independently by Huang, Malhamé and Caines [18] and Lasry and Lions [23], MFGs have received considerable attention in the probability and stochastic control literature in the last decade. A probabilistic approach to solving MFGs was introduced by Carmona and Delarue in [11]. Using a maximum principle of Pontryagin type, they showed that solving the MFG reduces to solving a McKean-Vlasov forward-backward SDE (FBSDE) of form,

$$\begin{cases} dX_t = b(t, X_t, Y_t, \mathcal{L}(X_t, Y_t)) dt + \sigma dW_t, \\ -dY_t = h(t, X_t, Y_t, \mathcal{L}(X_t, Y_t)) dt - Z_t dW_t, \\ X_0 = \chi, \quad Y_T = l(X_T, \mathcal{L}(X_T)), \end{cases} \quad (1.1)$$

where X is the state of the representative player, Y is the adjoint variable, and $\mathcal{L}(\cdot)$ denotes the law of a stochastic process. In MFGs with common noise [2, 3] the dependence of the coefficients on the law of the process (X, Y) is of conditional form. FBSDEs of the form (1.1) also arise in mean-field control (MFC)

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problems [1, 4, 12] and in MFGs with a major player [8, 9, 13] when formulating stochastic maximum principles. MFGs with a major player are a special class of leader-follower games with mean-field control. In such a game, the leader's optimization problem can be viewed as MFC control problem where the state dynamics follows a controlled FBSDE that characterizes the representative minor agent's optimal response to the leader's control. We study a novel class of leader-follower games with mean-field control and terminal state constraint on the state processes that naturally arise in Stackelberg games of optimal portfolio liquidation with asymmetrically informed players.

1.1 McKean-Vlasov FBSDE with terminal state constraint

Let $W = (\bar{W}, W^0)$ be a multi-dimensional Brownian motion generating the filtration $\mathbb{F} = (\mathcal{F}_t)_{t \geq 0}$ and let $\mathbb{F}^0 = (\mathcal{F}_t^0)_{t \geq 0}$ be the filtration generated by W^0 . In this paper, we consider linear McKean-Vlasov FBSDEs of the form

$$\begin{cases} dQ_t = (-\Lambda_t^1 R_t - \Lambda_t^2 \mathbb{E}[\gamma_t Q_t | \mathcal{F}_t^0] + \bar{f}_t) dt, \\ -dR_t = (\Lambda_t^4 Q_t + \Lambda_t^3 \mathbb{E}[\zeta_t R_t | \mathcal{F}_t^0] + \Lambda_t^5 \mathbb{E}[\varrho_t Q_t | \mathcal{F}_t^0] + \bar{g}_t) dt - Z_t dW_t, \\ Q_0 = \chi, Q_T = 0, \end{cases} \quad (1.2)$$

with given initial and terminal condition for the forward, and unspecified terminal condition for the backward process. FBSDEs of this form arise in linear-quadratic MFGs, MFC problems, and leader-follower games under a terminal state constraint on the state process when formulating stochastic maximum principles. Under a terminal state constraint on the state sequence the terminal value of the adjoint process is unknown. The special case $\Lambda^2 = \Lambda^3 = \Lambda^5 = \bar{f} = \bar{g} = 0$ arises in the single player portfolio liquidation models under market impact studied in, e.g. [5, 17]. The special case $\Lambda^2 = \Lambda^5 = \bar{f} = \bar{g} = 0$ was recently analyzed in [14] in the framework of a MFG of optimal portfolio liquidation.

We prove a general existence and uniqueness of solutions result for the system (1.2) under boundedness assumptions on the model parameters that allows us to solve single player portfolio liquidation problems with private information and expectations feedback. The existence and uniqueness result is complemented by a convergence result for the solution of (1.2) with respect to the parameters (\bar{f}, \bar{g}) that allows us to formulate a stochastic maximum principle for leader-follower games of portfolio liquidation with asymmetrically informed players.

The existence and uniqueness of solutions to (1.2) is obtained via two nested continuation arguments. Standard continuation methods for McKean-Vlasov FBSDEs established in, e.g. [3, 10] do not apply to the system (1.2), due to the unknown terminal value of the backward process. In order to overcome this problem we make a linear ansatz $R = AQ + H$, from which we derive an exogenous BSDE with singular terminal condition for the process A , and a BSDE with known asymptotic behavior at the terminal time for the process H . The driver of the latter BSDE depends on the unbounded process A . The nature of the FBSDE for (Q, H) is different from [14] where a similar ansatz gave a BSDE with known terminal condition. Analyzing simultaneously the triple (Q, H, R) allows us to prove the fixed-point condition arising in the application of the continuation method in a suitable space.

Our second main result is a convergence result for the solution (Q, R) to the system (1.2) with respect to the "input" (\bar{f}, \bar{g}) . Our convergence is not in the L^2 sense as in the standard FBSDE literature [24, 27] but rather in the L^ν ($1 < \nu < 2$) sense. Specifically, we consider the convergence of the solutions (Q^n, R^n) to a penalized version of (1.2) under a uniform L^2 boundedness assumption on the sequence (\bar{f}^n, \bar{g}^n) . For such inputs a result of Komlós [21] guarantees the Cesaro convergence of (\bar{f}^n, \bar{g}^n) along a subsequence in L^ν ($1 < \nu < 2$). We prove the convergence of the solutions in the same sense. To this end, we define auxiliary processes to decouple the system (1.2) and then show that these processes solve the system (1.2) in the right spaces. The convergence result then follows from the previously established uniqueness result.

1.2 Applications to optimal portfolio liquidation

Models of optimal portfolio liquidation have received substantial attention in the financial mathematics and stochastic control literature in recent years; see [5, 15, 16, 17, 22, 26] among many others. In such models, the controlled state sequence typically follows a dynamic of the form

$$X_t = x - \int_0^t \xi_s ds,$$

where $x \in \mathbb{R}$ is the initial portfolio, and ξ is the trading rate. The set of admissible controls is confined to those processes ξ that satisfy almost surely the liquidation constraint $X_T = 0$. It is typically assumed that the unaffected price process against which the trading costs are benchmarked follows some Brownian martingale S and that the trader's transaction price is given by

$$\tilde{S}_t = S_t - \int_0^t \kappa_s \xi_s ds - \eta_t \xi_t.$$

The integral term accounts for permanent price impact; the term $\eta_t \xi_t$ accounts for instantaneous impact that does not affect future transactions. The trader's objective is then to minimize the cost functional

$$J(\xi) = \mathbb{E} \left[\int_0^T \left(\kappa_s \xi_s X_s + \eta_s |\xi_s|^2 + \lambda_s |x_s|^2 \right) ds \right]$$

over all admissible liquidation strategies. We refer to [5, 17] for an interpretation of the processes η, κ, λ .

1.2.1 Single player model with expectations feedback

Standard portfolio liquidation models assume that a trader's permanent price impact is driven by his observable transactions. If the transactions are not directly observable, then it is natural to assume that the permanent impact is driven by the market's expectation about the trader's transactions as in [1, 6], given the publicly observable information.

In Section 3 we solve a single-player liquidation model with expectations feedback where uncertainty is generated by the multi-dimensional Brownian motion $W = (\bar{W}, W^0)$. The Brownian motion W^0 describes a commonly observed random factor that drives market dynamics; the Brownian motion \bar{W} is private information to the trader. Specifically, we assume that the trader's transaction price is given by

$$\tilde{S}_t = S_t - \int_0^t \left\{ \kappa_s \mathbb{E}[\xi_s | \mathcal{F}_s^0] + \tilde{g}_s \right\} ds - \eta_t \xi_t, \quad (1.3)$$

where S is an \mathbb{F}^0 martingale, $\mathbb{E}[\xi_s | \mathcal{F}_s^0]$ is the market's expectation about the trader's strategy, and \tilde{g} is an \mathbb{F}^0 -adapted process that will be endogenized in the next subsection. Assuming a standard quadratic running cost function as in [5, 16, 17], the objective of the trader is then to minimize the functional

$$J(\xi) = \mathbb{E} \left[\int_0^T \left(\kappa_t X_t \mathbb{E}[\xi_t | \mathcal{F}_t^0] + \tilde{g}_t X_t + \eta_t \xi_t^2 + \lambda_t X_t^2 \right) dt \right], \quad (1.4)$$

subject to the state dynamics

$$\begin{aligned} dX_t &= -\xi_t dt \\ X_0 &= x, \quad X_T = 0. \end{aligned} \quad (1.5)$$

We allow the cost coefficients to be private information, i.e. to be \mathbb{F} adapted. This justifies the conditional expectation term in the price dynamics. A standard stochastic maximum principle suggests that the optimal strategy is given by

$$\xi_t^* = \frac{Y_t - \mathbb{E}[\kappa_t X_t | \mathcal{F}_t^0]}{2\eta_t}, \quad (1.6)$$

where X is the portfolio process, Y is the adjoint variable, and (X, Y) solves (1.2) with $\bar{f} = 0$, $\bar{g} = \tilde{g}$:

$$\begin{cases} dX_t = -\frac{Y_t - \mathbb{E}[\kappa_t X_t | \mathcal{F}_t^0]}{2\eta_t} dt, \\ -dY_t = \left(\kappa_t \mathbb{E} \left[\frac{Y_t}{2\eta_t} \middle| \mathcal{F}_t^0 \right] - \kappa_t \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \mathbb{E}[\kappa_t X_t | \mathcal{F}_t^0] + 2\lambda_t X_t + \tilde{g}_t \right) dt - Z_t dW_t, \\ X_0 = x, \quad X_T = 0. \end{cases} \quad (1.7)$$

If the terms $\mathbb{E}[\kappa_t X_t | \mathcal{F}_t^0]$ and $\kappa_t \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \mathbb{E}[\kappa_t X_t | \mathcal{F}_t^0]$ drop out of the FBSDE system, then the system reduces to that arising in the MFG analyzed in [14]. In the next subsection we introduce a model extension where the privately informed trader is the follower in a Stackelberg game of optimal portfolio liquidation. As a byproduct we obtain an extension of the MFG in [14] to a MFG with a major player. A related model without liquidation constraint and without any feedback of the major player's strategy on the minor players' transaction price has been considered in [19].

1.2.2 Mean-Field type Stackelberg game with asymmetric information

In Section 4 we solve a Stackelberg game of optimal portfolio liquidation with asymmetrically informed players. The leader (she) has the first-mover advantage while the follower (he) has an informational advantage.

We assume again that uncertainty is generated by the multi-dimensional Brownian motion $W = (\bar{W}, W^0)$ and that W^0 describes a commonly observed market factor while \bar{W} is private information to the follower. For a given \mathbb{F}^0 -adapted strategy ξ^0 of the Stackelberg leader, we assume that the follower's liquidation problem is the same as in the previous subsection with

$$\tilde{g} = \tilde{\kappa}^0 \xi^0$$

for some \mathbb{F}^0 -adapted process $\tilde{\kappa}^0$ that measures the impact of the leader on the follower's transaction price. Let $\xi^*(\cdot)$ be the follower's optimal response function to the leader's strategy and put $\mu^* := \mathbb{E}[\xi^*(\cdot) | \mathcal{F}^0]$. Following the standard approach we assume that the leader's transaction price is

$$\tilde{S}_t^0 = S_t - \int_0^t \bar{\kappa}_s^0 \mu_s^* ds - \int_0^t \kappa_s^0 \xi_s^0 ds - \eta_t^0 \xi_t^0 \quad (1.8)$$

for \mathbb{F}^0 -adapted coefficients $\eta^0, \kappa^0, \bar{\kappa}^0$. The difference is that now the leader controls the transaction price both directly and indirectly through the dependence of the follower's optimal response on her trading strategy. We furthermore assume that the leader's cost functional is given by

$$J^0(\xi^0) = \mathbb{E} \left[\int_0^T (\bar{\kappa}_t^0 \mu_t^* X_t^0 + \kappa_t^0 X_t^0 \xi_t^0 + \eta_t^0 (\xi_t^0)^2 + \lambda_t^0 (X_t^0)^2 + \bar{\lambda}_t^0 (\mu_t^*)^2) dt \right], \quad (1.9)$$

where X^0 denotes her portfolio process and $\lambda^0, \bar{\lambda}$ are \mathbb{F}^0 -adapted. Her control problem is then a MFC problem with state process (X^0, X, Y) , where (X, Y) solves (1.7) with $\tilde{g} = \tilde{\kappa}^0 \xi^0$ and

$$\begin{aligned} dX_t^0 &= -\xi_t^0 dt \\ X_0^0 &= x, \quad X_T^0 = 0. \end{aligned} \quad (1.10)$$

We establish a new maximum principle for this control problem from which we derive an explicit representation of the major player's optimal control $\xi^{0,*}$ as

$$\xi_t^{0,*} = \frac{p_t + \mathbb{E}[\tilde{\kappa}_t^0 q_t | \mathcal{F}_t^0] - \kappa_t^0 X_t^{0,*}}{2\eta_t^0} \quad (1.11)$$

in terms of the state equation (1.10) and the adjoint equations:

$$-dp_t = \left(\bar{\kappa}_t^0 \mathbb{E} \left[\frac{Y_t}{2\eta_t} \middle| \mathcal{F}_t^0 \right] - \bar{\kappa}_t^0 \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \mathbb{E}[\kappa_t X_t | \mathcal{F}_t^0] + \kappa_t^0 \xi_t^0 + 2\lambda_t^0 X_t^0 \right) dt - Z_t dW_t^0 \quad (1.12)$$

and

$$\begin{cases} -dq_t = \left(-\frac{r_t}{2\eta_t} - \mathbb{E}[\kappa_t q_t | \mathcal{F}_t^0] \frac{1}{2\eta_t} + \bar{f}_t \right) dt, \\ -dr_t = \left(-2\lambda_t q_t + \kappa_t \mathbb{E} \left[\frac{r_t}{2\eta_t} \middle| \mathcal{F}_t^0 \right] + \kappa_t \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \mathbb{E}[\kappa_t q_t | \mathcal{F}_t^0] + \bar{g}_t \right) dt - Z_t dW_t, \\ q_0 = 0, \quad q_T = 0, \end{cases} \quad (1.13)$$

where

$$\bar{f}_t = \frac{\bar{\kappa}_t^0 X_t^0}{2\eta_t} + \frac{\bar{\lambda}_t}{\eta_t} \mathbb{E} \left[\frac{Y_t}{2\eta_t} \middle| \mathcal{F}_t^0 \right] - \frac{\bar{\lambda}_t}{\eta_t} \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \mathbb{E}[\kappa_t X_t | \mathcal{F}_t^0]$$

and

$$\bar{g}_t = -\kappa_t \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \bar{\kappa}_t^0 X_t^0 - 2\bar{\lambda}_t \kappa_t \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \left(\mathbb{E} \left[\frac{Y_t}{2\eta_t} \middle| \mathcal{F}_t^0 \right] - \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \mathbb{E}[\kappa_t X_t | \mathcal{F}_t^0] \right).$$

Here, p is the adjoint variable to X^0 and (q, r) are the adjoint variables to (Y, X) . The system (1.13) is again a special case of (1.2).

In order to establish our maximum principle we first consider a sequence of unconstrained optimization problems where the liquidation constraints are replaced by increasingly penalized open positions at the terminal time. The resulting optimal strategies for the Stackelberg leader turn out to be L^2 bounded, hence they have Cesaro convergent subsequence. From this we deduce that the sequence of state-adjoint equations for the penalized problems Cesaro converges to the system (1.7), (1.10), (1.12) and (1.13).

To the best of our knowledge no numerical methods for simulating the mean-field FBSDEs arising in our Stackelberg game are yet available. In order to get some quantitative insight into the equilibrium dynamics we therefore simulate a deterministic benchmark model with constant coefficients. In this case, our conditional mean-field FBSDEs reduce to deterministic forward-backward ODEs for which numerical methods exist. Our simulations suggest that the solution to the Stackelberg game is very different from the solution to single player models. In particular, beneficial round-trips may exist for the follower. This is not the case in deterministic single player models; in the Stackelberg game the follower may act as a liquidity provider for the leader. Furthermore, depending on the strength of interaction the presence of the follower may (or may not) reduce the leader's trading cost.

The rest of this paper is organized as follows. Our general existence, uniqueness and convergence results for the FBSDE (1.2) are established in Section 2. The MFC problem and the Stackelberg game of optimal portfolio liquidation introduced above are solved in Section 3 and Section 4, respectively. Our numerical simulations are reported in Section 4.3.

NOTATION AND CONVENTIONS. Throughout, we work on probability space $(\Omega, \mathbb{P}, \mathcal{F})$, on which there exist two independent Brownian motions W^0 and \bar{W} . We denote by $\mathbb{F}^0 = (\mathcal{F}_t^0)_{0 \leq t \leq T}$ and $\mathbb{F} = (\mathcal{F}_t)_{0 \leq t \leq T}$ the filtrations generated by W^0 and W , augmented by the \mathbb{P} null sets, respectively, where $W = (\bar{W}, W^0)$. For a space \mathbb{I} and a filtration \mathbb{G} we introduce the following spaces:

$$\begin{aligned} L_{\mathbb{G}}^0([0, T] \times \Omega; \mathbb{I}) &= \{X : X : [0, T] \times \Omega \rightarrow \mathbb{I} \text{ and } X \text{ is } \mathbb{G} \text{ progressively measurable and } \mathbb{I} \text{ valued}\} \\ L_{\mathbb{G}}^k([0, T] \times \Omega; \mathbb{I}) &= \left\{ X \in L_{\mathbb{G}}^0([0, T] \times \Omega; \mathbb{I}) : \mathbb{E} \left[\int_0^T |X_t|^k dt \right] < \infty \right\}, \quad k \geq 1 \\ L_{\mathbb{G}}^\infty([0, T] \times \Omega; \mathbb{I}) &= \left\{ X \in L_{\mathbb{G}}^0([0, T] \times \Omega; \mathbb{I}) : \operatorname{ess\,sup}_{(t, \omega) \in [0, T] \times \Omega} |X_t(\omega)| < \infty \right\}. \end{aligned}$$

The spaces $L_{\mathbb{G}}^k$ are equipped the norm $\|X\|_{L^k} = \left(\mathbb{E} \left[\int_0^T |X_t|^k dt \right] \right)^{1/k}$. The spaces

$$\begin{aligned} S_{\mathbb{G}}^2([0, T] \times \Omega; \mathbb{I}) &= \left\{ X \in L_{\mathbb{G}}^0([0, T] \times \Omega; \mathbb{I}) : \mathbb{E} \left[\sup_{0 \leq t \leq T} |X_t|^2 \right] < \infty \right\} \\ S_{\mathbb{G}}^{2,-}([0, T] \times \Omega; \mathbb{I}) &= \left\{ X \in L_{\mathbb{G}}^0([0, T] \times \Omega; \mathbb{I}) : \sup_{\epsilon > 0} \mathbb{E} \left[\sup_{0 \leq t \leq T-\epsilon} |X_t|^2 \right] \leq C \right\} \end{aligned}$$

are equipped with the respective norms

$$\|X\|_{S^2} := \left(\mathbb{E} \left[\sup_{0 \leq t \leq T} |X_t|^2 \right] \right)^{1/2}; \quad \|X\|_{S^{2,-}} := \sup_{\epsilon \geq 0} \left(\mathbb{E} \left[\sup_{0 \leq t \leq T-\epsilon} |X_t|^2 \right] \right)^{1/2},$$

and for $\beta > 0$ we introduce the space

$$\mathcal{H}_{\beta} = \left\{ X \in \mathbb{S}_{\mathbb{F}}^2([0, T] \times \Omega; \mathbb{I}) : E \left[\sup_{t \in [0, T]} \left| \frac{|X_t|}{(T-t)^{\beta}} \right|^2 \right] < \infty \right\} \text{ with } \|X\|_{\beta} := \left(\mathbb{E} \left[\sup_{0 \leq t \leq T} \left| \frac{X_t}{(T-t)^{\beta}} \right|^2 \right] \right)^{1/2}.$$

For $\phi \in L_{\mathbb{G}}^{\infty}([0, T] \times \Omega; \mathbb{I})$, we denote by $\|\phi\|$ and ϕ_{\star} its upper and lower bounds, respectively. Finally, we adopt the convention that a positive constant C may vary from line to line.

2 The McKean-Vlasov FBSDE

In this section, we prove a general existence and uniqueness of solutions result (in a suitable space) for the FBSDE (1.2) along with the convergence result with respect to the processes (\bar{f}, \bar{g}) . We assume throughout that the system coefficients satisfy the following assumption.

Assumption 2.1. i) The stochastic processes γ, ζ, ϱ and Λ^i ($i = 1, \dots, 5$) belong to $L_{\mathbb{F}}^{\infty}$.
ii) There exist constants $\theta_i > 0$ ($i = 1, 2$) such that

$$\left(\Lambda^1 - \frac{\|\gamma\| \|\Lambda^2\|^2}{2\theta_1} - \frac{\|\Lambda^3\| \|\zeta\|^2}{2\theta_2} \right)_{\star} > 0$$

and

$$\left(\Lambda^4 - \frac{\|\gamma\| \theta_1}{2} - \frac{\|\Lambda^3\| \theta_2}{2} - \|\Lambda^5\| \|\varrho\| \right)_{\star} > 0.$$

iii) The initial condition χ belongs to $L_{\mathbb{F}}^2$ and $(\bar{f}, \bar{g}) \in S_{\mathbb{F}}^2 \times L_{\mathbb{F}}^2$.

The linear ansatz $R = AQ + H$ on $[0, T)$ results in the following FBSDE for the triple (Q, H, R) :

$$\begin{cases} dQ_t = (-\Lambda_t^1 R_t - \Lambda_t^2 \mathbb{E}[\gamma_t Q_t | \mathcal{F}_t^0] + \bar{f}_t) dt, \\ -dH_t = (-\Lambda_t^1 A_t H_t - \Lambda_t^2 A_t \mathbb{E}[\gamma_t Q_t | \mathcal{F}_t^0] + A_t \bar{f}_t + \Lambda_t^3 \mathbb{E}[\zeta_t R_t | \mathcal{F}_t^0] \\ \quad + \Lambda_t^5 \mathbb{E}[\varrho_t Q_t | \mathcal{F}_t^0] + \bar{g}_t) dt - Z_t dW_t, \\ -dR_t = (\Lambda_t^4 Q_t + \Lambda_t^3 \mathbb{E}[\zeta_t R_t | \mathcal{F}_t^0] + \Lambda_t^5 \mathbb{E}[\varrho_t Q_t | \mathcal{F}_t^0] + \bar{g}_t) dt - Z_t dW_t, \\ R = AQ + H, \quad t \in [0, T), \\ Q_0 = \chi, \quad Q_T = 0, \end{cases} \quad (2.1)$$

where A satisfies the singular BSDE

$$-dA_t = (\Lambda_t^4 - \Lambda_t^1 A_t^2) dt - Z_t dW_t, \quad \lim_{t \nearrow T} A_t = \infty. \quad (2.2)$$

It has been shown in [5, 17] that the equation (2.2) is well-posed under Assumption 2.1 and that the following estimate holds:

$$\frac{1}{\mathbb{E} \left[\int_t^T \Lambda_u^1 du \middle| \mathcal{F}_t \right]} \leq A_t \leq \frac{1}{(T-t)^2} \mathbb{E} \left[\int_t^T \frac{1}{\Lambda_u^1} + (T-u)^2 \Lambda_u^4 du \middle| \mathcal{F}_t \right]. \quad (2.3)$$

It follows from (2.3) that A is nonnegative and that for all $0 \leq t_1 < t_2 \leq T$,

$$e^{-\int_{t_1}^{t_2} \Lambda_s^1 A_s ds} \leq C \left(\frac{T-t_2}{T-t_1} \right)^\beta \leq C \left(\frac{T-t_2}{T-t_1} \right)^\tau, \quad \text{where } \beta := \Lambda_\star^1 / \|\Lambda^1\| \text{ and } 0 \leq \tau \leq \beta. \quad (2.4)$$

2.1 Existence and uniqueness of solutions

In view of [14], we expect to find a solution (Q, H, R) to (2.1) such that $(Q, R) \in \mathcal{H}_\alpha \times L_{\mathbb{F}}^2$ for some $\alpha > 0$. Unlike in [14] the process H is only defined on $[0, T)$. The following heuristics suggests that if we can find a solution such that $(Q, R) \in \mathcal{H}_\alpha \times L_{\mathbb{F}}^2$, then $H \in S_{\mathbb{F}}^{2,-}$. In fact, by the general solution formula for linear BSDEs, for any $0 \leq t < \tilde{T} < T$,

$$H_t = \mathbb{E} \left[H_{\tilde{T}} e^{-\int_t^{\tilde{T}} \Lambda_u^1 A_u du} + \int_t^{\tilde{T}} e^{-\int_t^s \Lambda_u^1 A_u du} K_s ds \middle| \mathcal{F}_t \right],$$

where

$$K_s = (-\Lambda_s^2 A_s \mathbb{E}[\gamma_s Q_s | \mathcal{F}_s^0] + A_s \bar{f}_s + \Lambda_s^3 \mathbb{E}[\zeta_s R_s | \mathcal{F}_s^0] + \Lambda_s^5 \mathbb{E}[\varrho_s Q_s | \mathcal{F}_s^0] + \bar{g}_s).$$

If we knew that

$$\limsup_{\tilde{T} \nearrow T} \mathbb{E}[|H_{\tilde{T}}|^2] < \infty, \quad (2.5)$$

then taking the limit $\tilde{T} \nearrow T$ and using the estimate (2.4),

$$H_t = \mathbb{E} \left[\int_t^T e^{-\int_t^s \Lambda_u^1 A_u du} K_s ds \middle| \mathcal{F}_t \right]. \quad (2.6)$$

From this and using (2.4) again, we obtain a constant $C > 0$ such that for any $\epsilon > 0$,

$$\mathbb{E} \left[\sup_{0 \leq t \leq T-\epsilon} |H_t|^2 \right] \leq C (\|Q\|_\alpha + \|\bar{f}\|_{S^2} + \|R\|_{L^2} + \|\bar{g}\|_{L^2}).$$

Since (2.5) holds for $H \in S_{\mathbb{F}}^{2,-}$ our goal is to establish the existence and uniqueness of a solution $(Q, H, R) \in \mathcal{H}_\alpha \times S_{\mathbb{F}}^{2,-} \times L_{\mathbb{F}}^2$. To this end, we apply a nested continuation method to the system:

$$\begin{cases} dQ_t = (-\Lambda_t^1 R_t - \Lambda_t^2 \mathbb{E}[\gamma_t Q_t | \mathcal{F}_t^0] + \bar{f}_t) dt, \\ -dH_t = (-\Lambda_t^1 A_t H_t - \Lambda_t^2 A_t \mathbb{E}[\gamma_t Q_t | \mathcal{F}_t^0] + A_t \bar{f}_t + \mathbf{p} \Lambda_t^3 \mathbb{E}[\zeta_t R_t | \mathcal{F}_t^0] \\ \quad + \mathbf{p} \Lambda_t^5 \mathbb{E}[\varrho_t Q_t | \mathcal{F}_t^0] + \bar{g}_t + f_t) dt - Z_t dW_t, \\ -dR_t = (\Lambda_t^4 Q_t + \mathbf{p} \Lambda_t^3 \mathbb{E}[\zeta_t R_t | \mathcal{F}_t^0] + \mathbf{p} \Lambda_t^5 \mathbb{E}[\varrho_t Q_t | \mathcal{F}_t^0] + \bar{g}_t + f_t) dt - Z_t dW_t, \\ R = A Q + H, \quad t \in [0, T), \\ Q_0 = \chi, \quad Q_T = 0. \end{cases} \quad (2.7)$$

In a first step, we prove the existence of a unique solution to the above system for $\mathbf{p} = 0$. Subsequently, we show that the solution result extends to $\mathbf{p} = 1$.

Lemma 2.2. *If $\mathbf{p} = 0$, then the FBSDE (2.7) has a solution in $\mathcal{H}_\alpha \times S_{\mathbb{F}}^{2,-} \times L_{\mathbb{F}}^2$ for any $f \in L_{\mathbb{F}}^2$, where $0 < \alpha < \beta$.*

Proof. Notice that the system (2.7) is still coupled for $\mathbf{p} = 0$. To solve it, we apply a continuation method to the following system:

$$\begin{cases} dQ_t = (-\Lambda_t^1 R_t - \bar{\mathbf{p}} \Lambda_t^2 \mathbb{E}[\gamma_t Q_t | \mathcal{F}_t^0] + \bar{f}_t + b'_t) dt, \\ -dH_t = (-\Lambda_t^1 A_t H_t - \bar{\mathbf{p}} \Lambda_t^2 A_t \mathbb{E}[\gamma_t Q_t | \mathcal{F}_t^0] + A_t \bar{f}_t + \bar{g}_t + f_t + f'_t) dt - Z_t dW_t, \\ -dR_t = (\Lambda_t^4 Q_t + \bar{g}_t + f_t + f'_t - A_t b'_t) dt - Z_t dW_t, \\ R = AQ + H, \quad t \in [0, T], \\ Q_0 = \chi, \quad Q_T = 0. \end{cases} \quad (2.8)$$

Step 1. For $\bar{\mathbf{p}} = 0$, the system (2.8) is solvable in $\mathcal{H}_\alpha \times S_{\mathbb{F}}^{2,-} \times L_{\mathbb{F}}^2$ for any $(b', f') \in \mathcal{H}_\alpha \times \mathcal{H}_{\alpha-1}$.

If $\bar{\mathbf{p}} = 0$, then the system (2.8) is decoupled and we let H be

$$H_t = \mathbb{E} \left[\int_t^T e^{-\int_t^s \Lambda_u^1 A_u du} (A_s \bar{f}_s + \bar{g}_s + f_s + f'_s) ds \middle| \mathcal{F}_t \right], \quad 0 \leq t < T. \quad (2.9)$$

Moreover, by the estimate (2.4) and Doob's maximal inequality, we have for any $\epsilon > 0$,

$$\mathbb{E} \left[\sup_{0 \leq t \leq T-\epsilon} |H_t|^2 \right] \leq C (\|\bar{f}\|_{S^2} + \|\bar{g}\|_{L^2} + \|f\|_{L^2} + \|f'\|_{\alpha-1}), \quad (2.10)$$

where C is independent of ϵ . Thus, H belongs to $S_{\mathbb{F}}^{2,-}$ and satisfies the SDE in (2.8).

We now turn to the process Q . Taking $R = AQ + H$ into the SDE for Q yields,

$$Q_t = \chi e^{-\int_0^t \Lambda_u^1 A_u du} + \int_0^t e^{-\int_s^t \Lambda_u^1 A_u du} (-\Lambda_s^1 H_s + \bar{f}_s + b'_s) ds, \quad 0 \leq t \leq T. \quad (2.11)$$

Using monotone convergence and the estimate (2.10) this implies,

$$\begin{aligned} & \mathbb{E} \left[\sup_{0 \leq t \leq T} \left| \frac{Q_t}{(T-t)^\alpha} \right|^2 \right] \\ & \leq C \left(\|\chi\|_{L^2} + \mathbb{E} \left[\left(\int_0^T \frac{|H_s|}{(T-s)^\alpha} ds \right)^2 \right] + \|\bar{f}\|_{S^2} + \|b'\|_\alpha \right) \\ & = C \left(\|\chi\|_{L^2} + \lim_{\epsilon \searrow 0} \mathbb{E} \left[\left(\int_0^{T-\epsilon} \frac{|H_s|}{(T-s)^\alpha} ds \right)^2 \right] + \|\bar{f}\|_{S^2} + \|b'\|_\alpha \right) \\ & \leq C \left(\|\chi\|_{L^2} + \lim_{\epsilon \searrow 0} \mathbb{E} \left[\sup_{0 \leq t \leq T-\epsilon} |H_t|^2 \right] + \|\bar{f}\|_{S^2} + \|b'\|_\alpha \right) \\ & \leq C (\|\chi\|_{L^2} + \|\bar{f}\|_{S^2} + \|\bar{g}\|_{L^2} + \|f\|_{L^2} + \|f'\|_{\alpha-1} + \|b'\|_\alpha). \end{aligned} \quad (2.12)$$

This shows that $Q \in \mathcal{H}_\alpha$. Integration by parts for the product QR on $[0, T-\epsilon]$ yields,

$$\begin{aligned} H_{T-\epsilon} Q_{T-\epsilon} & \leq A_{T-\epsilon} Q_{T-\epsilon}^2 + H_{T-\epsilon} Q_{T-\epsilon} = Q_{T-\epsilon} R_{T-\epsilon} \\ & \leq - \int_0^{T-\epsilon} (Q_t^2 + R_t^2) dt + CA_0 \chi^2 + |\chi H_0| + C \int_0^{T-\epsilon} |Q_t| |\bar{g}_t + f_t + f'_t + A_t b'_t| dt \\ & \quad + \int_0^{T-\epsilon} Q_t Z_t d\bar{W}_t. \end{aligned}$$

Taking expectations on both sides we have

$$\begin{aligned}
& \mathbb{E} \left[\int_0^{T-\epsilon} (Q_t^2 + R_t^2) dt \right] \\
& \leq \mathbb{E}[CA_0\chi^2] + \mathbb{E}[|\chi H_0|] + C\mathbb{E} \left[\int_0^{T-\epsilon} |Q_t||\bar{g}_t + f_t + f'_t + A_t b'_t| dt \right] + \mathbb{E}[|H_{T-\epsilon} Q_{T-\epsilon}|] \\
& \leq C (\mathbb{E}[A_0\chi^2] + C\mathbb{E}[|\chi H_0|] + \|Q\|_\alpha) \\
& \quad + C (\|\bar{g}\|_{L^2} + \|f\|_{L^2} + \|f'\|_{\alpha-1} + \|b'\|_\alpha) + \mathbb{E}[|H_{T-\epsilon} Q_{T-\epsilon}|],
\end{aligned}$$

Thus, by taking $\epsilon \rightarrow 0$, from (2.3), (2.10) and (2.12) we get $R \in L^2_{\mathbb{R}}$.

Step 2. If (2.8) admits a solution for some $\bar{\mathbf{p}} \in [0, 1]$ and for any $(b', f') \in \mathcal{H}_\alpha \times \mathcal{H}_{\alpha-1}$, then the same holds for $\bar{\mathbf{p}} + \bar{\mathbf{d}}$ for some constant $\bar{\mathbf{d}}$ that does not depend on $\bar{\mathbf{p}}$.

For fixed $Q \in \mathcal{H}_\alpha$, since

$$-\bar{\mathbf{d}}\Lambda^2\mathbb{E}[\gamma Q|\mathcal{F}^0] + b' \in \mathcal{H}_\alpha, \quad -\bar{\mathbf{d}}\Lambda^2 A\mathbb{E}[\gamma Q|\mathcal{F}^0] + f' \in \mathcal{H}_{\alpha-1},$$

there exists a solution $(\tilde{Q}, \tilde{H}, \tilde{R}) \in \mathcal{H}_\alpha \times S^{2,-}_{\mathbb{R}} \times L^2_{\mathbb{R}}$ to the following system:

$$\begin{cases} d\tilde{Q}_t = \left(-\Lambda_t^1 \tilde{R}_t - \bar{\mathbf{p}}\Lambda_t^2 \mathbb{E}[\gamma_t \tilde{Q}_t | \mathcal{F}_t^0] - \bar{\mathbf{d}}\Lambda_t^2 \mathbb{E}[\gamma_t Q_t | \mathcal{F}_t^0] + \bar{f}_t + b'_t \right) dt, \\ d\tilde{H}_t = \left(-\Lambda_t^1 A_t \tilde{H}_t - \bar{\mathbf{p}}\Lambda_t^2 A_t \mathbb{E}[\gamma_t \tilde{Q}_t | \mathcal{F}_t^0] - \bar{\mathbf{d}}\Lambda_t^2 A_t \mathbb{E}[\gamma_t Q_t | \mathcal{F}_t^0] \right. \\ \quad \left. + A_t \bar{f}_t + \bar{g}_t + f_t + f'_t \right) dt - Z_t dW_t, \\ d\tilde{R}_t = \left(\Lambda_t^4 \tilde{Q}_t + \bar{g}_t + f_t + f'_t - A_t b'_t \right) dt - Z_t dW_t, \\ \tilde{R} = A\tilde{Q} + \tilde{H}, \quad t \in [0, T), \\ \tilde{Q}_0 = \chi, \quad \tilde{Q}_T = 0. \end{cases} \quad (2.13)$$

It remains to prove that the mapping $\Phi : \mathcal{H}_\alpha \rightarrow \mathcal{H}_\alpha, Q \mapsto \tilde{Q}$ is a contraction when $\bar{\mathbf{d}}$ is small enough and independent of $\bar{\mathbf{p}}$. For any $Q, Q' \in \mathcal{H}_\alpha$, let $(\tilde{Q}, \tilde{H}, \tilde{R})$ and $(\tilde{Q}', \tilde{H}', \tilde{R}')$ be the corresponding solutions. Integration by parts for $(\tilde{Q} - \tilde{Q}')(\tilde{R} - \tilde{R}')$ on $[0, T - \epsilon]$ implies,

$$\begin{aligned}
& \mathbb{E} \left[\int_0^{T-\epsilon} \left(\Lambda_s^4 - \frac{\|\gamma\|\theta_1}{2} \right) (\tilde{Q}_s - \tilde{Q}'_s)^2 ds \right] + \mathbb{E} \left[\int_0^{T-\epsilon} \left(\Lambda_s^1 - \frac{\|\gamma\|(\Lambda_s^2)^2}{2\theta^1} \right) (\tilde{R}_s - \tilde{R}'_s)^2 ds \right] \\
& \leq C\mathbb{E} \left[|\tilde{Q}_{T-\epsilon} \tilde{H}_{T-\epsilon}| \right] + \varepsilon \mathbb{E} \left[\int_0^{T-\epsilon} (\tilde{R}_s - \tilde{R}'_s)^2 ds \right] + C\bar{\mathbf{d}}\mathbb{E} \left[\int_0^{T-\epsilon} (Q_t - Q'_t)^2 dt \right].
\end{aligned}$$

Letting $\epsilon \rightarrow 0$ and choosing ε small enough, Assumption 2.1 yields,

$$\mathbb{E} \left[\int_0^T (\tilde{Q}_s - \tilde{Q}'_s)^2 ds \right] + \mathbb{E} \left[\int_0^T (\tilde{R}_s - \tilde{R}'_s)^2 ds \right] \leq C\bar{\mathbf{d}}\mathbb{E} \left[\int_0^T (Q_t - Q'_t)^2 dt \right]. \quad (2.14)$$

Considering the SDE for \tilde{Q} in terms of \tilde{R} , by (2.14) we have

$$\mathbb{E} \left[\sup_{0 \leq t \leq T} |\tilde{Q}_t - \tilde{Q}'_t|^2 \right] \leq C\bar{\mathbf{d}}\mathbb{E} \left[\int_0^T (Q_t - Q'_t)^2 dt \right]. \quad (2.15)$$

Since $\tilde{H} \in S^{2,-}_{\mathbb{R}}$, we have the following expression:

$$\begin{aligned} \tilde{H}_t = \mathbb{E} \left[\int_t^T e^{-\int_t^s \Lambda_u^1 A_u du} \left(-\bar{\mathbf{p}}\Lambda_t^2 A_t \mathbb{E}[\gamma_t \tilde{Q}_t | \mathcal{F}_t^0] - \bar{\mathbf{d}}\Lambda_t^2 A_t \mathbb{E}[\gamma_t Q_t | \mathcal{F}_t^0] \right. \right. \\ \left. \left. + A_t \bar{f}_t + \bar{g}_t + f_t + f'_t \right) dt \middle| \mathcal{F}_t \right]. \end{aligned} \quad (2.16)$$

From (2.16), Doob's maximal inequality and (2.15) yield that for any $\epsilon > 0$

$$\begin{aligned}
& \mathbb{E} \left[\sup_{0 \leq t \leq T-\epsilon} |\tilde{H}_t - \tilde{H}'_t|^2 \right] \\
& \leq C\mathbb{E} \left\{ \sup_{0 \leq t \leq T} \left| \mathbb{E} \left[\int_t^T \frac{(T-s)^{\beta-1}}{(T-t)^\beta} \mathbb{E}[|\tilde{Q}_s - \tilde{Q}'_s| | \mathcal{F}_s^0] ds \middle| \mathcal{F}_t \right] \right|^2 \right\} \\
& \quad + C\bar{\mathfrak{d}}\mathbb{E} \left\{ \sup_{0 \leq t \leq T} \left| \mathbb{E} \left[\int_t^T \frac{(T-s)^{\beta-1}}{(T-t)^\beta} \mathbb{E}[|Q_s - Q'_s| | \mathcal{F}_s^0] ds \middle| \mathcal{F}_t \right] \right|^2 \right\} \\
& \leq C\mathbb{E} \left\{ \sup_{0 \leq t \leq T} \left| \mathbb{E} \left[\sup_{0 \leq s \leq T} \mathbb{E}[|\tilde{Q}_s - \tilde{Q}'_s| | \mathcal{F}_s^0] \middle| \mathcal{F}_t \right] \right|^2 \right\} \\
& \quad + C\mathbb{E} \left\{ \sup_{0 \leq t \leq T} \left| \mathbb{E} \left[\sup_{0 \leq s \leq T} \mathbb{E}[|Q_s - Q'_s| | \mathcal{F}_s^0] \middle| \mathcal{F}_t \right] \right|^2 \right\} \\
& \leq C\bar{\mathfrak{d}}\mathbb{E} \left[\int_0^T (Q_t - Q'_t)^2 dt \right] + C\bar{\mathfrak{d}}\mathbb{E} \left[\sup_{0 \leq t \leq T} |Q_t - Q'_t|^2 \right],
\end{aligned} \tag{2.17}$$

where C is independent of ϵ . Finally, considering the SDE for \tilde{Q} in terms of \tilde{H} , by (2.15), (2.17) and the same argument as (2.12), we have

$$\|\tilde{Q} - \tilde{Q}'\|_\alpha \leq C\bar{\mathfrak{d}}\|Q - Q'\|_\alpha.$$

Thus, when $\bar{\mathfrak{d}}$ is small enough, Φ is a contraction. Iterating the argument finitely often and letting $f' = b' = 0$ yields the desired result. \square

Theorem 2.3. *The FBSDE system (2.1) admits a unique solution $(Q, H, R) \in \mathcal{H}_\alpha \times S_{\mathbb{F}}^{2,-} \times L_{\mathbb{F}}^2$, where $0 < \alpha < \beta$; the constant β was defined in (2.4).*

Proof. We first prove the existence of a solution. In a second step we prove the uniqueness of solutions.

Step 1. Existence of a solution. By Lemma 2.2, the FBSDE system (2.7) admits a solution $(Q, H, R) \in \mathcal{H}_\alpha \times S_{\mathbb{F}}^{2,-} \times L_{\mathbb{F}}^2$ when $\mathfrak{p} = 0$, for any $f \in L_{\mathbb{F}}^2$. Hence it remains to prove that if for some $\mathfrak{p} \in [0, 1]$ the system (2.7) admits a solution for any $f \in L_{\mathbb{F}}^2$, then the same result holds true for $\mathfrak{p} + \mathfrak{d}$ for some small enough constant \mathfrak{d} that is independent of \mathfrak{p} . The proof is similar to proof of Lemma 2.2.

For any fixed $(Q, R, f) \in \mathcal{H}_\alpha \times L_{\mathbb{F}}^2 \times L_{\mathbb{F}}^2$, we introduce the following system:

$$\begin{cases} d\tilde{Q}_t = \left(-\Lambda_t^1 \tilde{R}_t - \Lambda_t^2 \mathbb{E} \left[\gamma_t \tilde{Q}_t \middle| \mathcal{F}_t^0 \right] + \bar{f}_t \right) dt, \\ -d\tilde{H}_t = \left(-\Lambda_t^1 A_t \tilde{H}_t - \Lambda_t^2 A_t \mathbb{E} [\gamma_t \tilde{Q}_t | \mathcal{F}_t^0] + A_t \bar{f}_t + \mathfrak{p} \Lambda_t^3 \mathbb{E} [\zeta_t \tilde{R}_t | \mathcal{F}_t^0] + \mathfrak{p} \Lambda_t^5 \mathbb{E} [\varrho_t \tilde{Q}_t | \mathcal{F}_t^0] + \bar{g}_t \right) dt, \\ \quad + (f_t + \mathfrak{d} \Lambda_t^3 \mathbb{E} [\zeta_t R_t | \mathcal{F}_t^0] + \mathfrak{d} \Lambda_t^5 \mathbb{E} [\varrho_t Q_t | \mathcal{F}_t^0]) dt - Z_t dW_t, \\ -d\tilde{R}_t = \left(\Lambda_t^4 \tilde{Q}_t + \mathfrak{p} \Lambda_t^3 \mathbb{E} [\zeta_t \tilde{R}_t | \mathcal{F}_t^0] + \mathfrak{d} \Lambda_t^3 \mathbb{E} [\zeta_t R_t | \mathcal{F}_t^0] + \mathfrak{p} \Lambda_t^5 \mathbb{E} [\varrho_t \tilde{Q}_t | \mathcal{F}_t^0] + \mathfrak{d} \Lambda_t^5 \mathbb{E} [\varrho_t Q_t | \mathcal{F}_t^0] \right. \\ \quad \left. + \bar{g}_t + f_t \right) dt - Z_t dW_t, \\ \tilde{R} = A\tilde{Q} + \tilde{H}, \quad t \in [0, T), \\ \tilde{Q}_0 = \chi, \quad \tilde{Q}_T = 0. \end{cases} \tag{2.18}$$

Since $f + \mathfrak{d} \Lambda^3 \mathbb{E} [\zeta R | \mathcal{F}^0] + \mathfrak{d} \Lambda^5 \mathbb{E} [\varrho Q | \mathcal{F}^0] \in L_{\mathbb{F}}^2$, there exists a solution $(\tilde{Q}, \tilde{H}, \tilde{R}) \in \mathcal{H}_\alpha \times S_{\mathbb{F}}^{2,-} \times L_{\mathbb{F}}^2$ by assumption. This defines a mapping

$$\Phi : (Q, R) \in \mathcal{H}_\alpha \times L_{\mathbb{F}}^2 \rightarrow (\tilde{Q}, \tilde{R}) \in \mathcal{H}_\alpha \times L_{\mathbb{F}}^2. \tag{2.19}$$

It is sufficient to prove the existence of a fixed point of Φ . To this end, for any $Q, Q' \in \mathcal{H}_\alpha, R, R' \in L^2_{\mathbb{F}}$, by integration by part and using the same arguments leading to the estimate (2.14),

$$\begin{aligned} & \mathbb{E} \left[\int_0^T (\tilde{R}_t - \tilde{R}'_t)^2 dt \right] + \mathbb{E} \left[\int_0^T (\tilde{Q}_t - \tilde{Q}'_t)^2 dt \right] \\ & \leq \mathfrak{d}C \mathbb{E} \left[\int_0^T (Q_t - Q'_t)^2 dt \right] + \mathfrak{d}C \mathbb{E} \left[\int_0^T (R_t - R'_t)^2 dt \right]. \end{aligned} \quad (2.20)$$

The preceding estimate allows us to estimate \tilde{Q} in terms of \tilde{R} as follows

$$\begin{aligned} & \mathbb{E} \left[\sup_{0 \leq t \leq T} |\tilde{Q}_t - \tilde{Q}'_t|^2 \right] \\ & \leq C \mathbb{E} \left[\int_0^T |\tilde{R}_s - \tilde{R}'_s|^2 ds \right] + C \int_0^T \mathbb{E} \left[|\tilde{Q}'_s - \tilde{Q}_s|^2 \right] ds \\ & \leq \mathfrak{d}C \mathbb{E} \left[\int_0^T (Q_t - Q'_t)^2 dt \right] + \mathfrak{d}C \mathbb{E} \left[\int_0^T (R_t - R'_t)^2 dt \right]. \end{aligned} \quad (2.21)$$

By (2.21), a similar argument as in (2.17) yields the existence of a uniform C such that for any $\epsilon > 0$,

$$\begin{aligned} \mathbb{E} \left[\sup_{0 \leq t \leq T-\epsilon} |\tilde{H}_t - \tilde{H}'_t|^2 \right] & \leq C \mathbb{E} \left[\sup_{0 \leq s \leq T} |\tilde{Q}_s - \tilde{Q}'_s|^2 \right] + C \mathbb{E} \left[\int_0^T |\tilde{R}_t - \tilde{R}'_t|^2 dt \right] \\ & \quad + C \mathfrak{d} \mathbb{E} \left[\sup_{0 \leq s \leq T} |Q_s - Q'_s|^2 \right] + C \mathfrak{d} \mathbb{E} \left[\int_0^T |R_t - R'_t|^2 dt \right]. \end{aligned} \quad (2.22)$$

Now we return to the expression of \tilde{Q} in terms of \tilde{H} , from which we have by (2.21), (2.22) and the same argument as in (2.12) that,

$$\mathbb{E} \left[\sup_{0 \leq t \leq T} \left| \frac{\tilde{Q}_t - \tilde{Q}'_t}{(T-t)^\alpha} \right|^2 \right] \leq C \mathfrak{d} \|Q - Q'\|_\alpha^2 + C \mathfrak{d} \mathbb{E} \left[\int_0^T |R_t - R'_t|^2 dt \right]. \quad (2.23)$$

By the estimates (2.20) and (2.23), when \mathfrak{d} is small enough we have a fixed point which is a solution to (2.7) when \mathfrak{p} is replaced by $\mathfrak{p} + \mathfrak{d}$. Iterating the argument finitely often and then taking $f = 0$ yields the existence of a solution.

Step 2. Uniqueness of solutions. Let us assume to the contrary that there exist two solutions $(Q, H, R) \in \mathcal{H}_\alpha \times S_{\mathbb{F}}^{2,-} \times L^2_{\mathbb{F}}$ and $(Q', H', R') \in \mathcal{H}_\alpha \times S_{\mathbb{F}}^{2,-} \times L^2_{\mathbb{F}}$ to (2.1). As in the proof of Step 1. integration by part for $(Q - Q')(R - R')$ yields,

$$\mathbb{E} \left[\int_0^T (R_t - R'_t)^2 + (Q_t - Q'_t)^2 dt \right] = 0. \quad (2.24)$$

Secondly, by the expression of $(Q - Q')$ in terms of $R - R'$, (2.24) yields that

$$\mathbb{E} \left[\sup_{0 \leq t \leq T} |Q_t - Q'_t|^2 \right] = 0. \quad (2.25)$$

Thirdly, the expression for $(H - H')$, (2.24) and (2.25) yield that for any $\epsilon > 0$

$$\mathbb{E} \left[\sup_{0 \leq t \leq T-\epsilon} |H_t - H'_t|^2 \right] = 0. \quad (2.26)$$

Finally, by the expression for $(Q - Q')$ in terms of $(H - H')$, (2.24), (2.25), (2.26) and arbitrariness of ϵ yield that

$$\mathbb{E} \left[\sup_{0 \leq t \leq T} \left| \frac{Q_t - Q'_t}{(T-t)^\alpha} \right|^2 \right] = 0. \quad (2.27)$$

□

Remark 2.4. From the proof of Lemma 2.2 and Theorem 2.3 (see e.g. (2.9) and (2.11)), we see that for $\bar{f} \equiv 0$, the regularity of the solution can be increased to $(Q, H) \in \mathcal{H}_\beta \times \mathcal{H}_\varsigma$, where $\varsigma < \frac{1}{2} \wedge \beta$. This is the case in [14].

The following corollary is important for the analysis of our leader-follower game of optimal portfolio liquidation analyzed below. It implies that the follower's optimal response function is linear convex and hence that the leader's control problem is convex.

Corollary 2.5. *The mapping $(\bar{f}, \bar{g}) \in S_{\mathbb{F}}^2 \times L_{\mathbb{F}}^2 \rightarrow (Q, H, R)(\bar{f}, \bar{g}) \in \mathcal{H}_\alpha \times S_{\mathbb{F}}^{2,-} \times L_{\mathbb{F}}^2$ is well defined and convex.*

Proof. By Theorem 2.3, for each $(\bar{f}, \bar{g}) \in S_{\mathbb{F}}^2 \times L_{\mathbb{F}}^2$, there exists a unique solution (Q, H, R) . Thus, the mapping is well defined. Moreover, by the uniqueness again, we have for $\rho \in [0, 1]$

$$(Q, H, R)(\rho(\bar{f}, \bar{g}) + (1 - \rho)(\bar{f}', \bar{g}')) = \rho(Q, H, R)(\bar{f}, \bar{g}) + (1 - \rho)(Q, H, R)(\bar{f}', \bar{g}').$$

□

Using the same arguments as in the proof of Theorem 2.3 we can also get existence of a unique solution to the “penalized version” of (2.1) where the terminal state constraint on the forward process is replaced by the terminal condition of the backward process $R_T = 2nQ_T$. To this end, we introduce the BSDE,

$$-dA_t^n = (\Lambda_t^4 - \Lambda_t^1(A_t^n)^2) dt - Z_t dW_t, \quad A_T^n = 2n.$$

Existence and uniqueness of a solution to this equation has been established in [5]. Moreover, for each $t \in [0, T)$,

$$\lim_{n \rightarrow \infty} A_t^n = A_t, \text{ a.s.} \quad (2.28)$$

When the terminal state constraint is replaced by the penalty term introduced above, the system (2.1) translates into the following system:

$$\begin{cases} dQ_t^n = \left(-\Lambda_t^1 R_t^n - \Lambda_t^2 \mathbb{E}[\gamma_t Q_t^n | \mathcal{F}_t^0] + \bar{f}_t^n \right) dt, \\ -dH_t^n = \left(-\Lambda_t^1 A_t^n - \Lambda_t^2 A_t^n \mathbb{E}[\gamma_t Q_t^n | \mathcal{F}_t^0] + A_t^n \bar{f}_t^n + \Lambda_t^3 \mathbb{E}[\zeta_t R_t^n | \mathcal{F}_t^0] \right. \\ \quad \left. + \Lambda_t^5 \mathbb{E}[\varrho_t Q_t^n | \mathcal{F}_t^0] + \bar{g}_t^n \right) dt - Z_t dW_t, \\ -dR_t^n = \left(\Lambda_t^4 Q_t^n + \Lambda_t^3 \mathbb{E}[\zeta_t R_t^n | \mathcal{F}_t^0] + \Lambda_t^5 \mathbb{E}[\varrho_t Q_t^n | \mathcal{F}_t^0] + \bar{g}_t^n \right) dt - Z_t dW_t, \\ Q_0^n = \chi, \quad H_T^n = 0, \quad R_T^n = 2nQ_T^n, \end{cases} \quad (2.29)$$

Corollary 2.6. *Assume that for each fixed $n \in \mathbb{N}$, $(\bar{f}^n, g^n) \in S_{\mathbb{F}}^2 \times L_{\mathbb{F}}^2$. Then, for each $n \in \mathbb{N}$ the FBSDE (2.29) admits a unique solution $(Q^n, H^n, R^n) \in \mathcal{H}_{\alpha,n} \times S_{\mathbb{F}}^2 \times L_{\mathbb{F}}^2$, where*

$$\mathcal{H}_{\alpha,n} = \left\{ X : \mathbb{E} \left[\sup_{0 \leq t \leq T} \left| \frac{X_t}{(T - t + \frac{1}{n})^\alpha} \right|^2 \right] < \infty \right\}.$$

Remark 2.7. Note that in (2.29), the terminal condition for H^n is 0 so H^n is defined on $[0, T]$. In (2.1) the process H is only defined on $[0, T)$, due to the singularity of the process A at the terminal time.

2.2 Convergence

We now prove an approximation result for the system (2.1) in terms of the systems (2.29) as $n \rightarrow \infty$. The convergence result is established under the additional assumption that for any $0 \leq t_1 < t_2 \leq T$,

$$e^{-\int_{t_1}^{t_2} \Lambda_u^1 A_u du} \leq C \frac{T - t_2}{T - t_1} \text{ and } e^{-\int_{t_1}^{t_2} \Lambda_u^1 A_u^n du} \leq C \frac{T - t_2 + \frac{1}{n}}{T - t_1 + \frac{1}{n}}. \quad (2.30)$$

We refer to [14] for sufficient conditions on the model parameters under which this assumption is satisfied.

The proof of the following lemma can be found in [14, Lemma 4.4].

Lemma 2.8. *Let $\bar{f}^n \in S_{\mathbb{F}}^2$ and $\bar{g}^n \in L_{\mathbb{F}}^2$ be two sequences of progressively measurable stochastic processes and (Q^n, H^n, R^n) be the solution to the system (2.29). If the sequences \bar{f}^n and \bar{g}^n are bounded in $S_{\mathbb{F}}^2$ and $L_{\mathbb{F}}^2$ uniformly in n , respectively, then*

$$\sup_n \|Q^n\|_{\alpha, n} + \sup_n \|H^n\|_{S^{2,-}} + \sup_n \|R^n\|_{L^2} \leq C \left(\sup_n \|\bar{f}^n\|_{S^2} + \sup_n \|\bar{g}^n\|_{L^2} \right) < \infty.$$

Lemma 2.9. *Let \bar{f}^n and \bar{g}^n be two sequences of stochastic processes satisfying the conditions in Lemma 2.8. Then there exists $\bar{f} \in L_{\mathbb{F}}^2$, $\bar{g} \in L_{\mathbb{F}}^2$ and a convex combination of a subsequence of (\bar{f}^n, \bar{g}^n) converging to (\bar{f}, \bar{g}) in L^ν with $1 < \nu < 2$, i.e.,*

$$\lim_{N \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{N} \sum_{k=1}^N (\bar{f}_t^{n_k}, \bar{g}_t^{n_k}) - (\bar{f}_t, \bar{g}_t) \right|^\nu dt \right] = 0. \quad (2.31)$$

Proof. Since the sequence (\bar{f}^n, \bar{g}^n) is L^2 uniformly bounded, the proof of [7, Theorem 2.1] tells us there exists a subsequence of (\bar{f}^n, \bar{g}^n) and a progressively measurable stochastic processes (\bar{f}, \bar{g}) such that

$$\lim_{N \rightarrow \infty} \frac{1}{N} \sum_{k=1}^N (\bar{f}^{n_k}, \bar{g}^{n_k}) - (\bar{f}, \bar{g}) = 0, \quad \text{a.e. a.s. on } [0, T] \times \Omega.$$

Fatou's lemma implies that

$$\mathbb{E} \left[\int_0^T |(\bar{f}_t, \bar{g}_t)|^2 dt \right] \leq \liminf_{N \rightarrow \infty} \frac{1}{N} \sum_{k=1}^N \mathbb{E} \left[\int_0^T |(\bar{f}_t^{n_k}, \bar{g}_t^{n_k})|^2 dt \right] < \infty.$$

Thus, Vitali's convergence result implies (2.31). \square

The following theorem proves a convergence result for the FBSDE systems associated with the unconstrained penalized control problems to the system associated with the constrained one. The result is key to our maximum principle for the leader-follower game introduced above.

Theorem 2.10. *Let (\bar{f}^n, \bar{g}^n) be a sequence satisfying the conditions in Lemma 2.9 and $(\bar{f}, \bar{g}) \in L_{\mathbb{F}}^2 \times L_{\mathbb{F}}^2$ be the limit. Let (Q^n, H^n, R^n) and (Q, H, R) be the solution to (2.29) and (2.1), respectively. We further assume the limit $\bar{f} \in S_{\mathbb{F}}^2$. Then there exists a convex combination of a subsequence of $(\frac{1}{N} \sum_{k=1}^N Q^{n_k}, \frac{1}{N} \sum_{k=1}^N H^{n_k}, \frac{1}{N} \sum_{k=1}^N R^{n_k})$ converging to (Q, H, R) in $S_{\mathbb{F}}^\nu \times L_{\mathbb{F}}^1 \times L_{\mathbb{F}}^\nu$, i.e.,*

$$\begin{aligned} \lim_{N' \rightarrow \infty} \mathbb{E} \left[\sup_{0 \leq t \leq T} \left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} Q_t^{n_k} - Q_t \right|^\nu \right] &= 0, \\ \lim_{N' \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} H_t^{n_k} - H_t \right| dt \right] &= 0, \\ \lim_{N' \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} R_t^{n_k} - R_t \right|^\nu dt \right] &= 0. \end{aligned}$$

Proof. The uniform boundedness of \bar{f}^n and \bar{g}^n implies the uniform boundedness of R^n in L^2 (Lemma 2.8) and the uniform boundedness of $\frac{1}{N} \sum_{k=1}^N R^{n_k}$ in L^2 . Thus, [7] again yields the existence of a progressively

measurable process $\bar{R} \in L^2_{\mathbb{F}}$ and a subsequence of $\frac{1}{N} \sum_{k=1}^N R^{n_k}$ such that

$$\lim_{N' \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} R_t^{n_k} - \bar{R}_t \right|^\nu dt \right] = 0. \quad (2.32)$$

By (2.31), the convergence of the same convex combination holds for (\bar{f}^n, \bar{g}^n) :

$$\lim_{N' \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} (\bar{f}_t^{n_k}, \bar{g}_t^{n_k}) - (\bar{f}_t, \bar{g}_t) \right|^\nu dt \right] = 0. \quad (2.33)$$

Define \bar{Q} as the unique solution in $S^2_{\mathbb{F}}$ to the following mean field SDE in terms of the limits \bar{f} and \bar{R} :

$$\bar{Q}_t = \chi + \int_0^t (-\Lambda_s^1 \bar{R}_s - \Lambda_s^2 \mathbb{E}[\gamma_s \bar{Q}_s | \mathcal{F}_s^0] + \bar{f}_s) ds. \quad (2.34)$$

Standard SDE estimates, (2.32) and (2.33) yield,

$$\lim_{N' \rightarrow \infty} \mathbb{E} \left[\sup_{0 \leq t \leq T} \left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} Q_t^{n_k} - \bar{Q}_t \right|^\nu \right] = 0. \quad (2.35)$$

Now define \bar{H} in terms of the limits \bar{f} , \bar{R} and \bar{Q} as

$$\begin{aligned} \bar{H}_t = & \mathbb{E} \left[\int_t^T e^{-\int_t^s \Lambda_u^1 A_u du} (-\Lambda_s^2 A_s \mathbb{E}[\gamma_s \bar{Q}_s | \mathcal{F}_s^0] + A_s \bar{f}_s + \Lambda_s^3 \mathbb{E}[\zeta_s \bar{R}_s | \mathcal{F}_s^0] \right. \\ & \left. + \Lambda_s^5 \mathbb{E}[\varrho_s \bar{Q}_s | \mathcal{F}_s^0] + \bar{g}_s) ds \middle| \mathcal{F}_t \right]. \end{aligned} \quad (2.36)$$

Thus, by (2.3), (2.30) and Hölder inequality,

$$\begin{aligned} & \left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} H_t^{n_k} - \bar{H}_t \right| \\ & \leq \frac{C}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} \left(\mathbb{E} \left[\left(\int_t^T \left| e^{-\int_t^s \Lambda_u^1 A_u^{n_k} du} A_s^{n_k} - e^{-\int_t^s \Lambda_u^1 A_u du} A_s \right| ds \right)^2 \middle| \mathcal{F}_t \right] \right)^{\frac{1}{2}} \\ & \quad \times \left(\mathbb{E} \left[\sup_{0 \leq s \leq T} |\mathbb{E}[Q_s^{n_k} | \mathcal{F}_s^0]|^2 + \sup_{0 \leq s \leq T} (\bar{f}_s^{n_k})^2 \middle| \mathcal{F}_t \right] \right)^{\frac{1}{2}} \\ & \quad + \frac{C}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} \left(\mathbb{E} \left[\int_t^T \left| e^{-\int_t^s \Lambda_u^1 A_u^{n_k} du} - e^{-\int_t^s \Lambda_u^1 A_u du} \right|^2 ds \middle| \mathcal{F}_t \right] \right)^{\frac{1}{2}} \left(\mathbb{E} \left[\int_t^T |\bar{g}_s^{n_k}|^2 ds \middle| \mathcal{F}_t \right] \right)^{\frac{1}{2}} \\ & \quad + \frac{C}{(T-t)^{\frac{1}{\nu}}} \left(\mathbb{E} \left[\int_0^T \mathbb{E} \left[\left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} Q_s^{n_k} - \bar{Q}_s \right|^\nu \middle| \mathcal{F}_s^0 \right] + \left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} f_s^{n_k} - \bar{f}_s \right|^\nu ds \middle| \mathcal{F}_t \right] \right)^{\frac{1}{\nu}} \\ & \quad + \frac{C}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} \left(\mathbb{E} \left[\int_t^T \left| e^{-\int_t^s \Lambda_u^1 A_u^{n_k} du} - e^{-\int_t^s \Lambda_u^1 A_u du} \right|^2 ds \middle| \mathcal{F}_t \right] \right)^{\frac{1}{2}} \left(\mathbb{E} \left[\int_t^T \mathbb{E}[(R_s^{n_k})^2 + (Q_s^{n_k})^2 | \mathcal{F}_s^0] ds \middle| \mathcal{F}_t \right] \right)^{\frac{1}{2}} \\ & \quad + C \mathbb{E} \left[\int_0^T \mathbb{E} \left[\left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} R_s^{n_k} - \bar{R}_s \right| + \left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} Q_s^{n_k} - \bar{Q}_s \right| \middle| \mathcal{F}_s^0 \right] ds \middle| \mathcal{F}_t \right] \\ & \quad + \mathbb{E} \left[\int_t^T \left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} \bar{g}_s^{n_k} - \bar{g}_s \right| ds \middle| \mathcal{F}_t \right]. \end{aligned}$$

Applying Hölder's inequality again along with Doob's maximal inequality, the uniform boundedness of $(Q^n, R^n, \bar{f}^n, \bar{g}^n)$ and the dominated convergence theorem we get,

$$\lim_{N' \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} H_t^{n_k} - \bar{H}_t \right| dt \right] = 0. \quad (2.37)$$

Let $\hat{R} = A\bar{Q} + \bar{H}$. For any $\tilde{T} < T$, by (2.35) and (2.37) we have

$$\lim_{N' \rightarrow \infty} \mathbb{E} \left[\int_0^{\tilde{T}} \left| \frac{1}{N'} \sum_{j=1}^{N'} \frac{1}{N_j} \sum_{k=1}^{N_j} R_t^{n_k} - \hat{R}_t \right| dt \right] = 0.$$

Thus, (2.32) implies that for any $\tilde{T} < T$,

$$\mathbb{E} \left[\int_0^{\tilde{T}} |\hat{R}_t - \bar{R}_t| dt \right] = 0.$$

This proves that

$$\hat{R} = \bar{R}, \text{ a.e. a.s. on } [0, T] \times \Omega.$$

Thus, the limit $(\bar{Q}, \bar{H}, \hat{R})$ satisfies the system (2.1). Moreover,

$$(\bar{Q}, \bar{H}, \hat{R}) \in \mathcal{H}_\alpha \times S_{\mathbb{F}}^{2,-} \times L_{\mathbb{F}}^2.$$

Indeed, since $\bar{R} \in L_{\mathbb{F}}^2$ and $\bar{R} = \hat{R}$ a.e. a.s. on $[0, T] \times \Omega$, we have that $\hat{R} \in L_{\mathbb{F}}^2$. Moreover, (2.34) implies that $\bar{Q} \in S_{\mathbb{F}}^2$, from which (2.36) implies $H \in S_{\mathbb{F}}^{2,-}$ and taking $\hat{R} = A\bar{Q} + \bar{H}$ into (2.34) yields $\bar{Q} \in \mathcal{H}_\alpha$. Hence, the uniqueness of solutions in $\mathcal{H}_\alpha \times S_{\mathbb{F}}^{2,-} \times L_{\mathbb{F}}^2$ yields the desired convergence result. \square

3 A MFC problem of optimal portfolio liquidation

In this section, we solve the single-player portfolio liquidation model with expectations feedback introduced in Section 1.2.1. We make the following assumption which implies Assumption 2.1.

Assumption 3.1. The process \tilde{g} belongs to $L_{\mathbb{F}}^2$. The progressively measurable stochastic processes η, κ and λ are nonnegative and essentially bounded. Moreover, there exists some $\theta' > 0$ such that

$$\eta_\star - \frac{\|\kappa\|}{2\theta'} > 0, \quad \lambda_\star - \|\kappa\|\theta' > 0.$$

The trader's objective is to minimize the cost function $J(\cdot)$ introduced in (1.4) over the set of admissible controls

$$\mathcal{A}_{\mathbb{F}}(x) := \left\{ \xi \in L_{\mathbb{F}}^2([0, T] \times \Omega; \mathbb{R}) : \int_0^T \xi_s ds = x \right\}.$$

A standard stochastic maximum principle suggests the candidate optimal strategy is given by

$$\xi_t^* = \frac{Y_t - \mathbb{E}[\kappa_t X_t | \mathcal{F}_t^0]}{2\eta_t} \quad (3.1)$$

where $(X, Y) \in \mathcal{H}_\alpha \times L_{\mathbb{F}}^2$ is the unique solution to the FBSDE system (1.7). Standard arguments show that $\xi^* \in \mathcal{A}_{\mathbb{F}}(x)$. To prove that ξ^* is indeed the unique optimal control, we establish an auxiliary result that substitutes for the lack of convexity of the Hamiltonian for our MFC problem.

Lemma 3.2. *For every $t \in [0, T)$, we have*

$$\begin{aligned} & \mathbb{E} [\kappa_t X_t \mathbb{E}[\xi_t | \mathcal{F}_t^0] + \eta_t \xi_t^2 + \lambda_t X_t^2] - \mathbb{E} [\kappa_t X_t^* \mathbb{E}[\xi_t^* | \mathcal{F}_t^0] + \eta_t (\xi_t^*)^2 + \lambda_t (X_t^*)^2] \\ & \geq \mathbb{E} [(\mathbb{E}[\kappa_t X_t^* | \mathcal{F}_t^0] + 2\eta_t \xi_t^*) (\xi_t - \xi_t^*) + 2\lambda_t X_t^* (X_t - X_t^*) + \kappa_t (X_t - X_t^*) \mathbb{E}[\xi_t^* | \mathcal{F}_t^0]]. \end{aligned} \quad (3.2)$$

Moreover, the above inequality becomes an equality if and only if $\xi_t = \xi_t^*$ a.s..

Proof. To prove (3.2), it is equivalent to show

$$\mathbb{E} [\eta_t (\xi_t - \xi_t^*)^2 + \lambda_t (X_t - X_t^*)^2 + \mathbb{E}[(\xi_t - \xi_t^*) | \mathcal{F}_t^0] \mathbb{E}[\kappa_t (X_t - X_t^*) | \mathcal{F}_t^0]] \geq 0.$$

Note that

$$\begin{aligned} & |\mathbb{E} [\mathbb{E}[(\xi_t - \xi_t^*) | \mathcal{F}_t^0] \mathbb{E}[\kappa_t (X_t - X_t^*) | \mathcal{F}_t^0]]| \\ & \leq \|\kappa\| \mathbb{E} [\mathbb{E}[\|\xi_t - \xi_t^*\| | \mathcal{F}_t^0] \mathbb{E}[\|X_t - X_t^*\| | \mathcal{F}_t^0]] \\ & \leq \frac{\|\kappa\|}{2\theta} \mathbb{E} [(\mathbb{E}[\|\xi_t - \xi_t^*\| | \mathcal{F}_t^0])^2] + \frac{\|\kappa\|\theta}{2} \mathbb{E} [(\mathbb{E}[\|X_t - X_t^*\| | \mathcal{F}_t^0])^2]. \end{aligned}$$

Thus,

$$\begin{aligned} & \mathbb{E} [\eta_t (\xi_t - \xi_t^*)^2 + \lambda_t (X_t - X_t^*)^2 + \mathbb{E}[(\xi_t - \xi_t^*) | \mathcal{F}_t^0] \mathbb{E}[\kappa_t (X_t - X_t^*) | \mathcal{F}_t^0]] \\ & \geq \mathbb{E} \left[\left(\eta_* - \frac{\|\kappa\|}{2\theta} \right) (\xi_t - \xi_t^*)^2 + \left(\lambda_* - \frac{\|\kappa\|\theta}{2} \right) (X_t - X_t^*)^2 - \|\kappa\| \mathbb{E}[\|\xi_t - \xi_t^*\| | \mathcal{F}_t^0] \mathbb{E}[\|X_t - X_t^*\| | \mathcal{F}_t^0] \right] \\ & \quad + \frac{\|\kappa\|}{2\theta} \mathbb{E} [(\xi_t - \xi_t^*)^2] + \frac{\|\kappa\|\theta}{2} \mathbb{E} [(X_t - X_t^*)^2] \\ & \geq \mathbb{E} \left[\left(\eta_* - \frac{\|\kappa\|}{2\theta} \right) (\xi_t - \xi_t^*)^2 + \left(\lambda_* - \frac{\|\kappa\|\theta}{2} \right) (X_t - X_t^*)^2 - \|\kappa\| \mathbb{E}[\|\xi_t - \xi_t^*\| | \mathcal{F}_t^0] \mathbb{E}[\|X_t - X_t^*\| | \mathcal{F}_t^0] \right] \\ & \quad + \frac{\|\kappa\|}{2\theta} \mathbb{E} [(\mathbb{E}[\|\xi_t - \xi_t^*\| | \mathcal{F}_t^0])^2] + \frac{\|\kappa\|\theta}{2} \mathbb{E} [(\mathbb{E}[\|X_t - X_t^*\| | \mathcal{F}_t^0])^2] \\ & \geq \mathbb{E} \left[\left(\eta_* - \frac{\|\kappa\|}{2\theta} \right) (\xi_t - \xi_t^*)^2 + \left(\lambda_* - \frac{\|\kappa\|\theta}{2} \right) (X_t - X_t^*)^2 \right] \\ & \geq 0. \end{aligned}$$

The second claim is obvious from the above estimate. \square

We are now ready to state and prove the main result of this section.

Theorem 3.3. *Under Assumption 3.1 the process ξ^* defined in (3.1) is the unique optimal control to the MFC problem (1.4)-(1.5).*

Proof. To prove the optimality of the candidate strategy ξ^* we fix an arbitrary control $\xi \in \mathcal{A}_{\mathbb{R}}(x)$ and denote by X^* and X the corresponding state processes. For any $\epsilon > 0$, it follows from Lemma 3.2 that

$$\begin{aligned} & \mathbb{E} \left[\int_0^{T-\epsilon} \kappa_t X_t \mathbb{E}[\xi_t | \mathcal{F}_t^0] + \tilde{g}_t X_t + \eta_t \xi_t^2 + \lambda_t X_t^2 dt \right] \\ & - \mathbb{E} \left[\int_0^{T-\epsilon} \kappa_t X_t^* \mathbb{E}[\xi_t^* | \mathcal{F}_t^0] + \tilde{g}_t X_t^* + \eta_t (\xi_t^*)^2 + \lambda_t (X_t^*)^2 dt \right] \\ & \geq \mathbb{E} \left[\int_0^{T-\epsilon} (\mathbb{E}[\kappa_t X_t^* | \mathcal{F}_t^0] + 2\eta_t \xi_t^*) (\xi_t - \xi_t^*) + (2\lambda_t X_t^* + \kappa_t \mathbb{E}[\xi_t^* | \mathcal{F}_t^0] + \tilde{g}_t) (X_t - X_t^*) dt \right]. \end{aligned} \quad (3.3)$$

Integration by part yields,

$$\begin{aligned}
& \mathbb{E} [Y_{T-\epsilon}(X_{T-\epsilon} - X_{T-\epsilon}^*)] \\
&= -\mathbb{E} \left[\int_0^{T-\epsilon} Y_t(\xi_t - \xi_t^*) dt \right] - \mathbb{E} \left[\int_0^{T-\epsilon} (X_t - X_t^*) \left(\kappa_t \mathbb{E} \left[\frac{Y_t^*}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \right. \right. \\
&\quad \left. \left. - \kappa_t \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \mathbb{E}[\kappa_t X_t^* | \mathcal{F}_t^0] + 2\lambda_t X_t^* + \tilde{g}_t \right) dt \right] \\
&= -\mathbb{E} \left[\int_0^{T-\epsilon} Y_t(\xi_t - \xi_t^*) dt \right] - \mathbb{E} \left[\int_0^{T-\epsilon} (X_t - X_t^*) (\kappa_t \mathbb{E} [\xi_t^* | \mathcal{F}_t^0] + 2\lambda_t X_t^* + \tilde{g}_t) dt \right].
\end{aligned} \tag{3.4}$$

Putting (3.4) into (3.3), we have

$$\begin{aligned}
& \mathbb{E} \left[\int_0^{T-\epsilon} \kappa_t X_t \mathbb{E}[\xi_t | \mathcal{F}_t^0] + \tilde{g}_t X_t + \eta_t \xi_t^2 + \lambda_t X_t^2 dt \right] \\
& - \mathbb{E} \left[\int_0^{T-\epsilon} \kappa_t X_t^* \mathbb{E}[\xi_t^* | \mathcal{F}_t^0] + \tilde{g}_t X_t^* + \eta_t (\xi_t^*)^2 + \lambda_t (X_t^*)^2 dt \right] \\
& + \mathbb{E} [Y_{T-\epsilon}(X_{T-\epsilon} - X_{T-\epsilon}^*)] \\
& \geq \mathbb{E} \left[\int_0^{T-\epsilon} (\mathbb{E}[\kappa_t X_t^* | \mathcal{F}_t^0] + 2\eta_t \xi_t^* - Y_t) (\xi_t - \xi_t^*) dt \right] = 0.
\end{aligned} \tag{3.5}$$

Letting $\epsilon \rightarrow 0$, a similar argument as the proof of [14, Theorem 2.9] yields that

$$\lim_{\epsilon \rightarrow 0} \mathbb{E}[Y_{T-\epsilon}(X_{T-\epsilon} - X_{T-\epsilon}^*)] = 0.$$

Thus, (3.5) implies

$$J(\xi) \geq J(\xi^*).$$

In order to prove the uniqueness of optimal controls, let ξ' be another optimal control. Then, (3.5) yields

$$\begin{aligned}
0 &= \mathbb{E} \left[\int_0^T \kappa_t X_t \mathbb{E}[\xi_t' | \mathcal{F}_t^0] + \tilde{g}_t X_t' + \eta_t (\xi_t')^2 + \lambda_t (X_t')^2 dt \right] \\
& - \mathbb{E} \left[\int_0^T \kappa_t X_t^* \mathbb{E}[\xi_t^* | \mathcal{F}_t^0] + \tilde{g}_t X_t^* + \eta_t (\xi_t^*)^2 + \lambda_t (X_t^*)^2 dt \right] \\
& \geq \mathbb{E} \left[\int_0^T (\mathbb{E}[\kappa_t X_t^* | \mathcal{F}_t^0] + 2\eta_t \xi_t^* - Y_t) (\xi_t' - \xi_t^*) dt \right] = 0.
\end{aligned}$$

Thus, (3.3) holds with an equality. The second claim in Lemma 3.2 implies the uniqueness. \square

4 A Stackelberg game of optimal portfolio liquidation

In this section, we solve the Stackelberg game of optimal portfolio liquidation introduced in Section 1.2.2 above. We make the following assumption which implies Assumption 2.1 and Assumption (2.30).

- Assumption 4.1.** (1) The processes $\tilde{\kappa}^0$, κ , η , $1/\eta$ and λ belong to $L_{\mathbb{F}}^\infty([0, T] \times \Omega; [0, \infty))$.
(2) The processes $\bar{\kappa}^0$, κ^0 , η^0 , $1/\eta^0$ and λ^0 belong to $L_{\mathbb{F}^0}^\infty([0, T] \times \Omega; [0, \infty))$.

(3) For some positive constants θ' , θ and $\bar{\theta}$,

$$\eta_\star - \frac{\|\kappa\|}{2\theta'} > 0, \quad \lambda_\star - \|\kappa\|\theta' > 0.$$

and

$$\eta_\star^0 - \frac{\|\kappa^0\|}{2\theta} > 0, \quad \lambda_\star^0 - \frac{\|\kappa^0\|\theta}{2} - \frac{\|\bar{\kappa}^0\|\bar{\theta}}{2} > 0, \quad \bar{\lambda}_\star - \frac{\|\bar{\kappa}^0\|}{2\bar{\theta}} > 0.$$

(4) For any $0 \leq s < t \leq T$,

$$e^{-\int_s^t \frac{A_u}{2\eta_u} du} \leq C \left(\frac{T-t}{T-s} \right)$$

and

$$e^{-\int_s^t \frac{A_u^n}{2\eta_u} du} \leq C \left(\frac{T-t+\frac{1}{n}}{T-s+\frac{1}{n}} \right).$$

The problem of the Stackelberg leader is to minimize the cost functional (1.9) over the set of admissible controls

$$\mathcal{A}_{\mathbb{F}^0}(x^0) := \left\{ \xi^0 \in L_{\mathbb{F}^0}^2([0, T] \times \Omega; \mathbb{R}) : \int_0^T \xi_s^0 ds = x^0 \right\}.$$

The follower's optimal response function is given by

$$\bar{\xi}_t := \bar{\xi}_t(\xi^0) := \frac{Y_t(\xi^0) - \mathbb{E}[\kappa_t X_t(\xi^0) | \mathcal{F}_t^0]}{2\eta_t}, \quad (4.1)$$

where (X, Y) is the solution to (1.7) with $\tilde{g} = \tilde{\kappa}^0 \xi^0$. We will occasionally drop the dependence on ξ^0 if there is no confusion. Under Assumption 4.1 the solution (X, Y) enjoys better regularity properties, due to Remark 2.4 and the estimate (2.3).

Corollary 4.2. *Under Assumption 4.1, the solution to (1.7) belongs to $\mathcal{H}_1 \times S_{\mathbb{F}}^2$. Moreover, $Y = AX + B$ with $B \in \mathcal{H}_\zeta$.*

In the next section we first prove that the leader's problem has a unique solution if the terminal state constraints are replaced by finite penalty terms and establish a necessary maximum principle for the penalized problem. Subsequently we prove the convergence of the state and adjoint equations of the penalized problems as the degree of penalization tends to infinity.

4.1 The penalized problem: existence and maximum principle

The penalized optimization problem is obtained by replacing the terminal state constraint on the leader's and follower's state process by a finite penalty term. The leader's problem consists in minimizing the cost functional

$$J^{0,n}(\xi^0) := \mathbb{E} \left[\int_0^T \bar{\kappa}_s^0 \mathbb{E}[\bar{\xi}_s^n | \mathcal{F}_s^0] X_s^0 + \kappa_s^0 \xi_s^0 X_s^0 + \eta_s^0 (\xi_s^0)^2 + \lambda_s^0 (X_s^0)^2 + \bar{\lambda}_s (\mathbb{E}[\bar{\xi}_s^n | \mathcal{F}_s^0])^2 ds + n(X_T^0)^2 \right] \quad (4.2)$$

over all controls $\xi^0 \in L_{\mathbb{F}^0}^2$ subject to the state dynamics

$$\begin{cases} dX_t^0 = -\xi_t^0 dt, \\ dX_t = -\frac{Y_t - \mathbb{E}[\kappa_t X_t | \mathcal{F}_t^0]}{2\eta_t} dt, \\ -dY_t = \left(\kappa_t \mathbb{E} \left[\frac{Y_t}{2\eta_t} \middle| \mathcal{F}_t^0 \right] - \kappa_t \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \mathbb{E}[\kappa_t X_t | \mathcal{F}_t] + 2\lambda_t X_t + \tilde{\kappa}_t^0 \xi_t^0 \right) dt - Z_t dW_t, \\ X_0 = x, \quad X_0^0 = x^0, \quad Y_T = 2nX_T, \end{cases} \quad (4.3)$$

where the optimal response for the penalized follower $\bar{\xi}^n$ is defined as follows in terms of (X, Y) in (4.3)

$$\bar{\xi}^n := \frac{Y - \mathbb{E}[\kappa X | \mathcal{F}^0]}{2\eta}.$$

We are now going to show that the penalized optimization problem has a unique solution. Similar arguments could be used to prove the existence of an optimal control for the original problem. They would not, however, give us an open-loop characterization of the optimal control.

Theorem 4.3. *For each $n \in \mathbb{N}$, the penalized optimization problem (4.2)-(4.3) admits a unique optimal control in $L^2_{\mathbb{F}^0}$.*

Proof. In view of Corollary 2.6 the systems (4.3) is well-posed for each fixed $\xi^0 \in L^2_{\mathbb{F}^0}$. The representation of the cost functional

$$\begin{aligned} J^{0,n}(\xi^0) &= \mathbb{E} \left[\int_0^T \frac{\bar{\kappa}_t^0}{2} \left(\sqrt{\theta} X_t^0 + \frac{\mathbb{E}[\bar{\xi}_t^n | \mathcal{F}_t^0]}{\sqrt{\theta}} \right)^2 + \frac{\kappa_t^0}{2} \left(\sqrt{\theta} X_t^0 + \frac{\xi_t^0}{\sqrt{\theta}} \right)^2 + \left(\lambda_t^0 - \frac{\bar{\kappa}_t^0 \theta}{2} - \frac{\kappa_t^0 \theta}{2} \right) (X_t^0)^2 \right. \\ &\quad \left. + \left(\eta_t^0 - \frac{\kappa_t^0}{2\theta} \right) (\xi_t^0)^2 + \left(\bar{\lambda}_t - \frac{\bar{\kappa}_t^0}{2\theta} \right) \left(\mathbb{E}[\bar{\xi}_t^n | \mathcal{F}_t^0] \right)^2 dt + n(X_T^0)^2 \right] \end{aligned}$$

along with Corollary 2.5 and Assumption 4.1 shows that $J^{0,n}$ is strictly convex. Uniqueness of the optimal strategy follows.

Let $J^* = \inf_{\xi^0 \in L^2_{\mathbb{F}^0}} J^{0,n}(\xi^0)$. Then $J^* < \infty$ because $J^{0,n}(x^0/T)$ is bounded. Let $\{\xi^{0,n,m}\} \subseteq L^2_{\mathbb{F}^0}$ be a sequence such that

$$\lim_{m \rightarrow \infty} J^{0,n}(\xi^{0,n,m}) = J^*.$$

By Assumption 4.1 this implies,

$$\sup_m \mathbb{E} \left[\int_0^T (\xi_s^{0,n,m})^2 ds \right] < C. \quad (4.4)$$

Thus, Lemma 2.9 implies the existence of some $\xi^{0,n,*} \in L^2_{\mathbb{F}^0}$ such that

$$\lim_{N \rightarrow \infty} \mathbb{E} \left[\int_0^T |\bar{\xi}_t^{0,n,N} - \xi_t^{0,n,*}|^\nu dt \right] = 0, \quad 1 < \nu < 2, \quad (4.5)$$

where

$$\bar{\xi}^{0,n,N} = \frac{1}{N} \sum_{k=1}^N \xi^{0,n,m_k}.$$

Let $(X^{0,n,*}, X^{n,*}, Y^{n,*})$ be the solution to (4.3) associated with $\xi^{0,n,*}$. Then the same argument as in the proof of Theorem 2.10 implies,

$$\lim_{N \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{N} \sum_{j=1}^{\bar{N}} \frac{1}{N_j} \sum_{k=1}^{N_j} (X_t^{n,m_k}, Y_t^{n,m_k}) - (X_t^{n,*}, Y_t^{n,*}) \right|^\nu dt \right] = 0, \quad 1 < \nu < 2.$$

Moreover, (4.5) yields,

$$\lim_{N \rightarrow \infty} \mathbb{E} \left[\sup_{0 \leq t \leq T} \left| \frac{1}{N} \sum_{j=1}^{\bar{N}} \frac{1}{N_j} \sum_{k=1}^{N_j} X_t^{0,n,m_k} - X_t^{0,n,*} \right|^\nu dt \right] = 0.$$

Thus, Fatou's lemma and the convexity of $J^{0,n}$ imply that

$$J^{0,n}(\xi^{0,n,*}) \leq \liminf_{N \rightarrow \infty} J^{0,n} \left(\frac{1}{N} \sum_{j=1}^N \bar{\xi}^{0,n,N_j} \right) \leq \liminf_{N \rightarrow \infty} \frac{1}{N} \sum_{j=1}^N \frac{1}{N_j} \sum_{k=1}^{N_j} J^{0,n}(\xi^{0,n,m_k}) = J^*.$$

□

From now on, we denote by $\xi^{0,n,*}$ the unique optimal control for the penalized optimization (4.2)-(4.3). The following theorem provides a characterization of $\xi^{0,n,*}$.

Theorem 4.4 (Necessary maximum principle). *The optimal control $\xi^{0,n,*}$ admits the following representation:*

$$\xi_t^{0,n,*} = \frac{p_t^n + \mathbb{E}[\tilde{\kappa}_t^0 q_t^n | \mathcal{F}_t^0] - \kappa_t^0 X_t^{0,n,*}}{2\eta_t^0}, \quad \text{a.e. a.s. on } [0, T] \times \Omega, \quad (4.6)$$

where $X^{0,n,*}$, p^n and q^n satisfy the following FBSDE system:

$$\begin{cases} dX_t^{0,n,*} = -\xi_t^{0,n,*} dt, \\ dX_t^{n,*} = -\xi_t^{n,*} dt, \\ -dY_t^{n,*} = \left(\kappa_t \mathbb{E}[\xi_t^{n,*} | \mathcal{F}_t^0] + 2\lambda_t X_t^{n,*} + \tilde{\kappa}_t^0 \xi_t^{0,n,*} \right) dt - Z_t dW_t, \\ -dp_t^n = \left(\bar{\kappa}_t^0 \mathbb{E}[\xi_t^{n,*} | \mathcal{F}_t^0] + \kappa_t^0 \xi_t^{0,n,*} + 2\lambda_t^0 X_t^{0,n,*} \right) dt - Z_t dW_t^0, \\ -dq_t^n = \left(-\frac{r_t^n}{2\eta_t} - \mathbb{E}[\kappa_t q_t^n | \mathcal{F}_t^0] \frac{1}{2\eta_t} + \bar{f}_t^n \right) dt, \\ -dr_t^n = \left(-2\lambda_t q_t^n + \kappa_t \mathbb{E}\left[\frac{r_t}{2\eta_t} \middle| \mathcal{F}_t^0\right] + \kappa_t \mathbb{E}\left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0\right] \mathbb{E}[\kappa_t q_t^n | \mathcal{F}_t^0] + \bar{g}_t^n \right) dt - Z_t dW_t, \\ X_0^0 = x^0, X_0 = x, Y_T^{n,*} = 2nX_T^{n,*}, p_T^n = 2nX_T^{0,n,*}, r_T^n = -2nq_T^n, q_0^n = 0, \end{cases} \quad (4.7)$$

where

$$\xi_t^{n,*} := \frac{Y_t^{n,*} - \mathbb{E}[\kappa_t X_t^{n,*} | \mathcal{F}_t^0]}{2\eta_t}, \quad (4.8)$$

$$\bar{f}_t^n := \frac{\bar{\kappa}_t^0 X_t^{0,n,*}}{2\eta_t} + \frac{\bar{\lambda}_t}{\eta_t} \mathbb{E}[\xi_t^{n,*} | \mathcal{F}_t^0], \quad (4.9)$$

and

$$\bar{g}_t^n := -\kappa_t \mathbb{E}\left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0\right] \bar{\kappa}_t^0 X_t^{0,n,*} - 2\bar{\lambda}_t \kappa_t \mathbb{E}\left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0\right] \mathbb{E}[\xi_t^{n,*} | \mathcal{F}_t^0]. \quad (4.10)$$

Proof. A unique optimal control $\xi^{0,n,*}$ exists, due to Theorem 4.3. It is to be viewed as an exogenous input to the FBSDE system (4.7). Thus, the system $(X^{n,*}, Y^{n,*})$ is a special case of (2.29) by taking (4.8) into account. Corollary 2.6 implies that the system is well-posed. Considering \bar{f}^n and \bar{g}^n as inputs, the system (q^n, r^n) is well-posed, again due to Corollary 2.6. The characterization (4.6) is then a direct result of stochastic maximum principle for control of FBSDE with partial information; cf [25]. □

The ansatz $p^n = \bar{A}^n X^{0,n,*} + \bar{p}^n$ shows that the equation for p^n could be dropped from the above system. It yields the following BSDEs for the processes \bar{A}^n and \bar{p}^n that will be used in the next subsection:

$$\begin{cases} -d\bar{A}_t^n = \left(-\frac{(\bar{A}_t^n)^2}{2\eta_t^0} + \frac{\kappa_t^0 \bar{A}_t^n}{2\eta_t^0} + 2\lambda_t^0 \right) dt - Z_t^{\bar{A}^n} dW_t^0, \\ \bar{A}_T^n = 2n \end{cases} \quad (4.11)$$

and

$$\begin{cases} -d\bar{p}_t^n = \left(-\frac{\bar{A}_t^n \bar{p}_t^n}{2\eta_t^0} - \frac{\bar{A}_t^n \mathbb{E}[\tilde{\kappa}_t^0 q_t^n | \mathcal{F}_t^0]}{2\eta_t^0} + \kappa_t^0 \xi_t^{0,n,*} + \bar{\kappa}_t^0 \mathbb{E}[\xi_t^{n,*} | \mathcal{F}_t^0] \right) dt - Z_t^{\bar{p}^n} dW_t^0, \\ \bar{p}_T^n = 0. \end{cases} \quad (4.12)$$

4.2 The optimal solution to the Stackelberg game

Let us recall that $\xi^{0,n,*}$ denotes the leader's optimal control for penalized optimization with index $n \in \mathbb{N}$. The uniform boundedness of $J^{0,n}(x^0/T)$ in $n \in \mathbb{N}$ implies,

$$\sup_n \mathbb{E} \left[\int_0^T |\xi_t^{0,n,*}|^2 dt + n(X_T^{0,n,*})^2 \right] < \infty. \quad (4.13)$$

Thus, the same arguments as in the proof of Lemma 2.9 yield the existence of a progressively measurable process

$$\xi^{0,*} \in L_{\mathbb{F}^0}^2(\Omega \times [0, T]; \mathbb{R}) \quad (4.14)$$

such that

$$\lim_{N \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{N} \sum_{k=1}^N \xi_t^{0,n_k,*} - \xi_t^{0,*} \right|^\nu dt \right] = 0, \quad 1 < \nu < 2. \quad (4.15)$$

Our goal is to prove that $\xi^{0,*}$ is the leader's unique optimal strategy in the original state-constrained Stackelberg game. To this end, we first establish a representation of $\xi^{0,*}$ in terms of the solution to the system (1.10), (1.12) and (1.13) by proving that the solutions to the system of state and adjoint equations (4.7) for the unconstrained penalized MFC problem Cesaro converge to the solutions to the systems (1.7), (1.10), (1.12) and (1.13). From this, we then deduce a sufficient maximum principle for the leader's MFC problem from which we conclude the optimality of the candidate strategy $\xi^{0,*}$.

4.2.1 Approximation

With the limit $\xi^{0,*}$ at hand, we can consider the FBSDE system (1.7), (1.10), (1.12) and (1.13) with ξ^0 replaced by $\xi^{0,*}$. The system (1.7) for (X^*, Y^*) is well-posed, due to Corollary 4.2. The system for (q, r) is well-posed, due to the following corollary.

Corollary 4.5. *If we take $\chi = x^0$, $\Lambda^1 = \Lambda^2 = \zeta = 1/2\eta$, $\gamma = \Lambda^3 = \varrho = \kappa$, $\Lambda^4 = 2\lambda$, $\Lambda^5 = \kappa \mathbb{E} \left[\frac{1}{2\eta} \middle| \mathcal{F}^0 \right]$, $Q = -q$,*

$$\bar{f} = \frac{\kappa^0 X^{0,*}}{2\eta} + \frac{\bar{\lambda}}{\eta} \mathbb{E} [\xi^* | \mathcal{F}^0] \quad (4.16)$$

and

$$\bar{g} = -\kappa \mathbb{E} \left[\frac{1}{2\eta} \middle| \mathcal{F}^0 \right] \bar{\kappa}^0 X^{0,*} - 2\bar{\lambda} \kappa \mathbb{E} \left[\frac{1}{2\eta} \middle| \mathcal{F}^0 \right] \mathbb{E} [\xi^* | \mathcal{F}^0], \quad (4.17)$$

where

$$\xi^* := \frac{Y^*}{2\eta} - \frac{1}{2\eta} \mathbb{E}[\kappa_t X^* | \mathcal{F}^0]. \quad (4.18)$$

Then the system (1.2) reduces (1.13). Hence, existence and uniqueness of a solution holds for (1.13). Moreover, $r = -Aq + D$ with $D \in S_{\mathbb{F}}^{2,-}$.

We now introduce two BSDEs that we expect to be the limits to the equations (4.11) and (4.12):

$$\begin{cases} -d\bar{A}_t = \left(-\frac{\bar{A}_t^2}{2\eta_t^0} + \frac{\kappa_t^0 \bar{A}_t}{2\eta_t^0} + 2\lambda_t^0 \right) dt - Z_t dW_t^0 \\ \lim_{t \nearrow T} \bar{A}_t = \infty, \end{cases} \quad (4.19)$$

and

$$\begin{cases} -d\bar{p}_t = \left(-\frac{\bar{A}_t \bar{p}_t}{2\eta_t^0} - \frac{\bar{A}_t \mathbb{E}[\tilde{\kappa}_t^0 q_t | \mathcal{F}_t^0]}{2\eta_t^0} + \kappa_t^0 \xi_t^{0,*} + \bar{\kappa}_t^0 \mathbb{E}[\xi_t^* | \mathcal{F}_t^0] \right) dt - Z_t^{\bar{p}} dW_t^0, \\ \bar{p}_T = 0. \end{cases} \quad (4.20)$$

where ξ^* and $\xi^{0,*}$ are defined in (4.18) and (4.14), respectively. The following lemma confirms our guess. It shows that the solutions to the FBSDE system (4.7) converge to the solutions to the FBSDE systems (1.7), (1.10), (1.13) and (4.20) in the same sense as the optimal solutions to the unconstrained penalized problems converge to the candidate solution of the constrained problem.

Lemma 4.6. *For $1 < \nu < 2$, it holds that*

$$\lim_{N \rightarrow \infty} \mathbb{E} \left[\sup_{0 \leq t \leq T} \left| \frac{1}{N} \sum_{k=1}^N X_t^{0,n_k,*} - X_t^{0,*} \right|^\nu \right] = 0, \quad (4.21)$$

$$\lim_{\bar{N} \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{\bar{N}} \sum_{j=1}^{\bar{N}} \frac{1}{N_j} \sum_{k=1}^{N_j} X_t^{n_k,*} - X_t^* \right|^\nu dt \right] = 0, \quad (4.22)$$

$$\lim_{\bar{N} \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{\bar{N}} \sum_{j=1}^{\bar{N}} \frac{1}{N_j} \sum_{k=1}^{N_j} Y_t^{n_k,*} - Y_t^* \right|^\nu dt \right] = 0, \quad (4.23)$$

$$\lim_{\tilde{N} \rightarrow \infty} \mathbb{E} \left[\sup_{0 \leq t \leq T} \left| \frac{1}{\tilde{N}} \sum_{i=1}^{\tilde{N}} \frac{1}{\bar{N}_i} \sum_{j=1}^{\bar{N}_i} \frac{1}{N_j} \sum_{k=1}^{N_j} q_t^{n_k} - q_t \right|^\nu \right] = 0, \quad (4.24)$$

$$\lim_{\tilde{N} \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{\tilde{N}} \sum_{i=1}^{\tilde{N}} \frac{1}{\bar{N}_i} \sum_{j=1}^{\bar{N}_i} \frac{1}{N_j} \sum_{k=1}^{N_j} r_t^{n_k} - r_t \right|^\nu dt \right] = 0, \quad (4.25)$$

$$\lim_{\tilde{N} \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{\tilde{N}} \sum_{i=1}^{\tilde{N}} \frac{1}{\bar{N}_i} \sum_{j=1}^{\bar{N}_i} \frac{1}{N_j} \sum_{k=1}^{N_j} \bar{p}_t^{n_k} - \bar{p}_t \right|^\nu dt \right] = 0. \quad (4.26)$$

Proof. The convergence (4.21) follows immediately from the convergence (4.15) and the definition of $X^{0,*}$. Taking $\chi = x$, $\zeta = \Lambda^1 = -\Lambda^2 = 1/2\eta$, $\gamma = \Lambda^3 = \varrho = \kappa$, $\Lambda^4 = 2\lambda$, $\Lambda^5 = -\kappa \mathbb{E} \left[\frac{1}{2\eta} \middle| \mathcal{F}^0 \right]$, $\bar{f}^n = 0$ and $\bar{g}^n = \tilde{\kappa}^0 \xi^{0,n,*}$ in (2.29) the convergence (4.22) and (4.23) follows from Theorem 2.10, due to the uniform boundedness of \bar{g}^n in L^2 .

In (2.29), let $\chi = x^0$, $\Lambda^1 = \Lambda^2 = \zeta = 1/2\eta$, $\gamma = \Lambda^3 = \varrho = \kappa$, $\Lambda^4 = 2\lambda$, $\Lambda^5 = \kappa \mathbb{E} \left[\frac{1}{2\eta} \middle| \mathcal{F}^0 \right]$, $Q^n = -q^n$ and (\bar{f}^n, \bar{g}^n) as in (4.9) and (4.10). It follows from (4.21)-(4.23) that

$$\lim_{N \rightarrow \infty} \mathbb{E} \left[\int_0^T \left| \frac{1}{\bar{N}} \sum_{j=1}^{\bar{N}} \frac{1}{N_j} \sum_{k=1}^{N_j} (\bar{f}_t^{n_k}, \bar{g}_t^{n_k}) - (\bar{f}_t, \bar{g}_t) \right|^\nu dt \right] = 0, \quad (4.27)$$

where \bar{f} and \bar{g} are defined as in (4.16) and (4.17), respectively. By Corollary 4.2 and the estimate (2.3), we have $\bar{f} \in S_{\mathbb{F}}^2$ and $\bar{g} \in L_{\mathbb{F}}^2$. So (4.24) and (4.25) follow again from Theorem 2.10. By (4.15), (4.22), (4.23) and (4.24) we also have (4.26). \square

The preceding approximation lemma yields a representation on the candidate optimal strategy in terms of the candidate optimal state and adjoint processes akin to the maximum principle for the penalized problem.

Theorem 4.7. *The limit $\xi^{0,*}$ in (4.15) admits the following representation:*

$$\xi_t^{0,*} = \frac{p_t + \mathbb{E}[\tilde{\kappa}_t^0 q_t | \mathcal{F}_t^0] - \kappa_t^0 X_t^{0,*}}{2\eta_t^0}, \quad \text{a.e. a.s. on } [0, T] \times \Omega, \quad (4.28)$$

where $p := \bar{A}X^{0,*} + \bar{p}$. Moreover, $\xi^{0,*} \in \mathcal{A}_{\mathbb{F}}(x^0)$ and p satisfies the dynamic (1.12).

Proof. The characterization (4.28) follows immediately from Theorem 4.4 and Lemma 4.6. It remains to verify the admissibility of $\xi^{0,*}$. The fact that $\xi^{0,*}$ belongs to $L^2_{\mathbb{F}^0}$ is due to (4.14). By the uniform boundedness (4.13),

$$\lim_{n \rightarrow \infty} \mathbb{E}[(X_T^{0,n,*})^2] = 0.$$

By (4.21),

$$\lim_{\tilde{N} \rightarrow \infty} \mathbb{E} \left[\left| \frac{1}{\tilde{N}} \sum_{i=1}^{\tilde{N}} \frac{1}{\bar{N}_i} \sum_{j=1}^{\bar{N}_i} \frac{1}{N_j} \sum_{k=1}^{N_j} X_T^{0,n_k,*} - X_T^{0,*} \right|^\nu \right] = 0.$$

Thus,

$$\begin{aligned} & \mathbb{E}[|X_T^{0,*}|^\nu] \\ & \leq 2\mathbb{E} \left[\left| \frac{1}{\tilde{N}} \sum_{i=1}^{\tilde{N}} \frac{1}{\bar{N}_i} \sum_{j=1}^{\bar{N}_i} \frac{1}{N_j} \sum_{k=1}^{N_j} X_T^{0,n_k,*} - X_T^{0,*} \right|^\nu \right] + 2 \frac{1}{\tilde{N}} \sum_{i=1}^{\tilde{N}} \frac{1}{\bar{N}_i} \sum_{j=1}^{\bar{N}_i} \frac{1}{N_j} \sum_{k=1}^{N_j} \mathbb{E}[|X_T^{0,n_k,*}|^\nu] \rightarrow 0, \end{aligned}$$

which implies $X_T^{0,*} = 0$ a.s.. Finally, starting from $p := \bar{A}X^{0,*} + \bar{p}$ by integration by parts and taking into account the characterization (4.28), we know p satisfies (1.12). \square

4.2.2 Sufficient maximum principle

In this section, a sufficient maximum principle is established, from which we obtain the optimality of $\xi^{0,*}$ for the leader's MFC problem.

Theorem 4.8 (Sufficient maximum principle). *Under the Assumption 4.1, $\xi^{0,*}$ given by Theorem 4.7 is the unique optimal strategy to the leader's optimization problem.*

Proof. We denote by $(X^{0,*}, X^*, Y^*)$ the states corresponding to $\xi^{0,*}$ and by (X^0, X, Y) the states corresponding to a generic strategy $\xi^0 \in L^2_{\mathbb{F}^0}$. The verification is split into three steps.

Step 1. By Corollary 2.5, X and Y are convex in ξ^0 in the sense that

$$(X(\rho\xi^0 + (1-\rho)\xi^{0'}), Y(\rho\xi^0 + (1-\rho)\xi^{0'})) = \rho(X(\xi^0), Y(\xi^0)) + (1-\rho)(X(\xi^{0'}), Y(\xi^{0'})).$$

Thus, J^0 is strictly convex in ξ^0 . As a result, there is at most one optimal strategy.

Step 2. Integration by part for $(X^0 - X^{0,*})p$, $(X - X^*)r$ and $(Y - Y^*)q$ on $[0, \tilde{T}]$ for $0 \leq \tilde{T} < T$ yields,

$$\begin{aligned} & \mathbb{E} \left[(X_{\tilde{T}}^0 - X_{\tilde{T}}^{0,*})p_{\tilde{T}} \right] + \mathbb{E} \left[(X_{\tilde{T}} - X_{\tilde{T}}^*)r_{\tilde{T}} \right] + \mathbb{E} \left[(Y_{\tilde{T}} - Y_{\tilde{T}}^*)q_{\tilde{T}} \right] \\ & = -\mathbb{E} \left[\int_0^{\tilde{T}} (X_t^0 - X_t^{0,*}) \left(\bar{\kappa}_t^0 \mathbb{E}[\xi_t^* | \mathcal{F}_t^0] + \kappa_t^0 \xi_t^{0,*} + 2\lambda_t^0 X_t^{0,*} \right) dt \right] \\ & \quad - \mathbb{E} \left[\int_0^{T-\epsilon} \mathbb{E}[\kappa_t(X_t - X_t^*) | \mathcal{F}_t^0] \left(-\bar{\kappa}_t^0 \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] X_t^{0,*} - 2\bar{\lambda}_t \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \mathbb{E}[\xi_t^* | \mathcal{F}_t^0] \right) dt \right] \\ & \quad - \mathbb{E} \left[\int_0^{\tilde{T}} \mathbb{E} \left[\frac{Y_t - Y_t^*}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \left(\bar{\kappa}_t^0 X_t^{0,*} + 2\bar{\lambda}_t \mathbb{E}[\xi_t^* | \mathcal{F}_t^0] \right) dt \right] \\ & \quad - \mathbb{E} \left[\int_0^{\tilde{T}} (p_t + \mathbb{E}[\bar{\kappa}_t^0 q_t | \mathcal{F}_t^0]) (\xi_t^0 - \xi_t^{0,*}) dt \right], \end{aligned}$$

where we recall ξ^* is defined in (4.18).

Step 3. To prove the optimality of the strategy (4.28) we define, for any $\tilde{T} < T$ the cost functional

$$\begin{aligned} \tilde{J}^0(\xi^0) &:= \mathbb{E} \left[\int_0^{\tilde{T}} \bar{\kappa}_t^0 \left(\mathbb{E} \left[\frac{Y_t}{2\eta_t} \middle| \mathcal{F}_t^0 \right] - \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \mathbb{E}[\kappa_t X_t | \mathcal{F}_t^0] \right) X_t^0 + \kappa_t^0 \xi_t^0 X_t^0 + \eta_t^0 (\xi_t^0)^2 \right. \\ &\quad \left. + \lambda_t^0 (X_t^0)^2 + \bar{\lambda}_t \left| \mathbb{E} \left[\frac{Y_t}{2\eta_t} \middle| \mathcal{F}_t^0 \right] - \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \mathbb{E}[\kappa_t X_t | \mathcal{F}_t^0] \right|^2 dt \right]. \end{aligned}$$

By direct calculation we have

$$\begin{aligned} &\tilde{J}^0(\xi^0) - \tilde{J}^0(\xi^{0,*}) \\ &\geq \mathbb{E} \left[\int_0^{T-\epsilon} (X_t^0 - X_t^{0,*}) \left(\bar{\kappa}_t^0 \mathbb{E}[\xi_t^* | \mathcal{F}_t^0] + \kappa_t^0 \xi_t^0 + 2\lambda_t^0 \xi_t^{0,*} \right) dt \right] \\ &\quad + \mathbb{E} \left[\int_0^{T-\epsilon} \mathbb{E} \left[\frac{Y_t - Y_t^*}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \left(\bar{\kappa}_t^0 X_t^{0,*} + 2\bar{\lambda}_t \mathbb{E}[\xi_t^* | \mathcal{F}_t^0] \right) dt \right] \\ &\quad + \mathbb{E} \left[\int_0^{T-\epsilon} \mathbb{E}[\kappa_t (X_t - X_t^*) | \mathcal{F}_t^0] \left(-\bar{\kappa}_t^0 \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] X_t^{0,*} - 2\bar{\lambda}_t \mathbb{E} \left[\frac{1}{2\eta_t} \middle| \mathcal{F}_t^0 \right] \mathbb{E}[\xi_t^* | \mathcal{F}_t^0] \right) dt \right] \\ &\quad + \mathbb{E} \left[\int_0^{T-\epsilon} (\xi_t^0 - \xi_t^{0,*}) \left(\kappa_t^0 X_t^{0,*} + 2\eta_t^0 \xi_t^{0,*} \right) dt \right] \end{aligned} \tag{4.29}$$

Plugging the result in Step 2 into (4.29) and taking into account the characterization (4.28), we have

$$\tilde{J}^0(\xi^0) - \tilde{J}^0(\xi^{0,*}) + \mathbb{E} \left[(X_{\tilde{T}}^0 - X_{\tilde{T}}^{0,*}) p_{\tilde{T}} \right] + \mathbb{E} \left[(X_{\tilde{T}} - X_{\tilde{T}}^*) r_{\tilde{T}} \right] + \mathbb{E} \left[(Y_{\tilde{T}} - Y_{\tilde{T}}^*) q_{\tilde{T}} \right] \geq 0.$$

The same estimate as in the proof of [14, Theorem 2.9] yields that

$$\lim_{\tilde{T} \nearrow T} \mathbb{E} \left[(X_{\tilde{T}}^0 - X_{\tilde{T}}^{0,*}) p_{\tilde{T}} \right] = 0.$$

Moreover, Corollary 4.2 and Corollary 4.5 imply that

$$\begin{aligned} &\mathbb{E} \left[(X_{\tilde{T}} - X_{\tilde{T}}^*) r_{\tilde{T}} \right] + \mathbb{E} \left[(Y_{\tilde{T}} - Y_{\tilde{T}}^*) q_{\tilde{T}} \right] \\ &= \mathbb{E} \left[(X_{\tilde{T}} - X_{\tilde{T}}^*) (-A_{\tilde{T}} q_{\tilde{T}} + D_{\tilde{T}}) + (A_{\tilde{T}} X_{\tilde{T}} + B_{\tilde{T}} - A_{\tilde{T}} X_{\tilde{T}}^* - B_{\tilde{T}}^*) q_{\tilde{T}} \right] \\ &= \mathbb{E} \left[(X_{\tilde{T}} - X_{\tilde{T}}^*) D_{\tilde{T}} + (B_{\tilde{T}} - B_{\tilde{T}}^*) q_{\tilde{T}} \right] \\ &\rightarrow 0, \quad \text{as } \tilde{T} \nearrow T. \end{aligned}$$

Thus, letting $\tilde{T} \nearrow T$, dominated convergence yields $J^0(\xi^0) - J^0(\xi^{0,*}) \geq 0$. \square

As a corollary, we obtain that a convex combination of the value functions for the penalized optimization problems converges to the value function of the constrained problem.

Corollary 4.9. *There exists a convex combination of the value functions converging to $J^0(\xi^{0,*})$, i.e.,*

$$\lim_{\tilde{N} \rightarrow \infty} \frac{1}{\tilde{N}} \sum_{i=1}^{\tilde{N}} \frac{1}{\bar{N}_i} \sum_{j=1}^{\bar{N}_i} \frac{1}{N_j} \sum_{k=1}^{N_j} J^{0,n_k}(\xi^{0,n_k,*}) = J^0(\xi^{0,*}).$$

Proof. Recall that $X^{0,n_k,*}$ and $\xi^{n_k,*}$ are the optimal state of the leader and the optimal strategy of the follower corresponding to $\xi^{0,n_k,*}$, respectively. Due to the additional penalty term in the definition of J^{0,n_k} and because $\xi^{0,*}$ is an admissible strategy for the penalized problem,¹

$$J^0(\xi^{0,n_k,*}) \leq J^{0,n_k}(\xi^{0,n_k,*}) = \inf_{\xi \in L_{\mathbb{R}^0}^2([0,T] \times \Omega; \mathbb{R})} J^{0,n_k}(\xi) \leq J^0(\xi^{0,*})$$

¹Notice that $J^0(\xi^{0,n_k,*})$ is well-defined even though $\xi^{0,n_k,*}$ may not be admissible for the constrained optimization problem.

Denote by $K(\tilde{N})$ the cost functional with (ξ^0, X^0, ξ) in J^0 replaced by

$$\left(\frac{1}{\tilde{N}} \sum_{i=1}^{\tilde{N}} \frac{1}{\bar{N}_i} \sum_{j=1}^{\bar{N}_i} \frac{1}{N_j} \sum_{k=1}^{N_j} \xi^{0,n_k,*}, \frac{1}{\tilde{N}} \sum_{i=1}^{\tilde{N}} \frac{1}{\bar{N}_i} \sum_{j=1}^{\bar{N}_i} \frac{1}{N_j} \sum_{k=1}^{N_j} X^{0,n_k,*}, \frac{1}{\tilde{N}} \sum_{i=1}^{\tilde{N}} \frac{1}{\bar{N}_i} \sum_{j=1}^{\bar{N}_i} \frac{1}{N_j} \sum_{k=1}^{N_j} \xi^{n_k,*} \right).$$

By the convexity, we have

$$K(\tilde{N}) \leq \frac{1}{\tilde{N}} \sum_{i=1}^{\tilde{N}} \frac{1}{\bar{N}_i} \sum_{j=1}^{\bar{N}_i} \frac{1}{N_j} \sum_{k=1}^{N_j} J^0(\xi^{0,n_k,*}) \leq J^0(\xi^{0,*}).$$

By Lemma 4.6, (4.15) and Fatou's lemma,

$$J^0(\xi^{0,*}) \leq \liminf_{\tilde{N} \rightarrow \infty} K(\tilde{N}) \leq \liminf_{\tilde{N} \rightarrow \infty} \frac{1}{\tilde{N}} \sum_{i=1}^{\tilde{N}} \frac{1}{\bar{N}_i} \sum_{j=1}^{\bar{N}_i} \frac{1}{N_j} \sum_{k=1}^{N_j} J^0(\xi^{0,n_k,*}) \leq J^0(\xi^{0,*}).$$

□

4.3 Numerical simulations

We close this paper with a preliminary numerical analysis of the Stackelberg game previously analyzed. To the best of our knowledge no numerical methods for simulating the mean-field FBSDEs arising in our game are yet available. We therefore simulate a deterministic benchmark model with constant coefficients. In this case, the conditional mean-field FBSDEs reduce to deterministic forward-backward ODEs that can be solved numerically using the MATLAB package `bvpsuite` [20]. Figure 1 (left) shows the optimal positions for the leader (solid) and follower (dashed) for the parameter values $\eta = 0.5, \kappa = 0.5, \lambda = 2, \kappa^0 = 0.5, \bar{\kappa}^0 = 0.5, \eta^0 = 0.5, \bar{\kappa}^0 = 1, \lambda^0 = 2, \bar{\lambda} = 1$, and $T = 1, x^0 = 8, x = 0$. In particular, we see that a beneficial round trip exists for the follower. The right plot shows the leader's cost as a function of the initial portfolio for the same parameter in a model with follower (solid) and a benchmark model without follower (dashed). For these choices of model parameters, the leader benefits from the presence of the follower. Figure 2 shows the same quantities as Figure 1, except that the impact of the leader on the follower is now much stronger: $\bar{\kappa}^0 = 10$. In this case, the leader suffers from the presence of the follower.

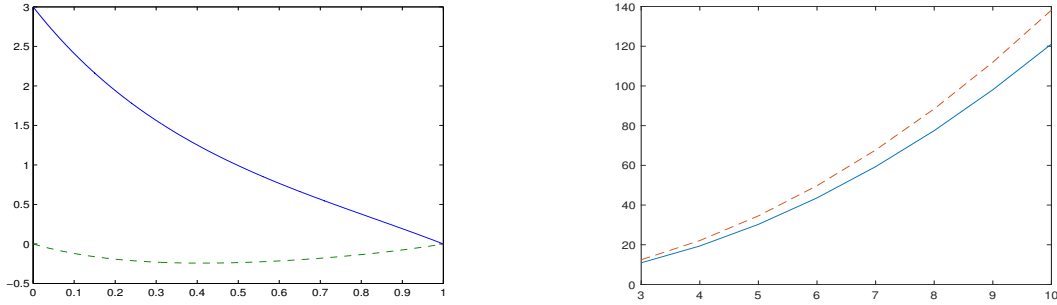


Figure 1: Left: optimal position for the leader (solid) and follower (dashed); right: leader's cost function in a model with (solid) and without follower (dashed). Weak impact of leader on follower

5 Conclusion

We established existence and uniqueness of solutions results for linear McKean Vlasov FBSDEs with a terminal state constraint on the forward process. The general results were used to solve novel MFC

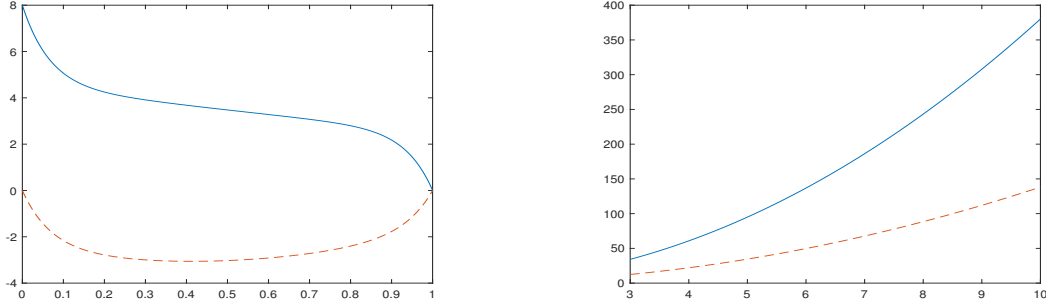


Figure 2: Left: optimal position for the leader (solid) and follower (dashed); right: leader's cost function in a model with (solid) and without follower (dashed). Strong impact of leader on follower

problems and mean-field leader-follower games of optimal portfolio liquidation. For the leader-follower game it could be viewed as a MFC problem where the state dynamics follows a controlled FBSDE. For such problems we proved a novel stochastic maximum principle. The proof was based on an approximation method. We proved that both the sequence of optimal solutions and the sequence of state and adjoint equations associated with a family of penalized problems Cesaro converge to a unique limit that yields the optimal solution, respectively, the adjoint equations to the original state-constrained problem. To the best of our knowledge, no numerical methods for simulating the solution to conditional McKean-Vlasov FBSDEs are yet available. It would be desirable to develop such methods in order to study the interplay between the leader's and the follower's equilibrium strategies in greater detail.

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